

Performance Hedging (Part 2)

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In the previous article we explored why making hedging decisions based upon the bottom line is the most direct path to improving overall hedging performance.

A prerequisite to hedging for performance is to have your model drive the analysis that is tuned to the layered dynamics of your pipeline.

Managing from a position of understanding

Managing a pipeline is an exercise in group dynamics. One of the challenges of hedging a mortgage pipeline in an optimal fashion is that your pipeline may appear to you as a blob. You need to understand the condition of the trees that make up your orchard. It is not until you study the pipeline at a stratified level that you understand the dynamics of the group. Not until you understand the dynamics of your group that you will be able to shape a hedging strategy that provides you control to shape your profit picture.

Stratification studies reveal that not all loans have the same:

- propensity to fallout
- price sensitivity
- yield sensitivity
- market liquidity
- package quality

Stratification reveals that loan dynamics change as they mature through the underwriting process, as market conditions change, as they are modified.

Thus, to not approach pipeline management through its layers is to compromise on the efficiency and opportunities available. Not managing with layer dynamics in mind leaves you vulnerable when market conditions shift dramatically.

Tests of a model

- Does it accurately replicate real world experience?
- Does it allow you to match your actions with your expectations?
- Does it allow you to match your actions with your tolerance?
- Does it allow you to understand whether you are positioned conservatively or aggressively?
- Does it provide a sufficient amount of transparency for you to understand the assumptions driving its reports?
- Does it allow you to manage the assumptions that drive its reports?