



# IMPACT OF HEDGING IN STOCK MARKET AND IN VALUATION OF FIRM

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## ABSTRACT

Hedging is the strategy used by investors to reduce the risk of a particular investment and to increase the returns of the investment. Hedging is done to minimize the effects of adverse price variations of stock market. Hedging can be done using financial instruments like shares, exchange traded funds, forward contracts. This paper examines the effect of hedging in stock market. This paper explains demystify the common hedging strategies used by investors and its relative effect on stock market. This paper elucidates the advantages and disadvantages of hedging in stock market. This paper also explicates about different hedging strategy and its impact in stock market. Hedging is basically done by the investor to protect their respective portfolios from the unpredictable market conditions. To protect their portfolio investors are required to pay money called premium. Depending upon the type of investment different hedging strategies are used by the investors. **KEYWORDS:** Hedging, portfolio, minimize risk, premium, maximize returns.

## INTRODUCTION

Hedging is usually done in stock market by the investors to minimize the losses of their portfolio and increase the returns. Some investors use hedging as an option to evade inflation problems. For hedging to happen investors usually pay an amount called as premium. Hedging is a tool used by the investors to protect their investments in the long run and to manage their portfolio efficiently. Stock market experiences fluctuations, as a result of the hedging process. There are three different strategies in hedging which are options, portfolio construction, and volatility indicators. Investors generally use hedging as a precautionary and protectionary measure to manage their portfolio in the best possible manner.

## OBJECTIVES OF THIS STUDY:

1. To see the meaning of hedging
2. To study about how hedging works
3. To analyze the impact of hedging in stock market and in valuation of firm.

The present study is based on various incidents in stock market due to hedging process. The information for Indian stock market is collected from the official website of Bombay stock exchange, national stock exchange and screener website. Information on certain other matters is collected from [www.google.com](http://www.google.com), [www.moneycontrol.com](http://www.moneycontrol.com).

## VALUE ADDED BY HEDGING:

- According to Modigliani and Miller, if there are no market imperfections only value of the firm can be affected by the financial policy and not on the stock prices. Modigliani and Miller also suggested that capital structure has no impact in the valuation of firm and the overall cost of capital, value of firm is independent of capital structure changes. Even if hedging is done for speculative purpose, value of the firm can be afflicted by hedging. Hedging plays a major role during the valuation of the firm. Amid the valuation of firm, hedging needs to be taken into consideration.

## BASIC CASH HEDGING EXAMPLE:

ASSET CLASS	NO CASH HEDGING	WITH CASH HEDGING
Stocks	\$30000	\$60000
Cash	\$0	\$60000
<b>Total</b>	<b>\$30000</b>	<b>\$120000</b>
<b>In the event stock drops by 5%</b>		
Stocks	\$28500	\$57000
Cash	\$50000	\$0
<b>Total</b>	<b>\$78500</b>	<b>\$57000</b>

## HEDGING AND FIRM'S VALUE:

- Hedging can both increase and decrease the value of the firm. Hedging increases the value of the firm by decreasing volatility and bankruptcy cost. Hedging can also decrease the firm's value due to utility maximization of the manager. Increase in value of the firm due to hedging has relatively a smaller impact as compared to other ways of increment in the firm's value. Hedging firms in the stock market has less volatility in their value than compared to the firms that does not use hedging. Hedging can be the good option to be used especially during the financial crisis and when stock market is dull, as hedging positively impacts the stock market and the value of the firm during the financial crisis.

## HOW HEDGING WORKS:

- Hedging supports all the type of investment. Among different forms of hedging one of the common forms is derivative. Some of the hedging strategies that investors should consider include diversification, arbitrage, staying in cash, average down. Hedging helps investors to manage their portfolio in an effective and efficient manner by minimizing risk and maximizing returns of their portfolio.
- Process of hedging can be most widely seen in the case of stocks and bonds. In case of price fluctuations and even in the case of inflation hedging can be used as a defensive option to counter the changes and to protect the portfolio. Hedging generally can be used by the investors using derivatives. Options and futures are the two most common types of derivatives. However hedging leads to double cost of trading, and also leads to inconsequential trading, insider trading, fraudulent and unfair trade practices and because of this reason hedging has been banned in the US.

## IMPACT OF HEDGING IN STOCK MARKET:

- Investors in stock market use hedging as a strategy to maintain their portfolio from unexpected price fluctuations happening in the stock market. Price fluctuations can occur because of hedging in stock market. Stock markets diverse nature makes hedging a critical process for the investors to use. Frequent changes in stock prices affects the trading practice of genuine traders which in turn has a negative impact on stock market.
- Hedging has both positive and negative impacts on stock market but the negative effects of hedging overpower the positive effects of hedging. Many investors in stock market use hedging as an option to minimize their exposure to risk and to minimize the losses. Negative effects caused in the stock market, affects the investment decisions of the genuine investors.

## REVIEW OF LITERATURE:

- According to Modigliani- Miller (1958) hedging adds zero value to the firm in the absence of financial information, taxes and transaction cost. However, the growing nature of stock market states that hedging has an impact to play on the value of the firm.
- According to Smith and Stulz (1985) hedging is used to evade underinvestment and to overcome financial distress. Hedging enables individuals to cope up with underinvestment and manage their portfolio in an effective and efficient way. Hedging can be used by the firms when stock market is dull and to cope up with problems related to finance.
- According to Graham and Smith (1993) hedging is used by the investors of the stock market to reduce the tax costs and to improve their earnings as a result of the reduced tax costs. Reduced tax costs enable the investors to save their earnings from stock market and they can use the earnings productively.
- According to Demarzo and Duffie (1995) investors use hedging to protect their portfolio from unexpected price changes and fluctuations happening in the stock market. Hedging primarily serves as a precautionary measure for the investors of the stock market.
- According to Suresh Lalwani (1999) emphasized the impact of hedging in the stock market and after effects that takes place after hedging is used by the investors. Hedging portrays a negative shade to stock market and affects the trading decisions of the investors.

## RESEARCH METHODOLOGY:

### Data collection:

- This research paper is derived on the basis of secondary data. The required data associated with Bombay stock exchange and national stock exchange are collected from various sources i.e., publications of ministry of commerce, handbook of SEBI related to hedging. Data related to impact of hedging in the stock market are collected from publications of various books and review given by the experts of stock market. Fundamental analysis has been used in this research to study the impacts of hedging in the stock market and also on the firm's valuation.

- Fundamental analysis is also used for carrying out this research work. Quantitative information such as earnings of the company, financial and operating leverage, competitive edge is considered. Qualitative factors like management.
- Business model, corporate governance is considered to derive the impact of hedging in valuation of the firm and in the stock market. Fundamental analysis involving company is analyzed to discern the impact of hedging in the firm's valuation. Technical analysis tools such as earnings of the company, competitive edge is considered to evaluate the impact of hedging in the valuation of firm. Technical analysis is also used to ascertain the prices changes in stock market as a result of hedging process.

## CONCLUSION AND RESEARCH FINDINGS:

- Hedging can have both positive and negative impact on the stock market and also on the value of the firm. Based on this research it is concluded that negative impacts of hedging are more than the positive impacts. Impact of hedging in stock market is huge and it affects the valuation of the firm to the greater extent. From investors point of view hedging is boon for them as it mitigates the risks and yields them better returns but stock market is affected because of the hedging process and because of this reason hedging has been banned in the United States of America.
- This research paper concludes that though hedging may benefit the investors to manage their portfolio, stock market is affected due to the impacts of hedging and it in turn affects the value of firms. Minimal usage of hedging by the investors can be helpful to maintain the stability of the stock markets.

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