

# UNDERSTANDING THE DIFFERENCES: HEDGING, ARBITRAGE, AND SPECULATION

Different objectives. Different approaches. Different levels of risk.



## HEDGING



### GOAL: RISK REDUCTION

Protect an existing position from adverse price movements.

#### WHAT IT MEANS:

Take an offsetting position in a related instrument to reduce the impact of unfavorable price changes.

#### EXAMPLES:

Using futures, forwards, options, or swaps to reduce exposure to currency, interest rate, commodity, or stock price risk.



### RISK LEVEL: LOWER, BUT NOT ZERO

Hedging reduces risk but cannot eliminate it entirely (e.g., basis risk, liquidity risk, model risk).



## ARBITRAGE



### GOAL: NEAR-RISKLESS PROFIT IN THEORY

Exploit price differences between identical or equivalent assets across markets.

#### WHAT IT MEANS:

Simultaneously buy the underpriced asset and sell the overpriced equivalent or related asset.

#### EXAMPLES:

Buying a stock on one exchange at a lower price and simultaneously selling on another exchange at a higher price.



### RISK LEVEL: LOW, BUT NOT ZERO IN PRACTICE

Low risk in theory, but practical risks remain (e.g., execution risk, funding risk, transaction costs, timing risk).



## SPECULATION



### GOAL: PROFIT FROM EXPECTED PRICE MOVEMENTS

Take a position based on a forecast of future price movements.

#### WHAT IT MEANS:

Accept higher risk in pursuit of potentially significant gains (and losses).

#### EXAMPLES:

Trading volatile stocks, buying call/put options to profit from expected price moves, cryptocurrency trading, or other speculative investments.



### RISK LEVEL: HIGH

Significant potential for gains and losses. Returns are uncertain because the trader accepts market volatility.

Dr. Jude W. Taunson

Labuan Faculty of International Finance

