At the bank, we don’t claim to be marketing or hedging experts. There are others out there whose licenses suggest they are the experts. However, all of our lenders and management have a solid understanding of how the various tools work. There is some homework to do prior to engaging into the world of marketing, whether with cash contracts or futures and options. In past articles we have outlined the importance of arriving at accurate breakeven cost of production analysis. We know that there is more involved in those calculations than just seed, chemical, fertilizer, and rent—or feed intake on the livestock side. One must include overhead expenses such as equipment payments, family living, hired labor and relatively smaller things like personal property taxes, supplies, repairs, etc. Once a solid number for cost of production is reached, one can develop marketing targets regardless of the type of marketing tool used. Most lending institutions recognize that futures and options are not for everyone, and that is no exception with our lenders.

WHAT CONSIDERATIONS DOES THE BANK MAKE REGARDING PRODUCERS WHO USE FUTURES AND/OR OPTIONS?

- Before providing credit needed to fund a hedging program, we will evaluate several elements of the borrower.
- The borrower’s overall financial condition.
- The borrower’s level of understanding of futures/options.
- The borrower’s plan for using futures/options in their marketing program.
A good hedging plan will follow the guidelines surrounding the definition of a true hedge.

In our own words, the definition of a true hedge is having an equal and opposite position in the futures market as compared to one’s physical commodity position. For example, a person with 100,000 bushels of corn in the bin is already “long” 100,000 bushels of corn. Therefore that person should have no more than 100,000 bushels worth of futures “short” positions at any given time. In a case where 50,000 bushels of the 100,000 are hedged, then we know that the other 50,000 is simply either unprotected, or that other portion may be protected with various cash contracts with a local buyer, in which case additional futures positions should not be added to bushels already contracted to a buyer in the cash market.

Also, what we view as a true hedge should not be “lifted” until the physical commodity is sold. Otherwise, if a hedge is lifted early or late, there is a period of time of exposure in the market where any protection offered by the hedge could potentially be erased if the market moves the wrong direction. Of course, one can reason that if a hedge is lifted at a profitable level and the market, in turn, moves in the favorable direction, increasing the price of the physical commodity, that could end up working out better on those bushels. However, early lifting of a hedge also represents an increase in risk and therefore defeats the purpose of risk management. The key to remember is hedging is similar to an insurance policy in that it is about managing risk, not necessarily hoping you collect. A person hoping to collect on a hedge is also then hoping the markets decrease, which hurts the price of any unprotected production.

**HOW DO FUTURES/OPTIONS AFFECT BORROWING?**

When all questions are answered and both lender and borrower are comfortable with the program to be used, often the bank will set up a separate line of credit with an estimated limit that is used strictly for the hedging portion of the business so as not to tie up the operating line of credit that helps fund regular operating expenses. That said, such a limit may at times be increased if the market moves against the hedge to where margin calls need to continue being funded—this ties back to keeping with the definition of a true hedge to prevent premature exit.

The key to remember here is that as long as the hedge is handled according to the true definition of hedging, and is handled in a disciplined manner by the borrower, the price of the physical commodity will change likewise to where when the physical commodity is sold and hedge(s) lifted, the originally locked-in net price will be realized (not considering changes in basis). That net price received being above or below breakeven cost is the ultimate measure of success in terms of final profitability on that production.

As one might guess, futures and options can be a useful strategy for risk management. As mentioned, we recognize it may not be for everyone to where cash market alternatives can be effective as well. We recommend finding the risk management that suits you best, or can simply help you sleep a bit better, is the way to go.