THE BUSINESS OF HEDGING

Sound Risk Management without the Rocket-Science

John J. Stephens



An imprint of Pearson Education

TABLE OF CONTENTS

Preface	xi
PART ONE	
Foundations of Hedging Financial Risk	1.
Chapter One The Background to Hedging	2
Why Hedging is Your Business	2
Identifying Risks in an Enterprise	2
Managing Risk and Hedging Risk	4
Conclusion	5
Chapter Two The fundamentals	7
The Nature of a Financial Hedge	7
Essential Elements of a Financial Hedge	10
The Need to Measure Risk	10
Volatility as a Measure of Risk	10
Measuring the Value at Risk (VAR)	13
Hedgeable Risk	16
The Three Risks of the Apocalypse	17
The Price of Money	17
Commodity Price Risk	19
Systemic Risk	20
PART TWO	
The Tools of Financial Hedging	23
Chapter Three The Derivatives	24
Know Your Tools	24
The Fundamentals of Derivatives	25
Over-The-Counter Derivatives (OTCs)	26
Exchange-Traded Derivatives	28
Chapter Four Financial Swaps	33
Background	33
The Subject Matter of a Financial Swap	33

Table of Contents

The Basic Structure of Swaps	34
The Risk in Interest Rate Swaps	. 38
Types of Interest Rate Swaps	39
Basic Currency Swaps	41
Cross-Currency Coupon Swap	44
The Cross-Currency Basis Swap	45
Complex Currency Swap Types	45
Commodity Swaps	47
Equity Index Swaps	49
Master Agreements and the ISDA	49
Flexibility of Swaps	50
Chapter Five Financial Options	51
Background	51
The Universal Principles of Options	51
Option Pricing	56
Time Value of an Option	58
The Greeks	61
Exercising an Option	63
Profit and Loss at Option Expiration	65
Option Multiple Exercise Constructs – Caps and Floors	70
The Risk of the Parties to Options	76
Chapter Six Commodity Futures	79
Background	79
Some Basic Features of Futures Contracts	80
The Three Innovations of the Futures Contract	82
The Minimum Standard Terms and Conditions	83
Contract Negotiability or On-Sellability	86
The Elimination of Credit Risk	89
Pricing the Futures	93
$The\ Basis$	100
Chapter Seven Option on Futures	107
Background	107
$Option\ Standardization$	107
Option Classification	110
Selling Options on Futures	111

Table of Contents

Chapter Eight Derivatives Risk	115
Basis Risk	116
Credit Risk	118
Legal Risk	['] 119
Operational Risk	120
PART THREE	
The Business of Hedging	121
Chapter Nine Laying the Groundwork	122
Background	122
Analyzing the Risk	122
Selecting the Right Hedging Tool	126
Meeting the Risk Criteria	127
Meeting Your Business Criteria	128
Chapter Ten Hedging the Price of Money	133
Background	133
Analyzing Money Price Risk – Additional Factors	134
Using Swaps	135
The Zero-Sum Objection	140
Using OTC Options	145
The Strike Rate and the Option Premium	147
Using Futures	153
Interest Rate Futures	153
Currency Futures	159
Using Options on Futures	163
Shapter Eleven Hedging Commodity and Systemic Risks	171
Background	171
Hedging Commodities	171
Hedging Systemic Risk	183
Hedging Creatively	186
Conclusion	188
Index	189