Overview of Price Risk Module 3: Marketing Alternatives to Manage Price Risk: Advantages and Disadvantages

This presentation provides an overview on the advantages and disadvantages of cash-based and futures/options-based marketing alternatives for grain producers. Selecting a marketing alternative should be based on a thorough comparison of available alternatives. It is unlikely that one alternative will consistently be the best choice. Selecting a marketing alternative helps determine not only the type and level of risk, but the risk management alternatives as well.

While selling a commodity in the spot market may be simple and fairly straightforward, marketing, in most circumstances, is not. Marketing is a complex activity because there is no single best alternative and because markets change constantly. There are many factors that affect markets, and as markets change, the preferred ranking among alternatives may also change. Markets are influenced by a wide variety of economic variables that are influenced by uncertain forces like human behavior, international politics, and crop growing conditions around the world. The appropriate marketing strategy has to fit the individual. When comparing marketing alternatives, the producer should look for the alternative that provides the highest net return, while reducing income variability and providing an acceptable level of risk. Trying to maximize short-term income without considering the impact on long term income variability and risk can be a serious mistake.

Producers should use a thoughtful and structured approach when evaluating marketing alternatives. Having set criteria can make this process easier. The order of listing of the criteria does not imply a ranking. The ranking or relative weight given each factor should depend on the individual's situation

The marketing alternatives discussed are those generally, but not universally available for grain. Grain produced for a very specific end use or one that is not commonly produced in a particular geographic region may present the producer with added marketing challenges. A producer should identify the viable marketing alternatives before planting.

Market cost should include opportunity cost, not just the dollars expended. When grain is held in storage, interest on loans continues to accumulate and should be counted as a marketing cost. If there are no outstanding loans, the forgone interest is a marketing cost. The potential impact of the marketing alternative's cost should be considered when developing cash flow projections. This is particularly true of hedging where margin calls are a factor. And while it may be harder to quantify, the time a producer spends on marketing should also be considered.

Futures/options-based marketing alternatives add complexity. Part of the complexity is nothing more than a lack of familiarity with terminology. Education and experience helps.

In general there is a direct relationship between the potential for a higher return and risk. There may also be a higher cost associated with this greater potential return. Storage for later sale may mean increased risk from storage losses. A cash forward contract may eliminate price risk, but now production risk takes on increased importance. Crop insurance may become more crucial with cash forward contracts. Deferred pricing and basis contracts put the producer in the position of an unsecured creditor in a bankruptcy. Futures-based marketing alternatives shift price risk to basis risk. In cases where cross hedging is required, basis may be less predictable than cash and would therefore increase rather than decrease risk.

Since the cost of the different marketing alternatives can vary considerably, it is important to compare the net selling price, not the gross.

Market outlook should also be considered when evaluating marketing alternatives. If the market outlook indicates that prices will stay flat or decline, why hold the grain? One advantage of options is that they allow the producer to participate in some of the gain if the price moves up. In a flat market there is little upside price potential. So why spend the extra money on a call option if you believe the market will stay flat? An understanding of how market outlook affects the alternative marketing alternatives is important to using them effectively.

The financial situation of a farm business should certainly be considered when evaluating alternative marketing opportunities. Much of the farms ability to withstand risk can be determined from analyzing financial statements.

The cash-based alternatives and the advantages and disadvantages are self-explanatory.

Pricing grain with futures/option-based marketing alternatives still means the grain will be sold in the local cash market, or whatever market is traditionally used. The net selling price to the producer is the combination of the cash market and the futures/options transactions. The effectiveness of a pricing mechanism is influenced largely by the producer's ability to accurately predict the basis. Hedging will not allow the producer to participate in any price improvement. The cash flow implications of margin calls should also be considered. Options, on the other hand, do allow the producer to gain when prices increase. They allow the producer to establish a minimum selling price and there is no margin requirement.

Choosing among marketing alternatives gives a producer some influence over the type and the amount of risk they will face. Using marketing alternatives effectively as a risk management tool requires understanding the advantages and disadvantages, in addition to the knowledge of how and when to use them.

Marketing Alternatives To Manage Price Risk: Advantages & Disadvantages

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SLIDE 3.1 ***Marketing overview***

- Marketing is a complex activity with many alternatives.
- No single "best" or "recommended" strategy fits all growers, or even one grower from year to year.
- Objective: find alternative that has:
  – *highest net return*
  – *reduces income variability*
  – *acceptable level of risk*

SLIDE 3.2 ***Criteria for Evaluating Marketing Alternatives***

- Availability
- Cost
- Complexity
- Level of risk
- Type of risk
- Net selling price
- Market outlook
- Financial Situation
- Constraints

SLIDE 3.3 *Cash market based marketing alternatives*

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- Sell at harvest: grain is delivered and sold for cash at harvest in a convenient market.
- Advantages:
  - + *no costs or inconvenience of storage*
  - + *no accumulating interest costs*
  - + *easily understood*
  - + *price is known immediately*
  - + *no shrink or deterioration*
- Disadvantages:
  - – *shortens marketing window*
  - – *harvest price is often lowest*
  - – *eliminates other cash-based alternatives*
  - – *congestion at elevators*

SLIDE 3.4 *Cash market based marketing alternatives*

- Storing for later sale: grain is placed in on-farm or commercial storage and sold at a later time determined by the grower.
- Advantages:
  - + *extends pricing decision window*
  - + *increases delivery flexibility with on-farm storage or increases delivery convenience with commercial storage*
  - + *return on storage if price rises*
- Disadvantages:
  - – *quality may deteriorate*
  - – *decreased delivery flexibility if stored commercially*
  - – *increased storage and interest costs*
  - – *risk of adverse price change during storage*

SLIDE 3.5 ***Cash mark et based mark eting alternativ es***

- Cash forward contracts: prior to harvest, grower signs a contract to deliver a fixed quantity and grade of grain as a specified price, and at a specified location.
- Advantages:
  - *+ extends pricing decision window*
  - *+ eliminates risk of adverse price or basis change*
  - *+ easy to understand*
  - *+ available in convenient quantities*
- Disadvantages:
  - *– increases production risk; delivery is an obligation*
  - *– reduces flexibility when market conditions change*
  - *– no gain if price rises or basis strengthens*

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SLIDE 3.6 ***Cash mark et based mark eting alternativ es***

- Deferred pricing contract: grain is delivered to a commercial elevator and sold by a specified date at a price to be determined in the future. Price is tied to local posted bid or a terminal market bid.
- Advantages:
  - *+ extends pricing decision window*
  - *+ gain when prices rise*
  - *+ may eliminate or reduce commercial storage fees*
  - *+ possible advance payment*
  - *+ convenient contract quantities*
- Disadvantages:
  - *– interest cost and storage fees*
  - *– unsecured creditor in bankruptcy*
  - *– risk of adverse price or basis change until grain is priced*
  - *– potential repayment of advance*

SLIDE 3.7 ***Cash market based marketing alternatives***

- Basis contract: grain is delivered to a commercial elevator and sold prior to a designated date at a specified amount above or below a futures price (or basis).
- Advantages:
  - + *extends pricing decision window*
  - + *may reduce commercial storage costs*
  - + *no risk of adverse basis change*
  - + *convenient contract quantities*
  - + *possible advance partial payment*
- Disadvantages:
  - – *unsecured creditor in bankruptcy*
  - – *risk of adverse price change until grain is priced*
  - – *potential repayment of advance*
  - – *basis knowledge is required*

SLIDE 3.8 ***Futures and options based marketing alternatives***

- Hedging with a futures contract:
  - – *Actual or expected cash market position is offset by selling appropriate amount of futures contracts.*
  - – *Futures contracts are "bought back" when grain is sold on cash market.*
  - – *Net price received is a combination of the cash market and futures transactions.*

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SLIDE 3.9 *Cash market based marketing alternatives*

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- Hedging with a futures contract:
- Advantages:
  + *extends pricing decision window*
  + *risk of adverse price change is eliminated*
  + *easy to reverse position (liquidity)*
  + *basis is more predictable than price*
- Disadvantages:
  – *risk of adverse basis change*
  – *margin requirements increase interest costs & may cause cash flow problems*
  – *contracts only in fixed increments*
  – *requires knowledge of futures & basis*
  – *eliminates gain from rising cash price*

SLIDE 3.10 *Futures and options based marketing alternatives*

- Using an option contract:
  – *A put option(s) that allows the holder to take a futures position is purchased for the actual or expected cash position.*
  – *Options can be exercised, sold, or allowed to expire.*
  – *Net price received is a combination of the cash market and options market transactions.*

SLIDE 3.11 ***Futures and options based marketing alternatives***

- Using an option contract:
- Advantages:
  - + *extends pricing decision window*
  - + *risk of adverse price change is eliminated*
  - + *partial gain from rising cash price*
  - + *eliminates margin requirements*
  - + *easy to reverse position (liquidity)*
- Disadvantages:
  - – *risk of adverse basis change*
  - – *cost may be greater than price protection*
  - – *contracts in fixed quantities only*
  - – *requires significant knowledge and substantial data*

SLIDE 3.12 ***Marketing alternatives can help manage risk***

- Risk cannot be eliminated.
- Using marketing alternatives effectively requires understanding and knowledge.
- Managing price risk must be integrated with production and financial risk management.

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