Metallgesellchaft: A Prudent Hedger Ruined Or A Wildcatter on NYMEX? – Stephen Craig Pirrong

Nicholas Lyle

A01757213

There are many debates on what the goal of Metallegesellschaft was trying to accomplish their strategies. Some people think that they were using a calculated hedging strategy and mistook liquidity problems with insolvencies in the market. Some also think that they were trying to speculate the market and just suffered large losses due to the market being in contango when they tried using their strategy. However you see it, the fact remains that the firm still had to cancel their program and suffered the largest derivatives loss in history.

MG was dealing with a one to one hedge where they would but a futures contract and immediately buy the same amount in of the physical commodity. They would then roll the futures contracts over from month to month. The author of lthe paper argues that this was a very excessive form of hedging because he thought they were trying to use a minimum variance hedge which would have a hedge ratio closer to .5. This was not what they were trying to do however and Pirrong missed it.

Pirrong goes into the details of what he thinks was happening inside MG at this time. He describes their one to one hedge in detail. The firm would purchase future price on gas or crude oil and then enter into an over the counter energy swap to hedge against it.

MG just entered in to this strategy at a poor time. The market environment was not optimal for their strategy. If they were able to stay in this strategy for a few more years most speculators agree they would have turned a profit.

Pirrong wrote this paper to criticize a paper written by Culp and Miller. They rejected Pirrongs minimum variance strategy, which he did concede on. He also admits fault when he states that variance-minimizing hedging doesn’t maximize firm value. But argues that it should be used as a benchmark to evaluate the relative importance of the hedging and speculating aspects.

In the end MG was trying to hedge its risk in a new way. If they had not done anything they would have been at risk to changes in oil prices. They did put themselves at risk of steepening term structures by using a one to one hedge for the firm.