AgriLIFE EXTENSION
Texas A&M System

Selling Hedge with Futures

What is a Hedge?

- A selling hedge involves taking a position in the futures market that is equal and opposite to the position one expects to have in the cash market, so one is covered (subject to basis risk) against price declines during the intervening period.
- If futures and cash prices decrease while the hedge is in place, the lower cash price the producer realizes for his production is offset by a profit in the futures market.
- Conversely, if prices increase, losses in the futures market are offset by the improved cash price.

Steps to Implementing a Selling Hedge

- Analyze the expected profit of the enterprise in question. Whether or not you decide to implement a selling hedge will depend somewhat on the cost of production for the enterprise and on having an acceptable profit expectation. However, protecting an acceptable profit might not always be possible. A prudent manager might also use a selling hedge to limit losses when market conditions dictate.
- Be sure to hedge the correct quantity. Check contact quantity specifications and be sure the proper amount of a commodity is hedged.
- Use the proper futures contract. Most widely produced agricultural commodities have a corresponding futures contract. Fed and feeder cattle, hogs, corn, wheat, and soybeans are a few examples. A notable exception is grain sorghum. Because of grain sorghum's close price relationship to corn, producers can use corn futures to manage grain sorghum price risk. Once the proper futures contract is selected, pay close attention to the contract month. Project the date of the anticipated cash market transaction and select the nearest contract month after the anticipated sale in the cash market. Futures contracts expire before the end of the month and this ensures that all cash sales will take place before futures contracts expire.

Steps to Implementing a Selling Hedge *cont.*

- Understand basis and develop an accurate basis forecast. Basis is the relationship between local cash prices and futures prices. Basis is defined as cash minus futures. If projected basis and actual basis at the time of purchase are the same, then the selling price that was hedged will be achieved. Failure to account for basis and basis risk could mean not meeting your selling hedge pricing goals.
- Be disciplined and hold the hedge until the cash sale of the commodity or until the hedge is offset by another price risk management tool. Producers should hedge only prices that are acceptable to them. Once you have initiated a hedge position, do not remove the hedge before the cash sale date without carefully considering the risk exposure.

Table 1. Selling Hedge for Corn

	Cash Market	Futures Market	Basis
March 5	Objective: to realize a corn sales price of $5.60/bushel	Sells three CBOT December corn contracts at $5.65/bushel	Projected at -$0.05/bushel
October 10	Sells 15,000 bushels of corn at $5.40/bushel	Buys three CBOT December corn contracts at $5.45/bushel	Actual basis, -$0.05/bushel ($5.40 - $5.45)
Gain or loss in futures: Gain of $0.20 ($5.65 - $5.45)			
Results:			
Actual cash sales price ……………………………………………$5.45			
Futures profit ………………………………………………………+$0.20			
Realized sales price ………………………………………………..$5.60*			
*Without commission and interest			

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Table 2. Price Increase on a Selling Hedge for Corn

	Cash Market	Futures Market	Basis
March 5	Objective: to realize a corn sales price of $5.60/bushel	Sells three CBOT December corn contracts at $5.65/bushel	Projected at -$0.05
October 10	Sells 15,000 bushels of corn at $5.85/bushel	Buys three CBOT December corn contracts at $5.90/bushel	Actual basis, -$0.05/bushel ($5.85 - $5.90)
Gain or loss in futures: *Loss* of $0.25 ($5.65 - $5.90)			
Results:			
Actual cash sales price $5.85			
Futures loss ....-$0.25			
Realized sales price $5.60*			
*Without commission and interest			

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Table 3. Advantages and Disadvantages of a Selling Hedge with Futures.

Advantages	Disadvantages
Reduces risk of price increases	Gains from price increases are limited
Could make it easier to obtain credit	Risk that actual basis will differ from projection
Establishing a price aids in management decisions and can help stabilize crop income within a crop year	Year-to-year income fluctuations may not be reduced with hedging
Easier to cancel than a forward contract arrangement	Contract quantity is standardized and may not match cash quantity
	Futures position requires a margin deposit and margin calls are possible