Not so 'evil': Finance study makes case for hedging

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The overuse of financial contracts known as derivatives – which were designed to help companies hedge against risk – was widely blamed for triggering the economic crisis of 2008. None other than Warren Buffet has attacked derivatives as "time bombs – both for the parties that deal in them and the economic system."

But now, for the first time, researchers have found that hedging can increase firm value.

In a pioneering study published in the *Journal of Finance*, Michigan State University's Hayong Yun and Stanford University's Francisco Pérez-González show that electric and gas utilities that used derivatives to hedge against unpredictable weather experienced a "positive and significant effect" on the value of their firms.

"Many people have a perception that derivatives are evil, that they helped destroy the economy," said Yun, MSU assistant professor of finance. "And while there is some truth to the argument that derivatives were overused, our research provides the first fundamental evidence that hedging with derivatives can improve company value."

Derivatives are widely used in the corporate world – from a CEO's stock options to corn futures, in which a cereal maker, for example, purchases 2,500 corn bushels from a farmer at current prices for delivery in three months. Mortgage-backed securities, another type of derivative, were blamed for creating the housing bubble and subsequent recession.

Yun said he's not advocating that derivatives be completely deregulated. But at the same time, his research suggests derivatives – when used wisely – have an upside and should not be discounted as a potential instrument for company growth.

In the study, the researchers examined the value of publicly traded electric and gas utilities in the United States both before and after a weather derivatives market opened in the late 1990s. The market allowed the utilities to sell weather futures to investors.

Before the market opened, utility companies that were susceptible to unpredictable weather – such as those in the Midwest – were valued 3 percent to 4 percent lower, on average, than utilities where the weather was more stable, such as in southern California and Texas.

After the weather derivative market opened, that difference disappeared. Investors no longer cared the utility was located in an unstable-weather locale. In essence, the use of derivatives leveled the playing field, and utilities in the Midwest and other areas with unstable weather had equal value to those in stable-weather areas, as well as increased leverage and investments.

More information: The study was recently awarded the 2013 Brattle Group First Prize in Corporate Finance, given annually to the best corporate finance paper published in the highly selective *Journal of Finance*.

Provided by Michigan State University

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