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How Farmers Can Use the Futures Market

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Hedging in the futures market offers many advantages to corn producers, but each producer must decide for himself whether he wants to use the futures market as a marketing tool and if so, to what extent.

There are many reasons to use the futures market:

1. To lock in a price that is acceptable. You might not get the highest possible price for your crop by hedging, but you can usually choose a price that is profitable to you.

2. To avoid large losses and transfer the market risk to someone else. By hedging your crop in the futures market, you transfer most of your marketing or price risk to the buyer of an offsetting contract. While you are not able to take advantage of large price increases that might occur after you hedge your crop, you are also protected against large price declines.

3. To make production decisions. The futures market can give you clues about future prices of the different crops you might grow in any given year. It can help you decide whether to grow corn at all that year or how much corn to grow compared with soybeans.

4. To decide when to expand your operation. Hedging your crop in the futures market can give you the assurance that you will have the money to make your payments at the end of the year.

5. To get credit easier. If you have your crop hedged, your lender will usually lend you a higher percentage of your crop's value. Loans of up to 90 percent of the value of hedged commodities are not unusual.

6. To evaluate other marketing alternatives. Even if you decide not to use the futures market in your own operation, you can use futures quotations to help judge the fairness of cash or cash contract prices. By knowing the normal basis in your area, you can spot abnormal situations and time your storage and sale decisions for more favorable prices.

DEVELOPING A HEDGING PHILOSOPHY

Once you decide that you do want to hedge your corn in the futures market the next step is to develop your own personal hedging philosophy. This will depend upon your own ideas and goals as well as the characteristics of your operation.

-- The size of your production will determine how much you can participate in futures trading. On the Chicago Board of Trade, which handles most corn futures contracts, the minimum number of bushels that may be traded is 5,000. The Mid-America Commodity Exchange handles contracts of 1,000 bushels, which allows small corn producers to participate in the futures market.

-- The stability of your production -- or your ability to come up with a normal crop each year -- will also affect the extent that you should participate in the futures market. You should never hedge all of your anticipated production before your crop is produced, since you always want to be sure that you have as many bushels of corn to sell as you have hedged in the futures market. This is the only way you can be sure of a successful hedge.

-- Your willingness to accept risk is probably the main factor that you should consider in developing your own hedging philosophy. If you are financially independent and can survive large losses, you might prefer to take your chances with the cash market every year and leave the futures market to others.

But, fewer and fewer farmers are willing to carry all the marketing risk themselves -- particularly young farmers with large debt loads and relatively small equity in their operations.

KINDS OF HEDGES

Probably the most common kind of hedge used by corn producers is *the production hedge*. This type of hedge establishes a future price for a corn crop that is yet unplanted or one that is growing.

The other common type of hedge that corn producers use is *the storage hedge*. This is a hedge that locks in a specific return to storage for corn that is held at harvest time for later sale. The storage hedge requires the same decision procedures that you go through in deciding whether to place a production hedge.

1. The first step is to *calculate a price objective or asking price for your growing or stored crop*. You start by figuring your costs. For stored grain, you must calculate your direct cost of storage and add this figure to the market price of your corn at harvest. Whether you are considering a growing or a stored crop, you should add a desired return to management and a desired profit. You can then arrive at a total asking price per bushel.

2. The second step is to *localize the quoted futures price*. To do this, you must subtract your normal basis from the Chicago futures for the time you will be delivering the grain and then subtract the cost of the hedging transaction.

3. The last step in deciding whether to hedge is to *make the hedging decision itself*. In other words, you must decide whether to accept the price the futures market is offering you.

CHOOSING A BROKER

Once you feel that you understand the principles of hedging and you decide that you want to try it, you need to select a broker to handle your business. This is one of the most important decisions you will make in setting up a hedging program. It's good to visit several brokers before you pick the one you want.

Here are some suggestions to help you locate a broker:

-- If you have a securities account with a brokerage firm, that same firm may have a commodities department, or it may refer you to one.

-- Other farmers who are regular hedgers are good contacts.

-- Your local grain elevators or merchants probably have hedging connections and can suggest brokers to you.

-- Your local banker probably knows several brokerage firms who are qualified to handle hedging accounts. If not, your banker certainly can obtain a list of firms for you if he has a correspondent banking relationship with a major city bank that is active in helping its borrowers hedge.

-- The major commodity futures exchanges, such as the Chicago Board of Trade, will give you a list of firms in your area whose representatives have passed the necessary examinations and have met the other requirements to handle your commodity accounts.

When you find a broker you like, discuss your hedging philosophy with him thoroughly. Let him know everything pertinent about you and your business. Don't be afraid to ask him hard questions about his knowledge and experience in hedging corn. Be sure he has the proper understanding and experience with hedging, not speculating, before you do business with him. If he talks about routinly getting in and out of the market with a hedged account, more than likely he doesn't understand hedging and could get you in trouble.

When you are satisfied with a broker, open an account.

CHOOSING A LENDER

The lender you choose can also make or break you in the hedging business. Unless you are financially independent, you will need a lender to finance occasional margin calls for you. If your lender understands hedging, he will be willing to finance your margin calls. He will understand that the market is on the rise and the value of his collateral is increasing. If you have a lender who doesn't want to finance your margin calls, you have the wrong lender.

DEVELOPING OTHER SOURCES OF INFORMATION

In additon to the information your broker will provide for you, you should learn all you can about hedging from other sources such as:

-- Newspapers which carry daily futures quotations, like The Wall Street Journal.

-- Radio stations which carry periodic grain price quotations. Find out what time they broadcast in your area, then tune in to follow market trends.

-- Most commodity exchanges have publications available which explain how the futures market works. You might write to.

The Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

The Chicago Mercantile Exchange
44 Jackson Blvd.
Chicago, Illinois 60606

The Mid-America Commodity Exchange
343 S. Dearborn
Chicago, Illinois 60604

-- Most land-grant colleges or universities have publications about the futures market.

-- The following USDA reports can be obtained by writing the Office of Information, USDA, Washington, D.C. 20250.

Weekly Grain Market News
Feed Situation
Fats and Oils Situation

MANAGEMENT PRACTICES TO FOLLOW

As you begin your hedging experience, be sure to keep these precautions in mind:

1. Don't hedge all of your anticipated production. A good rule of thumb is to hedge only up to about two-thirds of your expected crop.

2. Be sure to properly calculate your basis, your production or storage costs and your anticipated profits -- in other words, your asking price -- before you lock in a price in the futures market. If you don't know what you are doing, you can lock in a loss as easily as you can lock in a profit.

3. Be prepared to meet margin calls. If you don't have the cash, be sure your lender is prepared to finance you.

4. With storage hedges, keep your hedging contracts about equal to the amount of cash grain you have in storage.

5. Buy back your futures contracts on the same day that you sell your corn in the cash market.

TEN DON'TS IN HEDGING

-- Don't enter the futures market until you understand it.

-- Don't ask your broker to make management decisions for you.

-- Don't combine hedging and speculating.

-- Don't hedge unless you know your "basis."

-- Don't hedge if you can't meet additional margin calls.

-- Don't view futures markets as an outlet for delivery of your corn.

-- Don't think of futures markets as a way to get higher prices.

-- Don't lift your hedge before you sell or buy your commodity in the cash market.

-- Don't forget that hedging insulates you from subsequent major price changes--both downward and upward.

-- Don't expect hedging to be a cover-up for poor management.

SUMMARY

The futures market is an advanced and sophisticated system of trading in contracts for future delivery. It's a marketing tool that you can use to accomplish many objectives, but it is not a "get rich quick" scheme, and it is not simple. To be successful at hedging, you should develop your own hedging philosophy and then learn all you can about the futures market and how it works. Choosing the right broker and lender is extremely important. Once you have found the right people to work with, you should constantly develop new sources of information. Then, if you will follow the right management practices, your chances for success are excellent.

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