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WEEKLY OUTLOOK

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1996 CROP SALES SHOULD HAVE "UPSIDE PRICE INSURANCE"

Since the advent of agricultural options in 1984, farmers have another marketing tool to reduce part of the price risk when making marketing decisions. The purchase of an option gives the buyer the right, but not the obligation, to take a position in the underlying futures contract. The purchase of a put option gives the producer the right to sell futures at a specific price (strike price). If the futures price goes higher, the put option can be sold for any remaining time value, or allowed to expire worthless. The farmer can then sell futures, or cash forward contract grain, at the higher price. If the futures price declines, the put option can be sold for a higher premium or exchanged for a short futures position at the strike price.

In a similar manner, the purchase of a call option allows farmers to sell the call at a higher premium, or to exchange the call for a long futures position at the strike price, if futures prices rise. If the futures price declines, the call option can be sold for any remaining time value, or allowed to expire worthless.

There is a cost (premium) associated with buying options. In addition, commission fees are charged for the purchase and sale of options. The big advantage of options over futures is the limited risk (owning options). There are no margin calls associated with owning options. Sellers of options incur margin risks similar to those for trading futures, but receive the premium.

The application in marketing involves using a combination of cash sales, futures, and/or options. With the huge surge in demand and low stock levels being experienced for grains and oilseeds, weather related production problems with the 1996 crops could send prices sharply higher. This means that any short futures positions could require large margin calls and result in a lower price than would be possible later on. Many farmers are making sales as wheat prices are at 15 year highs, corn prices at 8 year highs, and soybeans above $7 per bushel and at 18 month and contract highs. They are aware that "a short crop has a long tail" and do not want to let these high prices slip away.

For 1995 crop corn, consider a scale-up cash sales program with March 1996 futures at $3.50 or higher. To insure against higher prices, March 1996 corn call options with a $3.60 strike price can be purchased for 5 cents, or a $3.70 strike price for 3 cents (plus commission). These premiums change as price and volatility change.

Use of July 1996 corn futures to price 1996 production can add 50 cents to the current price for the 1996 crop, but involves both price risk and spread risk. Consider this strategy with July 1996 futures at $3.60 or higher. For upside price protection, July 1996 corn call options with a $3.70 strike price can be purchased for 9 cents. The options expire approximately one month ahead of the futures contract. If prospects for unfavorable weather develop by June 1996, you may have to exchange the call options for futures. By July, you can roll the July 1996 corn futures into December 1996 futures. This can also be done in stages by first rolling to the September 1996 futures. By late July, you should no longer need the upside price protection from options.

If there are weather problems affecting the 1996 corn crop, futures prices could set new records above $4 per bushel. If this should occur, the spread between July 1996 and December 1996 corn futures could widen to $1 or more and may not decline significantly before expiration of the July contract. This risk can be controlled by buying July 1996 futures and selling December 1996 futures as a spread trade. The price risk will be offset by the increase in the value of the call options or by the sale of the futures you acquired in exchange for the call options.

Corn is in a demand led bull market. Price peaks in this type of market typically occur later than a supply led bull market. Prices also tend to go higher and stay high longer than expected. Until there is evidence the prices are high enough to ration use, or that corn prices have peaked, there is no hurry to make multi-year crop sales. An opportunity to initiate these sales at a higher price may occur. Once a sale in the futures market is made, the things that impact the final cash price are the spread (as you roll the contracts forward), the commission , slippage, and basis.

Multi-year sales involves taking on larger futures positions (and risk of huge margin calls) than most producers are used to. While forward pricing can be accomplished by other marketing alternatives, each have certain constraints. The biggest disadvantage of other alternatives is that they result in a lower price. So while the use of both futures and options may at first seem complex, the results can be very rewarding financially. It may be worth hiring some professional help, if needed. Remember, sales of 1996 crop corn should have "upside price protection" until the weather risk next summer is past.

This is the last issue of the <u>Weekly Outlook</u> in 1995. The next issue will be January 8, 1996.

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