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Monday night marketing - Session 3: Using the options markets to manage price risk

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Unknown

Good evening. It's got 7:00 straight up. We're going to go ahead and get started. I'd like to welcome you to session three of the Monday night marketing program. Glad you could join us tonight. I think we've got an interesting session ahead of us, and, hopefully, an opportunity for you to ask some good questions and for us to have some discussion.

00:01:14:14 - 00:01:46:11

Unknown

So we'd like to start off as we have in the past. Just a quick review of what we covered last week. And give you, an opportunity to ask any questions you might have. I did notice that a number of people, took advantage of the recording this week. That typically happens as we get into the, in-depth sessions and get talk about especially futures markets and the options markets tonight.

00:01:46:13 - 00:02:17:09

Unknown

I find that it really helps some time to be able to go back, and especially with those recorded sessions where you can advance those to, the part of the discussion that maybe you weren't quite comfortable with and be able to go through that. So, again, just give you just a few minutes here. Any questions about, any of the topics we talked about last week?

00:02:17:11 - 00:02:38:11

Unknown

Okay. We're going to move forward then. If you have some questions that come up, please feel free to ask. And, we'll do our best to answer those. Kind of continuing on with our bases tracking. I have been quite disappointed. In years past, that little, catalog unit Loma actually has some pretty good, volume for this time of the year.

00:02:38:11 - 00:03:01:07

Unknown

And know they pull cattle not only from western Colorado, but from eastern Utah as well. And I do know that they've had a couple of feeder cattle auctions since we first started the class, but unfortunately they're not posting any market results. So I've not been able to, calculate, cash price a futures on a basis, but, carrying through with corn and wheat.

00:03:01:09 - 00:03:24:13

Unknown

Obviously we've seen, both an increase in the futures prices over the last week. Basis has remained flat. And so, I'm got a message here, Ernie, of the rush, if you're having an issue hearing me.

00:03:24:15 - 00:04:38:12

Unknown

If you can hear me, maybe give me a thumbs up. I can hear you. Great. Thanks, Ginger. I appreciate that. Okay, great. Super. I'm going to do. Thank you. I'm going to do a little bit of, troubleshooting with one of our, attendees. Right quick. Give me just a second and, see if we can get them up and rolling.

00:04:38:14 - 00:05:00:13

Unknown

Okay. Hopefully we've got some instructions to help. One of our participants, be able to address, microphone and or excuse me, speaker, and be able to hear tonight some. So again, I was mentioning, if you look both at the spot cash price and the, futures contract prices, they've gone up. Basis has remained, flat.

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Unknown

No changes there. The wheat bases in peach is, one that I would expect this time of year. One of the things if you trade in wheat that you've noticed, we had probably about going on three years ago, some really low quality wheat that was produced. And we had really wide bases. We had, in some cases, bases as wide as \$1.20 under.

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Unknown

And we've narrowed that considerably. I am a little surprised that the corn bases and the action is as narrow as it is typically that bases this time of year. It can be as wide as 20 to \$0.30. But obviously we've got a very short old crop, corn. And so with bases that narrow, that market is saying we want corn.

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Unknown

We want you to bring corn in where we're are willing to, to take it. Now that bases I said again for Haxton, it's pretty narrow for this time of the year. We actually have corn bases in northeastern Colorado. That's a positive basis. I know the, I think the market in peach for corn today was ten over.

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Unknown

So that's, a very big indication that in this market, there is a demand for corn. We need corn. I know a number of the feedlots are getting pretty low, and then we've got an ethanol plant. If we've talked before and they need a consistent, constant supply of corn to keep that batch plant going. The other thing I'd mention, I don't have a slide for it, but this would be a good place to talk about it.

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Unknown

Again, another really interesting week as far as markets go. You're really getting a treat in this particular class. Having an opportunity to, see markets move. Typically this time of the year, markets move sideways and they're very, very boring. What we are finding, this year, however, last week, a couple of factors are really moving the market.

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One, the extremely cold weather all across the country. But more importantly, in the cattle feeding and, and, cattle processing region of the Texas Panhandle. That was really having an effect on the cattle market. We're still trying to move through that. I expect it'll take another week or two before we get kind of the backlog of cattle moving the feedlot into processing plants, and we see some improvement in local basis, local bids and ultimately some more strength in the futures market.

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The other big market mover last year, or excuse me, last week, was the USDA had their annual outlook conference. And giving Covid this conference was, presented in a, virtual basis. I was able to attend a few of the sessions. Typically it's a live in D.C., and that kind of limits the number of people that attend.

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Unknown

But it's the, really first time that USDA, starts to talk about the balance sheet for the new crop. And, they did that. And as a result of that, all of the grains plus cotton, have seen, some, increased prices and some rallies. And that rally extended through today. For most commodities, I think wheat and cotton really led that.

00:08:22:24 - 00:08:58:17

Unknown

But corn and soybeans were very strong as well. And one of the things that that USDA is saying at this point is even if we have record, acreage planted for corn and soybeans and near twin yields, we still expect the carryover from the 21 crop to the 2022 crop, to be very small. And so we really saw today, especially new crop contracts, really, rallied and went up quite significantly.

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Unknown

One of the old sayings that you hear in markets is that bull markets have to be fed, which mainly means good news has to be preceded by more good news, buy more good news to keep the ball rolling when it comes to a market that's going up. Or again, a strengthening bull market. And so certainly the news with this last week from the outlook conference was very positive.

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The next big test of that new crop market will come at the end of March. March 31st is the planting intentions report. And that's a big, big report as markets go into this spring and as we look at those, new crop markets. So, if you're hoping for a continued rally and continued strength in the grain markets, what you really need to see between now and March 31st is continued.

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Unknown

Good news. That good news should probably be in the form of weather issues in South America and in, export sales bookings. So those will probably be the two big areas that we'll see. Start to play into that continual feeding of the bulls and keeping that that market rally going. As we get into the spring, the other thing, we'll start transitioning from, right now, which is a real weather concern in South America to a weather concern.

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Unknown

Going into the spring here in North America. And so, again, a pretty exciting week and, very unusual for this time of the year. Questions about market movement, comments, observations that you would have about, you know, what happened with the markets, last week.

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Unknown

I hope you've had a chance to take a look at the, two market reports or our market, weekly analysis reports that have been sending you Brock report and also cattle facts. I know they can be pretty lengthy, but if at a minimum, pick a commodity or two that you have an interest in, that you produce and spend a little time looking through those reports as it relates to that commodity, I think you'll find that that pretty fascinating.

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Unknown

The other thing I like, especially about that Brok report, is the first two pages, I think do an excellent job of summarizing, what's happening in the marketplace, what happened, the previous week. And it does a good job of setting us up for the coming week. So, if you get a chance, spend a little time with those again.

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Unknown

I think they're good reading and certainly some really good information. So again, just to reiterate, you probably are getting a little tired of this, but I think it's really important. We haven't talked about cost production in detail. We will do that next week. Reluctance to pre harvest price commodities. That again is the general topic of this evening.

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Unknown

We're just going to add another tool to your toolbox, that tool being the using options. And so we're, we're going to spend some continue to spend some time on mistake number two. Failure to understand and track local basis. I think we did a good job talking about that. And I'll continue to update you on the basis of the couple of markets that, I'm currently taking a look at.

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Failure to have a pricing strategy. Starting next week, we're going to start that process of building a, marketing plan, a comprehensive marketing plan. And so we're really start to get into what are the components of a pricing strategy and how you put those together and what my plan will be starting the end of next week, and then the final four weeks of the the program I want to bring, to you every week, a new tool that we can put in your toolbox.

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And then we'll also build on a marketing plan. And I've kind of I've got a, a systematic approach for how you put together a marketing plan. This is a pretty simple plan that we're going to go with. I'm going to provide for you a link, internet link to a plan that, Texas A&M puts together, which I think is a really good plan.

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But it's quite complex. I believe the the handbook is like 90 pages. That's a little overkill as you're just getting into it. Not that it's not got some really good things with it, but we're going to try to keep it simple. This first time around, as we introduce you to developing a marketing plan and pricing strategy.

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Strategies are a big part of that. And then we'll touch on this idea of holding on price, grain and storage too long. We're not going to spend a lot of time on that. Typically, it's more of an issue, in the Midwest. However, there may be some of you, involved in the program this year that have grain storage.

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Unknown

And so, there's some real advantages to having storage. We'll talk about what those advantages are. But we have to be a little, cautious as well.

Again, we attribute those to had asset. I'm not going to go through these in detail. We introduced them to you last year or last session. Excuse me. I'm just really hopeful, that we'll be able to, convince you that, this is a good thing for you to look at this idea of pre harvest pricing.

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Unknown

Your commodities again, we talked about soybeans. This works as well. Not as pronounced in wheat. Mainly because we have, various types of wheat. Wheat is grown across the globe. And, we, we are harvesting wheat almost sometime in, someplace in the world, almost year round. And so we don't see those really distinct, marketing patterns and price seasonality that we see with the other commodities.

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Unknown

Feeder cattle, seasonality. We talked a little bit about that, and certainly why that market tends to have its, lowest prices in that February, March, April timeframe. So as I mentioned, we're adding tools to your toolbox. The first evening we talked about four contracts, which is a tool to to pre harvest price commodities. Last week it was hedging with futures contracts.

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And then this week we're going to talk about setting price floors and ceilings with options. And I've got a graph in your handout tonight that you know graphically we can we can give you an idea of, of how that we're able to set of price floors and ceilings with options and even talk about based on the examples of goals for tonight, were those floors and ceilings actually are.

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So what do we want to accomplish tonight? Well, first of all, we want to become familiar with the options markets. They're a little bit more detailed than the futures markets, because they're more versatile. Lots of of different things you can do with an options contract. So that tends to make them a little bit more complex.

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We need to understand the difference between puts and calls. And again that's a little nuance to options trading. How to determine the value of the option premium. And, in a few minutes we'll discuss what those premiums are. And, and, and we'll actually look at, where those, those premiums are quoted on the exchange websites and, how those change, with time, how these options set, those price floors and ceilings.

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Unknown

And then, one of the things that other two things that producers, challenged me the most when I talk about pre harvest pricing commodities. The first one typically is okay, I see what you're saying. I agree with

it. But what if I lock in a price with a for contract or maybe options or puts in calls and the market goes up?

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Unknown

You know, I'm going to feel bad about that. So we're going to talk about how you can actually use call options to take advantage of rising prices, either after the commodities have been sold for contract or for price. There is a way to do that and we'll go through how to do it. But the second thing that, producers have an issue with in pre pricing a commodity is, well, what if I price all this commodity and I have a hailstorm in it wipes me out and I can't deliver on the contracts.

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And the way we handle that is with crop insurance. And so we'll probably talk more about that next week as the part of a marketing plan. Interestingly enough, I think many people look at crop insurance just strictly from a standpoint of, what value do I have to protect? How many dollars per acre do I need to protect, in order to be able to farm again next year?

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And all of that's very important. And probably the primary reason for, looking at crop insurance. A very important secondary reason is as part of your marketing plan. And sometimes, person needs to be thinking it, you know, the line of maybe I should buy a little bit higher percentage of crop insurance because I could for price, more commodity.

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Unknown

And if I expect the market is going to, give me an opportunity prior to harvest, that's a good, good opportunity to market that price. Maybe I bumped that crop insurance up 5% just to cover a little bit more guaranteed commodity. So when you start looking at crop insurance, not only as a way to protect your investment, to protect your cash flow, to insure that you can farm again, the next year, then it becomes, an opportunity for you to look at it, as part of the comprehensive marketing plan.

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We're going to use that cross hedging example, feeder cattle, because we can also use the options market to do that. So one of the things I like to do when possible is try to, compare an unknown, concept to one that's known. And if I can find that known concept is one that's universally known, that I think it makes it easier to understand the new concept.

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If you can make that comparison. So to start off tonight, I'd like to compare options with insurance. And all of us, have, you know, when I go and talk to my insurance agent and he or she is trying to to, you know,

sell me on a, another edition of that policy, my first reaction is, goodness, we're we're insurance poor.

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Unknown

I mean, we've got everything. Insurance insured to the hilt. I just can't afford any more. But most of us are very, very familiar with how insurance works. So tonight, that's our. No. Our unknown would be options. And some people refer to the options as price insurance. So the comparison between options and insurance, is a meaningful comparison.

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It works quite well. So let's start off on this comparison here. So we're going to put together this this chart. And we're going to compare various terms that we would use in talking about insurance and options. So in insurance we have a term called face value. This is probably more common with, life insurance.

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So if you have a \$50,000 policy, the face value is \$50,000. That's what you would collect or your beneficiary would collect. If you became deceased in the options market, it's called a strike price. And so that strike price is the face value or the value of the underlying futures contract that you've purchased an option for. And we'll find that we can get strike prices at various prices, just like you can get insurance policies at various levels of face value.

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Unknown

Another way to look at a strike price might be a deductible, because it is possible to get a strike price lower than the current futures price. So you've taken a lower position. It's also possible to get an options price higher than the value of the underlying futures. Now an insurance that's usually difficult if not impossible to do.

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It's harder to insure something for more than its value. The next term is premium. And premium means the same thing. So in order to purchase that insurance policy and keep it in effect, we have to pay a premium in the options market in order to buy that, policy, that price assurance and a certain strike price. There's a premium involved, and we'll just see in a few minutes how that premium changes based on the value of that strike price.

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And so that's a, easy comparison with insurance. You know, if if we take out a \$50,000 life insurance policy versus a \$100,000 life insurance policy, we're going to pay a higher premium for that \$100,000 life insurance policy. We'll see that. Also, with options as an option, strike price becomes more valuable. The premium goes up. Now, one of the things

that we're going to find as we go through this, evening is that, there's really three things we can do with that options contract and we can, relate these three things we can do with insurance.

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So one thing we can do with an options contract is we can simply allow it to expire. And we would do this if the option has no value, if it has no cash value, meaning no one else would be willing to buy it from us, or the underlying futures contract that it gives us an option to exercise has no value.

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Unknown

And so the comparable in insurance would be we have no loss. We had, insurance on our home. We didn't have, you know, any claim. So we've still paid the premium, but we the insurance policy would expire at the end of its term. We still are at the premium, but we didn't, have a loss. We didn't get a payment.

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Unknown

The same thing with the options we it has no value. We let it expire. We could also exercise the option. And the comparable there would be if, and in terms of an insurance policy, if we have some sort of a loss, if we have a covered loss. And in that case we would collect an indemnity payment, in the, example of an option, we would exercise our option if that underlying futures contract has value.

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Unknown

And by exercising the option, what that means is we get into the futures market at the strike price that we purchased. And we would do that again because the futures contract has value. The third thing we can do with the option is we can offset it or sell it to someone else, and we typically do that when the option itself has value.

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And as long as the underlying futures contract is viable, the option will have value as well. And as we'll see with our examples tonight, sometimes the option itself is more valuable than the underlying futures position. And so in that case we would offset it by selling that option to someone else. The best example I can give you in the insurance world would be if you have a policy that has cash value and a couple of things you can do with that, you can,

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Cash value on the insurance policy, obviously, you could cash that policy in and collect the cash value or in some cases, someone might, purchase that policy from you and they would continue maybe to pay the, the premiums and, at some point they would have the option to cash it out or,

if you were to, to die, then they would collect, you know, collect the, the payment for a loss.

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Unknown

And so not all insurance policies obviously have cash value, but being able to offset or sell an option is comparable to an insurance policy with cash value. So hopefully this will help you understand options a little better. And as we go through the next few slides, when we start using the terminology, then I think, it's helpful to remember, okay, what does that mean?

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Unknown

In the language of insurance.

00:27:15:06 - 00:27:38:01

Unknown

Okay. So here's the basics of options. An option is agreement between two parties, a buyer and the seller. We are going to concentrate our work tonight on just the side of buying the option. We're going to be a buyer of options. Another term we use for a seller of an option would be someone that writes an option.

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Unknown

And as we'll find out a little later in our, our time together, if you are writing options, you might be subject to margin calls, and, you're in a little bit higher risk than just a simple buyer of options. So, again, just as the name would imply, if you buy an option, you have the right but not the obligation to buy or sell a specific contract known as a fixed price, at any time on or before a known expiration date.

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The options typically expire prior to the underlying futures contract, because it takes a little bit more time to kind of sort everything out. So basically they are, two types of options. There are puts and calls. And I think the easiest way to remember this is a put means you're putting something on the market. And so as we'll find out in a minute, you would want to use a put if you want to sell or have the, the right or the option to sell a futures contract, think of a call as you're wanting to call something from the market.

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Unknown

And so you would buy a call if you want to have the option to buy a underlying futures market. So a put you're putting on in the market. You're selling it a call, you're pulling it back from the market. You're buying it. One of the cool things about options, it gives you the opportunity to take advantage of a futures price without actually having a futures position.

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Unknown

And the nice thing about that is, since we don't actually have a futures position, we're not subject to margin call. So one of the advantages of, dealing with the options is you don't have to have, a margin account and you're not subject to margin calls. So in many cases, people who are new to the futures market might start, buying puts and or calls because, they don't have that margin requirement.

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Unknown

Also, if you are dealing with a lender who is not, maybe comfortable with the futures market, they may be more comfortable, working with you to make use of options as a way to for pre harvest price your commodities again because it gives you, the opportunity to avoid margin calls. And as I mentioned earlier, a put option gives a buyer the right to sell a futures market contract or a call option gives you the right to buy a contract.

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Okay. Unlike the futures, since there's no margin call, the only thing that you have to do to trade options is to pay the premium. And once you've paid the premium, you have no further obligation. Again, we've talked purchasing options does not require margin deposit. We've already given you the example with the, comparing, options to, insurance policies.

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Unknown

You have three things you can do. You can allow the option to expire. You can exercise the option and take a position in the futures market. Or you can off sell it by selling it to someone else. Option premiums are determined by open outcry bids on the trading floor. The way this usually works and a live open, prior outcry of bids, there's two trading floors, there's a large trading floor, and, typically they're, an octagon.

00:31:41:06 - 00:32:09:13

Unknown

They consist of several levels of steps. And, then that would be for trading the futures contract. And then adjacent to it is a smaller pit. That's for the options. Less volume and options we don't need as big a pit, but as we'll see in a few minutes, knowing what's happening in the futures market is important for being able to buy and sell or at least bid on the options market.

00:32:09:13 - 00:32:23:20

Unknown

So that's why they're adjacent to one another. The buyer of an option in terms of delivery a month and the strike price that they desire.

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Unknown

Additional information about options depending on the strike price options can be purchased in one of three ways. An in the money option

means that it has cash value, meaning that the option is in a position that strike price is in a position relative to the underlying futures, where it has value. And at the money strike price is trading, at the same level as the underlying futures contract.

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Unknown

So it has no value. And out of the money option is one that, the strike price is at a position relative to the underlying futures, where there is no, intrinsic value in that strike price. And as you can imagine, the premiums are more expensive for in the money options than they are out of the money options.

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Unknown

This will become a little bit more, understandable in the next couple of slides. Again, that big caution if you're selling or writing options, you may have margin calls, and you've got to make those margin calls in order to maintain your position. Nice thing about options. Again, there's a limited financial obligation. Typically that financial obligation, is simply the cost of the premium.

00:33:50:12 - 00:34:17:00

Unknown

So that's why they're attractive to some people. The other thing that makes options really attractive is they allow the producer to take advantage of favorable price moves and protects against unfavorable moves. When we talk about a futures contract, as we saw from last week, it really sets a price, plus or minus basis. And so we use a futures to set a price.

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Unknown

So as we saw with the examples last week, if the if the futures market moves against us, we're not able to take that, improved upward market or we're really kind of stuck with what we locked in with the futures. And so we'll see in a minute. Options don't lock us in if we are a seller of a commodity.

00:34:44:11 - 00:35:06:19

Unknown

We, you know, we own that commodity. We you options to set a floor. But if prices go up, we have the ability to take the, upward trajectory or the higher prices. If we are a buyer of futures, we're trying to protect prices from going higher. An option sets a ceiling. The maximum amount will have to pay for that input.

00:35:06:21 - 00:35:35:18

Unknown

If we're a feeder cattle feeder, the maximum we have to pay for corn, the maximum we have to pay for feeder cattle. But if the market goes down, we can take advantage of those lower prices. And so that's another, advantage that options have over the futures market. So let's look at this. Idea of what in out in out in at the money meets.

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Unknown

So let's look first of all at a strike price of \$4, that's that middle column. If you let's say that the futures market was trading at \$4 today. And so regardless if I am a buyer of a call or the buyer of a put \$4, is that the money? That's what the futures is trading for. So let's look on the buyer side.

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Unknown

If I buy a contract at \$4 and the market goes up to 410, I could make \$0.10, I could buy it \$4 and sell it for ten. And so if the market is trading at the money at for a strike price of 14 is in the money that strike price immediately has \$0.10 worth of value. On the other side, a put if I sell the market at \$4 and it goes up to 410, then I've got to buy it back at 410, then I've lost \$0.10.

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Unknown

So if I'm selling, if I want to buy a put which gives me the right to sell a futures contract for ten is out of the money if the market is trading at \$4. So an out of the money put option would be cheaper than an act of money or in in the money. Well, let's see what happens if we bought a strike price at \$4 or if the market's trading at \$4, and we could get a strike price of 390.

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Unknown

Well, if we buy at \$4 and sell at 390, we've lost \$0.10. So on the call side, if the at the money or the futures is trading at \$4, 390 is out of the money, we'd be losing \$0.90. And so that, premium would be lower. If we're on the put side, we want to sell a futures contract.

00:37:41:05 - 00:38:21:00

Unknown

If we sold it at \$4 and could buy it back at 390, that has \$0.10 value. And so with the futures trading at \$4, a 390 strike price on a put is in the money. It has value. And so we're going to use these terms as we go through them more we use them. Hopefully the more you'll be able to understand, this concept of in the money, at the money and out of the money, as I mentioned, that's important because it changes the value and the cost of the premiums.

00:38:21:02 - 00:38:44:11

Unknown

So what our puts and calls. So again a put is the right but not the obligation to sell or go short in a futures contract. And again that's used to set a flat price floor I don't want to price. I'm going to sell my commodity to go lower than a certain point. So I'm going to buy a put.

00:38:44:13 - 00:39:13:13

Unknown

Who would use a put. Well since it gives you the right but not the obligation to go short in the futures market, you need to be long in the cash market. So you would buy puts if you have commodities to sell either pre harvest or stored grain. So basically if you are producing a commodity in order to set that price floor, you want to use a put you want to buy puts.

00:39:13:15 - 00:39:37:24

Unknown

A call on the other hand is the right but not the obligation to buy a long futures contract. This is used by commodity buyers. So if you're going to go long in futures you've got to go. You've got to be short in cash. You would be short in the cash market if you need to buy the commodity. And buying call sets a ceiling on what you have to pay for the commodity.

00:39:37:24 - 00:40:08:24

Unknown

The maximum amount, but gives you the opportunity to pay less if the market goes that direction. Or we can also use this if we sold our commodities, and there's an opportunity for us to take advantage of rising prices. Think of that scenario is, actually making, taking advantage of the market just like someone would if they have storage.

00:40:09:05 - 00:40:41:00

Unknown

But you don't have to have money tied up in storage bins. And we'll show you how that works as we go on. Okay. So how are the costs of these premiums determined? Now? I mentioned earlier that it's never determined by open outcry or a bidding system, just like the futures contracts are. But there's got to be a way to determine some kind of value, the way we determine value in a futures price has to do with, the outlook for supply and demand.

00:40:41:02 - 00:41:08:01

Unknown

So we have to have a way to determine what the value of an option premium is. And so that option premium has two, parts to it. It has intrinsic value and time value. So the intrinsic value is the actual value of the options today. And it's that idea of looking at the strike price versus that underlying futures price.

00:41:08:03 - 00:41:39:14

Unknown

And that gets back to that previous slide that sat in the money, out of the money, and at the money. So that transaction value value is the difference between strike price versus that futures price time value is a little more difficult to determine. And it's based on the time left in the option. And so typically, the further away we are from the expiration date we have more time value.

00:41:39:16 - 00:42:05:17

Unknown

And basically it's saying from this day till the time that option expires, lots of things could happen. And so we need to build in, to the price, a way to, to consider the fact that things could change a lot between now and then. There's more risk, as time is the time factor is longer. The other factor is price volatility.

00:42:05:19 - 00:42:53:05

Unknown

If prices are moving up and down, very rapidly. Day to day, and they're making big moves from highs to lows, that price volatility is an unknown. And there it's the more uncertainty we have in a market, the more you have to pay to compensate for that uncertainty. The traders who actually determine the price strike prices of and the option premiums or, excuse me, the option premiums, actually work with formulas, and each trader may have a little different idea about what the time value is of an option, and maybe use a little different formula to determine that.

00:42:53:07 - 00:43:26:09

Unknown

So let's put this to action. Let's say that we're looking at a Kansas City wheat put option. That option gives us the opportunity to sell a futures contract. And that option is for a 515. The market is trading at 515 a bushel. So on day one, futures price is 515. We take an option position after money, which means we buy a 515 strike price.

00:43:26:11 - 00:44:02:01

Unknown

And let's say we pay \$0.20 for that, option premium. And that's at that point, that's all time value. If the market is trading at 515 and we've got a strike price at 515, there's no intrinsic value. We're at the money. So that \$0.20 represents time value only. Okay. Day two. The market moves to 520. So if we sold 515 and we want to get out of the position at 520, we'd have to buy it back at 520.

00:44:02:01 - 00:44:38:10

Unknown

We've lost money. So that's an out of the money option. Our premium went down to \$0.18 because it's out of the money. It has no intrinsic value. It's losing money. So that \$0.18 is going to be all time value. And we could, speculate that it's worth \$0.18 because we're one day closer to expiration. And so we've seen a reduction in the time value, let's say on day three, futures are trading at 5 or 5.

00:44:38:12 - 00:45:07:11

Unknown

So if we sold a contract at 515 and we could buy it back at 505, we actually have made money. We've made \$0.10. Let's say that option was trading at \$0.27. We could determine that of that \$0.27, \$0.10 was intrinsic value. That's the actual value of that position. So the additional \$0.17 has to be time value. Let's go day to day.

00:45:07:11 - 00:45:38:11

Unknown

Four futures are now at \$5. If I sold a contract at 515 and I could buy it back at \$5, I've made \$0.15. Let's say that option was trading for \$0.30. So we would know that there's intrinsic value of \$0.15 and time value of \$0.15. Day five futures came up. They're trading at five, ten, ten. That's still in the money position.

00:45:38:11 - 00:46:05:18

Unknown

Because if I sold it 515 and I bought back at 510, I've made \$0.05. That option is trading at \$0.21. We know that \$0.05 of that is the intrinsic value of the option. And the remaining must be time value of \$0.16. Now, I would say this is a very simplistic example of how time value and intrinsic value work.

00:46:05:20 - 00:46:40:03

Unknown

And in this example, for the most part, time value has gone down with the exception of day five. And so you might ask, well if they for that time value was \$0.15, why is it now \$0.16. Because day five means we're a day closer to expiration. Well remember we said time value is two factors. It's the actual estimation or value of time.

00:46:40:05 - 00:47:07:03

Unknown

From the day that that option premium traded to the day that the option expires. But it also includes a factor for volatility. So we would probably explain why in day five the time value had ticked up a penny. We can explain that through the fact that the market had become more volatile. And because it's more volatile, there's more risk in the market.

00:47:07:05 - 00:47:36:14

Unknown

And so the premium is higher. And again, a really good, example of this, you know, if you drive a new car, let's say let let's change that. Let's say you drive a very, very safe car versus a red sports car. And they're both the same. The cars are worth the same amount. You may pay more premium for that racy red sports car because, there's a higher risk you're going to get in a wreck.

00:47:36:16 - 00:48:12:22

Unknown

And so that's a good example here. We've had something happened in the market, and now there's more risk that that that market could change over time. Questions at this point cover a lot. Because as I mentioned earlier, options are, give you a lot more opportunities. You know, a lot more options. They, are a little more complex.

00:48:12:24 - 00:48:23:19

Unknown

And again, make use of chat if you want to unmute your mic and ask a question, please feel free to do that.

00:48:23:21 - 00:48:48:18

Unknown

Okay. Let's keep going. So where do you find options quotes. Well hopefully you've gone to the CME sites. We've looked at them a couple of different times online, especially as we try to determine, feeder cattle prices in the past. So hopefully you know how to find, this is a quotes page. And so if we look at a quotes page, we have the month of the year that's trading.

00:48:48:24 - 00:49:11:10

Unknown

We have all the quote information and then we have the charts and we've looked at some charts, but then we have a link that we can click on opt for option. If you click that link, it'll take you to a page that looks like this. So what we're going to have is we're going to have various levels of strike prices.

00:49:11:12 - 00:49:37:10

Unknown

And typically kind of in the middle of this chart, you'll see about where the contract is trading. Let's say it's trading. This is a a feeder cattle contract. And let's say it's, you know, it's trading at 139. So we have one 8550 are one. Excuse me, 139 138 5138 one 3750. We can go the other direction.

00:49:37:10 - 00:50:09:01

Unknown

One 3951 4140 5141 we have the calls and the puts, and then we have the last bid price. And that's a premium price there. So we see those premium prices. And then we see what's happened with those premium prices. So that's where we would go to find out what's happening with those premium prices based on a certain strike price.

00:50:09:03 - 00:50:29:05

Unknown

Again we see some have some, you know, some have quite a bit of volume, others have no volume. So there's no price quote. And so that could be another limiting factor with options is sometimes the amount of liquidity in those options markets.

00:50:29:07 - 00:50:53:01

Unknown

So let's go through a couple of examples. And we're going to go to some put examples to set the price for. So because we're talking about it put that means that we are producing the commodity. We want to put it on the market. And since we are long in the cash market we want to go short in the futures market and to short the futures market, we have to sell contracts.

00:50:53:03 - 00:51:21:17

Unknown

So if we buy a put that gives us the option but not the obligation to sell a futures contract. So let's work through a couple of examples here. So here's a put option. When prices decline this is what we would expect would happen. And that's why we might want to to buy a put option. So

let's use today as an example December 21st corn futures are trading at 455.

00:51:21:19 - 00:51:44:14

Unknown

They're actually a little bit high quite a bit higher than that. That was the price I pulled from last week so that we could get the the slide set to in a timely manner. So we want to buy an at the money put at 455. And we're interested in the at the money put because we think the premium is reasonable and we can buy that put for \$0.15 a bushel.

00:51:44:16 - 00:52:08:24

Unknown

So if we take that 5000 bushel contract times \$0.15 a bushel, that insurance policy is going to cost us \$750. November 20th rolls around. We harvest corn. We sell cash corn at \$4. One of the things I neglected to do, and I realized that after I sent this to you, I didn't work any of these was basis.

00:52:09:01 - 00:52:38:08

Unknown

But, we can talk about basis. It's pretty easy to figure out. We can slap it in at the at the end of the discussion or at the end of this example. So we sell cash corn at \$4. So December futures is four. So again we've set up a perfect hedge or in this case zero basis. That December corn put 455 that we bought today is trading at at \$0.35.

00:52:38:10 - 00:53:04:07

Unknown

Someone would pay us \$0.35 to own that option. And so we've got to decide what we do with that put option. Remember we have three choices. We can let it expire. We can exercise it and get in the futures market, or we can sell it to someone else. So what we let it expire. No, we know that the option has at least \$0.35 value.

00:53:04:09 - 00:53:39:22

Unknown

So we want to do something with it. We've had we've had a claim we've had, a loss in prices. And so our insurance policy has some value. Would we offset it or sell it to someone else? Well, in this case we would say no because the puts worth \$0.35. But getting into the futures would make more money for us because today we could exercise the option would be the same thing as, we will have sold a futures contract at 455.

00:53:39:24 - 00:53:50:14

Unknown

We can buy it back at four bucks. And so we will make \$0.55 minus commission on the futures.

00:53:50:16 - 00:54:19:00

Unknown

Contract. So we want to exercise that. We want to exercise our option. We want to be able to sell that futures contract or take that position in the futures market. So our net return on buying the put we made \$0.55

when we exercise it and got in the futures market we paid a 50 cent premium. So we actually made \$0.40 or \$2000 a contract on that.

00:54:19:02 - 00:54:43:24

Unknown

Put option. So the net price for the corn was \$4. Plus the option of \$0.40 was for 40. So at this point, I mean, we could figure basis if we said basis was \$0.20 under, then our net corn cash was 380 plus the 40 cent option, given us for 20. So, you know, we could plug the basis in.

00:54:44:01 - 00:55:19:18

Unknown

And again, nice thing about basis. It's, follows certain patterns and it's fairly easy for us to be able to predict about where it's going to be. Questions about, how this put option work for us. And this is a situation where we were predicting prices would decline. And because we predicted prices would decline, we wanted to, get some, some price protection, but we didn't want to, be subject to margin call.

00:55:19:20 - 00:55:46:02

Unknown

And if the market rallied because we, you know, our information was skewed or something happened that we didn't, you know, no one can predict, we want to have an opportunity to take a higher price. Questions about this one, either in chat or do you want to unmute the mic and ask? So on this one, if it goes up, would you just sell the grain and let it expire.

00:55:46:02 - 00:56:08:02

Unknown

Then if it if the your mark or your information or skewed and it did go up at the cash value. Great question. And it segues really well to the next slide. Thanks for asking. So let's look at that example. What happens if prices increase. So in this case we're set it up the same way. December corn futures are trading at 455.

00:56:08:04 - 00:56:38:09

Unknown

We buy an at the money put it for 55 for \$0.15. We pay \$7 or \$750 on that, 5000 bushel contract. Harvest corn and prices go up. We sell cash. Corn at six for 65. Again, we're using zero basis here. December corn futures are trading at 465. So our December, 455 put it doesn't have any value.

00:56:38:10 - 00:57:01:05

Unknown

No one's going to give us if we sell. We sold it for 55 to get out of it today. Would have to buy it back at 465. So that's out of the money. Put it has no value. And so what would we do. Exactly. Right. We just let it expire. The option has no value. Again no one's willing to buy it from us.

00:57:01:07 - 00:57:23:07

Unknown

So the put has no value. We don't want to exercise it because by exercising it, we're going to automatically lose \$0.10 a bushel. So what was the net? Again the cost of that put was 750 a contract. That's all. We're out. We don't have to pay anything else other than that in brokerage fees. But as I mentioned, those are, you know, penny and a half, \$0.02 a bushel.

00:57:23:07 - 00:57:51:10

Unknown

They're they're pretty minimal. So then what was the net? Well, we got 465 for the cash corn. We paid \$0.15 a bushel for the option, so we actually ended up with 450, net for the corn. And so basically, we again, we've set a, floor, the minimum amount we have to to take for the, the product.

00:57:51:12 - 00:58:15:15

Unknown

But if prices rally, we take advantage of those, prices that are going up again, minus that, premium that we've paid. So in insurance terms, this is a situation where we didn't have a wreck due to prices and so or the house and burned down the prices didn't burn up. Bernice. And so because, we didn't have a claim.

00:58:15:17 - 00:58:51:04

Unknown

Yes, we're still at the premium price. But, again, we've we've had protection to a certain level. And again, a couple of things that people tend to like better about options and then, futures. At no point was I subject to margin call. I knew exactly what this was going to cost me. I knew up front \$750, and I've not locked in a price, minus basis.

00:58:51:06 - 00:59:08:08

Unknown

I've locked in a floor. But if the price goes up, I'm in a position to take the upper price. Questions about put options when prices increase.

00:59:08:10 - 00:59:31:10

Unknown

Let me go back one here. Let's talk about what you would do actually in this case, because we haven't talked about working with the broker, we will do that. Had some great questions via email last week, and I appreciate those. Anytime you have questions, send those along. One question I had was, what can you trade, futures contracts without a broker?

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Unknown

The answer is no. You have to have a broker. And, the situation is and very briefly, is that, the exchange, Grant, so many trading seats, those trading seats are very valuable, big companies on so many seats on the exchange. And those are the people that actually do the trading. And so in order to place, a trade, you have to go through a broker who goes through, a member on the exchange.

01:00:07:13 - 01:00:37:18

Unknown

And so every time you utilize that broker, you pay a fee and we'll go through the fee structure. But the other thing about an option is in this case where the option expired, it had no value. You don't do anything. You don't call your broker. I mean, there's no reason to, and you only pay the brokerage fee once you pay the fee when you bought the put.

01:00:37:20 - 01:01:12:07

Unknown

Now, in the, situation where you offset, the contract, you have two fees. You have the fee when you bought the put, and you also have the fee when you tell your broker to sell it to someone else because they have to do something. If you exercise an option, you pay three fees. You pay to buy the option you pay to exercise it, which in this case would mean to exercise.

01:01:12:09 - 01:01:37:11

Unknown

We would sell, we would get into the futures market with that position having sold a, a, December corn futures at 555. And we would tell our broker as soon as you exercise, offset it so they would exercise would be one thing. Offset would be the next one. So you could pay actually three fees under the scenario of exercising.

01:01:37:13 - 01:02:02:17

Unknown

Now brokers may have, ways they discount that. They may not charge you all three of those. But in essence, your broker has done three things on your behalf. If you exercise the option, they, you know, you they helped you buy it, they helped you exercise it, which puts you in a, position in the futures market.

01:02:02:19 - 01:02:17:15

Unknown

And they they also offset it to get you out of that position and so that you could collect, the difference between the two positions.

01:02:17:17 - 01:02:38:18

Unknown

Okay. Let's look at the other side of this. Let's look at how you might buy a call option to set a price ceiling. As we mentioned before, this would be something you would do if you use the commodity. So I'm a, cattle feeder, I buy corn, I buy feeder cattle. I would use call options to set the maximum.

01:02:38:18 - 01:02:59:06

Unknown

I would have to pay for those two inputs. And again, what I'm trying to do is to, lock in a price that provides a margin. A profit margin, helps me with budgeting, helps me with business planning.

01:02:59:08 - 01:03:22:18

Unknown

It's it's the, you know, it's a prudent thing to do. Great question here. Do you always have to trade in full contracts? You can do partials. You have to trade in full contracts. However, there are many contracts. So let's look at the grains of a contract for corn is 5000 bushels. A mini contract.

01:03:22:22 - 01:03:47:24

Unknown

Many contracts are a thousand bushels. So there are many contracts. The issue with the mini contracts is typically they don't have the volume that that that's a standard contract does. And so you don't see the market change as much with those mini contracts. We'll talk about as we go into this and get into market planning. And we've done this a little bit.

01:03:48:00 - 01:03:55:03

Unknown

We'll actually go through another, another example. But typically you would

01:03:55:05 - 01:04:26:20

Unknown

Utilize, you calculate how many contracts, you want to deal with based on crop insurance, based on, the number of cattle you produce. And, typically you would, hedge or use options, on less than, the full amount. Typically when you figure it out, you know, production doesn't work out 5000 bushel increments and 40,000 pounds for a cattle.

01:04:26:22 - 01:04:54:10

Unknown

Usually it's it's a contract plus part of a contract. So you, you know, always still in the full contract amount. For that reason, small producers may shy away from, futures and options and may prefer to do either for contracts. And some purchasers of accelerated forward contracts will do in less than 5000 or standard contract limits.

01:04:54:12 - 01:05:25:03

Unknown

And so that may be a way around it. But short answer is full contracts. But there are many contracts that are a thousand bushel contracts. Okay. So let's look at a call option with price increases. And obviously this is why you would buy a call option. You're concerned prices are going to increase and you want to set that ceiling, that maximum amount you have to pay.

01:05:25:05 - 01:05:50:22

Unknown

So we'll set this up the same way that we did before. Again corn futures are trading at 455. You're really concerned that prices are going to go up at 455. You've locked in the margin on the corn side. So you're happy with that. See, buying at the money call \$4.55. And again we're just using numbers. Let's say it's trading at that \$0.15 a bushel.

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So we know that that call is \$750 per contract. When you go to buy corn in November, cash corn is 485. So your hunch was right. Corn went up considerably by \$0.30 a bushel. And maybe at 455 at your margin, you can't make that work. So corn futures are trading at 485 that December call that particular day was trading at \$0.45.

01:06:18:04 - 01:06:49:15

Unknown

So what do you do? Well, certainly you don't let it expire because it has \$0.45 value. And in this case we're going to sell it to someone else for \$0.45. That's because, if we, buy we bought that call. At 455, we can get in the futures market and sell it for 85. And so, we'd make \$0.30, but the call is worth 45.

01:06:49:17 - 01:07:21:09

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So what does that tell us about that call? Well, one of the things it tells us is that, the time value is there's there's some time value involved there. There's \$0.15 worth of time value. And so, that's where that additional \$0.15 is coming from. So, that selling price of \$0.45, my minus our premium, that 15 that call option netted us \$0.30.

01:07:21:11 - 01:07:48:07

Unknown

We paid for 85 for the cash corn. We could subtract the \$0.30 we got from the call option. So in essence, we paid for 55, for that, that grain. Right. What we hoped the price, we hoped we would, when we put together and purchased that call option. So indeed, it did set a price ceiling for us.

01:07:48:09 - 01:08:18:05

Unknown

So what happens if prices decrease? So we've set it up the same way. But now we can buy corn at 440. Futures is trading at 440. Again that call would have no value because we've got we have the if we exercise that we can get in the futures market. But having bought corn at 455, if we sold it at \$4 440, which is where futures is trading today, we lose \$0.15.

01:08:18:07 - 01:08:54:13

Unknown

So again, the net cost of that option was 450 a contract. So we paid cash corn at 450. We've got to add that \$0.15 back to it because that's what we paid for the premium. So we bought corn at 455. Now in this example you know, it didn't make a whole lot of difference. But as you can see, if corn had been cash, corn had been for 30 or for 20, we would have seen that, that we would have been able to take that, lower movement in the market.

01:08:54:15 - 01:09:21:19

Unknown

So let's look at this graphically. Let's look at and this is actually based on other examples that we were given. So the top line here is that call option. So if we take where we got into the futures market at 455

and we had that 15 cent premium that we paid, we have actually set a ceiling the most would have to pay for corn at 470.

01:09:21:21 - 01:10:02:02

Unknown

But if that market goes down, we get the advantage of that down market. If the market goes up, the most we have to pay is for 70. If we'd look at this middle line, that's the futures contract. That's the price we get in at that futures contract at 455. And that's the price we've locked in. We've locked in a price, basis considered at that 455 range here would be our put option if we take that 455 include, that, cost of the premium, puts us about that 440 range.

01:10:02:04 - 01:10:34:22

Unknown

And so that's the lowest, that will accept or have to accept for a price. We've set a floor. If the price goes up, we're able to take that increase price. So again, one of the, the big, big, advantages with puts and calls for the options market as compared to a futures price because that futures locks in locks in a price space is considered.

01:10:34:24 - 01:10:51:16

Unknown

As you look at that questions about that concept, questions about the concepts of puts and calls versus futures.

01:10:51:18 - 01:11:15:12

Unknown

Now when I first looked at this the first thing that struck me is, okay, why would anyone ever trade in futures contracts? For one thing, I've locked in a price. If the market goes to my advantage up or down, depending on my position, that's favorable to me. I don't capture that. I've just locked in the price. So I don't like that.

01:11:15:14 - 01:11:49:11

Unknown

I'm subject to margin calls. They'll scare me. I don't like that. But we see a lot more people trade in futures. I shouldn't say that. We see we see people trading futures and options. So any idea if, you know, if this is the way this thing sets up, why would you and you have the opportunity to use an option, why would you ever trade a few straight futures contract.

01:11:49:13 - 01:11:56:01

Unknown

I mean, looking at this, it's hard to figure out why.

01:11:56:03 - 01:12:23:05

Unknown

Well, the basic reason that you would still consider a futures contract, even with all the advantages of the options markets, are those premiums can really be high. And so sometimes, we're going to look at a futures contract, even though we're subject to margin. Because if we understand

the concept of futures trading, we know that when we have a margin call, that means something good has happened in the cash market.

01:12:23:06 - 01:12:52:24

Unknown

And that if we keep that position on until we're ready to either sell the cash commodity or buy the cash commodity, the difference will all be made up minus basis. And so one of the things that we can have is an issue with, the options is we can get some pretty pricey, premiums. Now as we get, a little further in the class, we're going to show you a way that you can reduce the premium costs.

01:12:53:01 - 01:13:18:15

Unknown

And typically that involves, if you are a, producer of the commodity, writing a call, if you write a call, you get the premium. You're like the insurance company. Now you're subject to margin. So there's some things about that. But sometimes what we can do is write a call, collect the premium, and then take that money to reduce the price of a of a put premium.

01:13:18:17 - 01:13:44:02

Unknown

So it's a way we can reduce those premium costs. And so we'll go through some examples of how you can do that. It's a little more sophisticated a little bit more risk. But that's a method we can use to reduce the the cost of those premiums. And that is the biggest downfall with the options. Premiums can kind of be expensive.

01:13:44:04 - 01:14:12:14

Unknown

Okay. I want to go through another example of calls, but I want to throw a twist in this thing. And the twist is we're going to show how a producer of a commodity can use a call option. Now, typically if we're just talking price protection, if you produce a commodity, you deal inputs, you deal in the right to buy.

01:14:12:16 - 01:14:39:02

Unknown

Excuse me? To sell the futures contract. You want to sell it. But there are times when you may want to use a call option if prices have gone up. And as I mentioned earlier, one of the biggest stumbling blocks and convincing producers to pre harvest price crops is I always get this. Well, what if I lock in that price and tomorrow the price goes up I'm going to feel like an idiot.

01:14:39:04 - 01:15:07:03

Unknown

I can't show my face at the coffee shop. It's just devastating. And I always come back to, okay, what would be more devastating? You sell a \$4 corn contract as an example, and that, is a profit for you. You make money at it and the market goes to 410, or you have the opportunity to sell a \$4 corn contract.

01:15:07:05 - 01:15:32:04

Unknown

You thought the market would go up, so you didn't do anything, and you end up selling corn, for 350, which is below cost of production, for example. Personally, I would feel worse about selling at below cost of production if I had the opportunity to sell it, make some money. And so, you know, you got to play those games.

01:15:32:06 - 01:15:51:19

Unknown

But I tell people, there are times when even if you've sold the corn and maybe you didn't sell it at the, you know, the market went up after you sold it and you could have made more money. There are ways that you can recoup that market going up. And actually this would have worked really, really well this year.

01:15:51:21 - 01:16:16:03

Unknown

And once we get into market planning, one of the things that we have to establish are some pricing triggers. A point by, by where, at which, by a certain time, if the market reaches a certain price, I'm going to for forward price, a certain part of my production and typically it's a certain part of, of what I've guaranteed was crop insurance.

01:16:16:05 - 01:16:44:08

Unknown

And so this corn a lot of us and I can raise my hand and say it caught us as farmers when we were looking at building our marketing plan for 2020. We were doing this in, December of 2019. And so in order to set those price triggers, you need to do a little work with outlook. You need to have an idea of what we think prices are going to do in the future.

01:16:44:10 - 01:17:18:01

Unknown

And most people, try to to utilize information from the so called experts. And there are a lot of them out there and they do a better job than I do. They are experts and have them look into their crystal ball and say, this is what we think prices are going to do in the future, and we can even look at the futures contract, you know, even in, December of 2019, the 20 20th December futures contract was trading and that contract is, a pretty good guess at this point.

01:17:18:01 - 01:17:47:04

Unknown

A, you know, a reasonable guess of what prices are going to be. When we had corn to sell. And so our marketing plan, had some, triggers, at 350 and, another one at 375. So we sold some corn at 350, and we sold some corn at 375. Well, we all know what happened. You know, we had Covid and we had the, market.

01:17:47:04 - 01:18:09:04

Unknown

Just take a dive. And then the Chinese came in and started buying corn, buying corn, buying corn. And the market really rallied. But we'd already

committed to corn. We did this on four contracts, not options. So we were locked into those four contracts. And so this would have been a year where this strategy would have worked really, really well because that corn was committed.

01:18:09:06 - 01:18:30:12

Unknown

But as the prices started to rally, you could have used call options to take advantage of the rising prices. So let's go through a couple of examples and show you how this works. So we have sold all of our corn. It's at harvest. Everything's sold. We don't have storage I don't want to pay for storage at the elevator.

01:18:30:14 - 01:18:45:13

Unknown

And so we had pre harvest price corn of course, that was delivered upon and then the corn that we had over and above what we had pre harvest price, we just sold at harvest time because we didn't want to store it.

01:18:45:15 - 01:18:49:21

Unknown

So we sold cash corn at four bucks.

01:18:49:23 - 01:19:20:14

Unknown

Let's say that day July 22nd, corn futures were selling at 440. And I had a feeling they're going to go up. I think there's, you know, there's some issues with weather. I think there's a, an opportunity for, cash corn to be higher than 440 in July or before it expires. So again, I'm going to buy because I'm buying a call by a July 22nd corn call, at the money, 440 at \$0.15.

01:19:20:15 - 01:19:42:19

Unknown

So again, that \$750 to contract July 26th. And I probably need to back that date back a little bit. That contract probably expires before then. However, I may have looked this up and that may be the last trading day. But anyway, we want to be careful to make sure that that, the contract, that option hasn't expired.

01:19:42:21 - 01:20:03:18

Unknown

But during this time, we've had flooding in the corn belt. Planning is delayed. The crop that has emerged is in poor condition. In July, corn futures are at 480. That call I could sell to someone else for, \$0.35. So what do I do with the option? Well, do I let it expire? No, it's got value.

01:20:03:18 - 01:20:29:13

Unknown

I need to do something with it. Do I offset it? I could, but that calls for \$0.35. But I really would prefer to exercise it because, I bought a futures that, I can get in the market, by exercising my call, which means

I buy a futures contract at 440. I sell it at 480. So I made \$0.40, and so \$0.40.

01:20:29:13 - 01:21:08:21

Unknown

Mine is a 15 cent premium. That's another \$0.25 a bushel or 1250 a contract. So I sold my corn for \$4. I made \$0.25 on the option. So in essence, I sold corn for four and a quarter. And remember back here, as of November 20th, I didn't own a bushel of corn, but I can still trade in the call option, and I can still do that as a hedge because I'm a producer and that, profit of \$0.25 a bushel is ordinary income.

01:21:08:21 - 01:21:39:02

Unknown

It's not capital gains. Now, I have to be careful with this because I can only sell the contracts equivalent to my total corn harvest, or the total amount of corn I produced. Any, contracts above that. Those contracts are speculative, and those are subject to capital gains. There's a term for that. We call it a Texas hedge.

01:21:39:04 - 01:22:11:17

Unknown

When you trade more contracts than the, bushels or pounds of products that you produce, those additional contracts are speculative positions. And again, the trading term for it is a Texas hedge. What if this doesn't work? What if prices decrease? So again, we set it up the same way we harvest the corn, sell it for \$4 July contract to trading it for 40.

01:22:11:19 - 01:22:39:02

Unknown

I buy, a call at 440 for \$0.15. July 26th. The weather's great. The condition is mostly good. Excellent. Corn futures are four bucks. My calls not worth anything. What do I do with it? Well, it's just expires. It has no value. So what happened here? Well, my net return for buying the call. I paid \$0.15 a bushel.

01:22:39:04 - 01:23:08:11

Unknown

I sold the corn for \$4. I've got a, count in the option loss at 15. So the net on the corn was 385. So can you lose money on this? Absolutely. Can you lose money on corn in storage? Absolutely. And so, it doesn't work every time, but it is an opportunity, to, recapture part of the gains if you miss out on them.

01:23:08:11 - 01:23:19:13

Unknown

Because if Ford priced it too low or, sold everything at harvest because you don't want to store it, and the price rallies afterwards.

01:23:19:15 - 01:23:41:02

Unknown

Questions about this strategy. Is the better. I see you did a lot like six months in advance to the better to be on the longer term. Or is it can you do it on the short term? Good question. Longer term or shorter

term? It kind of depends on what the market is doing. You know, there's a march May in a July contract.

01:23:41:04 - 01:24:07:03

Unknown

I probably wouldn't do this on the march necessarily. I probably would do Mayor July because I'd really like to have a little bit more time for that contract to, you know, for things to happen in the market. Now, I think when I set this up and I need to go back, I think I picked July 26th. It's maybe that's the last date you would have to, do this or do something before the option expired.

01:24:07:05 - 01:24:35:00

Unknown

But one of the things that that you could do is you can you can turn this thing around any time you want to. You don't, you know, we're not waiting until a corn harvest or something like that. And so maybe I'm going to do this on the May contract for whatever reason. I think there's more opportunity there. And, you know, I put the thing on in two weeks, the market's going crazy, and that option is worth \$0.50.

01:24:35:02 - 01:24:56:10

Unknown

If I wanted to pull the trigger and sell it that day and take the profits, I could do it at any point. Or maybe I've got multiple, put options, and I might sell some of them and keep some of them going. So, that's kind of the other advantage with this thing is it's basically you can pull the trigger any time you want to do it.

01:24:56:12 - 01:25:24:10

Unknown

And so that, typically when we look at a futures contract, we offset it when we sell the cash corn. And the theory behind that is, when once we've sold the cash corn, we no longer have market risk and we've sold it, we've got the cash. We no longer have market risk. So we don't need that futures contract anymore.

01:25:24:12 - 01:25:55:09

Unknown

Now, let me throw out another thing here. Let's say that, and we did this year. This year I mentioned this, we actually, four contracted, 2021 corn in November. The earliest we've ever done this. So we've been putting together marketing plans for 20 years. But, we could for contract corn at four bucks and four bucks.

01:25:55:11 - 01:26:33:19

Unknown

What's the trigger? And we make money at four bucks. So we we contracted some corn at \$4. Well, once that corn is four contracted, we no longer have price risk. I mean, it's locked in. We know what we're getting for it. And in fact, when we were applying for our operating on loan renewal, we plugged in the price of that corn that we had contracted at four bucks, because it's there, you know, it's it's like, it's like a, you

know, somebody owes, you know, I've got account receivable or I've prepaid, and, you know, prepaid an expense.

01:26:33:21 - 01:26:56:21

Unknown

So it's it's locked in. We've got it because we'll, we'll back it up with crop insurance. So we, you know, it figured into our, our balance sheet, and cash flow, I mean, we've we've got it figured in there because we've got the contract. We could turn around. We could do this now. We could do this, this call option thing, because we've already priced it four bucks.

01:26:56:21 - 01:27:13:04

Unknown

The market is going up. And so I could I could, buy some call options and, be in a position to take advantage of improving prices on that corn that I for contracted in November.

01:27:13:06 - 01:27:36:06

Unknown

In that case, the market's got a lot of time to do funky things. And so that would that would be interesting to take a look at that. And probably what's going to happen is I'm going to kick myself that I haven't done it. That doesn't mean I still can't. And, as I, tell you about it, I'm kind of thinking to myself, you know, you oughta you ought to pencil this out.

01:27:36:06 - 01:27:59:16

Unknown

Maybe you want to do that on the corn. You've contracted because, you know, it's it has, you know, December corn. You know, I could do it on the December contract. December corn. What is it for 49? Something like that. I may not do December. I may do a contract. This, after December or spring contract for, 2022.

01:27:59:16 - 01:28:17:08

Unknown

But anyway, the point being that corn that I for contract, is not under price risk anymore, so it would fit. It would fit the scenario as well.

01:28:17:10 - 01:28:23:11

Unknown

Other questions about this.

01:28:23:13 - 01:28:48:18

Unknown

This could be hard to grasp. You know, when we're talking about futures, we're talking about how can I sell something that I haven't even planted, which basically is what you're doing, and this is how can I sell something that I've already sold? Because in essence, yeah, that's what you're doing. Your you're selling it again. And how can this be legal.

01:28:48:20 - 01:29:10:03

Unknown

You know which it is perfectly legal. People do it all the time. So it's it's it's kind of a concept sometimes it's it's hard to wrap your head around. Questions about it before we go on.

01:29:10:05 - 01:29:30:06

Unknown

Okay. I want to do the cross hedging like we did last week. But I want to show you you can do it with an option. Kind of the same concept. You know, we talked about it's hedging a cash commodity in a futures market of a different commodity. I've got some examples. One we looked at was swing calves and feeder cattle.

01:29:30:08 - 01:29:49:18

Unknown

We had to go through this example to determine how many contracts we could actually. And then from last week, how many we could hedge this week, how many we can, you know, we could set up or utilize an option with. And this is the same type of a process you're going to go through with a grain.

01:29:49:20 - 01:30:12:05

Unknown

Obviously, you know, it's it's a different process. But, you know, basically the way this works for a grain and we'll go through some actual examples, but, you know, based on your approach and based on most people, that the utilize their crop insurance as part of their marketing plan typically will look at a revenue protection crop insurance plan.

01:30:12:05 - 01:30:41:17

Unknown

Now, they're expensive. But there's some things that are important about that because because it's revenue, not only obviously does it take into account yield based on your age, but also takes an account into account, a, a price. And it's that, for example, you know, if you're looking at revenue protection insurance and corn, we're going through price discovery now to set that, that price point or that beginning price.

01:30:41:19 - 01:31:08:24

Unknown

And so, what we're really looking at is, you know, the revenue side for how much of our, production experiences are we going to be able to cover with, with this insurance, but are also looking at how many bushels do we guarantee and that number of bushels that we guarantee then gives us an idea of how many contracts can we pre harvest price.

01:31:09:01 - 01:31:38:22

Unknown

So we'll go through a crop example. But basically what we're doing here with feeder cattle would be the same thing we'd be doing with our crops and crop insurance as we develop our pre harvest marketing plan. So remember we looked at the table, we're trying to find out, what weight equivalent for, 5 to 6 weight steers are equivalent to that 50,000 pound feeder contract.

01:31:38:22 - 01:32:05:19

Unknown

We've got that number at 40,001 93. We determined that we could sell three contracts. A novice trader, probably only one, even an experienced trader. No more than two. Three contracts get you too close to that. The edges there. And it could be a situation where you wouldn't be able to deliver enough calves to make up. Two full contracts are your three.

01:32:05:19 - 01:32:39:01

Unknown

So you back it off to two. We went through the example here, and, I did make a correction. I'd use the wrong number. What we really did here was we went from, with this example, \$145.90. We added 333 100 weight from our futures gain. And so the net selling weight for those cattle should have been \$149.23, 100 weight.

01:32:39:03 - 01:33:15:04

Unknown

And we're going to do the options. What we do would do is buy and after money put and certainly livestock options are more expensive if you've got, higher value product. So that would cost us \$1.50. Again, we figured out how many calves would have to sell. In our example here, when we sell those cash calves, the, October 20th put was that one 3517 that put was worth \$2.80.

01:33:15:06 - 01:33:40:12

Unknown

And our example here we wouldn't let it expire because it has value. We would actually sell the put because the put is worth more than the futures position because we, sold a if we got in that, if we exercised the option, we could sell, a contract at one 3785. We could buy it back at one 3517.

01:33:40:14 - 01:34:14:11

Unknown

So we would net 268 where the puts forth 280. So it's got some some time value in it. So how does that work out? Well, we do the math on this one. One 4590 for the cash cattle. The option made us \$1.62 100. Wait. So our realized net on the cattle were 147, 52, 100. Wait.

01:34:14:13 - 01:34:41:02

Unknown

So we're finished a little early tonight, and I do that. There's there's a method to the madness. What I have found in the past is, options are a little bit more difficult to again, get your hands around. And I want to make sure we have ample time tonight for questions. Also, I've had people tell me that after this session, their head hurts.

01:34:41:04 - 01:35:08:17

Unknown

So if we do, close a little early tonight. Typically, I've never had anyone complain. They didn't think they got their money's worth after going through the discussion with the options. So I definitely want to give you ample time to ask any questions. I certainly don't mind

scrolling back through the slides. If there's a particular example that you've got questions about, we can scroll back and find it, you know, kind of work through it.

01:35:08:19 - 01:35:40:14

Unknown

As I mentioned, I did not include basis any of these. Obviously. So they're set up like a perfect cage. But again, we could just subtract the basis difference from the net. In situations where, well, in all situations we in the cash market and, and get the true, bottom line, of what we would be looking at with, the options transaction.

01:35:40:16 - 01:36:11:11

Unknown

So again, questions chat box, unmute the mic comments. From what you've learned today tonight and use your little show of hands icon there just on the face value of this. How are you think you might initially be more comfortable with using options than futures?

01:36:11:13 - 01:36:38:16

Unknown

Okay, we've got a few of you that the options might be a little bit, you might be more comfortable. Okay. Any of you the other way around? I think the futures maybe actually are easier for you to understand. You prefer to go that route. Okay, great. Very good. And that's that's pretty comparable. We're about 5050.

01:36:38:16 - 01:36:52:07

Unknown

And of those that you responded and that's typically what what I get at, when I ask that question after this, this session.

01:36:52:09 - 01:37:17:11

Unknown

Other questions comments. So on a would you prefer, negative basis, them. Okay. Now, make sure we've got the right terminology. Negative basis is going to refer to the cash market. Did you mean to say an out of the money, put.

01:37:17:13 - 01:37:50:05

Unknown

Yeah, I think so. Okay. I think you probably did because, one of the, yeah, one of the ways you reduce, premium cost is to go with an out of the money put and so very often people will do that. Typically that the, the further away you get from where the futures is trading or at the, at the money position, the, at the money strike, the further away you get from that, obviously the premiums go down, but the volume goes down.

01:37:50:05 - 01:38:13:05

Unknown

Fewer people are trading those. So people who do out of the money puts typically because of volume issues and, you know, trying to get someone to take the other side of the trade for you. They may be out, 1 or 2

levels or three, from where the futures are trading or the, the money. But that is the strategy.

01:38:13:08 - 01:38:31:17

Unknown

A lot of people do that to reduce the cost of those, premiums. Look at what are the out of the money positions. Good. Good question.

01:38:31:19 - 01:38:47:22

Unknown

Last shot, last call, last call for questions. I don't want to belabor this, but certainly if you've got questions or comments, I want to make sure you have plenty of time to to express those.

01:38:47:24 - 01:39:18:14

Unknown

Okay. So next week we're going to start this process to develop a marketing plan. I will spend a little bit of time on the, broker. There's a couple of issues in those five, you know, common mistakes people make and marketing that we want to address. But, after next week, the last four weeks is really going to be a combination of adding new tools to your toolbox and helping you develop a pretty simple marketing plan.

01:39:18:14 - 01:39:40:18

Unknown

But I think that that all of you could put together based on what you've learned so far and at least have a plan moving forward. And then I'll give you some resources. If is something you really get into and you wanted to get more sophisticated, I mean, there's some really good stuff out there and you can develop some very, very sophisticated marketing plans if you so desire.

01:39:40:18 - 01:40:04:00

Unknown

So just kind of a preview of, of what, the class will look like, moving forward. So again, I appreciate your time tonight. If you have questions, feel free to, send me an email. Hopefully we'll have this recording posted. It's usually, you know, between futures and options, these are the two that most people are.

01:40:04:02 - 01:40:23:11

Unknown

A greater number of people will go back and take a look at. So, please feel free to do that. And I will have a challenge for those of you that are doing a commodity challenge, related to options. So with that, I'll say, good night and, we'll see you back here, a week from tonight.

01:40:23:13 - 01:40:29:02

Unknown

And, will, kind of wrap a few things up. So have a good rest of the week.

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