HongLeong Investment Bank

HL eFutures

HEDGE

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Definition

The purchase or sale of a futures contract as a temporary substitute for a cash market transaction to be made at a later date. Usually involves simultaneous, opposite positions in the cash market and futures market.

Users

Physical goods producers or refiners use hedging to reduce the financial risk arising from adverse price movement by entering an opposite position in futures contracts.

Source: Investopedia

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HEDGING EXAMPLE

You are a producer who sells crude palm oil (CPO) and expects to deliver physical CPO four months later.

You are afraid that the price of CPO will drop four months later and want to mitigate your financial risk.

You sell FCPO futures contract to hedge your portfolio. If the CPO's price drops, you can use the profit from futures to offset the loss from selling physical CPO.

Four months later, the price of CPO drops and the futures contract also declines.

You sell CPO at a lower price than expected but earn a profit in the futures contract, thus reducing financial risk.