Hedging in the Theory of Corporate Finance: A Reply to our Critics

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This paper is response to the critics that did not understand the model that MGRM was involved in or maybe some of these critics thought they were talking about a different company. The standard models that focus on reducing financial distress could have been appropriate if MGRM was a stand-alone company instead of a branch of a conglomerate that had independent outside creditors but this is not the case. Instead of using the usual models of hedging to asses the success of MGRM the authors used a carrying charge hedging model that was first proposed by Holbrook Working. They also call out there critics for not looking at their references claiming they cited this paper but the critics must have not bothered to look at it.

They look at this carrying charge hedging more in-depth in this paper. The main effect of carrying charge hedging was to profit people that seek anticipated price changes in price level and one who anticipate changes in price relations. This means that they could exploit small asymmetric prices while still having a neutral position in the market.

Synthetic is used as a method to reduce the commonly occurring exposures in price levels. This inherently reduces the volatility of the firm. They would use spot prices, which have a higher volatility against futures contracts with lower volatility.

Culp and Miller go on in the paper to show calculations on how they valued the firm and showed that the strategy cost a lot less than what other critics had speculated. They talk about all the fallacies that the critics of their paper assumed to be true. When looking at what happened to MGRM it seems apparent that this is a risky strategy when it should be reducing risk. The authors address this by saying they just pulled out of the strategy too early. If they would have waited and stuck it out they could have realized a positive NPV later down the road.