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Pulling the trigger or not: Factors affecting behavior of initiating a position in derivatives markets

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Abstract

The behavior of managers in initiating a derivatives market position brings to the surface an interesting phenomenon: sometimes managers initiate a position in derivatives markets (i.e., futures and options markets) and sometimes they do not, even though the price volatility of the underlying asset has not changed. The current (hedging) models might explain the phenomenon of derivatives position-initiating behavior by assuming changes in the manager's risk attitude and in the volatility of the underlying asset. However, this explanation is not in line with the literature that suggests that risk attitude in a particular domain does not show strong changes within a short time frame. In this paper we try to solve this puzzle by providing a conceptual model that is able to explain the manager's futures contract initiation behavior. The psychological reference price and the futures market price level at the manager's decision moment play a key role in this model. The model is able to explain futures initiation behavior without assuming changing risk attitudes or changing price volatility. Using data from experiments obtained from personal computer-guided interviews conducted with 450 managers, the proposed model is tested with logistic regression on choice probabilities. The manager's risk attitude, the ratio of the futures price level to the manager's psychological reference price and the interaction between them, appear to explain the manager's behavior in initiating a futures position. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Recently, growing attention has been paid to the factors that explain why firms use derivatives as risk reduction instruments. Carter and Sinkey (1998), Géczy, Minton, and Schrand (1997), Howton and Perfect (1998), Koski and Pontiff (1999), Lee and Hoyt (1997), Mian (1996), Nance, Smith, and Smithson (1993), Pennings and Leuthold (2000), Schrand and Unal (1998), Smith and Stulz (1985), Tufano (1996) and Visvanathan (1998) among others have analyzed the determinants of corporate derivative use.¹ These studies provide valuable insight into the characteristics of corporations that are associated with the decision to use derivatives. Several factors, such as the firm's risk exposure, its growth opportunity, the level of wealth, managerial risk aversion, financial distress costs, and the accessibility to financing appear to influence the decision of a corporation to adapt derivatives to their risk management toolbox. However, gaining insight into why firms use derivatives as risk management tools does not explain the manager's decision whether or not to enter the derivatives market in a *concrete choice situation*.² In this paper, we focus on futures as an example of a derivative used as a hedging tool.³ We will focus our attention on the situation in which managers are deciding whether or not to initiate a position in the futures market. In such a concrete choice situation, the manager has two options: to initiate a futures position or not to initiate a position (the latter could mean delaying the initiation of the futures position). The behavior of a manager in such a concrete choice situation will be referred to as "the manager's behavior in initiating a futures position".

¹ In business today there is no doubt managers have recognized the usefulness of derivatives as risk management tools. In 1998, 2.2 billion contracts both futures and options were traded throughout the world (Futures Industry Association, 1999) presenting an underlying value of 800 billion US Dollars. The derivatives industry is composed of exchanges, banks and brokerage houses offering and facilitating over-the-counter trading.

² Notable research conducted by Antonides and van der Sar (1990) and Guth, Krahnhen, and Rieck (1997), focussed on the investment decisions. In this study, we exclusively focus on the use of derivatives as risk reduction instruments.

³ Hedging is the practice of offsetting the price risk inherent in any spot market position by taking an equal but opposite position in the futures market. The futures contract serve, as it were, as the medium through which the hedging service is provided. The exchanges make it possible for those who want to manage price risk—hedgers—to transfer risk (hedging service of the exchange) to those who are willing to accept it, i.e., speculators (speculation service of the exchange) (Stoll & Whaley, 1993). Futures contracts are standardized with respect to characteristics of the product covered by the contract, time and place of delivery of the product and they are traded under the rules of an organized exchange.

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