

Seminar Explains

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your neighbor is executed an option contract," he said. "What your neighbor has done is given you an option to buy the land at a particular price over a price particular period of time and you had to pay your neighbor a fee up front for that privilege. If you decide not to buy the land, your \$100 is gone. If you decide to buy the land your neighbor's net selling price is \$2,100 (\$2,000 per acre plus \$100 option fee)."

To further illustrate how an option works, Barclay said, "let's say that some time before the end of the six months you decide to sell your rights to buy that land (you sell your option) for \$150, in that case you pass the option to your friend and then he has the right to buy the land from your neighbor

for \$2,000 per acre. An option contract gives you a right to benefit if prices go in your favor and gives you protection if they go against you. For hedgers it's like an insurance policy. You really don't want to need to use insurance. You don't say I wish I would wreck my car so I get some use out of the premium I paid for the policy to the insurance company. No, you're glad to give up the cost of the premium for the protection, always hoping you don't need it. You always want an insurance policy to expire worthless. That's really the way hedgers should look at the option markets," Barclay said.

To help understand the option market better, Barclay listed some terminology that must be understood. "The names for options

are puts and calls," he said. "A put is the option to sell, a call is the option to buy. You can remember the difference because put is to put away from you or to sell, call is to bring to yourself or buy. If I have a put option I have the right to sell, if I have a call option I have the right to buy. Don't confuse puts and calls, they are not the opposite side of the same transaction. In the land illustration I bought a call option, the right to buy and my neighbor sold me a call option. When you watch the option markets in the pits of the commodity exchanges, there are really two option markets going on at the same time. The put market and the call market and there's buyers and sellers in both markets. That makes understanding options a bit more complicated to understand than the futures market," Barclay said.

"In an option contract the buyer can do one of three things: he can offset the option or sell it to someone else; he can exercise the option, actually use the option; or he can let it expire. The strike price is the price at which the transaction will occur. In the land example the strike price was \$2,000."

Once hedgers understand the use of options the next question is usually: what strike price should I buy? For option hedgers, the choice of strike price is a trade off between the level of price protection offered versus the opportunity to benefit from a favorable price movement.

At-the-money options offer the most balanced trade off between protection against downward price moves and the chance to gain from a favorable price move after option purchase. A hedger could choose greater protection against adverse price moves by purchasing an in-the-money option or a lower amount of price protection by purchasing an out-of-the-money option.

Out-of-the-money options are the cheapest because they offer the

least protection against an unfavorable price move. In-the-money options, on the other hand, are the most expensive because they offer greater protection. Out-of-the-money options provide the greatest leverage in the case of a favorable price move after option purchase; in-the-money options provide the least amount of leverage. At-the-money options offer an intermediate level of price protection, leverage as well as costs.

In determining the actual cost of the insurance offered by an option, you should look at the time value of the option premium. The time value is the amount the option seller charges to write the option, and it should be allocated over the option's life. Deep-in-the-money and deep-out-of-the-money options will have the lowest monthly cost because of their minimal time value. Of course, the amount of price protection provided and the total cost of deep-in and deep-out options are quite different.

Deciding whether to buy an at-the-money, in-the-money or out-of-the-money option for price protection depends upon how much protection you need; your assessment of how prices are likely to move; and your risk: reward preferences.

Here are some of the factors you may want to consider when choosing a strike price:

1. What is your breakeven point?

When selecting an option strike price, keep in mind your cost of production, the option premium and expected basis.

As an example, suppose you expect the wheat harvest basis to be 15 cents under the July contract. If July wheat is trading at \$2.70 and the July \$2.70 put is 7 cents, you will set a floor selling price of \$2.48. (Strike price (\$2.70) - basis (.15) - premium (.07).) If your cost of production is above this level, this strike may not be your best choice.

What is your financial situation?

Suppose your financial condition is sound and you can afford to purchase insurance with a large deductible, in the hopes of benefiting from a favorable price move. Then, a put with a lower strike price may provide adequate protection.

On the other hand, if you're highly leveraged you (and your lender) may want the additional protection provided by a higher put strike price. A lender may be willing to advance the additional funds needed to purchase a higher strike in return for the assurance of a lower risk exposure.

3. What direction do you expect prices to move and how sure are you of this?

Choosing a put strike price on this basis requires considerable self-discipline.



William Barclay

The question is not: what direction do you wish prices to go? But: give the best supply-and-demand information available for the current crop year, what direction are prices likely to go?

If the chances of an upward price move greatly outweigh the chances of a downward price move (but you do not want to be vulnerable to the latter) the put with the lower strike price may be your best choice. However, if demand is weak, the dollar is strong, and yields look good, a higher strike price may serve your marketing needs best.

In comparing options, remember, if futures go above the higher (lower) strike less (plus) the difference in the premiums, the higher strike put (lower strike call) will provide a higher selling (lower buying) price.

4. How much additional premium are you willing to spend for each additional cent of price protection?

Each successively higher (lower) put (call) strike raises (lowers) the floor selling (ceiling buying) price. However, as you choose successively higher strike puts (lower strike calls), the ratio of additional premium cost to the increased (decreased) floor selling (ceiling buying) price becomes progressively unfavorable. For example, if you are unwilling to buy additional price protection at more than a 1:1 ratio, you will find at-the-money options your best choice.

Let's review some specific examples:

Assume it is April and July wheat futures are at \$2.80. The \$2.60 July put is 4 cents, the \$2.80 July put is 12 cents, and the \$3.00 July put is 24 cents. Expected harvest basis is -12N.

TABLE 1

Strike	Put Option Premium	Time Value	Monthly Time Value Cost	Floor Selling Price
\$2.60	.04	.04	.02	\$2.44
\$2.80	.12	.12	.06	\$2.56
\$3.00	.24	.24	.12	\$2.64

If July wheat is at or below \$2.60 at option expiration the floor selling prices will be the actual net selling prices, assuming the expected basis of 12 under is accurate

Assume July wheat declines to \$2.72 at option expiration and the basis is 12 under for a cash price of \$2.60

TABLE 2

Strike	Cash Price	Premium Paid	Option Value	Net Selling Price
\$2.60	\$2.60	.04	.00	\$2.56
\$2.80	\$2.60	.12	.08	\$2.56
\$3.00	\$2.60	.24	.28	\$2.64

Assume July wheat is unchanged at \$2.80 at option expiration and the basis is 12 under for a cash price of \$2.68

TABLE 3

Strike	Cash Price	Premium Paid	Option Value	Net Selling Price
\$2.60	\$2.68	.04	.00	\$2.64
\$2.80	\$2.68	.12	.00	\$2.56
\$3.00	\$2.68	.24	.20	\$2.64

JULY

SAT. JULY 12 - 10AM, Public Benefit Auction at the Manheim Farm Show Building, Manheim, PA. Quilts, Household Goods, Baked Goods, Assorted Items. Auction by Singing Servants Chorus. John H. Fry, Auct.

SAT. JULY 12 - 1:30PM, Silos, Farm Equip. Located in Juniata Co. at the farm of Robert Swartz, 2 mi. south of East Salem just off Rt. 235 and 6 mi. north of Rt. 322 at Thompsontown. Follow direction signs Robert & Delbert Swartz, owners. Bryan D. Imes, Auct.

PUBLIC AUCTION

BUSINESS ESTATE LIQUIDATION

"KRICK TOWING"

Of Lancaster, Pa.

Automobiles, Antique Trucks, Late Model Heavy & Light Duty Wreckers

FRIDAY, JULY 18, 1986

9:30 A.M.

Vehicles at 11:00 A.M.

Located at 1136 Marshall Avenue, Lancaster, Pa.

VEHICLES

1976 Peterbilt Tandem axel, GVWR 55,280,SR#77545N wrecker with cat engine and 750 Holmes Boom, 1976 Peterbilt Tandem axel also with cat engine and 750 Holmes Boom, 1980 Chev. Scottsdale 30 wrecker SR.#CKM33A1167536 4 wheel drive with Holms Commander model 1200 boom 26,000 miles, 1980 Chev. Scottsdale 30 wrecker, SR.#CKM33A116 4750 with Holms Commander model 1200 boom, 4 wheel drive and snow plow, 41,000 miles, both have twin cable hydraulic booms, 1970 International Loadstar model C01800 SR.#4268006048536 moving van, 1967 Mack Stub Nose Tractor Chassis #H67T SR.#2795 (rough) 1977 Chrysler Cordoba 8 auto., 1978 Chev. pick-up 8 auto., 1974 Dodge Swinger 6 auto., 1973 Chev. Mal. 8 auto., 1976 Chrysler Cordoba 8 auto., 1972 Monte Carlo 8 auto..

ANTIQUES

7-chain driven Mack Bull Dog tractors (restoration projects) 1928? Reo Speed wagon wrecker good condition, Fruehauf short flatbed trailer, Fruehauf equipment trailer on hard rubber, old model tow motor.

OFFICE EQUIPMENT

To be sold following the vehicles. Sanyo 800 copy machine, Silver Reed 800 elec. typewriter, 4 drawer filing cabinets, Cimatron 208 S adding machine, desk, swival and straight chairs.

SHOP EQUIPMENT

Motorola Compa Station radio office-mobile system, gas buggy automatic siphoning machine, Kellogg American model 331 TU SR.#463921 industrial size air compressor, Coats 30-40A tire changer and other tire changers, Atlas model 1080 drill press, gas operated chop saw, high pressure washer, Lincoln welder, farm heater model 105P, Marquette battery charger and other chargers, acetylene torches, disc harrow storage trailer, gas tanks with pumps, chain saws, buffers, elec. and air sanders, elec. drills, air wrenches, parts bins, tarps, creepers, cables, air hose, grease pumps, hand trucks, tire and tow chains galore, hooks and pulleys, binders, Bear Cat 210 scanner, loads of Craftsman and Snap On hand tools, Snap On tool chest, belts and straps, C clamps, floor jacks, 2-Hahn Eclipse 200 riding mowers, 2-Hahn Eclipse self propelled power mowers, new and used tires, scaffolding and junk pile and many items not mentioned.

Auction For FARMERS FIRST BANK EXECUTORS CARL E. KRICK ESTATE

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COMPLETE DISPERSAL

THOMAS AND KELLY MILIN

Cazenovia, New York

Discontinuing farming Mr. & Mrs. Milin will sell there cattle and machinery at their farm located just off Rt. 13 on the East Road midway between Cazenovia and New Woodstock on the former Washbon Farm. Watch for arrows.

THURSDAY EVENING, JULY 10, 1986

7:00 P.M.

79-HEAD REGISTERED AND HI-GRADE HOLSTEINS-79

Herd consists of 55 Mature Cows, 4 Bagging Heifers, 4 Shortbreds, 15 Calves and 1 Purebred Bull.

Sires Represented- Jewel Maker, Valiant, Mars, Bootnick, etc.

Service Sires- Elmer Chief, Valiant, Lone Ranger, etc.

You'll find several top cows in this herd. Most are classified. DHIA records available with records up to 25,000 lbs. milk.

Cataloges will be available at ring side.

MACHINERY

IH 1086 Diesel Tractor; Farmall 806 Diesel Tractor; IH 2001 loader; IH 710 5B plow drag; Ontario grain drill; cultipacker; Gehl 600 chopper with 2 row corn head, picker head and hopper w/screen for Hi-Moisture corn; JD blower; IH 990 haybine; NH #282 baler; kicker rack wagons with JD running gears; elevator; backblade; feed cart; NH manure spreader; bedding chopper; 3 DeLaval milkers (60 lb. pails); dumping station and misc. farm tools. Also selling: 1980 4 wheel drive Chevy C-10 truck; 16'x40' silo of corn (will furnish auger); 16'x50' silo on new Alfalfa seeding.

Terms- Cash or good check.

Owners,

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Lunch served