

## Study Plan

### Chapter 16

#### **Learning Objectives**

After studying this chapter you should be able to:

- Describe the types of risks that can adversely affect a firm's cash flows and explain why firms might choose to hedge those risks;
- Calculate the price of a forward contract and illustrate how to use such a contract to hedge a risk exposure;
- Explain the differences between forward and futures contracts; and
- Describe the basic features of options and swaps and explain how they can be used to hedge risk exposure.

#### **Summary and Conclusions**

- Increased volatility in interest rates, currency exchange rates, and commodity prices has led to mushrooming demand for financial instruments that corporations can use to hedge their exposure to these risk factors.
- It is not always in the corporation's best interest to hedge. However, hedging can reduce the likelihood of financial distress, thereby reducing the expected costs of financial distress.
- A forward contract is an over-the-counter instrument that involves two parties agreeing on a price at which the purchaser will buy a specified amount of an asset from the seller at a fixed date sometime in the future. A futures contract is similar to a forward contract but is traded on an organized exchange.
- The fair forward price (or rate) in a forward contract is the price that eliminates the possibility of an arbitrageur generating riskless profits by trading in the forward contract.
- Unlike forward contracts, which are customized instruments, futures are standardized. Several issues to consider when using futures to hedge include basis risk, cross-hedging, tailing the hedge, and delivery options.
- Options offer a corporation the opportunity to hedge its downside risk without giving up its upside potential. However, this comes at a cost in the form of the premium paid for the option. Swap contracts are longer-term hedging instruments that allow corporations to change the characteristics of their periodic cash flows.
- In some cases, a corporation may not be able to hedge its risk exposure using off-the-shelf forwards, futures, options, or swaps. In these cases, the corporation may turn to financial engineering in an effort to create a specialized financial instrument that will hedge the exposure.