AgriLIFE EXTENSION
Texas A&M System

Introduction to Options

The Basics of Options

- An option is an agreement between two parties, a buyer and a seller.
- In the case of futures contract options, the buyer acquires the right, but not the obligation, to buy or sell a specific futures contract at a known fixed price at any time on or before a known expiration date.
- There are two types of options: PUTS and CALLS. They offer opposite pricing alternatives.
- Each offers an opportunity to take advantage of futures price moves without actually having a futures position.
- A put option gives the buyer the right to sell in the underlying futures market and a call option gives the buyer the right to buy.

The Basics of Options (continued)

- Unlike futures, after paying the option premium the buyer has no further obligation.
- Purchasing options does not require margin deposits.
- What you can do with an option:
    - Allow it to expire
    - Exercise the option
    - Offset
- Option premiums are determined by open outcry of bids on the trading floor of the exchange.
- The buyer of the option determines the delivery month and strike price he desires.

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CASE EXAMPLE: Put Option

A producer expects to harvest 500 bales of cotton.

In June, the March cotton futures is at 71 cents per pound. The producer buys a put option contract for a strike price "at-the-money", at a premium of 4 cents per pound. As the cotton is coming up, the October crop report comes out and says that there will be a record cotton crop. As a result, March cotton futures crop to 60 cents per pound. The put option is now up to 11 cents per pound. The producer has the option to sell this put to someone else for a premium of 11 cents per pound.

		cents/pound
June:	March Futures	71.00
	March put premium	4.00

		cents/pound
October:	March Futures	60.00
	March put premium	11.00

		cents/pound
Result:	March premium paid	-4.00
	March premium received	11.00
	Commission charge	-1.00
	Net gain (loss)	6.00

CASE EXAMPLE: Call Option

A producer expects to harvest 500 bales of cotton.

In June, the March cotton futures are at 71 cents per pound. The producer buys a call option contract for a strike price “at-the-money”, at a premium of 4 cents per pound. As the cotton is coming up, the October crop report comes out and says that there will be a record cotton crop. In this case, March cotton futures drop to 60 cents per pound. The call option is now worth almost nothing.* A trader will not want a call option that allows him to buy March futures at 71 cents per pound, when he is currently able to purchase March futures at 60 cents per pound.

		cents/pound
June:	March Futures	71.00
	March call premium	4.00

		cents/pound
October:	March Futures	60.00
	March call premium	0.00

		cents/pound
Result:	March premium paid	-4.00
	March premium received	0.00
	Commission charge	-1.00
	Net gain (loss)	-5.00

*The call option will probably still have some value to it. There will still be some time value associated with the option. The option does not expire until the middle of February and March futures could still go back up increasing the price of the option.

Additional Information About Options

- Depending on the strike price, options can be purchased one of three ways:
  - ✓ In-the-money
  - ✓ At-the-money
  - ✓ Out-of-the-money
- Caution: if selling options, margin calls may occur if the market moves against your position.
- There is limited financial obligation with options.
- Options allow a producer to take advantage of favorable price moves and protects against unfavorable moves.