CHOOSING THE CORRECT MARKETING TOOL

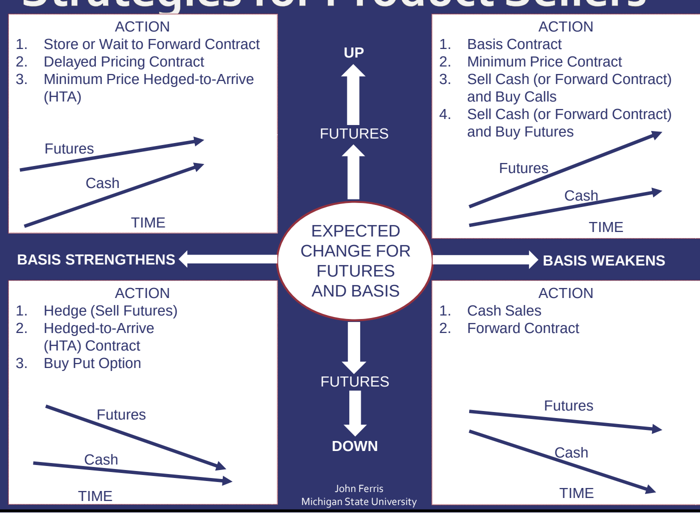
FRAYNE OLSON, PHD

CROPS ECONOMIST/MARKETING SPEC.
NDSU EXTENSION SERVICE
AGRIBUSINESS & APPLIED ECONOMICS

Objectives for Today

- Provide a brief review of futures markets.
- Carefully review alternative market conditions and which marketing strategies work best under alternative conditions.
- Have an open and ***interactive*** discussion!!

Strategies for Product Sellers



Choosing the Correct Tool

- The key to choosing the correct marketing tool (results in the highest local cash price) is to understand:

1) The expected trends in futures prices
2) The expected trends in basis

A QUICK REFRESHER:

THE RELATIONSHIP BETWEEN CASH AND FUTURES MARKETS

What is a Futures Contract?

- A contract to deliver a specific quantity of grain (5,000 bu. of Hard Red Spring Wheat) with a specific quality standard (# 2 Northern Spring with min. of 13.5 % pro.) to a specific location (Minneapolis/St. Paul) by a specific date (before 15th of contract month).

What is a Futures Contract?

- Delivery months for Hard Red Spring Wheat on Minneapolis Grain Exchange:
  - September
  - December
  - March
  - May
  - July

What is a Futures Contract?

- Delivery months for Corn on Chicago Board of Trade:
  - December
  - March
  - May
  - July
  - September

What is a Futures Contract?

- Delivery months for Soybeans on Chicago Board of Trade:
  - November, January
  - March, May
  - July, August
  - September

What is a Futures Contract?

- **PRICE** is the only contract provision that is negotiable.
- Remember, for every seller there must be a buyer; and, for every buyer there must be a seller.

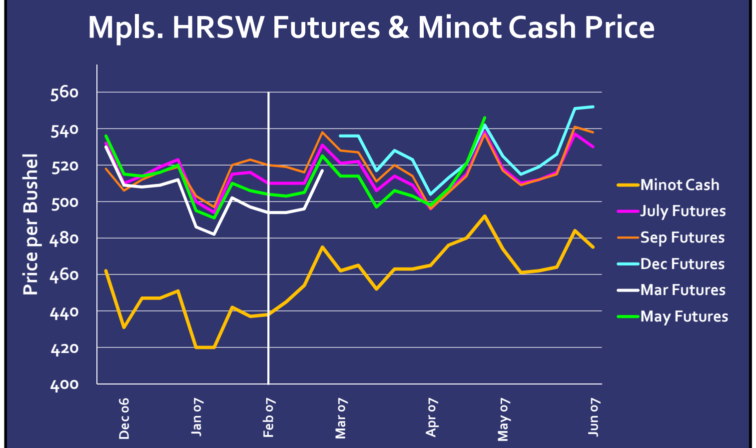
What is a Futures Contract?

- You can buy a contract or sell a contract without owning any commodity. The contract is an agreement to deliver in the future.
- Contracts are rarely fully executed (physical deliver made), the are ***off-set***.

What is a Futures Contract?

- Every trading day, a price is "negotiated" for the delivery of the specific commodity (Hard Red Spring Wheat) at different times in the future.
- The *near-by* futures month is the one closest to today's date.

Futures Price vs. Cash Price



What is a Futures Contract?

- There is a strong relationship, although not perfect, between the futures contract and the cash trading of the same commodity.
- The futures price is also commonly used as a proxy for a national average price.

Local Cash Market

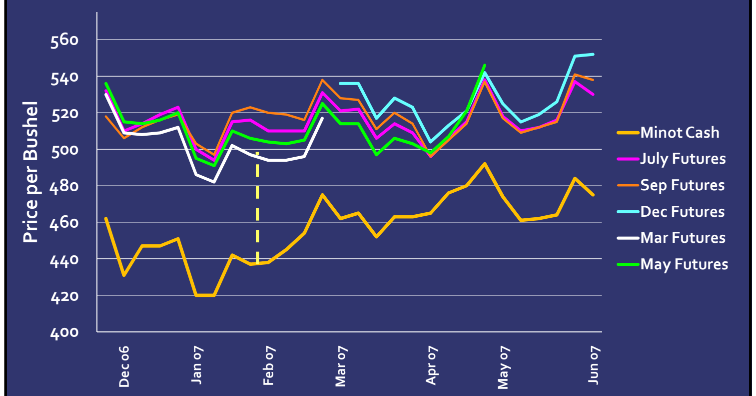
- The local physical delivery of grain for sale today.
- Local sale price is influenced by:
  - Grain dealer's cost structure (margins)
  - Local competition (supply & demand)
  - Transportation to processor or terminal market
  - Time differences between purchase and processing or re-selling (storage & interest)

Futures Price vs. Cash Price

- The difference between the cash price and the futures price (cash price – futures price) is *the basis*, and is unique to each local cash market.
- NOTE: A basis value can be calculated between different trading months for the same commodity or across different commodity exchanges (ex. Minneapolis vs. Chicago).

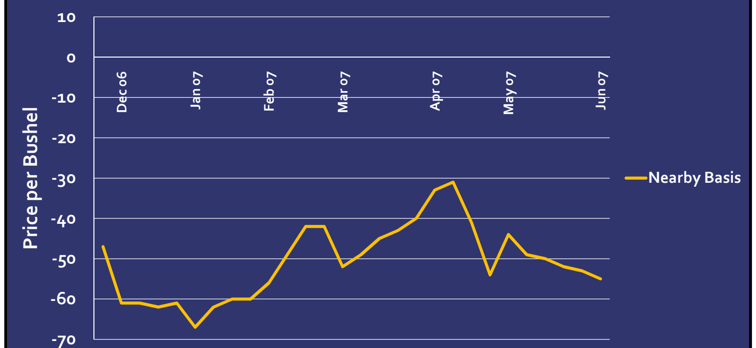
Futures Price vs. Cash Price

Mpls. HRSW Futures & Minot Cash Price



Minot Spring Wheat Basis

Nearby Spring Wheat Basis for Minot



Futures Price vs. Cash Price

- When is the local basis typically the widest (biggest difference between cash and futures prices)?
- When is the local basis typically the narrowest (smallest difference between cash and futures prices)?

Why Do We Use The Futures Markets?

- Grain dealers, like the local elevator, use the futures market to reduce risk.
- Farmers and processors can use futures markets to establish a base price for a commodity without having to actually deliver or receive the commodity (establish a price for future delivery).

Why Do We Use The Futures Markets?

- Allows grain dealers and processors to offer more sophisticated cash marketing contracts to farmers:
  - Hedge-To-Arrive (Futures Fixed) Contract
  - Basis Fixed Contract
  - Minimum Price Contract
  - Delayed Price Contract

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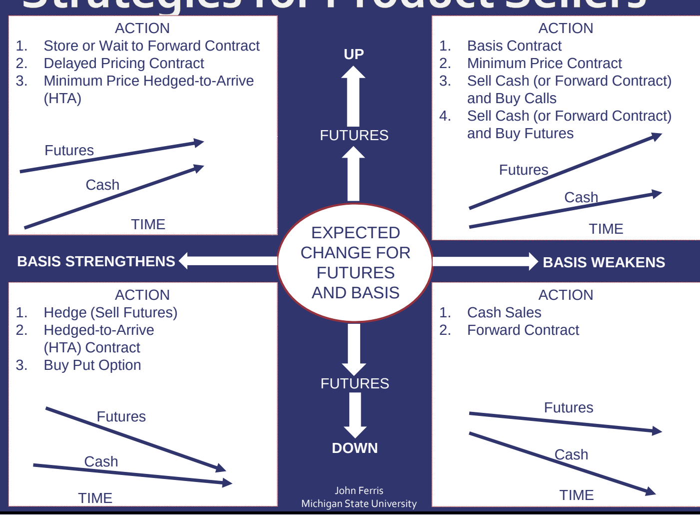
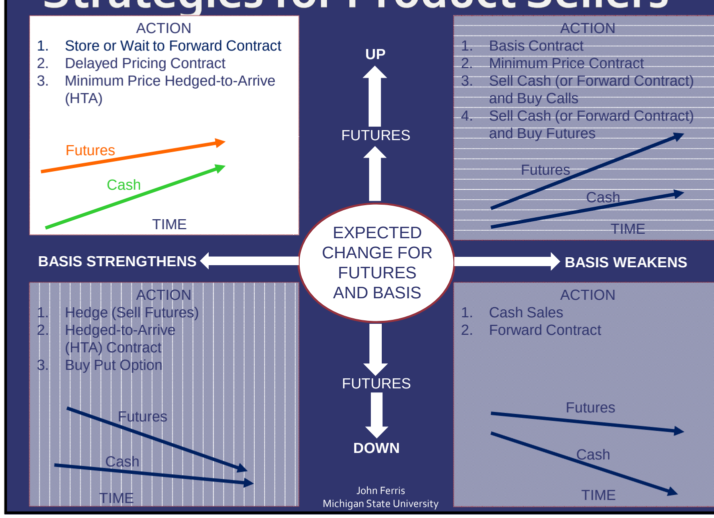
Strategies for Product Sellers



Strategies for Product Sellers



What is a *Delayed Pricing Contract?*

- Farmer delivers grain today, but cash price is not established until a future date.
- Title for grain is transferred to the buyer, and buyer commonly resells grain before final cash price is established.

What is a *Delayed Pricing Contract?*

- Seller is unsecured creditor, but grain dealers bonding applies for first 30 days of contract.
- The grain dealers bond may or may not apply after 30 days. N.D. Credit-Sale Contract Indemnity fund covers 80% of value for contracts over 30 days.

What is a *Delayed Pricing Contract?*

- The futures price is not established.
- The basis is not established.
- The grain buyer typically charges a fee to write a Delayed Pricing Contract, which covers a portion of the basis risk.

What is a *Minimum Price Hedge-to-Arrive?*

- Grain buyer purchases a Call Option and writes a forward contract with the farmer.
- This establishes a *minimum* futures price for the cash sale in the future.
- The basis has NOT been established.
- The premium for the Call Option is part of the contract fees.

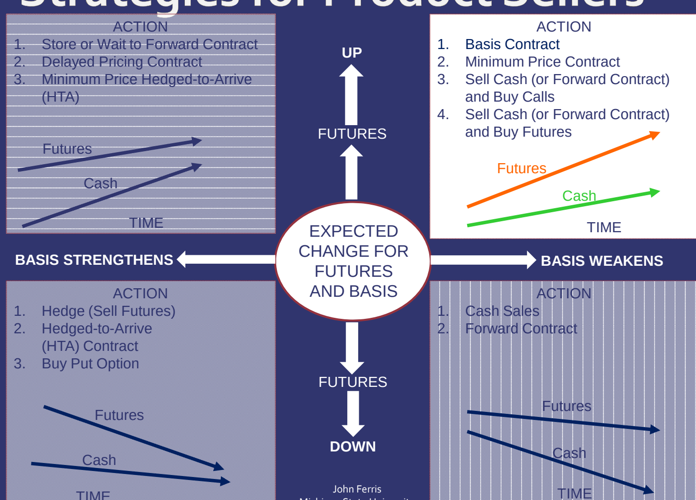
What is the difference between buying a Call Option & Put Option?

- The buyer of a Call Option gains money when the futures price goes UP.
- The buyer of a Put Option gains money when the futures price goes DOWN.
- A ***NET PROFIT*** is not made until the price movement is more than the premium paid for the option.

Question:

- How could a farmer implement this type of options strategy without using a Minimum Price Hedge-to-Arrive contract?

Strategies for Product Sellers



John Ferris
Michigan State University

What is a *Basis Contract*?

- This is a contract between a grain buyer and farmer where the basis is specified in the contract, but the futures price has NOT been established.
- The farmer can choose the futures price at a later date (time of final sale).

What is a *Minimum Price Contract*?

- The grain buyer purchases a Call Option and writes a forward contract with the farmer.
- This establishes a minimum ***cash*** price for the cash sale in the future.
- The basis IS specified in the contract.
- The option premium is included as a cost within the contract.

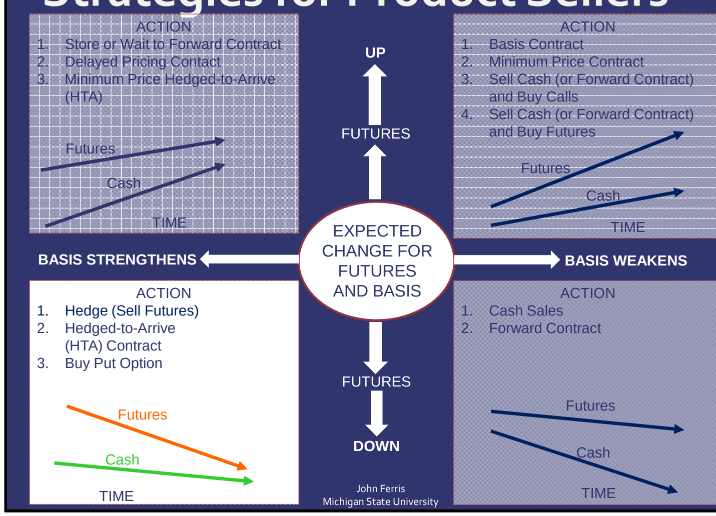
Sell Cash - Buy a Call Option

- Reminder, the buyer of a Call Option makes money when the futures price increases.
- A Net Gain is realized when the price increase is greater than the cost of the option.
- Why does this strategy work?

Sell Cash - Buy Futures

- Why does this strategy work?
- Is this more risky than storing cash grain and waiting for a price increase?
- Is this more risky than a *minimum price contract* or *sell cash – buy call* strategy?

Strategies for Product Sellers



What is a Hedge (sell futures)?

- Hedge – taking an opposite position in the cash and futures markets.
  - Ex. Sell Cash – Buy Futures
  - Ex. Buy Cash – Sell Futures
- Why does this strategy work?

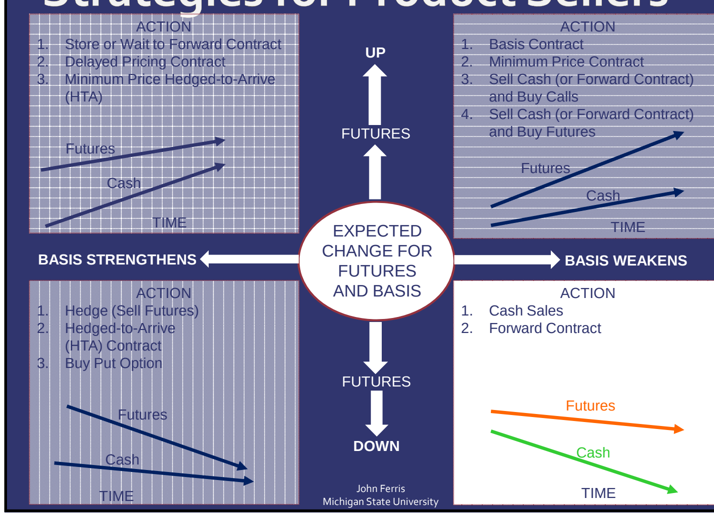
What is a *Hedge-to-Arrive Contract?*

- This is a also called a Futures Fixed Contract.
- The grain buyer purchases a futures contract to set the base price, but the basis has NOT been determined.
- The basis is usually determined at the time of final sale.

Buy a Put Option?

- When does the buyer of a put option make money?
- When does the buyer of a put option make a net gain?
- Why does this strategy work?

Strategies for Product Sellers



Caution

- All of these strategies assume that you have a relatively strong opinion about what direction prices will move (both futures and cash).
- Following a strong trend line is easy; picking the turns is hard.
- A large part of marketing strategies is also risk management.

Caution

- A "good" risk management strategy tests:
  - "What would happen if I made the 'wrong' decision?"
  - "Can I absorb the results of a 'wrong' decision?"
  - "Do the benefits of the risk management strategy out weight the costs?"

Summary

- Knowing when to use the appropriate marketing tool can pay big dividends.
- Unfortunately, not all the crops grown in the Northern Plains have futures markets.
- This does not eliminate forward pricing opportunities, it just limits the available tools.

Questions & Comments?

Frayne Olson

Dept. of Agribusiness & Applied Econ.

NDSU Dept. 7110

P.O. Box 6050

Fargo, ND 58108-6050

701-231-7377

frayne.olson@ndsu.edu