# FARM JOURNAL

## MARKETING EDUCATION SERIES

# Chapter 3: The Fundamentals of Hedging

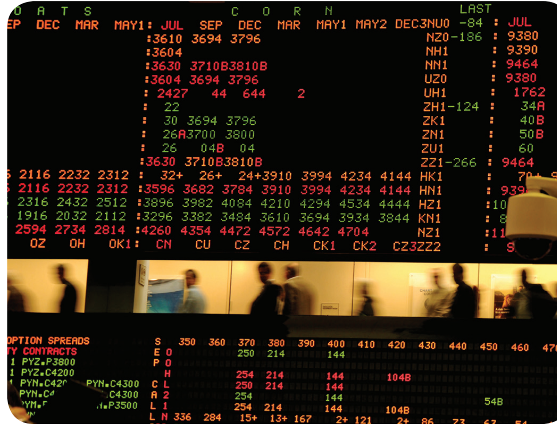
*Plain talk that brings clarity to the what, how, when and why of options and futures.*

Includes instructional DVD with ***Pro Farmer*** Editor Chip Flory

**Topics Include:**

- Flexible Marketing Strategies
- The Decision-Making Process
- Strong-Basis Hedging Strategies
- Weak-Basis Hedging Strategies

## Weak-Basis Hedging Strategies




When dealing with weak basis, use marketing tools that will leave basis open, giving basis time to return to normal levels. Therefore, every weak basis hedging strategy starts with a move in the futures or options market to leave basis open.

That presents three hedging strategies:

1. Offensive hedge in futures
2. Defensive hedge in futures
3. Buying put options

When you sell futures in an offensive or defensive hedging strategy, you lock in price but leave basis open. Locking in price removes downside price risk (and erases upside price potential). These strategies also provide time for basis to return to normal levels, allowing you to capture the basis appreciation.

When you sell futures either against grain in the bin or against anticipated production in the field, it doesn't matter what happens to price. The price you set with the hedge is the price you will receive when delivering the cash grain. That's because gains in your hedge account (if futures go lower) will be offset by a lower cash price when delivering the cash grain. Conversely, if prices move higher, losses in your hedge account will be offset by a higher cash price when you deliver the cash grain.

Basis is what makes the difference and is why an offensive or defensive hedging strategy should only be used when basis is weaker than normal.

Once the price is established with a short futures position in an offensive or defensive hedge strategy, any gain in basis is captured when the cash grain is delivered. Conversely, once the price is established with a hedge, any widening of basis (weaker basis) will be lost when the cash grain is delivered.

**The hedging road map:** A hedge is a great marketing strategy when:

1. Basis is weaker than normal.
2. If you are convinced prices are headed lower and headed lower now but prices are currently at an excellent level (well above your cost of production). In this scenario, use an offensive hedging strategy.
3. If you believe prices are headed lower but prices are currently at less-than-excellent levels. This is when you should use a defensive hedging strategy to establish downside price protection while allowing basis to recover back to normal levels.

A defensive hedge can be established if prices don't generate enough revenue to cover your cost of production, but you're concerned prices will drop even lower.

Other factors come into play in this decision-making process. For example, your risk-comfort level (see Chapter 1) must also be considered. If the idea of trading futures (even in a hedge) would keep you up at night, then eliminate futures positions from your strategies and consider using put options that have clearly defined and limited risks.

If you expect to produce 100,000 bu. of corn in the year ahead and believe prices are headed lower (and basis is weaker than normal), you can establish downside price protection by selling futures against all or a portion of expected production.

To lock in prices on 25% of expected production (25,000 bu.), you would sell five new-crop (December) futures contracts. (Each futures contract represents 5,000 bu. of corn.)

If prices drop, you would accumulate hedge gains in your account. Once basis returns to normal levels and you believe basis improvement has come to an end, it's time to liquidate the hedge. Liquidating a hedge is simple, but it's more complicated than covering short futures positions.

The first step in liquidating the hedge is to make a cash sale (either spot-market or forward-contract) to lock in basis. The immediate second step is to buy back futures to zero-out your hedge positions. If you had hedged (sold) 25,000 bu. of corn in December corn futures, that means making the cash sale and buying five contracts of December corn futures at the same time.

When you do this, you cover all short futures positions (that protected price risk, but not basis risk). By making the cash sale, you erase downside price risk and lock in basis. That leaves you with no downside price risk (or potential) and no downside basis risk (or potential).

If you cover hedges but don't make the cash sale, you reopen downside price risk (and upside price potential) and maintain downside basis risk (and upside basis potential). This is an acceptable maneuver if you are in a defensive (or selective) hedging strategy. This is normally done if the fundamentals of the market have changed (drought, for example) and your price outlook has switched from bearish to bullish.

That's a prime example of the flexibility that using futures and options brings to risk-management strategies. If a cash-only marketer is bearish toward prices and makes forward-contract cash sales before markets begin to react to drought conditions, there's no way to reopen upside price potential in the cash market. A buyback strategy (long futures or long call option) is the only way to reopen upside price potential on grains already sold in the cash market.

If you have hedges covering downside price risk on 25,000 bu. of expected production and sell 25,000 bu. of corn via forward cash contract, you've now erased downside price risk (and upside price potential) on 50,000 bu. of corn. If you've decided to increase downside price protection to 50% of expected production, this may be an acceptable strategy, but only if basis has returned to at least normal levels.

**Can you really be bullish puts?** As discussed previously, a call option's premium increases as the price of the underlying futures contract rises and falls when the futures price falls. A put option is just the opposite. A put option's premium increases as the price of the underlying futures price falls and falls when the futures price increases. (Think of a see-saw with futures prices on one side and the put option premium on the other side—when one goes down, the other goes up.)

That's why many describe a put option as insurance against lower prices. You pay a premium for the right to sell futures at a specified price—the strike price. If prices fall, the premium of the put option increases to offset the lower price.

Many struggle with the concept of buying the option to sell. When you buy a put option (go long), the only way you will gain from the position is if futures prices go lower. So while words such as "buying" and "long" are normally associated with a bullish attitude toward prices, you buy put options (go long) when you have a bearish attitude toward prices.

## Put Options Defined

The following description will look familiar because the framework is the same as the description given earlier for call options.

A put option is a legal contract between two parties that gives the buyer the right, but not the obligation, to sell a futures contract at a specific price within a specific time period. For that right, the buyer pays a cost, referred to as "premium."

That's the standard definition of a put option, but what does it really mean?

■ A legal contract ...

It's a standardized contract. Each put option represents the same number of bushels as the underlying futures contract, which is 5,000 bu. It's standardized to create liquidity in the market so buyers know exactly what they are buying and sellers know exactly what they are selling. Put (and call) options trade in $^1/_8$¢ increments, making each tick worth 0.125¢ per bushel; each tick moves the value of the option $6.25. A 1¢ move changes the value of the option $50; a $1 move changes the value of the option by $5,000.

■ ... between two parties ...

For every buyer of a put option, there is also a seller. They don't know each other, but each is legally bound to the specifics of the contract.

■ ... gives the buyer the right ...

The buyer of a put option has the right to sell the underlying futures contract (go short) at the "strike price."

This free roadmap is included in chapter 3, Fundamentals of Hedging, in Farm Journal's Marketing Education Series. The complete 4-chapter series, featuring *Pro Farmer's* Chip Flory shares real life examples of choices and decisions to improve your marketing skills.

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