



www.dairy.nu Presents...

OPT FOR PUT OPTIONS

BY DAVE KURZAWSKI 4/22/05

There is an old saying in the commodity business that “High prices cure high prices”. Regrettably, there is no one-liner for when high prices cure high prices. Thanks to a variety of risk management strategies utilizing the Class III futures and options market, which has been developing over the past 10 years, dairy producers now have a number of different methods to go about protecting a profit during those times of high futures prices. Dairy producers won’t likely get a one-liner to when any time soon. With the risk management tools currently available, they don’t need one anyway.

One successful way to manage risk is to simply sell futures prices at profitable levels. After the banner year for milk prices in 2004, dairy producers are gun-shy about selling the above average futures prices 2005/06 has to offer. Some think there’s no way prices could fall back to \$13.00 or, even, \$12.00/cwt, so they don’t see a reason to hedge. Others envision more room to the upside. Still others are unsure where prices will end up and are interested in hedging their production, but are certain that they don’t want to leave the kind of money on the table that they did last year. Put option protection is a reasonable consideration for all three mindsets.

Put options allow a dairy producer to take an active role in the price he receives for his milk, without limiting the upside potential. What’s the catch? There is no “catch”. There are simply guidelines and rules of using put options to effectively hedge your milk production and there are only certain times – under certain market conditions - when buying put options is a viable strategy.

WHAT IS A PUT OPTION?

A put option gives the option buyer the right to sell (go "short") the underlying Class III futures contract at a predetermined price – the strike price. As a hedger, you will usually be a buyer of a put option – a buyer of price insurance. But before you decide to protect your price, you need to understand and be comfortable with the process. Strike prices are available in 0.25/cwt increments on both sides of the Class III futures price for any given month. For example, \$12.00 strike, \$12.25 strike, \$12.50 strike and so on both below and above the futures prices. The closer the strike price gets to the current Class III futures price in a given month, the more expensive it becomes (intrinsic value). Using an insurance industry analogy, the strike price is the

deductible. In other words, the higher the Class III floor price in a given month, the more price protection your farm receives and the more money you pay to buy that protection. As a dairy producer, you should concern yourself with strike prices below the futures market prices.

The money you pay to buy put options is called premium – again, the same vein as insurance (plus brokerage commissions and fees). The premium is derived by a mathematical formula that takes into consideration a number of variables, intrinsic and time values as well as futures price volatility to name a few. For this article, you do not need to know how they are priced beyond what has been discussed, however, you should be aware of what is a reasonable price and when to buy given those variables.

What you pay in premium is your risk exposure in buying put options. If the announced Class III price is above your strike price, your put option will expire worthless and you will lose your premium. From a hedge standpoint, this is what you want to have happen. Think about our insurance analogy. You don't hope to use your car, health or life insurance yet you happily pay for the coverage every month. Milk price protection in the form of put options is no different.

How do you decide a reasonable strike price; a reasonable floor price? First, you need to gather information on what your costs of production are – your breakeven. There is no sense in setting a floor price \$1.00/cwt below your costs. Once you get a figure in mind as to what it costs you to produce milk every month, your broker should have a good idea of what premiums are trading at and what the market is doing to help guide your decision.

If you are without good advice, remember to (a) keep a lid on premium expenses at 0.35/cwt to 0.40/cwt, which may hinder your ability to go out more than seven or eight months in the future (time value), and (b) be a buyer when you don't think you need the protection (intrinsic value). You may also want to consider the volatility of the market. If the class III market is giving you motion sickness, it's probably not a good time to be a buyer of put options.

Think about it another way: if you were to buy home insurance as a tornado were ripping your home from top to bottom, your insurance agent probably wouldn't sell you any homeowners insurance – but if he did you'd pay dearly for it. Likewise, if Class III prices are falling, premiums for put options will be more costly possibly keeping you from getting coverage. Word to the wise, buy your insurance on a sunny day.