

What Are We Hedging, Anyway?

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The explosive price rally in the bond and mortgage securities markets of the past several months have provided more than ample opportunities for hedgers to be out of step with their coverage. Many may have done soul searching about their hedging mission, strategy and execution.

Doubtless, depending upon the method employed colleagues and/or outsiders may have posed the question of either: (1) How can we lose money in a rally or (2) You're making so much money, are you sure you are not speculating?

As you've seen interest rates work themselves lower in a saw-tooth fashion. You've no doubt been struck by the mass psychology of correspondents who lock in when they perceive the market is about to turn south. Even when the market proves them human and continues to improve, the paper profits you reflect don't give you cause to rest easy. You know with a pipeline filled with loans provided by market-sensitive adversaries, realizing those profits is far from assured.

In markets like these mindset can make all the difference. At the risk of painting with too broad of a brush there are three camps of pipeline risk managers.

Group A tends to have static expectations about volume and are extremely adverse to being perceived as taking a market position. This group will tend to focus on positioning themselves such that their pipeline and hedge coverage at current market (rate) levels is in balance. What we would call being flat in the current rate scenario.

Group B tends to use market direction bias to hedge. If they believe the market is in danger of selling off they will position themselves to be fully covered should that possibility occur. They may or may not consider the alternative direction that interest rates and their loan closing volumes might take. This tends to be what we would call "One Tail" hedging.

Group C are volatility hedgers. They feel they always have risks whether interest rates rise or fall. They understand that how they are positioned for the current level of rates is a delivery matching question and not a hedging question. The exposure to the market appears when market rates move up or down, not if they do not change.

This Group C understands that the calculus of this volatility risk has several layers.

- Rate Change Layer... This layer drives / influences the other layers. The more volatile interest rates are the more possibility for losses to occur.
- Price Change Layer ... The direction and magnitude of rate changes combine with the expected maturity of the mortgage or hedge to causes volatility in unit price sensitivity. Often known as the duration/convexity or delta/gamma of an instrument.
- Closing Ratio Layer .. The direction and magnitude of rate changes and the nature of the pipeline can cause wide fluctuations in the percentage of locked loans that close (without term concessions).

- Application Volume Layer ... The volume of applications flowing in daily can be greatly influenced by market volatility. In turn, this can greatly impact hedging performance. An all too common experience involves the market backing up after a long run. A flood of loans are discovered to have locked in at higher prices. The unprepared hedger must now place hedges that would lock in losses or, at the very least, reduce profits.

The hedgers that tend to have the most stable long-term success are those that acknowledge volatility risk and manage accordingly.