COLUMN

Increase farm cash flow with covered calls

This stocks and bonds strategy can fit the world of agriculture commodities too

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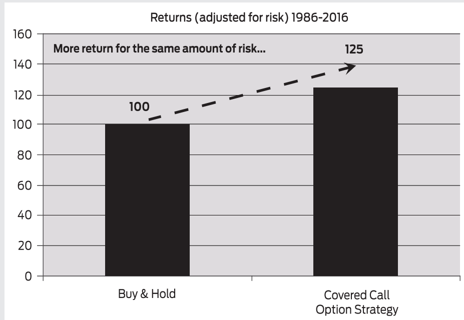
COMPARING S&P 500 STOCK MARKET STRATEGIES:



Data source: www.cboe.com

COMMODITY FUTURE	3-MONTH PREMIUM %	PREMIUM RETURN ANNUALIZED %
Corn	2.0%	8.8%
Hard Red Winter Wheat	2.1%	9.3%
Soybeans	1.2%	5.3%
Canola	1.6%	7.0%
Cattle	2.6%	10.9%
Hogs	3.7%	13.6%

Bottom line, if you are expecting a down, sideways or even slightly rising markets, selling covered calls on grain in the bin or on equities is a sophisticated strategy to increase cash flow.

The benefit of living in both the commodity trading world and the stocks and bonds investment world is you get to see similarities between different markets and how they are all connected.

Strategies in one can often be used successfully in the other. This makes sense since all markets are basically just people (and computers) making decisions.

One trading approach that has historically worked very well in the world of stock investing is the covered call. Basically the strategy allows you to collect some extra cash up front today in exchange for giving up some potential upside tomorrow.

While you may give up some potential upside if that market has a big move higher, historical analysis, data research and my own experience show that markets don't usually make big moves. So the covered call strategy can be one method to increase the revenue from your assets.

Even though most people just buy options, selling options as part of an overall hedging or investment strategy can be effective as well. With covered calls, you aren't buying the options, you are selling options on canola, stocks or the Canadian dollar

Resources available

Most covered call research is focused on the stock market. The Chicago Board Options Exchange (CBOE) has some excellent studies, data and online resources for the U.S. stock market. In particular, using CBOE data, an analysis of an S&P 500 covered call strategy versus just a plain S&P 500 buy & hold approach shows that over the past 30 years, the cover call can improve annualized returns adjusted for risk by 25 per cent, as seen in the accompanying chart. So, you get more return for the same amount of risk.

This theory and approach to selling calls on the stocks you own can also apply to the farm commodities you own. Given you have the physical grain sitting in the bin or in the field, the position is essentially covered. While there are some additional risks and margin required if the market moves higher, your physical grain is moving up as well to more or less offset the calls you sold. So, if your commodity account is properly capitalized and you have access to financial resources, it might just be a cash flow timing issue if the market moves significantly higher.

The second chart shows what some three-month covered call numbers with strike prices about five per cent above the market looked like at the beginning of September.

The premiums themselves could yield an extra two per cent to three per cent over three months, or between five to 15 per cent annualized. These numbers can look even better when option premiums are more expensive and implied volatilities are at higher levels.

A better way to set target prices

You can also think of the covered call strategy as a better way to set target prices. With a target price, you are committing to sell your grain at a higher level. This is similar if you sell a call above the market, except for the fact that you get paid to do it. Another advantage is that if the market goes sideways, lower or up only a little but not enough to reach your target level, you still keep the premium and those premiums can add up.

Bottom line, if you are expecting a down, sideways or even slightly rising markets, selling covered calls on grain in the bin or on equities is a sophisticated strategy to increase cash flow. While selling covered calls strategies won't work every time and does have risk associated with it, it's one of those strategies that can be effective over time. Either on its own or as part of other hedging strategies, selling options is a way to get more out of your marketing efforts knowing that you are increasing cash flow from your assets.

David Derwin is a portfolio manager and commodity/investment adviser with PI Financial Corp. (dderwin@pifinancial.com / www.commodity-options.ca), a member of the Canadian Investor Protection Fund. The risk of loss in trading commodity interests can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. This is intended for distribution in those jurisdictions where PI Financial Corp. is registered as an adviser or a dealer in securities and/or futures and options.