Chapter 21: Risk management

Risk management entails assessing and managing the corporation's exposure to various sources of risk through the use of financial derivatives, insurance, and other activities. *The risk profile* is a description of what types of risk a company is exposed.

A stock's sensitivity to factor risk as well as organization-specific risk is determined by the organization's capital expenditure and operating decisions and its financial decisions. Factor risk is usually not diversifiable, but often it can be hedged by taking offsetting positions in financial derivatives. Organization-specific risk is just the opposite; it is usually diversifiable but cannot be hedged with derivative contracts. It is possible, however, to hedge many sources of organization-specific risk with insurance contracts.

The *Modigliani-Miller Theorem* holds that when there are no taxes and other market frictions, the capital structure decision is irrelevant. If hedging choices do not effect cash flows from real assets, then, in the absence of taxes and transaction costs, hedging decisions do not affect organization values.

MM entails that shareholders as well as corporations have access to hedging instruments with no transaction costs. In reality, corporations are often in a much improved position to hedge certain risk than their shareholders. In addition, corporate executives are much more knowledgeable than shareholders about their organization's risk exposures and thus are in a improved position to know how much to hedge. Hedging is unlikely to improve an organization's value if it does no more than reduce the variance of its future cash flows. To improve an organization's value, hedging also must raise expected cash flows.