The Professional Commodities Trader

Your **a**ccurate, **a**uthentic and **a**ffordable guide to commodities trading

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Inter exchange hedge – II

In the piece, I wrote about how essential it is for an investor / trader to slash his risk even at the cost of sacrificing returns to a minor degree. In this second part of the three series articles, we will go through the dynamics of the trade as also the rationale for this activity.

Low cost factor – if a trader took a long position in the equity futures and hedged it by way of buying puts on the same underlying, we saw in the previous article that the returns suffered tremendously. If a hedge was initiated by writing an option in the contrary direction of the futures trade, the capital outlay will he high as the trader pays margins on **both** the trades. As we all know capital constraints hound all of us and expensive propositions are therefore unlikely to gain wide acceptance. On the other hand, commodity exchanges provide excellent low cost opportunities as the margin requirements are extremely reasonable and affordable by all and sundry in the f&o segment. A case study of a pure equity derivative hedge where a trader is long and short to balance the risk vis-à-vis an inter exchange model is given below –

Equity derivative hedge

Security	Margin
Titan Inds fut short	83,000
Write Titan OTM puts	75,000
Total	1,58,000

Inter exchange hedge Titan Inds v/s Gold

Instrument	Margin
MCX gold futures long	24,000
Titan Inds futures short	83, 000
Total	1,07,000

As can be seen from the table above, the cost advantage is too significant to be ignored. In many cases, this differential itself is likely to act an as impediment to initiating the hedge.

Greater risk spread – inter exchange hedges are excellent for spreading out the risk over a broader front. In the above example itself, if a trader was bearish on Titan Industries because gold prices were rising and therefore input costs would zoom, he was clear that futures had to be shorted. That is where the similarity between the two hedging strategies end ! In the pure equity play, writing a put would mean **reduce the loss** in case the futures trade went out of hand. In the case of the inter exchange hedge, Titan futures were short sold and Gold futures were purchased. Since we know that gold prices were rising so we were bearish on Titan, the gold long position would yield profits. Even if the Titan short position turned against us, a stop loss to the extent of the notional profits on Gold futures could be enforced and the trade could be closed at no profit / no loss ! In the case of inter exchange hedging, we have not reduced the loss, we have **cut the loss out**

More focused approach – inter exchange hedges cannot be initiated across the board on all equity shares. But any co-relation between the commodities available for trade with listed companies which are impacted by the price swing in raw materials are a plum opportunity. In the above table, the only choice a trader had in the pure equities segment was to hedge the scrip against itself or the Nifty. Hedging against itself meant a narrow outlook and hedging against the Nifty meant hedging against unrelated scrips due to the bouquet approach. On the the other hand, price swings in Gold were used to hedge gold against Titan Inds which was the company directly impacted by the commodity swing. Needless to say, clear focus means higher profits and lower risks.

Now that we have seen the benefits from inter exchange hedges, we will get down to the actual opportunities that specific scrips vis-à-vis commodities are presently available. That is in the third and concluding part of this series. Till then, have a profitable day.

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