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# On the application of the dynamic conditional correlation model in estimating optimal time-varying hedge ratios

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Pages 503-509 | Published online: 18 Jun 2007

Cite this article

<https://doi.org/10.1080/13504850500447331>

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# Notes

<sup>1</sup> Bautista ([2003](#)) uses the DCC of Engle to obtain the dynamic correlation between the interest rate and the exchange rate in the Philippines in order to observe its structural changes. Recognizing the dynamic conditional correlation, we instead use this approach, incorporated with ECM, to obtain the variance matrix so as to analyse the hedging effectiveness of foreign currency futures, which is then compared with OLS and other multivariate GARCH hedges.

<sup>2</sup> The hedge ratio is calculated as the ratio of the covariance between spot and futures prices to the variance of the futures price.

<sup>3</sup> For discussions of other hedging strategies, readers can refer to Chen et al. ([2003](#)).

<sup>4</sup> Bollerslev ([1990](#)) decomposes the covariances into SDs and correlations and assumes CCCs between financial variables. Engle and Kroner ([1995](#)) instead propose the BEKK (named after Baba, Engle, Kraft and Kroner) multivariate GARCH model to ensure time-varying second moments and a positive-definite conditional-variance matrix. Its disadvantage is that the parameters cannot be easily interpreted.

<sup>5</sup> Kroner decomposes the conditional variance matrix into a mean and a variance-covariance matrix. The first moment of the exchange rate is the spot rate, and the second moment is the exchange rate squared.

<sup>6</sup> The minimum variance portfolio is the portfolio of spot and futures prices, respectively. By the first-order conditions, the minimum variance portfolio is the portfolio of spot and futures prices, respectively. By the first-order conditions, the minimum variance portfolio is the portfolio of spot and futures prices, respectively.



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