**Price Risk Management for Cow-Calf Producers: Part 4**

Rachael Brooke
Phillips-Rooks District Extension Agent
Agriculture and Natural Resources

Cow-calf producers use various strategies to manage price risk. Hedging is a formal price risk management tool that allows a producer to directly manage the risk associated with changes in expected market prices.

*Background*-Today most agricultural commodities are traded in futures markets—largely under the CME Group (Chicago Mercantile Exchange). Local or cash prices are generally driven by futures prices, plus any differences in transportation costs, nearby markets, etc. Future markets allow for "price discovery" when there are enough potential buyers and sellers that are willing to commit to purchase or sell a specific amount of a specific commodity at a future date. Today very little physical delivery of commodities occurs, but futures markets are widely used by market participants to manage price risk in commodity markets. Better knowledge of current and expected price levels allows a business to make decisions and plan for the future.

Buyers and sellers of commodities use futures markets to "hedge" or protect their anticipated profit margin from unexpected prices changes. This article focuses on hedging feeder cattle. Producers can hedge feeder cattle prices with either futures or options. We will use the example of a producer who is calving in February and plans to sell around mid-August.

A futures contract allows a producer to set a specific price at a future date, subject to changes in basis, or the difference between cash and futures prices. The current August futures price for feeder cattle is around $186 per cwt. A hedge is placed by establishing a short position ("selling") for an August feeder contract at $186 per cwt. If actual August futures and cash prices are *lower* when calves are sold, the producer's loss in the cash value of the calves is balanced by a gain in the value of the futures market position. However, if actual August prices are *higher*, the producer's gain in the cash market is balanced by a loss in the futures market. Further, if futures prices go up, the producer may face a "margin call" or have to put additional money into a "margin account". Margin calls may be a disadvantage of a futures contract for some producers.

An options contract, or a 'put option' in the case when you are selling feeder cattle, gives the producer the right but not the obligation to sell at a specific price in a specific futures contract. For example, a producer selling feeder cattle in August currently can purchase a put option at strike price of $186 per cwt. This put option would cost around $7.50 per cwt and allow the holder to sell the August contract at $186 any time before expiration. This position sets an effective price floor around $178.50 per cwt plus expected basis. The producer can still benefit from higher actual prices, less the cost of purchasing the option.

There are a few other considerations. A producer must pay a commission to a broker to establish a futures contract or purchase an option. A potential disadvantage of using futures is the necessity of tying up capital, temporarily, in a margin account. The cost of purchasing an option may deter some producers. Another issue for cow-calf producers may be the required minimum contract size of 50,000 pounds, which is equivalent to about seventy-one 700-pound calves.

For more information, please contact the local K-State Research and Extension Office.
K-State Research and Extension is an equal opportunity provider and employer.
*Information provided by: Jennifer Ifft, K-State Department of Agricultural Economics*