Hard red spring wheat: A case study in hedging

Pricing opportunities can be fast moving and fleeting, so understand the tools at your disposal ahead of time

BY DAVID DERWIN PI FINANCIAL

The dramatic rise in Minneapolis hard red spring wheat futures during the summer of 2017 provides a case study for having a comprehensive revenue management program.

Those opportunities don't come along very often so you want to be prepared for the next one with all the right sales tools in your marketing tool box.

This article will review and analyze the conditions, psychology, as well as sales and hedging decisions leading up to the price peak in early July.

During the winter and spring months of 2017, September Minneapolis hard red spring wheat futures were trading around US$5.50/bu. In fact, they were hovering near that level for the previous six months since the fall of 2016.

Then, around the beginning of June, as hot, dry weather continued across the growing regions, hard red spring futures started to climb... quickly. They steadily increased almost daily, all the way up to around US$8.50/bu. by Canada Day and the 4th of July, providing their own set of fireworks for producers.

This kind of fast-moving and volatile market action necessitates using numerous marketing alternatives including deferred delivery and basis contracts as well as options and futures. A weather rally like this shows why options, in particular, are an ideal marketing tool to have, especially in times of greater uncertainty.

No offence to our canine companions, but I like to call options a farmer's best friend. Flexible put strategies provide the downside protection you need with the upside potential you want without having to commit any grain for delivery or the concern of margin calls. Think of options like a minimum price contract but without any delivery risk.

They helped manage many of the production, financial as well as emotional issues that were running through producers' minds that summer. I spoke with many growers who shared thoughts like: • "It's too hot and dry so yields will be very uncertain."

• "I've already priced 50 per cent, but don't want to commit any more grain."

• "I want downside floor price protection but some upside as well."

• "I just want to say, 'I sold some hard red for $8/bushel...'"

• and, of course, "How high can this go!!!"

All of these were good reasons to include option-based marketing strategies. They bought you some protection, time and flexibility until you could become a bit more confident in your yields and pricing decisions. This all reminds me of an early-morning breakfast I had with a client as well as another one of his grainmarketing advisers near the end of June.

Minneapolis wheat had already been climbing for the past month, but not without both volatile up and down trading action. On that particular morning, by the time we got to the restaurant, Minneapolis wheat futures were already down about 15 to 20 cents on overnight trading, so there was no time for small talk. We started discussing marketing strategies right away.

When breakfast arrived, wheat was back up to unchanged. As we ate, we all kept a close eye on our phones, following prices as wheat continued higher and higher, being up 40 cents at one point. We talked about selling a bit more physical wheat off the combine. We all agreed that it made sense to capture some nice profits up at these levels. So the client called the elevator to book the sale.

We also bought put options on 25 per cent of expected production.

With this minimum put price protection in place, it gave him the potential opportunity to sell some of his physical wheat later at higher levels but without having any delivery risk from uncertain production.

We continued to sip our coffees and then by the time the cheque came, wheat was back down 10 cents on the day. The client happily grabbed the bill, turned to us and said: “I guess I’ll get this one since you guys just helped me make an extra 40 cents on 30,000 bushels.”

This is just one example of numerous conversations that took place during those volatile weeks. And for those of us who also like a good picture with our stories, the accompanying chart illustrates what the various pricing and hedging decisions looked like.

The US$6.20 puts that were purchased for about 25 cents expired worthless, but they did give growers the ability to protect prices without production concerns and to eventually sell their physical grain in the cash market at a much higher price. Given many growers subsequently sold their wheat $2 per bushel higher, that was the best 25 cents they ever spent.

Based on what was already priced and hedged, other clients also bought US$7 puts, which resulted in a net hedge gain of 30 U.S. cents at expiry. Some clients, who were more experienced and comfortable with futures, also sold short September futures as the tide turned and the drought concerns turned out to be less severe than expected.

Finally, a lot of growers simply entered deferred delivery contracts for fall when futures were between US$7.50/bu. and US$8.50/bu. because prices were just so profitably high.

Everyone’s situation was different depending on previous cash pricing decisions and the hedging combination strategies chosen so results did vary. Regardless, this is the power of having access to marketing advisers with the right tools and strategies at the right time.

Bottom line, the point of this is not to look back at what worked and say, “I told you so,” but rather to fully understand the value of having a full range of pricing and hedging strategies at the ready. When a weather market hits, it’s a good idea to have option and futures in your marketing tool box. Since different strategies are needed in different situations, like any good business approach, it helps to diversify and prepare for the inevitable price moves, both up and down.

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