

**MARKET TECHNIQUES AND STRATEGIES
FOR USING FEED COMMODITIES**

by

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Producers are asking several questions about factors that will have major short-term and long-term impacts on American agriculture. No one, including myself, can provide all the answers today. The best we can do is be aware and ready to react as the answers become apparent and the impact on your marketing plan becomes evident.

The big question: "Is the end of the war bearish to the general economy and the agricultural economy?"

The recent reduction in the discount rate by the Fed due to the poor economic performance shows it's obvious the administration and the Fed are worried. While we have won the war, can we win and pay for the peace? This is where it's tricky to determine the impact of war. Initially, it contributed to a mild recession by turning businesses and consumers conservative on spending. This reduces the size and growth of the general economy and eventually will reduce government tax revenues. At the same time the federal deficit is increasing and demand for government services is increasing. Now that the war is over, consumers and businesses must begin to loosen their purse strings; otherwise, the dollar could continue to decline. That could impact the grain export market. In effect, many buyers will continue buying hand-to-mouth if they perceive the reduction in the dollar will offset any modest increase in prices due to seasonal rallies.

Specific to agriculture there are still some big factors to be determined this year. The GATT trade talks may be coming to an agreement with the E.C. over reduction of some subsidies and duties. My opinion is, don't hold your breath for a big breakthrough. Any impacts in this area will be long-term, so don't expect quick results. My biggest fear is we will have three large economic sectors: North America, the European Common Market and the Far East.

Without some reduction in trade barriers, overall economic activity will be adversely affected. More immediate to grains is an announcement by Secretary Yeutter that he is requesting permission to uncap the EEP Program.

It appears the Program will see an increase of \$475 million this year and include all commodities in the Program.

In summary, it appears to me that the demand side of the question for domestic and foreign usage of our corn and beans is the real big gray area for the market at this time.

Granted, as June and July approach, a short-term focus on supply will occur. The yearly tug of war between corn and beans planted acreage plus the traditional summer weather scare will surface.

With regard to plantings, enough corn acres should be sown to ensure an adequate crop under normal growing weather conditions. The December 91 corn market rally is allowing producers to lock in a selling price of \$2.70, enough to motivate some to drop out of the farm program and move into full production. I don't look for a big increase in soybean acres, because the corn deficiency payment of 58 cents a bushel will produce estimated returns in excess of 30% over fixed and variable costs.

As a result, protection for feed needs is necessary only for the April through September time period. If nothing develops in the weather this summer, the market will quickly go back to focusing on demand to indicate how high or low the clearing market price must go.

As a side note on soybeans, the unseasonably sharp gains in cotton and rice because of the drought in California production areas could potentially reduce the amount of bean acres planted in the Delta. This I believe is the real short-term wild card for bean plantings. This strongly suggests that meal needs must be protected from now through September also.

CORN

The corn market is now entering a time period of some strong seasonal characteristics and increased market volatility. The cycle pattern suggests a high in late April to early May, a low in mid-June, and a final high in early July. For the July contract, a low of \$2.50 should be difficult to break. A close below \$2.42 strongly suggests a major trend reversal and would be very bearish. In the popular press I have heard discussions of \$2.90 to \$3.00 price levels this summer. While I would like to say this is a shoe-in, my instincts suggest it will only occur if dry and hot weather develop. For the feed buyer this implies the primary risk time period is from now to early August.

Case Study: 500 Dairy Cow Operation

For the purposes of this presentation, I will base my calculations on the figures given to me by Dr. Beede. I will assume that a 500 milking cow operation with 60 dry cows and 400 replacement heifers will consume 55,000 bushels of corn (11 contracts) and 40,000 bushels of soybeans (8 contracts). Because of time restrictions, I will restrict my analysis of alternatives today to only corn. (The techniques used in corn can easily be applied to soybeans.) I want to discuss with you the cash flow requirements, projected profit/loss, and advantages and disadvantages of each alternative.

Marketing Plan Objective

The specific objectives of a marketing plan heavily depends upon:

1. The flat price outlook;
2. The intensity of market volatility; and
3. The degree of market risk a producer can handle.

It should be your objective to develop a marketing plan that gives you:

1. Adequate price protection;
2. Control of cash flow exposure; and
3. A program you can emotionally handle.

1991 Feed Buying Strategies

I will discuss five techniques today:

1. Buy futures -- December at \$2.65.
2. Buy calls -- \$2.70 through \$3.00 December calls.
3. Vertical bull call -- Buy \$2.70 calls; sell \$3.00 calls.
4. Straddle or Fence -- Buy \$2.70 December call; sell \$2.40 puts.
5. Sell puts.

Strategy #1. Buy December Futures at \$2.65.

This strategy is the standard technique for protecting a future cash buying decision. The advantage is it protects future cash transactions in a 1 to 1 ratio.

The disadvantage is it has high cash flow consequences if the timing of the buy decision is wrong.

To compare all alternatives we will look at three pricing situations. This examines the cash flow impact and revenue enhancement if prices move to \$2.20, \$2.65 and \$3.40 basis the December futures by the first of December.

Margin Requirement	\$300/contract @ 11 = \$3,300		
Commissions	\$ 70	@ 11 = \$ 770	
Per bu.	\$2.20-\$2.65 (\$2,320)	\$2.65-\$2.65 \$70	\$2.65-\$3.40 \$3,680
Total farm unit	(\$25,520)	(\$770)	\$40,480

In summary, this alternative gives unlimited upside potential; but, if prices drop, one is locked into the \$2.65 futures floor. The win/loss potential ranges from (\$25,520) to \$40,080 or a price range of \$65,600. While the benefits are high, I believe the adverse consequences of negative cash flow make this alternative very difficult for farmers to implement even if the \$2.65 floor gives one a good cost of production. This leads to a logical question: Is there any way to develop a floor price, but eliminate the destructive consequences of a high cash flow obligation?

Alternatives 2 through 5:

All of the following objectives are designed to give one a floor and attempt to reduce the negative cash flow obligation of the transactions. The key to which Alternative 1 picks is heavily influenced by:

- a. One's opinion on the flat price outlook, i.e., how high or low will the market move over the time period in question.
- b. As important as flat price is, how volatile will the market move over the time period in question. In options, one quickly learns that correct volatility projections are just as important as flat price outlooks.

Strategy #2:

By December \$2.70 calls for 16 cents OR buy December \$3.00 calls for 7 cents.

The purchase of a call gives one the RIGHT, but not the OBLIGATION to accept the underlying futures contract. In this capacity, one can relate purchase of calls to an insurance

policy. The more coverage you want, the more you will pay. Like insurance, you will also pay a premium or a renting price for the protection.

Cash Flow Requirements

\$2.70 Call: .16 @ 5000 = \$800	\$3.00 Call: .07 @ 5000 = \$350
Commission: 70	Commission: 70
No Margin Required <u>-0-</u>	No Margin Required <u>-0-</u>

Total Cash Flow: \$870/5000 bu. Total Cash Flow: \$420/5000bu.

	<u>\$2.20</u>	<u>\$2.65</u>	<u>\$3.40</u>
\$2.70 Call	(\$ 870)	(\$ 870)	\$ 3,080
Total Farm Unit	(\$9,570)	(\$9,570)	\$33,880
\$3.00 Call	(\$ 420)	(\$ 420)	\$ 1,580
Total Farm Unit	(\$4,620)	(\$4,620)	\$17,380

As you can see, the down side is limited to the premiums paid. The amount of gain is reduced by the premiums paid. Here comes the critical question: How certain of the flat price outlook are you? Since purchased calls are a wasting asset, one must have market violence to make the strategy work. Remember, as a buyer of calls, time is your worst enemy and volatility is your best friend.

Since my opening comments suggest that limited upside potential exists unless significant weather problems develop, I would recommend feed buyers consider purchasing the cost of the \$3.00 calls. The reason: Because of my fundamental and technical prospective, I would recommend clients only have catastrophic insurance rather than full coverage.

This now leads to another logical question: What if I don't want all the insurance?

Alternatives 3 through 5 are all more intense in their design. The success or failure of each alternative is dependent upon the correct interpretation of trend and volatility. The advantage of the following alternatives is to reduce the cost of ownership of a price floor close to "zero"; in exchange one has to give up potential or accept some type of price risk.

Strategy #3: Vertical Bull Call Spread

This strategy is my most favorite conservative way to maintain coverage, but at a more reduced cost. The reason is it has no margin risk and a relatively low cost.

Buy one \$2.70 call \$.16 @ 5000 = Cash Flow \$800
 Commission 70
****NO MARGIN REQUIRED**** (\$870)

Sell one \$3.00 call \$.08 @ 5000 = No Margin \$400
 Commission 70
****NO MARGIN REQUIRED**** 330
 TOTAL COST/5000 Bushels \$540

	<u>\$2.20</u>	<u>\$2.65</u>	<u>\$3.40</u>
2.70/3.00	(\$ 540)	(\$ 590)	\$ 960
Total Farm Unit	(\$5,940)	(\$5,940)	\$10,560

There are several variations of this strategy one can develop, but the key is for the reduction of cost of the insurance, one must be willing to give up upside potential. This strategy is for producers who feel there is some upside potential, but not explosive potential.

Strategy #4: Strangle Strategy

This strategy provides one the unlimited feature of the futures position but a slightly less risk potential of the futures.

Buy \$2.70 December corn call for \$.16 @ 5000 = (\$800)
 Commission: 70
****NO MARGIN REQUIRED**** (\$870)

Sell \$2.40 December corn put for \$.08 @ 5000 = \$400
 Commission: 70
****MARGIN REQUIRED VARIES \$150 - \$300.** \$330

Sell \$3.00 December corn call for \$.07 @ 5000 = \$350
 Commission: 70
\$280

Total Cost at Expiration \$260

Total Cash Flow \$800 + Margin 300 + Commission 210 = \$1,310

	\$2.20	\$2.65	\$3.40
Strangle	(\$ 1,260)	(\$ 260)	\$ 1,240
Total Farm Unit	(\$13,860)	(\$2,860)	\$13,640

The strangle strategy, as you can see, is second to futures in downside price risk. While I've illustrated a sit and hold strategy, realistically one will only write the puts and calls in conjunction with the trend and seasonal. This strategy has the potential to be extremely profitable if one

is willing to work with the strategy. The problem is one has to be more involved than he/she would be with the previous three alternatives.

Alternative #5: Writing Puts

Writing puts is a very seasonally sensitive technique. This means one should write puts between December and June. Writing calls between July and December is generally recommended. Remember, as a writer, time is your best friend while volatility is your worst enemy. The writer not only receives the premium paid, but also has the full risk of a position. Since feed buyers like to be long calls, the exercising of a put is an extremely good way to be paid to wait to place a long position in place. At this time I would limit selling puts to July futures.

Sell July \$2.60 puts for \$.10	\$500
Commission:	<u>70</u>
MARGIN REQUIRED	\$430

Sell December \$2.30 puts in July for \$.11	\$550
Commission:	<u>70</u>
MARGIN REQUIRED	\$480

Cash Flow (\$140)....Initial Margin \$300 per contract.

Total gain if calls expire worthless = \$910.
Per Farm Unit \$10,010.

As you can see, this strategy is very seasonally specific and provides one significant contribution to future cash purchases. If the July futures closes below \$2.60 on June 20, a long position will be assigned to you.

The second part sells the December \$2.30 puts on high implied volatility of the summer highs at the strike price you would be willing to be long. The total gain from this strategy is \$910 plus you will be assigned a long position at your desired price. The disadvantage of this strategy is, if the market explodes to the upside, your gain is limited to your premium received.

I realize I have given you a lot of material in a very short time period. The point I want to leave you with is this: With the development of options, one is now able to design a marketing strategy to the specific needs of your operation. It is now possible, based upon your flat price outlook and cash flow restrictions, to design a customized program. The only factor one has to determine is the degree of risk one wants to accept for the specified gain in the market.