

TRADING

Beginner's Guide to Hedging: Definition and Example of Hedges in Finance

By THE INVESTOPEDIA TEAM Updated April 06, 2022

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Although it may sound like the term "hedging" refers to something that is done by your gardening-obsessed neighbor, when it comes to investing [hedging](#) is a useful practice that every investor should be aware of. In the stock market, hedging is a way to get portfolio protection—and protection is often just as important as portfolio appreciation.

Hedging is often discussed more broadly than it is explained. However, it is not an esoteric term. Even if you are a beginning investor, it can be beneficial to learn what hedging is and how it works.

KEY TAKEAWAYS

- Hedging is a risk management strategy employed to offset losses in investments by taking an opposite position in a related asset.
- The reduction in risk provided by hedging also typically results in a reduction in potential profits.
- Hedging requires one to pay money for the protection it provides, known as the premium.

What Is Hedging?

The best way to understand hedging is to think of it as a form of insurance. When people decide to hedge, they are insuring themselves against a negative event's impact on their finances. This doesn't prevent all negative events from happening. However, if a negative event does happen and you're properly hedged, the impact of the event is reduced.

In practice, hedging occurs almost everywhere. For example, if you buy homeowner's insurance, you are hedging yourself against fires, break-ins, or other unforeseen disasters.

[Portfolio managers](#), individual investors, and corporations use hedging techniques to reduce their exposure to various risks. In financial markets, however, hedging is not as simple as paying an insurance company a fee every year for coverage.

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Hedging against investment risk means strategically using financial instruments or market strategies to offset the risk of any adverse price movements. Put another way, investors hedge one investment by making a trade in another.

Technically, to hedge requires you to make offsetting trades in securities with negative correlations. Of course, you still have to pay for this type of insurance in one form or another.

For instance, if you are long shares of XYZ corporation, you can buy a [put option](#) to protect your investment from large downside moves. However, to purchase

A reduction in risk, therefore, always means a reduction in potential profits. So, hedging, for the most part, is a technique that is meant to reduce a potential loss (and not maximize a potential gain). If the investment you are hedging against makes money, you have also usually reduced your potential profit. However, if the investment loses money, and your hedge was successful, you will have reduced your loss.

Understanding Hedging

Hedging techniques generally involve the use of financial instruments known as [derivatives](#). Two of the most common derivatives are [options](#) and [futures](#). With derivatives, you can develop trading strategies where a loss in one investment is offset by a gain in a derivative.

Suppose you own shares of Cory's Tequila Corporation (ticker: CTC). Although you believe in the company for the long run, you are worried about some short-term losses in the tequila industry. To protect yourself from a fall in CTC, you can buy a put option on the company, which gives you the right to sell CTC at a specific price (also called the strike price). This strategy is known as a married put. If your stock price tumbles below the strike price, these losses will be offset by gains in the [put option](#).

Another classic hedging example involves a company that depends on a certain commodity. Suppose that Cory's Tequila Corporation is worried about the volatility in the price of agave (the plant used to make tequila). The company would be in deep trouble if the price of agave were to skyrocket because this would severely impact their profits.

To protect against the uncertainty of agave prices, CTC can enter into a [futures contract](#) (or its less-regulated cousin, the forward contract). A futures contract is a type of hedging instrument that allows the company to buy the agave at a specific price at a set date in the future. Now, CTC can budget without worrying about the fluctuating price of agave.

If the agave skyrockets above the price specified by the futures contract, this hedging strategy will have paid off because CTC will save money by paying the lower price. However, if the price goes down, CTC is still obligated to pay the price in the contract. And, therefore, they would have been better off not hedging against this risk.

Because there are so many different types of options and futures contracts, an investor can hedge against nearly anything, including stocks, commodities, interest rates, or currencies.

Disadvantages of Hedging

Every hedging strategy has a cost associated with it. So, before you decide to use hedging, you should ask yourself if the potential benefits justify the expense. Remember, the goal of hedging isn't to make money; it's to protect from losses. The cost of the hedge, whether it is the cost of an option—or lost profits from being on the wrong side of a futures contract—can't be avoided.

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is far more
 or loss (usually

minus a deductible). Hedging a portfolio isn't a perfect science. Things can easily go wrong. Although risk managers are always aiming for the [perfect hedge](#), it is very difficult to achieve in practice.

What Hedging Means for You

The majority of investors will never trade a derivative contract. In fact, most [buy-and-hold](#) investors ignore short-term fluctuations altogether. For these investors, there is little point in engaging in hedging because they let their investments grow with the overall market. So why learn about hedging?

Even if you never hedge for your own portfolio, you should understand how it works. Many big companies and investment funds will hedge in some form. For example, oil companies might hedge against the price of oil. An international [mutual fund](#) might hedge against fluctuations in foreign exchange rates. Having a basic understanding of hedging can help you comprehend and analyze these investments.

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SELECT INVESTMENT AMOUNT

\$ 1000

SELECT A PURCHASE DATE

5 years ago ▼

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Example of a Forward Hedge

A classic example of hedging involves a wheat farmer and the wheat futures market. The farmer plants his seeds in the spring and sells his harvest in the fall. In the intervening months, the farmer is subject to the price risk that wheat will be lower in the fall than it is now. While the farmer wants to make as much money as possible from his harvest, he does not want to speculate on the price of wheat. So, when he plants his wheat, he can also sell a six-month futures contract at the current price of \$40 a bushel. This is known as a forward hedge.

Suppose that six months pass and the farmer is ready to harvest and sell his wheat at the prevailing market price. The market price has indeed dropped to just \$32 per bushel. He sells his wheat for that price. At the same time, he buys back his short futures contract for \$32, which generates a net \$8 profit. He therefore sells his wheat at $\$32 + \$8 \text{ hedging profit} = \$40$. He has essentially locked in the \$40 price when he planted his crop.

Assume now that the price of wheat has instead risen to \$44 per bushel. The farmer sells his wheat at that market price, and also repurchases his short futures for a \$4 loss. His net proceeds are thus $\$44 - \$4 = \$40$. The farmer has limited his losses, but also his gains.

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with a lower strike price than the current market price of the underlying asset). The put gives you the right (but not the obligation) to sell the underlying stock at the strike price before it expires. So, if you own XYZ stock from \$100 and want to hedge against a 10% loss, you can buy the 90-strike put. This way, if the stock were to drop all the way to, say \$50, you would still be able to sell your XYZ shares at \$90.

How Is Delta Used in Hedging Options Trades?

[Delta](#) is a risk measure used in options trading that tells you how much the option's price (called its premium) will change given a \$1 move in the underlying security. So, if you buy a call option with a 30 delta, its price will change by \$0.30 if the underlying moves by \$1.00. If you want to [hedge this directional risk](#) you could sell 30 shares (each equity options contract is worth 100 shares) to become [delta neutral](#). Because of this, delta can also be thought of as the [hedge ratio](#) of an option.

What Is a Commercial Hedger?

A [commercial hedger](#) is a company or producer of some product that uses derivatives markets to hedge their market exposure to either the items they produce or the inputs needed for those items. For instance, Kellogg's uses corn to make its breakfast cereals. It may therefore buy corn futures to hedge against the price of corn rising. Similarly, a corn farmer may sell corn futures instead to hedge against the market price falling before harvest.

What Is De-Hedging?

To [de-hedge](#) is to close out of an existing hedge position. This can be done if the hedge is no longer needed, if the cost of the hedge is too high, or if one seeks to take on the additional risk of an unhedged position.

The Bottom Line

Risk is an essential, yet a precarious element of investing. Regardless of what kind of investor one aims to be, having a basic knowledge of hedging strategies will lead to better awareness of how investors and companies work to protect themselves.

Whether or not you decide to start practicing the intricate uses of derivatives, learning about how hedging works will help advance your understanding of the market, which will always help you be a better investor.

Correction - April 6, 2022: In a previous version of this article the example of options hedging referred incorrectly to 300 shares sold rather than 30.

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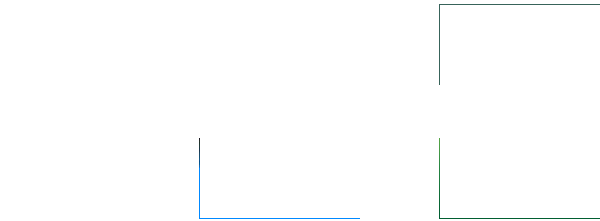
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