**1.1 Summarize Barrick’s business model, its view of itself and the industry in which it lives. Would a hedging program fit the firm’s view and its strategic objectives?**

Barrick is currently the largest gold producer in the world. It makes money by developing and operating high quality mines and growing its resource base through new mineral reserve discoveries and acquisitions.

Barrick views itself as the gold industry leader in production, reserves and market capitalization. It focuses on gold, growing cash flow per share by developing and operating high-quality assets through disciplined allocation of human and financial capital and operational excellence. Gold market is not that mature so that individual actions by large producers do have an impact on the gold price. Large gold producers are not, in the strictest sense, price-takers. Barrick maintains a commodity-price-risk-management strategy that uses derivative instruments to mitigate significant, unanticipated earnings and cash flow fluctuations that may arise from volatility in commodity prices. Since the gold price is highly volatile, and the American Barrick’s ultimate objective is to grow free cash flow per share over the long term, it seeks for long-term and stable cash flows to their shareholders. In this way a hedging program will control the risk of gold price and it fits the firm’s view and its strategic objectives.

**1.2 How easy is it for Barrick to pass along any increases in gold production costs to the buyers it serves? Is hedging a way that Barrick can profitably differentiate itself from competitors? Be specific.**

For the hedge part, it is not easy to pass along the increases in gold production costs to the buyer because when an increase in gold production leads to an increase in gold price, the hedging part of Barrick gold cannot benefit from this kind of price increase. However, for the non-hedging part, it is easy to pass along the increasing cost to buyer just by increasing the selling price. As for American Barrick, the spot deferred contracts help them perform better than other competitors and increase their revenue and profits. “Spot-deferred” contracts are often producer-specific, owing to the nature of the credit and trust involved. The typical spot-deferred contract is a forward contract that may be rolled over into a new forward contract on due date.

The typical SDC is a forward contract that may be rolled over into a new forward contract on due date. The Barrick “spot deferred” contracts have the unique feature of being of 10 or of 15 years duration. For all intents and purposes, Barrick need not deliver any gold at below-spot market prices before final termination date of the contract. Since the gold market is small, the leading company like American Barrick does have the ability to predict the gold market price. And by using the SDC, it can choose the best time to exercise the contract, which profitably differentiates itself from competitors.

**2. What are the advantages and disadvantages of each type of derivative that can be used to hedge gold price? Consider at least the following: futures, forwards, swaps, options, structured notes. Are symmetric hedges (futures, forwards and swaps) preferable to asymmetric hedges?**

* **Futures**: Advantage is that counterparty credit risk is almost close to negligible as the derivative exchange will facilitate the transaction, settlement and collateral management of the traded contract. Disadvantage of futures is that you can only accept the price that is quoted by the market at any point of time and you cannot select the price at which you would like to hedge your physical gold position against. One more disadvantage is that it has a range of delivery dates.
* **Forwards**: Advantage is that it has a specified delivery date and everything is settled at the end of the contract. Disadvantage of forwards is that they have credit risk, as there is no clearing house, no mark-to-market mechanism. They are less transparent and liquid unlike futures traded in the open market.
* **Swaps**: Advantage is that there is no upfront premium and therefore, the transactional cost is reduced. It can be used to hedge risk and for long period of time hedging is possible. It provides flexibility and runs for longer years. Disadvantage is that it lacks liquidity and is subject to default risk.
* **Options**: Advantages of options are the smaller cash outlay required and the greater flexibility in selecting the price at which you would like to hedge from. Also, the buyer gains additional leverage, limits potential loses and flexibility. Main disadvantage is that they are wasting assets that have the potential to expire worthless.
* **Structured notes**: Advantage is that have customized payouts and exposures. Disadvantages are credit risk, lack of liquidity and inaccurate pricing.

Asymmetric hedging is preferred over symmetric hedging.

# **7. Why does American Barrick prefer spot deferred contracts vs. standard forwards to hedge its production?**

A spot-deferred contract is a forward contract that may be rolled over into a new forward contract on due date. Spot-deferred contracts grant seller the option to defer delivery to a specific date in the future rather than make delivery at a date when the trade is not in his interest. In case of American Barrick, the spot deferred contracts help Barrick perform better than other competitors and also help in improving its revenues and profits. A forward contract is a non-standardized contract between two parties to buy or to sell an asset at a specified future time at a price agreed upon today.

By using spot deferred contracts American Barrick ensures that they do not have the risk of producing lower than hedged amount in any one year. This prevents Barrick from getting itself into the situation of having to deliver gold that it has not produced. Furthermore, the spot deferred contracts used by Barrick have the unique feature of being of 10 or of 15 years duration. This means Barrick can roll over the contract till its termination date. Due to this feature, Barrick can defer delivery of any gold that is below-spot market prices before final termination date of the contract. This feature allows Barrick to choose the best time to exercise the contract.