Global Journal of Management and Business Research: C
Finance
Volume 17 Issue 3 Version 1.0 Year 2017
Type: Double Blind Peer Reviewed International Research Journal
Publisher: Global Journals Inc. (USA)
Online ISSN: 2249-4588 & Print ISSN: 0975-5853

Hedging Effectiveness Analysis of High Market Cap Indian Stocks Using OLS and GARCH Hedge Ratios

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Abstract- Managing portfolios is a daunting task in the current environment of complex integrated financial markets. Fund managers are always facing the question of whether to Hedge or not. Though hedging is done for minimizing the value erosion of the portfolio, there have been times where hedging has proved to be a wrong decision. In this context, this research is done to find out the impact of dynamic hedging of a portfolio comprising of high market cap stocks using Nifty index futures during the period from Jan 2007 to Dec 2012. As the study focused on the practical aspects of trading, hedge ratio required to hedge the portfolio was determined with two important econometric methods OLS (Ordinary least squares) and GARC (Generalized autoregressive conditional heteroscedasticity) using Eviews software. The research proves that the equity risk of a portfolio can be offset by hedging the portfolio with nifty index futures. The study concludes that during periods of uncertainty an investor holding a portfolio containing high market cap stocks can do hedging. The traditional simple OLS model is preferred to complex GARCH model in calculating hedge ratio.

Keywords: hedging, high market capitalization, index futures, OLS, GARC.

GJMBR-C Classification: JEL Code: E22

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