

## CHAPTER 3

### Hedging Strategies Using Futures

#### Practice Questions

##### 3.1

A perfect hedge is one that completely eliminates the hedger's risk. A perfect hedge does not always lead to a better outcome than an imperfect hedge. It just leads to a more certain outcome. Consider a company that hedges its exposure to the price of an asset. Suppose the asset's price movements prove to be favorable to the company. A perfect hedge totally neutralizes the company's gain from these favorable price movements. An imperfect hedge, which only partially neutralizes the gains, might well give a better outcome.

##### 3.2

A minimum variance hedge leads to no hedging when the coefficient of correlation between the futures price changes and changes in the price of the asset being hedged is zero.

##### 3.3

The optimal hedge ratio is

$$0.8 \times \frac{0.65}{0.81} = 0.642$$

This means that the size of the futures position should be 64.2% of the size of the company's exposure in a three-month hedge.

##### 3.4

The formula for the number of contracts that should be shorted gives

$$1.2 \times \frac{20,000,000}{1,080 \times 250} = 88.9$$

Rounding to the nearest whole number, 89 contracts should be shorted. To reduce the beta to 0.6, half of this position, or a short position in 44 contracts, is required.

##### 3.5

A good rule of thumb is to choose a futures contract that has a delivery month as close as possible to, but later than, the month containing the expiration of the hedge. The contracts that should be used are therefore,

- (a) July
- (b) September
- (c) March

# Hull Chapter 3 Solutions

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