Commodity Marketing Strategies Utilizing Options

Trent Milacek

NW Area Ag Econ Specialist

trent.milacek@okstate.edu

580-237-7677

What's in an Option

- Put/Call Option
- Strike Price
- Underlying Futures Contract
- Expiration
- Exercise
- Premium: Intrinsic Value and Time Value

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What is an Option?

- The right but not the obligation to buy/sell a futures contract.
- Two versions: Put Options and Call Options
- Cannot exist without an underlying futures contract

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Futures Contract

- An underlying futures contract is required for an option to exist.
- By purchasing an option I am paying a premium for the right to purchase/sell a futures contract.

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Option Premium

- The cost to purchase the right but not the obligation to enter into a futures contract.
- A buyer of an option pays the premium to the seller of an option.

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How is the premium determined?

- The option premium is made up of two parts: intrinsic value and time value.
- Intrinsic value is equal to the value of the futures contract if the option is exercised today.
- Time value differs depending on the length of time until expiration and volatility in the market.

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When is margin required?

- Margin is the capital required to enter into a futures contract.
- Margin is not required when buying options; margin is only required if <u>selling</u> options.

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Strike Price

- Options are purchased at various strike prices.

- The strike price can be “at the money” which would be equal to the underlying futures contract price.

Choosing a strike price

- Generally a producer would purchase a strike price that is out of the money.

- For a put option this would be a price below the underlying futures contract price.

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Put Option

- The right but not the obligation to sell a futures contract.
- Buying a put option allows a producer to sell a futures contract at the strike price.

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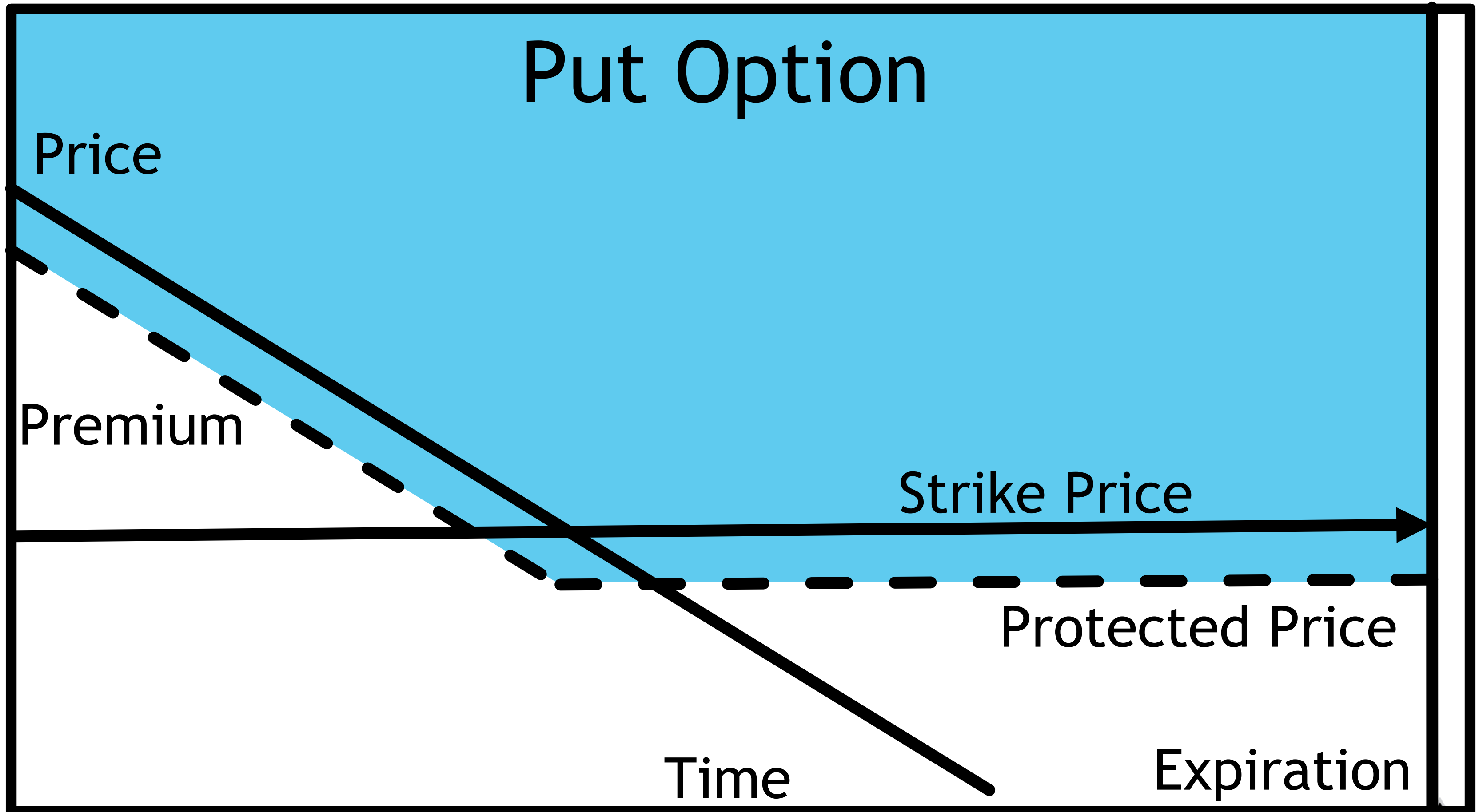

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When to buy put options

- A producer purchases put options when they want to protect against falling prices.
- Put options allow a producer to capture upward movements in prices.

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Call Option

- The right but not the obligation to buy a futures contract.

- Buying a call option allows a producer to purchase a futures contract at the strike price.

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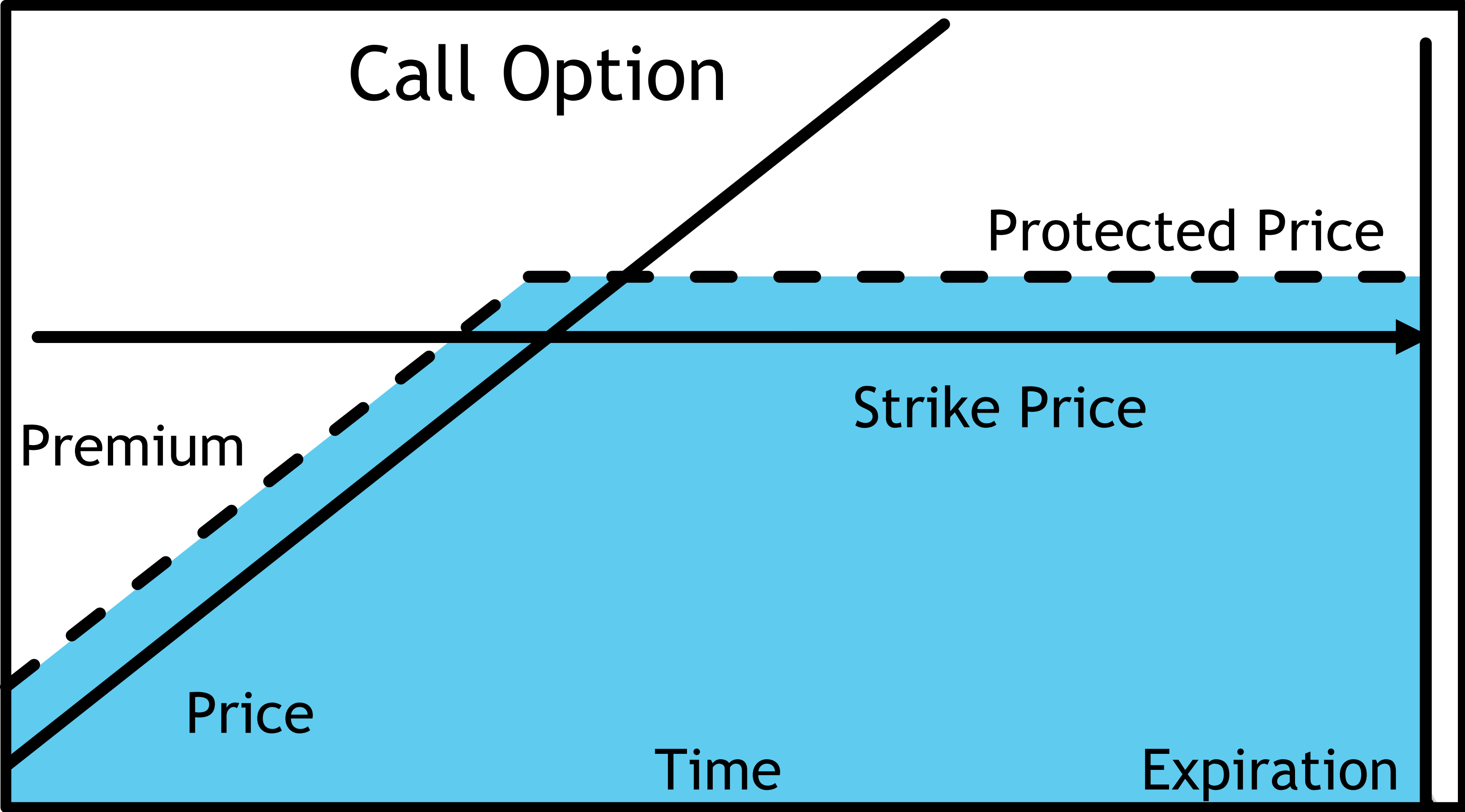

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When to buy call options

- A producer purchases call options when they want to protect against rising prices.

- Call options allow a producer to capture downward movements in prices.

Example of put/call purchasers

- A producer who is growing wheat and wants to protect against downward movements in prices would purchase a put/call.
- A producer who is feeding cattle and wants to protect against upward movements in corn prices would purchase a put/call.

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Choosing a strike price

- As the strike price approaches the underlying futures contract price, the value of the option increases.

- Producers choose a strike price “out of the money” in order to reduce the cost of the option.

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Strike price for put options

- As the strike price is reduced below the underlying futures contract price, a put option premium goes down.

- As the strike price is increased above the underlying futures contract price, a call option premium goes down.

Thank You!

- Trent Milacek
- NW Area Ag Econ Specialist
- trent.milacek@okstate.edu

- Link to more information:
- www.efarmanagement.okstate.edu

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