



WEEKLY OUTLOOK

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AGRICULTURAL OPTIONS MAKE THEIR DEBUT

OPTIONS ON SIX DIFFERENT AGRICULTURAL FUTURES started trading last week. The futures markets include cotton, spring wheat, hard red winter wheat, soft red winter wheat, soybeans, and cattle. The options markets provide a potential new marketing tool to producers and users of these commodities.

Options on soybean futures are used here to illustrate how producers might use options in their marketing programs. This example is not all-inclusive in that it does not examine the use of options as an alternative for holding soybean inventories or a long position in the futures market. It examines only the pricing or selling side of the producer's decision.

Producers interested in using soybean options as a pricing tool might consider either buying a put option on soybean futures or selling a call option. These are quite different transactions with different implications. Buying put options is like buying insurance against unfavorable price movements. Selling call options is like selling insurance - it generates premium income but exposes the seller to price risk.

We will use March soybean options to illustrate the difference. On November 2, March soybean futures closed at \$6.505 per bushel. Assuming a 10 cent basis in March, the market is offering the producer a price of \$6.405 for March delivery. The premium on a March put option with a \$6.50 strike price was \$.29 per bushel. The premium on the March call option with a \$6.50 strike price was \$.30.

If a soybean producer buys the put option, he or she has reserved the right to sell March soybean futures at \$6.50 regardless of which direction prices move. The producer pays \$.29 per bushel for that right. If prices go down, the producer can exercise the option (or sell the option at a profit and add the profit to the selling price of his or her soybeans). If prices go higher, the producer lets the option expire and sells at the higher price. Buying the put option has established a minimum selling price for soybeans. That price is the strike price (\$6.50) minus the premium (\$.29) minus the basis (assumed to be \$.10 in March), or \$6.11. At the same time, the producer is not obligated to exercise the option and can profit if prices move higher.

If the producer sells the call option, he or she has guaranteed that the buyer can take a long position in March futures at \$6.50. The seller, then, is obligated

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to take a short position in the market at \$6.50 if the buyer exercises the option. In return the seller receives \$.30 per bushel premium at the time the option is sold. By selling the call option, the producer has established a maximum selling price for his or her soybeans. That price is the strike price (\$6.50) plus the premium (\$.30) minus the expected basis (\$.10), or \$6.70. The actual price will depend on the magnitude and direction of price change after the call option is sold.

If March futures move higher, the producer will have to pay a higher premium to buy back the option, or will have to take a short position in March futures at \$6.50, but will also receive a higher price for the soybeans in inventory. Regardless of how high prices go, the seller will receive a net price of only \$6.70 per bushel.

If March futures prices decline, the call option becomes worthless to the buyer and it will not be exercised. The seller keeps the \$.30 premium and adds that to the actual selling price of the soybeans. If the price of March futures drops by less than \$.30, the producer is better off than if he or she had initially hedged his or her soybeans. If the price drops by more than \$.30, the net price is lower than would have resulted from an initial hedge.

We will pursue this example periodically to see which alternative, buying a put option or selling a call option, fares better.

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