Agricultural Futures and Options

Principles and Strategies

SECOND EDITION

Wayne D. Purcell
Stephen R. Koontz

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PREFACE

In a historical context, highly visible trade in commodity futures is still relatively new. During the 1960s and 1970s, price volatility in the agricultural commodities increased significantly. Changes in government policies and increased exposure to a world market brought price uncertainty to the grain and oilseed complex. Volatile prices for feedstuffs, fluctuating demand for beef and pork, and short-run changes in the number of cattle and hogs in feeding programs brought increased price variability to the livestock complex. Exposure to the risk of unpredictable price fluctuations became a major economic problem for agricultural producers.

In the 1980s, still other sources of risk surfaced. Interest rates moved to unprecedented levels and became more volatile. Exchange rates for the major world currencies fluctuated. The U.S. stock market proved vulnerable to the surrounding economic instability and stock prices began to fluctuate, often wildly. The 1985 farm bill legislation paved the way for loan rates often well below market prices, and grain prices became even more volatile as exposure to global market uncertainties was accentuated.

To an economic environment that was increasingly characterized by exposure to price risk came new futures instruments and a revitalization of older instruments. The grain and oilseed futures were more widely used. Futures contracts in live (slaughter) cattle were initiated in 1964, and trade in hog futures followed in 1966. Feeder cattle futures were started in 1971. Interest rate and foreign currency futures were initiated in the 1970s, and trade in stock index futures burst on the scene in 1982. A bit later in the 1980s, trade in options on futures for the agricultural commodities was authorized, and a significant new and flexible price risk management tool was introduced. All the developments were motivated by a common objective: to provide a means of protecting against increasingly dangerous and unpredictable fluctuations in cash prices.

In the 1990s, the trends toward uncertain market conditions increased their speed. The North American Free Trade Agreement and the General Agreement on Tariffs and Trade formalized the moves toward increased world trade. New farm bill legislation, passed in early 1996, brought an end to the long-standing programs of acreage set-asides and deficiency payments. Even the dairy farmer was now facing price risk. The need for effective price risk management escalated.

Potential users of the futures and options markets are sometimes intimidated by change and the introduction of new services. Adaptation and use are often delayed.

Beginners often perceive the markets to be complex and obscure, but they are neither. The primary objective of this book is to provide the beginning student of the markets with the understanding and basic tools needed to use the futures markets and options on futures contracts effectively.

In terms of level, the first edition of this book was written with a third-year student in a college or university program in mind. It was intended also to fit the needs of the second-year student in a two-year program. It was definitely a beginning-level book. The only prerequisites were an interest in the markets and some exposure to basic principles of economics. The student or the private-sector reader who is interested and curious and who has no formal education in economics should have been very comfortable with the book.

The book was designed for a one-semester course or a two-quarter sequence. Each succeeding chapter was designed to take a logical step forward in the education process. Both fundamental (supply–demand) and technical analysis (charts, chart interpretations, etc.) are stressed. The orientation is toward the agricultural sector, but the relatively new financial futures were also covered.

This second edition builds on the basic framework of the first edition. Coverage of options on futures is expanded, with more attention to option premiums. Options on futures are increasingly popular with decision makers, and more detailed coverage is merited. Separate chapters on foreign currencies and on stock market applications have been added. As our exposure to a global market grows, currency exchange risk becomes more important and has direct ramifications for the American farmer. And all the markets—stock, financial, agricultural, currency—are becoming closely intertwined.

Each chapter contributes to the base of understanding on risk management, but Chapter 11 is perhaps the most important chapter in the book. It integrates the fundamental and technical analyses of the markets and demonstrates strategies tied to the financial position of the firm and to the abilities of the firm manager. Chapters 1 through 10 provide the necessary base and Chapter 11 pulls it all together in what is intended to be a unique and creative way.

Chapters 12 and 13 put it all in a proper perspective. The tools that will allow successful use of the futures markets and options are relatively easy to acquire. The perspective and the discipline that are sufficient conditions for effective use of the markets are not that easy to acquire. Throughout this new edition, that thread of thought is present, and a conscious effort is made to deal with the intangibles of the market as well as the more apparent and observable dimensions. An explicit example of this orientation is Chapter 6, which deals with the psychology of the markets and of the trader.

In putting the initial book together some choices had to be made. Not everything can be or should be covered in one book. Many futures instruments including crude oil, gasoline, and lumber are not covered in any detail. The coverage of financial futures and foreign currencies was limited to one chapter, and that reflects another choice that was difficult to make. It is important for the beginner in these markets to recognize the risk of volatile interest rates and the implications to export demand of changing exchange rates. The expanded coverage demonstrates those issues and contributes to the breadth of the book that is so important in a beginning treatment. The new chapter on stock market futures and options applications reflects the growing importance of futures-based risk management in this important market.

References listed at the ends of the chapters were selected because they deal with the concepts in the chapters. There is no attempt, in a beginning-level book, to provide an extensive listing of the literature, and that approach represents another choice that had to be made. In the end, we focused on a coverage that is sufficiently broad to give the reader an accurate impression of the scope of activity in futures, but is sufficiently detailed to give the important working knowledge of futures trade.

All this is important. The futures markets offer tremendous economic potential to the individual decision maker and to sectors of our economy. The individual has the opportunity to manage exposure to price risk. A particular sector, such as the agricultural sector, has the opportunity to transfer the costs of exposure to price risk to the speculator who is outside the sector and who is willing to accept that risk.

We need to move to use of the markets from an understanding of what they can and cannot do with an open mind and from an informed perspective as to what trade in futures and options on futures can offer. Contributing to that perspective has been an equally important objective of the book. As readers, we hope you enjoy reading this edition of the book as much as we have enjoyed preparing it.

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