Performance of Utility Based Hedges

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Abstract

Hedgers as investors are concerned with both risk and return however the literature has generally neglected the role of both returns and investor risk aversion by its focus on Minimum Variance Hedging. In this paper we address this by using utility based performance metrics to evaluate the hedging effectiveness of Utility based hedges for hedgers with both moderate and high risk aversion together with the more traditional Minimum Variance approach. We apply our approach to both Equities and Oil for three different hedging horizons, Daily, Weekly and Monthly. We find significant differences between the Minimum Variance and Utility based Hedges however, Out-of-Sample, the attendant performance of these hedges is not significantly different in economic terms except at the monthly frequency.

Keywords: Energy; Hedging; Risk Management; Risk Aversion; Forecasting.
JEL classification: G10, G12, G15.

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