IOWA COMMODITY CHALLENGE

Futures Hedging

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Futures Hedging

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- Hedging: taking an equal and opposite position in the futures market than you have in the cash market.
- A farmer hedges by taking an action now in the futures market that they will take later in the cash market.

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Futures Hedging Example

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DATE	CASH	FUTURES	BASIS
Start date		Sell now	
End date			
Results			

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Basis

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- The difference between the cash price and futures price. Many factors influence basis: local supply/demand, etc.

- The calculation for basis is:

Cash Price	–	Futures Price	=	Basis
\$3.10	–	\$3.55	=	- 45¢
\$9.00	–	\$9.60	=	- 60¢

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Basis

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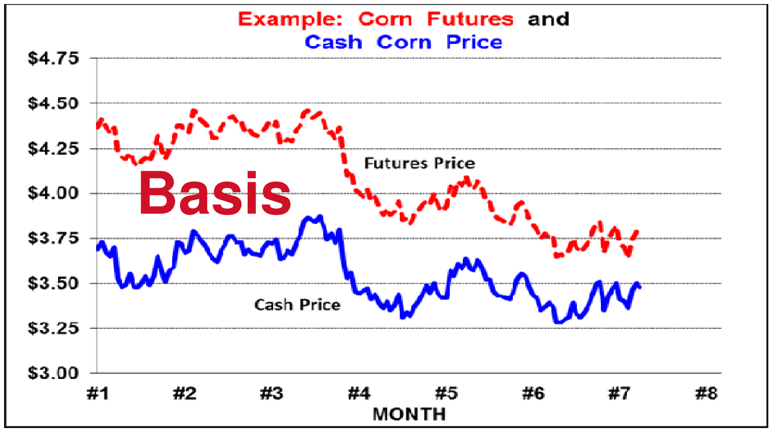
The difference between the local cash price and the underlying futures price of a commodity.



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Example futures hedge story

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- It's November: goal is to sell 5000 bu. of cash corn in late Feb. at $3.70.
- Estimated basis for late February is -30¢ (cash under March futures).
- March corn futures are sold at $4.00.
- **What happens if price goes lower or higher?**
- **Hedging examples do not include commissions and interest.*

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Hedging Example (market lower)

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DATE	CASH	FUTURES	BASIS
November	Goal: $3.70 Cash Corn	Sell 1 March Corn @ $4.00	Estimated: - 30¢
Late February	Sell Cash Corn @ $3.25	Buy 1 March Corn @ $3.55	Actual: - 30¢
Results	- 45¢	+ 45¢	0.00

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Hedging Example (market lower)

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DATE	CASH	FUTURES	BASIS
November	Goal: $3.70 Cash Corn	Sell 1 March Corn @ $4.00	Estimated: - 30¢
Late February	Sell Cash Corn @ $3.25	Buy 1 March Corn @ $3.55	Actual: - 30¢
Results	- 45¢	+ 45¢	0.00

Net Hedge (without commissions and interest cost)

1. Original futures less actual basis = net hedge
   $4.00 – 0.30 = $3.70
2. Cash sale to buyer +/– futures gain/loss = net hedge
   $3.25 + 0.45 = $3.70

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Hedging Example (market lower)

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DATE	CASH	FUTURES	BASIS
November	Goal: $3.70 Cash Corn	Sell 1 March Corn @ $4.00	Estimated: - 30¢
Late February	Sell Cash Corn @ $3.25	Buy 1 March Corn @ $3.55	Actual: - 30¢
Results	- 45¢	+ 45¢	0.00

Net Hedge (without commissions and interest cost)

1. Original futures less actual basis = net hedge
   $4.00 – 0.30 = $3.70
2. Cash sale to buyer +/– futures gain/loss = net hedge
   $3.25 + 0.45 = $3.70

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Hedging Example (market higher)

IOWA COMMODITY CHALLENGE

DATE	CASH	FUTURES	BASIS
November	Goal: $3.70 Cash Corn	Sell 1 March Corn @ $4.00	Estimated: - 30¢
Late February	Sell Cash Corn @ $4.10	Buy 1 March Corn @ $4.40	Actual: - 30¢
Results	+ 40¢	- 40¢	0.00

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Hedging Example (market higher)

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DATE	CASH	FUTURES	BASIS
November	Goal: $3.70 Cash Corn	Sell 1 March Corn @ $4.00	Estimated: - 30¢
Late February	Sell Cash Corn @ $4.10	Buy 1 March Corn @ $4.40	Actual: - 30¢
Results	+ 40¢	- 40¢	0.00

Net Hedge (without commissions and interest cost)

1. Original futures less actual basis = net hedge
   $4.00 – 0.30 = $3.70
2. Cash sale to buyer +/– futures gain/loss = net hedge
   $4.10 – 0.40 = $3.70

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Hedging Example (market higher)

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DATE	CASH	FUTURES	BASIS
November	Goal: $3.70 Cash Corn	Sell 1 March Corn @ $4.00	Estimated: - 30¢
Late February	Sell Cash Corn @ $4.10	Buy 1 March Corn @ $4.40	Actual: - 30¢
Results	+ 40¢	- 40¢	0.00

Net Hedge (without commissions and interest cost)

1. Original futures less actual basis = net hedge
   $4.00 – 0.30 = $3.70
2. Cash sale to buyer +/– futures gain/loss = net hedge
   $4.10 – 0.40 = $3.70

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Key points:

Futures Hedging

- The cash market, futures market and basis can be tracked in futures hedges.
- A futures hedge works in lower and higher markets.
- A Hedge-To-Arrive cash contract is similar to futures contract hedging.

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