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Abstract

Dynamic futures hedging strategies have been shown to be effective in a number of markets, but the gain in risk reduction over simple, constant hedges varies. This paper examines the hedging effectiveness of German stock index DAX futures and shows that the application of a dynamic hedging strategy based on a GARCH(1,1) covariance structure, combined with an error correction of the mean returns, yields economically significant in- and out-of-sample improvements in welfare over a simple constant hedge and over a dynamic hedge with the error correction but without the GARCH(1,1) covariance structure. A nonparametric test of the model's forecasts shows that it is able to predict both portfolio returns and investor utility significantly better than the simpler alternative models considered.

Keywords:

Hedging Stock Index Futures Garch Models Dynamic Hedging

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