In today's volatile environment -
Are futures still a viable marketing tool?

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Let's say a farmer wanted to do the right thing a couple of summers back and lock in a futures price of $10.00 on 5,000 bushels of 2011 soybeans. At the time, $10.00 looked pretty good. His elevator was not willing to offer a booking contract that early in the season so he decided his only alternative was to sell a futures contract.

That same summer, our producer wanted to lock in a futures price of 80.00 cents on 100 bales of 2011 cotton. Once again, his buyer was not yet in the picture so he sold a futures contract. The idea was to hold the futures contract until a cash sale is made to a buyer.

By the following spring, in order to hang on to one contract of soybeans and one contract of cotton our producer would have had to send in over $41,000 in order to meet margin calls. That was for two contracts. Consider producers who hedged a significant portion of their expected production that summer. The numbers got big in a hurry.

Anyone who used the futures markets to hedge risk last season in any meaningful way had a tough time. The money required turned out to be much more than most were expecting. That made for some sleepless nights for elevator managers, cotton buyers and certainly any producer hedged in the markets. It was basically a replay of the 08/09 season.

We have now seen extreme margin volatility in two of the last four seasons. That has many of us involved in agricultural marketing asking a fundamental question**. Should producers still consider futures a viable marketing tool?**

First, some background. Selling futures is a way for producers to lock in a futures price without having to set the basis. When it is done through a buyer it is called a hedge to arrive contract. When it is done in the producers own brokerage account it is called a futures hedge. If you sell futures and prices go up, you are required to send in money matching the unrealized loss in the future position. That is the infamous "margin call". If done properly, you will get the money back when you sell your production into the cash market but that may be months down the road. Meanwhile, you must tie up capital.

The Perfect Storm

For years, futures were rarely used by producers because most cash buyers were willing to offer hta contracts two and even three seasons ahead. A producer was able to capture an attractive price anytime during the season simply by calling his or her buyer. That changed after the 2008 season.

Most cash buyers decided after the bull market of 08/09 occasionally having to borrow millions of dollars to margin hta contracts for two or three years was not something they wanted to do anymore. The only reason many were willing to book that far out prior to 2008 was for competitive reasons. With everyone now on the same page, that competitive incentive is no longer there.

That decision was bad news for producers because it dramatically reduced their marketing season. Cotton, soybean, corn and wheat futures will now trade for year to a year and a half before most buyers are willing to offer a contract. Buyers are basically saying, "Mr. Farmer, if you want lock in prices early in the season, you will have to do it yourself".

In addition to a much longer marketing season, producers with on-farm storage saw another advantage to selling futures. They are able to protect a futures price without committing to a particular buyer. That puts them in position to shop basis after harvest giving them flexibility and leverage which often results in a much better cash price.

At the same time producers were beginning to see the marketing benefits of futures, there was another important development was taking place. Mid South agricultural lenders were beginning to appreciate the risk poor marketing brings to their loan portfolio. Ag lenders began to encourage and in some cases require a written marketing plan. Many took the next logical step and set up a separate line of credit for marketing purposes. When prices began to rise in the summer of 2009 some producers put on the first futures hedges of their careers, just in time for the great bull market of 2010 - 2011.

As prices shot higher, it did not take long for the margin calls to mount up taking many producers up to and beyond their established lines of credit. Those who tried to finance their hedges out of their production loan were especially hard hit. It became very difficult both financially and emotionally for many to hang on to their hedges. The stress caused some to abandon their marketing plan in the heat of the moment, a classic marketing mistake. It left many newcomers with a bad impression.

That takes us back to our original question… Should producers still consider futures a viable marketing tool?

For many producers, the answer will be easy to come to. They simply do not have the access to sufficient capital. What is needed is capital that goes beyond what will likely be

needed for production costs and living expenses. Thanks to the 2008 and 2011 seasons, we now have a better concept of what may be needed. For those producers not in a financial position to deal with a similar bull market, futures should not be considered.

What about producers who do have the ability to borrow beyond their production needs? Clearly, futures bring important marketing benefits to the table but limits have to be established. Here is the approach we are now recommending to our clients.

We suggest they get with their lender and come up with two important numbers.
1) How much additional capital could they *possibly* access once production and living expenses are accounted for, and then, 2) How much capital would they be *comfortable* making available for marketing? We call that a FARM #, Funds Available for Risk Management.

Working with their FARM # and factoring in a realistic estimate of margin risk, we will then help our clients determine what tools and strategies are available to them. Some will have to limit their marketing to the cash market. Others will be able to include options strategies. A portion of our clients we will be able to consider futures strategies. The more tools a producer has in the marketing tool box the better, but it is important to be realistic.

Bottom line…Even in today's volatile environment, futures should still be considered a viable marketing tool if you can handle the margin risk. Figure out what is possible, determine limits you are comfortable with and make sure you stick with your plan. That is how to sleep well next season no matter where prices go.

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