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Inter exchange hedging – III

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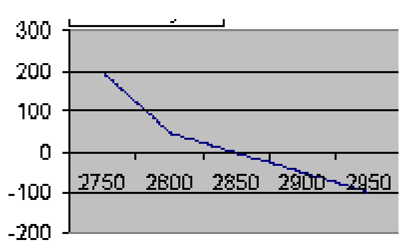
In the previous two pieces, I wrote about the virtues of inter exchange hedging as a tool to contain risk. Now that the concept has been digested, the most logical question is how do you make money ? We undertake a practical example of crude oil in the commodities market versus BPCL in the equities segment.

Of late, the price of crude have been diving as can be seen from the Nymex crude chart below. We also understand the implications for refining scrips which stand to benefit from the fall. Barring ONGC which is likely to lose in case of weaker crude prices. Since we nurse a weak outlook on crude, we initiate a long position on the refining counter to hedge our bets.

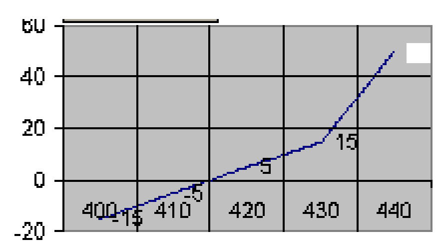
The trade would be as follows –

Crude short @ 2850	Crude payoff	BPCL long at 415	BPCL payoff
2950	- 100	400	- 15
2900	- 50	410	- 5
2850	0	420	5
2800	50	430	15
2750	100	440	25

Crude oil short



BPCL long



The payoff graphs indicate that the prices are likely to impact the movement in the securities in an inversely proportionate co-relation. The lower the crude price, the higher the price of BPCL, not necessarily in an exact proportion. It is this area of non exact yet inverse movement in prices that are the risk that we are trying to contain in this cross exchange hedge. To any lay trader, it is clear that one of the two trades must result in profits – even if notional. In the happy event of both the trades resulting in profit, no one is likely to complain. In the event of one of the trades going against us, the real purpose of the inter exchange hedge comes to the fore. Suppose the short sale in crude is yielding a profit of Rs 50 per barrel. Since we know the contract size of crude is 100 barrels, the profit is Rs 5000. If BPCL starts to fall after we buy at 415, we have the envious situation of crude shorts sustaining the loss in BPCL of upto Rs 5,000. The minute we see the price of BPCL falling below a level where the loss exceeds Rs 5000, we exit both trades and walk away with no profit / no loss.

The modus operandi in the above endeavor is to minimize risk and maximize returns. Your stop loss levels are pre-determined by the profit available in any one trade and thereafter you know you are playing a zero loss, infinite profit game. Qualitatively speaking, this type of strategy should attract the maximum percentage of your capital as the degree of safety is the highest. Rather than initiate naked positions, traders would do well to cultivate the “ safety first “ habit not just in their driving, but also in their trading regimen.

Till then, have a profitable day !

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Mandatory disclosure :- the analyst has exposure to the MCX crude futures mentioned above, the exact quantum may vary from day to day.