Hedging Policy Consistency Theory vs. Practice: The Role of Management's Expectations in the Implementation of Hedging Policy[1]

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1. The content of this paper represents the views of the author only.

Abstract

This paper addresses the contradiction between the financial theory of hedging and management practice. The theory has identified a series of legitimate reasons for companies to hedge and create shareholder value. When these conditions are present, companies are supposed to implement a consistent level of hedging over a period of time. This paper examines how consistent hedging policy is incompatible with management's competencies and role in the company, requiring management to form strong future price expectations. We outline key differences between an insurance decision model and a hedging decision model. Based on these differences, we describe a process that management actually follows when making decisions about hedging and stress the role of the expectations discrepancy in this process. We call this decision process management expectations-based hedging.

Keywords: Hedging, Hedging Policy, Derivatives, Risk Management, Insurance, Management Expectations, Management Expectations-based Hedging.