CHOOSING THE CORRECT MARKETING TOOL

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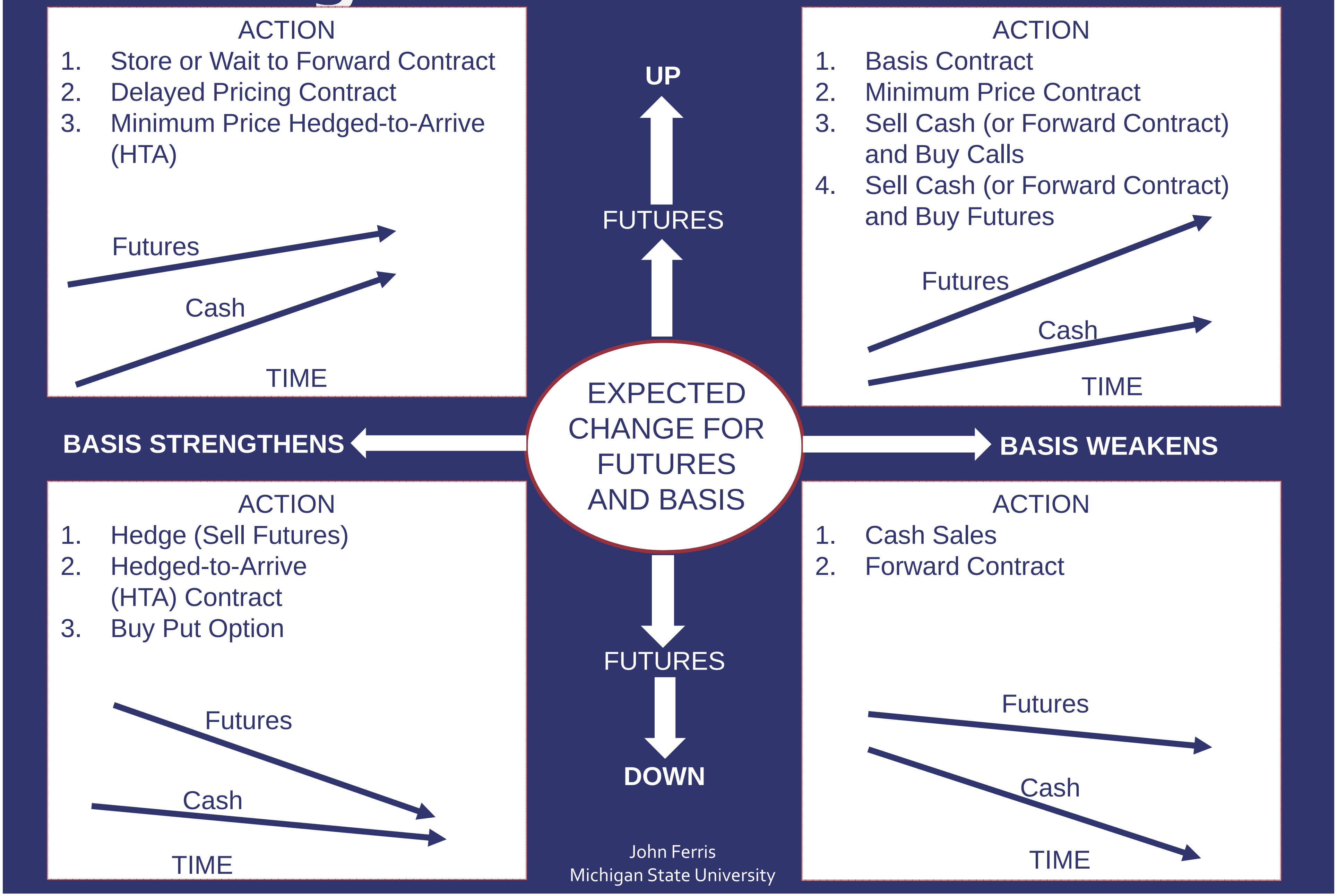
Objectives for Today

- 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?

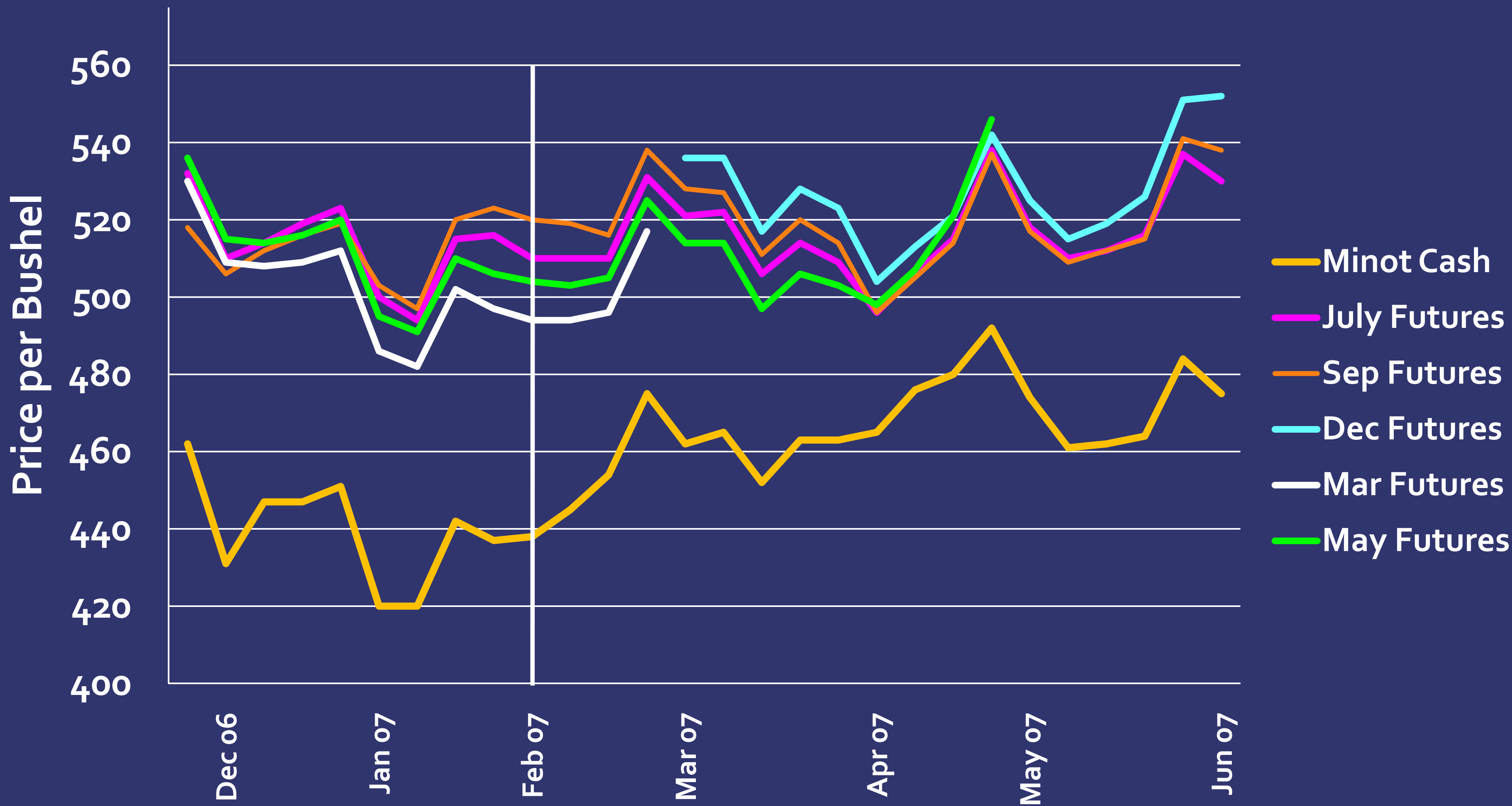
- You can buy a contract or sell a contract without owning any commodity. The contract is an agreement to deliver in the future.
- Contracts are rarely fully executed (physical deliver made), the are ***off-set***.

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

Mpls. HRSW Futures & Minot 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

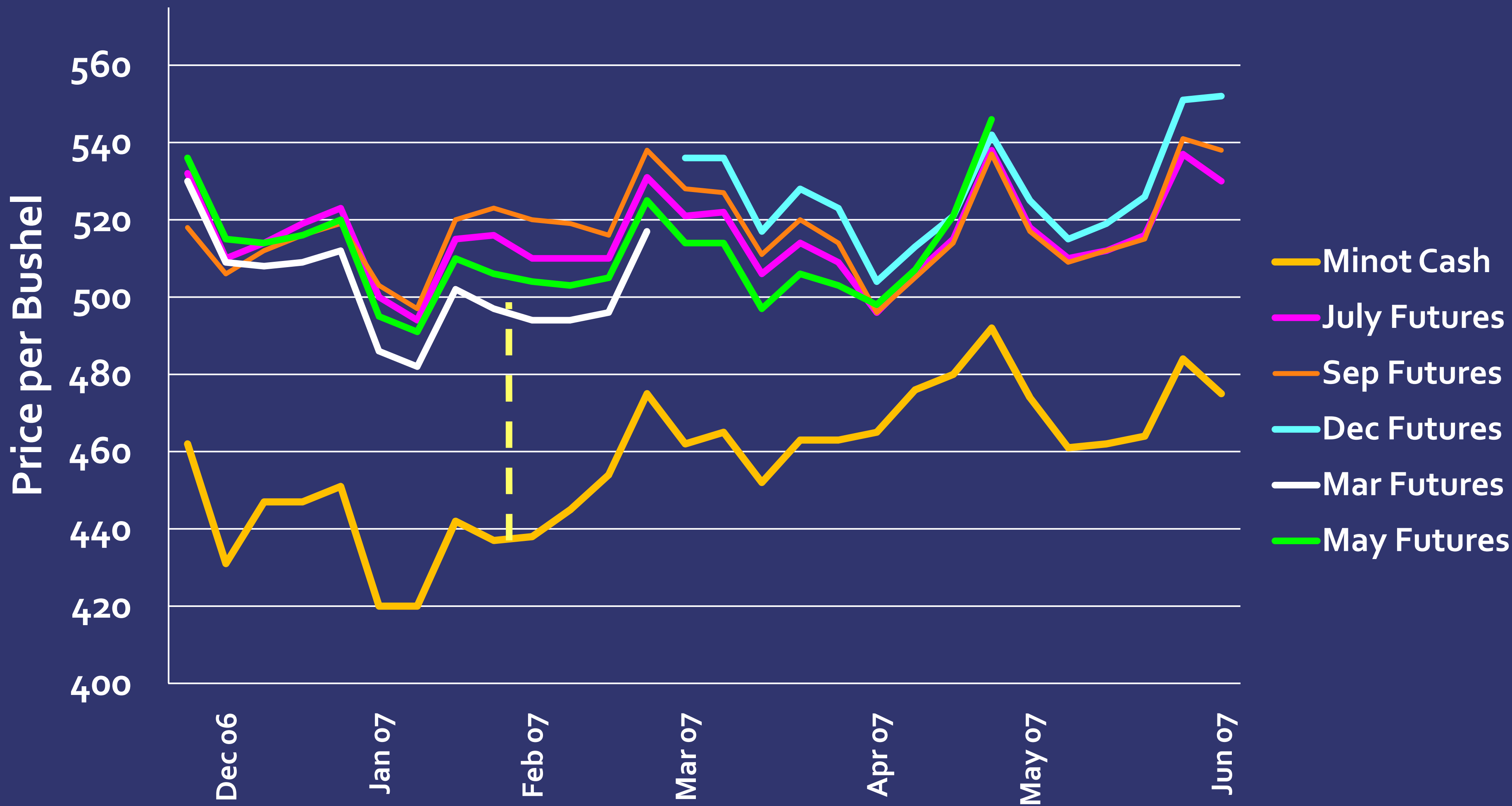
- The local physical delivery of grain for sale today.
- Local sale price is influenced by:
  - Grain dealer's cost structure (margins)
  - Local competition (supply & demand)
  - Transportation to processor or terminal market
  - Time differences between purchase and processing or re-selling (storage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

Futures Price vs. Cash Price

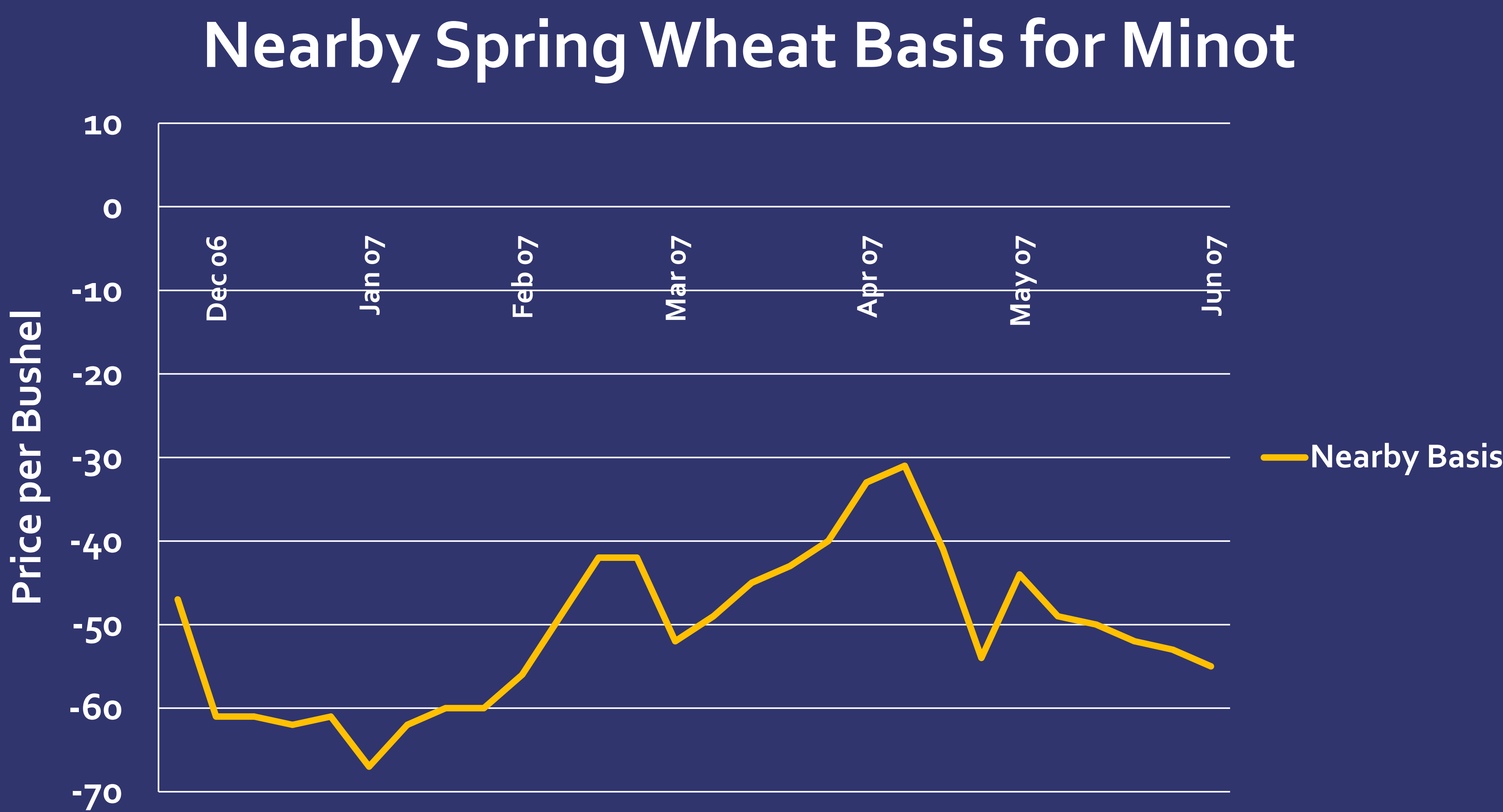
- The difference between the cash price and the futures price (cash price – futures price) is *the basis*, and is unique to each local cash market.
- NOTE: A basis value can be calculated between different trading months for the same commodity or across different commodity exchanges (ex. Minneapolis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

Futures Price vs. Cash Price

Mpls. HRSW Futures & Minot Cash Price



Minot Spring Wheat Basis



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

UP

FUTURES

EXPECTED CHANGE FOR FUTURES AND BASIS

BASIS STRENGTHENS

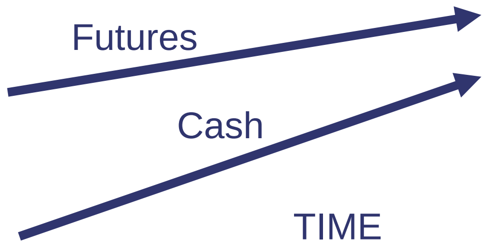
BASIS WEAKENS

FUTURES

DOWN

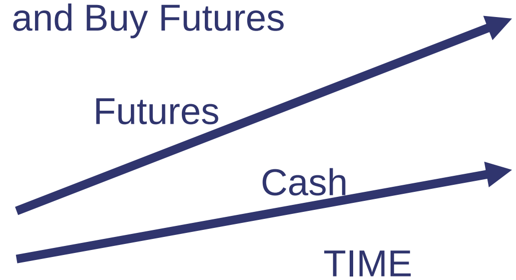
ACTION

1. Store or Wait to Forward Contract
2. Delayed Pricing Contract
3. Minimum Price Hedged-to-Arrive (HTA)



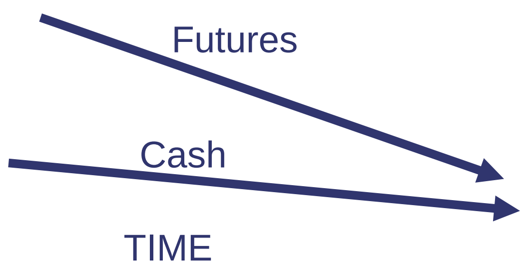
ACTION

1. Basis Contract
2. Minimum Price Contract
3. Sell Cash (or Forward Contract) and Buy Calls
4. Sell Cash (or Forward Contract) and Buy Futures



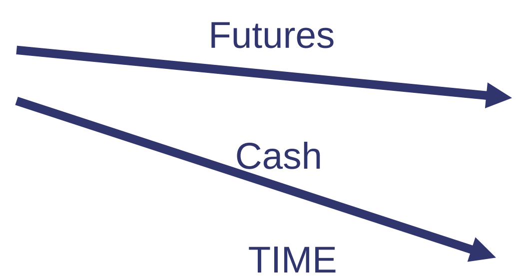
ACTION

1. Hedge (Sell Futures)
2. Hedged-to-Arrive (HTA) Contract
3. Buy Put Option



ACTION

1. Cash Sales
2. Forward Contract



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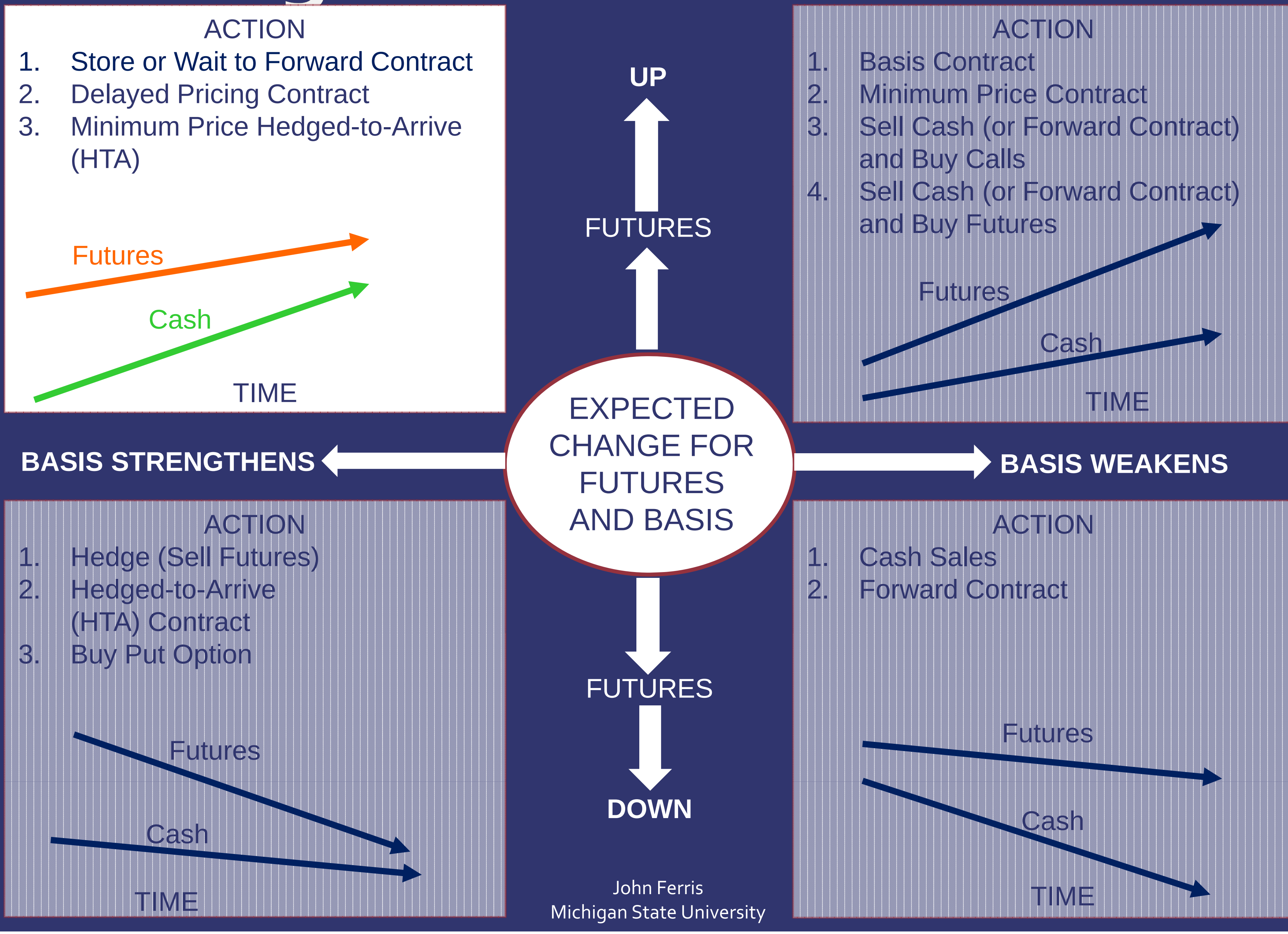
Strategies for Product Sellers



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?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2. Delayed Pricing Contract
3. Minimum Price Hedged-to-Arrive (HTA)
Futures
Cash
TIME
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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*?

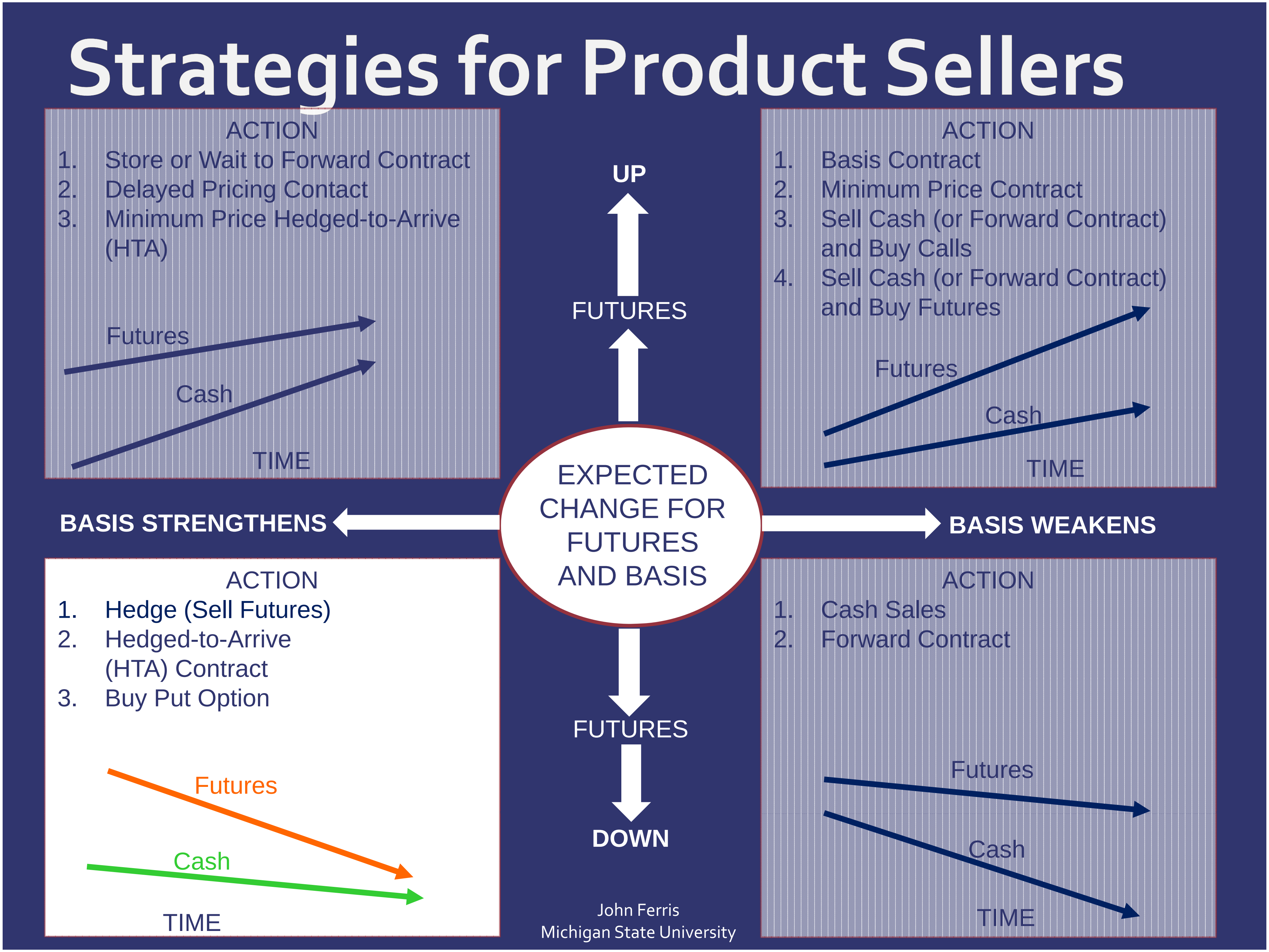
- The grain buyer purchases a Call Option and writes a forward contract with the farmer.
- This establishes a minimum ***cash*** price for the cash sale in the future.
- The basis IS specified in the contract.
- The option premium is included as a cost within the contract.

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?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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?

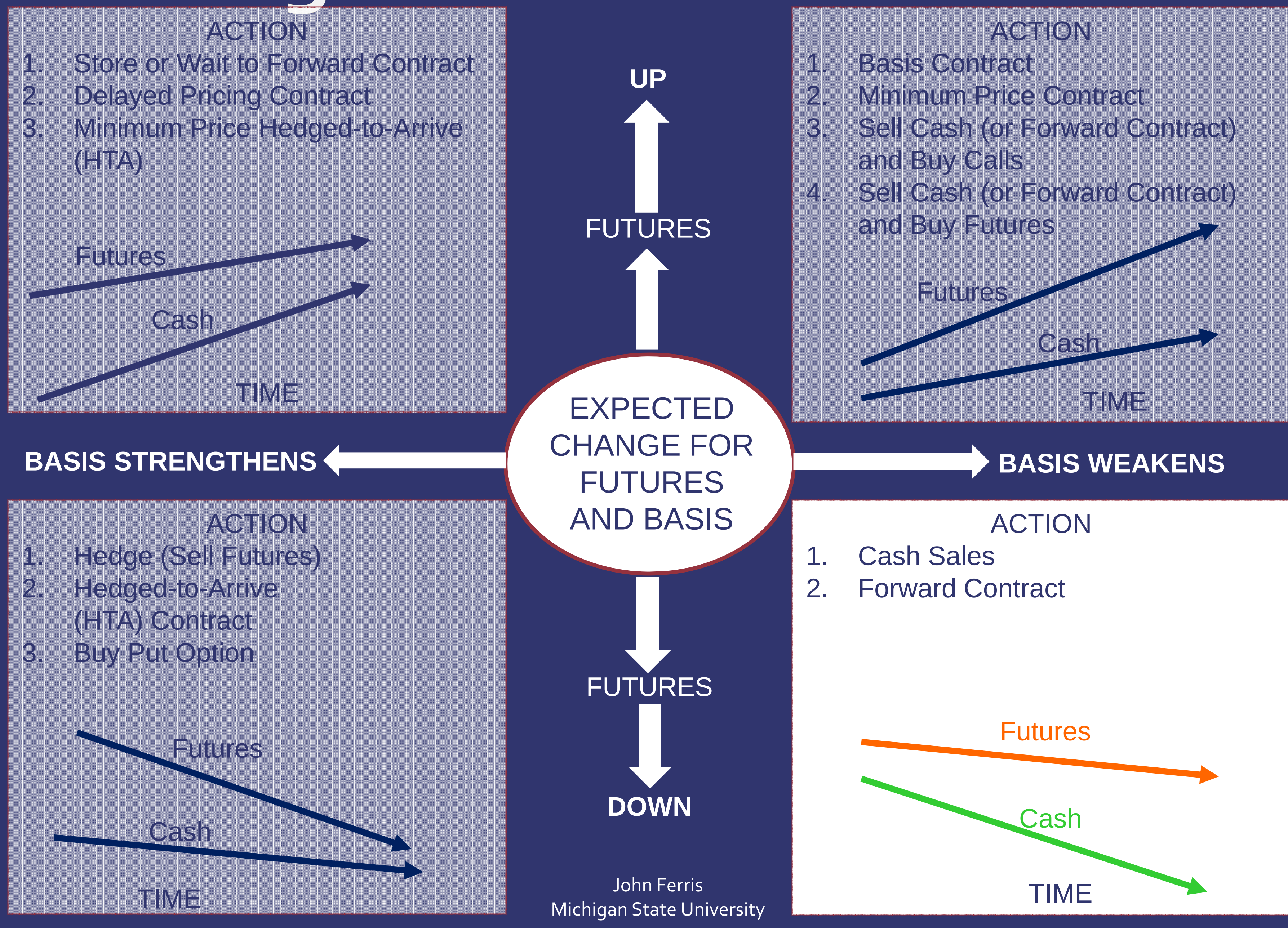
What is a *Hedge-to-Arrive Contract*?

- 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?

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