

Buying Hedge with Futures

What is a Hedge?

- A buying hedge involves taking a position in the futures market that is equal and opposite to the position one expects to take later in the cash market.
- The hedger is covered against input price increases during the intervening period.
- If prices rise while the hedge is in place, the higher cash price the producer must pay for his or her inputs is offset by a profit in the futures market.
- Conversely, if prices fall, losses in the futures market are offset by the lower cash price.

Five Steps to Implementing a Buying Hedge

- Analyze the expected profit of the enterprise in question. For example, a cattle feeder should analyze how expected profits for fed cattle change as corn price changes. Only then can the producer know if the corn price he could hedge would allow the cattle feeding enterprise to achieve its corn pricing goal for the period, holding all other input prices and animal performance constant.
- Be sure to hedge the correct quantity. Check contract quantity specifications and be sure the proper amount of inputs is hedged.
- Use the proper futures contract. Most widely produced agricultural commodities have a corresponding futures contract. Fed and feeder cattle, hogs, corn, wheat and soybeans are a few examples. A notable exception is grain sorghum. Because grain sorghum's close price relationship to corn, producers can use corn futures to manage grain sorghum price risk. Once the proper futures contract is selected, pay close attention to the contract month. Project the date of the anticipated cash market transaction and select the nearest futures contract month after the anticipated purchase in the cash market.

Five Steps to Implementing a Buying Hedge *cont.*

- Understand basis and develop a basis forecast. Basis is the relationship between local cash prices and futures prices. If projected basis and actual basis at the time of cash purchase are the same, then the purchase price that was hedged will be achieved. Failure to account for basis and basis risk could mean not meeting the buying hedge pricing goal.
- Be disciplined and maintain the hedge until the commodity is purchased in the cash market or the hedge is offset by another price risk management tool. Producers should hedge only prices that are acceptable to them. Once you have initiated a hedge position, do not remove the hedge before the cash purchase date without carefully considering the risk exposure.

Table 1. Buying Hedge for Feeder Steers

	Cash Market	Futures Market	Basis
June 15	Objective: to realize a feeder cattle purchase price of \$104.00/cwt	Buys two CME November Feeder Cattle contracts at \$105.00/cwt	Projected at -\$1.00/cwt
October 1	Buys 120 head of 750-lb feeder steers at \$110.00/cwt	Sells two CME November Feeder Cattle contracts at \$111.00/cwt	Actual basis -\$1.00/cwt (\$110.00 - \$111.00)
Gain or loss in futures: <i>Gain</i> of \$6/cwt (\$111 - \$105)			
Results:			
Actual cash purchase price\$110.00			
Futures profit- \$ 6.00			
Realized purchase price\$104.00*			
*Without commission and interest			

Table 2. Buying Hedge for Feeder Steers with Price Decline

	Cash Market	Futures Market	Basis
June 15	Objective: to realize a feeder cattle purchase price of \$104.00/cwt	Buys two CME November Feeder Cattle contracts at \$105.00/cwt	Projected at -\$1.00/cwt
October 1	Buys 120 head of 750-lb. feeder steers at \$100.00/cwt	Sells two CME November Feeder Cattle contracts at \$101.00/cwt	Actual basis -\$1.00/cwt (\$100.00 - \$101.00)
Gain or loss in Futures: Loss of \$4.00/cwt (\$101.00 - \$105.00)			
Results:			
Actual cash purchase price\$100.00			
Futures loss+\$ 4.00			
Realized purchase price\$104.00*			
*Without commission and interest			

Table 3. Advantages and Disadvantages of a buying hedge with futures.

Advantages	Disadvantages
Reduces risk of price increases	Gains from price declines are limited
Could make it easier to obtain credit	Risk that actual basis will differ from projection
Establishing a price aids in management decisions	Futures position requires a margin deposit and margin calls are possible
Easier to cancel than a forward contract arrangement	Contract quantity is standardized and may not match cash quantity.