Winter 2019-20 Alkire Advisory Education Series

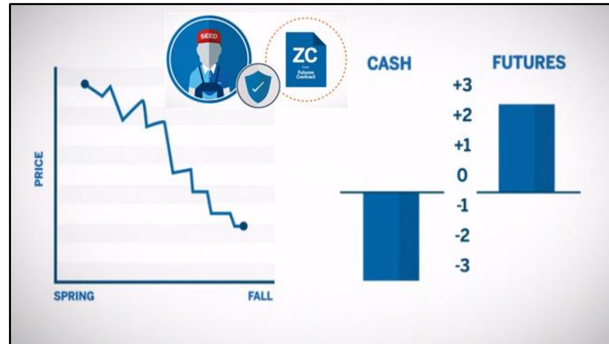
Module 2: How Hedgers Use Futures Markets

First recommended CME video –
Understanding the Role of Hedgers

Hedgers and speculators use futures markets to maximize investment returns, but fundamentally differ in how they use them.

A hedger uses futures markets to reduce profit margin risk until delivery of the physical commodity.

A speculator uses futures markets to accept price risk in exchange for potential profits.



Our most successful clients maximize investment returns of on-farm storage by marketing grain like commercial hedgers. Most clients use a combination of futures, options and cash contracts to make money farming.

Using futures and options, we hedge price risk by selling production before markets consider it "made," and in most non-drought years, for prices higher than the Fall. We buy call options prior to making sales to define margin exposure on summer weather rallies. Some require call options before making sales.

All use a **Crop Marketing Plan**, which uses inputs, expected production and sales execution to detail profit and loss per acre.

Alkire Advisory Crop Marketing Plan EXAMPLE

2020-21 Profit/Loss				Updated:	12/11/2019
	Acres	Yield		Acres	Yield
CORN	500	180.0	SOYBEANS	500	50.0
Profit Goal	Total Bu:	90,000	Profit Goal	Total Bu:	25,000
$70.00	Breakeven	w/Profit	$50.00	Breakeven	w/Profit
Costs:	$700.00	$770.00	Costs:	$500.00	$550.00

--- Net Profit per Acre ---

CORN	Expected	5%	-5%	15%	-15%
Price/Yield	180.0	189.0	171.0	207.0	153.0
$5.00	$200.00	$245.00	$155.00	$335.00	-$5.00
$4.80	$164.00	$207.20	$120.80	$293.60	-$35.60
$4.50	$110.00	$150.50	$69.50	$231.50	-$81.50
$4.00	$20.00	$56.00	-$16.00	$128.00	-$158.00
$3.50	-$70.00	-$38.50	-$101.50	$24.50	-$234.50

SOYBEANS	Expected	5%	-5%	15%	-15%
Price/Yield	50.0	52.5	47.5	57.5	42.5
$11.00	$50.00	$77.50	$22.50	$132.50	-$32.50
$10.91	$45.30	$72.57	$18.04	$127.10	-$36.49
$10.00	$0.00	$25.00	-$25.00	$75.00	-$75.00
$9.00	-$50.00	-$27.50	-$72.50	$17.50	-$117.50
$8.00	-$100.00	-$80.00	-$120.00	-$40.00	-$160.00

Second recommended CME video – Understanding Futures Expiration & Contract Roll

After selling a futures contract (5,000 bushels) of current or expected production, hedgers hold contracts until they deliver grain.

Prior to the delivery period, farmers must either 1) **offset** their position with an Exchange for Physical, or buy "back" a short hedge;

2) **Roll** the position – by buying "back" and re-selling a deferred month futures contract;

or 3) **Deliver** to a buyer issued by the contract's lister, CME. Farmers who exit short positions prior to First Notice Day (FND) are not assigned delivery by the CME. Commercial traders deal in the CME delivery market, while others simply liquidate futures positions prior to the delivery period.

Farmers can use an **Exchange for Physical (EFP)** to offset, or exchange, futures positions with a cash buyer, when basis argues farm storage returns are great enough to deliver grain.

An **Exchange for Physical** is an agreement between a farmer and grain buyer to offset each other's futures positions at the same price, resulting in zero slippage upon liquidation. The cash price the buyer sets upon delivery, is the same used to realize profit on the futures hedge in your RJO account.

When supplies exceed demand, nearby futures contracts are worth less than deferred, or later, month futures contracts, resulting in a spread **carry**. The price of grain sold with a nearby futures contract ***increases*** by the market carry when rolled to a deferred month prior to expiration.

Spread – the price difference between two futures contract months. For example, if Mar'20 Corn futures are $3.75 and July'20 futures are $3.90, the March-July'20 corn spread is 15 cents **carry**. Conversely, if July'20 futures are $4.00 and Dec'20 futures are $3.75, the July-Dec'20 corn spread is 15 cents **inverse**.

Farmers roll futures contracts until **basis** implies storage returns are great enough to **exchange** futures positions and deliver. Obviously not all bushels can realistically move out of farm storage during optimal delivery.

Basis – the amount by which a futures price is above or below a cash price. For example, if Mar'20 Corn futures are $3.75 and the local ethanol plant is offering $3.90 Mar'20 cash corn for February delivery, basis is 15 cents over Mar'20 futures.

Because farmers predictably sell in the cash market at certain times of the year, and grain buyers physically deal in supply and demand, we can profitably speculate on more predictable basis and futures spread trends, rather than futures prices.

In our experience, farmers who exchange futures positions upon delivery achieve higher prices than those who offset for speculative gains prior to delivery. Consistent returns trump speculative gains over the long run, which is how Alkire Advisory has helped clients make money farming since 1988.

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