

# Futures and Options Terminology



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Recognizing and taking advantage of pricing opportunities through the employment of futures contracts or options on futures contracts is intriguing to most managers, but can be confusing. Replacing this confusion with understanding provides agricultural producers the basic knowledge and skills required to profit from marketing opportunities when and if they occur.

The first step in utilizing futures markets is to become familiar with the vocabulary. This fact sheet provides marketing terms and definitions critical to understanding agricultural futures and options.

**Assignment** — notice to an option writer that the option which he has written has been exercised by an option holder. Assignments are made by the futures exchange's clearing organization to the brokerage firm and by the brokerage firm to individual option writers.

**Assignment of Hedging Account** — the establishment of first lien by the lender who provided credit to the borrower for purposes of hedging (margin money). Part of a Three-Way-Agreement.

**At-the-Market** — an order to buy or sell at the first price obtainable when the order reaches the trading floor.

**At-the-Money** — an option whose strike price is equal to the current market price of the underlying futures contract.

**Basis** — the difference between current cash price and futures contract price of the same commodity. The basis is calculated by subtracting the price of the appropriate futures contract from the local cash market price. See Estimated Basis.

**Basis Contract** — a contract between buyer and seller of a particular commodity that specifies a level of the cash-futures basis that will be used in final settlement of the contract.

**Basis Risk** — the possibility that the cash-futures basis will not move to expected or predicted levels.

**Brokerage Firm** — any Futures Commission Merchant as licensed by the Commodity Futures Trading Commission. This firm or person is actively engaged in accepting and handling orders for the purchase or sale of futures contracts.

**Call Option** — an option that gives the option buyer the right to purchase (go "long") the underlying futures contract at the strike price on or before the expiration date.

**Cash Settlement** — a process whereby open positions, long and short in futures contracts, are settled or "accounted" using a measure of the cash price level versus delivery of the physical commodity under the provisions of the futures contract.

**CBOT** — Chicago Board of Trade.

**CFTC** — Commodity Futures Trading Commission, an independent federal agency that oversees all futures trading in the U.S.

**Clearing Corporation** — the Board of Trade Clearing Corporation, whose function is to clear (match) all purchases and sales and to assure the financial integrity of all futures and option transactions on the Chicago Board of Trade. Once a trade has been cleared, the Clearing Corporation becomes the buyer to every seller and seller to every buyer.

**Clearing House** — the guarantor of all futures transactions on the Chicago Mercantile Exchange. Its responsibilities are identical to the Board of Trade Clearing Corporation.

**Closing Purchase** — an option purchase that liquidates (offsets) the position of an option writer (seller). It involves the purchase of an option identical in strike price and expiration to the option originally sold. A closing purchase by the writer of a call involves the purchase of an identical call. A closing purchase by the writer of a put involves the purchase of an identical put.

**Closing Sale** — the sale of an option with the same terms as the original option purchase. A closing sale results in the liquidation of the position of the option buyer (holder).

**CME** — Chicago Mercantile Exchange.

**Commission** — fees paid to the broker for execution of an order.

**Contract** - a term describing a unit of trading for a commodity future. Also, actual bilateral agreement between the buyer and seller of a futures transaction, as defined by the exchange.

**Convergence** — a term referring to cash and futures prices tending to come together (the basis approaches zero) as the futures contract nears expiration.

**Cover** — a term used to refer to the action of completing a round turn as in “covering short positions” when short. Sell positions are closed out or offset by buying back.

**Covered Option** — an option position in which the option writer has an opposite cash or futures position.

**Deferred Futures** — the futures, of those currently traded, that expire during the most distant months.

**Delivery** — the transfer of the cash commodity from the seller of a futures contract to the buyer of a futures contract.

**Delivery Month** — a specified month within which delivery may be made under the terms of the futures contract.

**Delta Factor** — used in the context of options, it is the probability of a price move from a specific price level by the underlying futures contract.

**Estimated Basis** — estimate of the normal difference between a local cash market price and the futures market price based on past history for a specific time period.

**Exercise** — an action taken by the holder of a call who wishes to purchase (go “long”) the underlying futures contract or by the holder of a put who wishes to sell (go “short”) the underlying futures contract.

**Exercise Price** — see Strike Price.

**Expiration Date** — the last day on which an option may be exercised. Options expire on a specified date preceding delivery. Options for cash settled commodities expire the same time as the underlying futures contract.

**Fence** — an options hedging strategy available to people long in the underlying cash commodity or futures whereby a put is bought and call is simultaneously sold at a higher strike to defray the cost of the put. The strategy maintains a minimum price via the put, but limits the upside pricing potential at the call’s strike price.

**Fill** — act of fulfilling an order to buy or sell commodity futures.

**Fill or Kill** — a designation added to an order indicating that if the order is not filled immediately, it is cancelled.

**Fundamentals** — the major factors that are considered to influence the supply and demand for a product and thus its price movement and direction.

**Futures Contract** — a legally binding agreement, made on the trading floor of a futures exchange, to make or take delivery of a specified commodity at a future time. The contract specifies the item to be delivered and the terms and conditions of delivery.

**Hedge** — the purchase or sale of offsetting positions in the cash, futures, and/or options markets to protect against adverse price changes.

**Historical Basis** — the historical difference between the cash market price and futures market price for a particular time of the year.

**Initial Margin** — see Margin.

**In-the-Money** — an option that has intrinsic value. A call is in-the-money if the current futures price is above the option strike price. A put is in-the-money if the current futures price is below the option strike price.

**Intrinsic Value** — the dollar amount that could be realized if an option were to be currently exercised. See In-the-Money.

**Inverted Market** — a futures market in which the nearer months are selling at premiums to the more distant months; a market displaying “inverse carrying charges”, characteristic of situations in which supplies are currently in shortage.

**KCBOT** — Kansas City Board of Trade.

**Locked Limit** — a situation where a limit move occurs and trading stagnates (is locked) at one price caused by an imbalance of buyers and sellers. See Limit Move.

**Limit Move** — the maximum allowable daily future or option price move up or down from the previous day’s settlement as defined by a futures exchange.

**Limit Order** — a designation added to an order indicating that the order is to be executed at a specific price or better.

**Liquidity (Liquid Market)** — the presence of active trade in a futures market to ensure an order can be quickly filled.

**Localized Futures Price** — the futures market price for the contract month nearest, but in front of, the time you will be marketing your commodity adjusted by your local basis.

**Long** — the position created by the purchase of a futures contract or option if there is no offsetting position.

**Long Hedge(r)** — a cash market participant who needs to purchase the cash commodity in the future and is at risk if prices rise. The cash market risk is offset by buying a futures contract that will profit by price increases.

**Maintenance Margin** — a sum, usually smaller than the initial margin, which must be held on deposit at all times. If a customer’s equity falls below this margin level, the broker must issue a “margin call” for the amount of money required to restore the customer’s equity in the account to the original margin level.

**Margin** — money which must be deposited with the broker for each futures contract as a guarantee of fulfillment of the contract. Also known as a security deposit, initial margin or performance bond. Buyers of options do not have to post margins since their risk is limited to the option premium.

**Margin Calls** — additional funds that a person with a futures position or the writer of an option may be called upon to deposit if there is an adverse price change or if margin requirements are increased. Buyers of options are not subject to margin calls.

**Margin Liquidation** — refers to traders being forced out of their futures positions because they are unable to meet margin calls.

**Market-If-Touched** — an order that specifies a price that when touched, the order becomes a market order.

**Market Order** — an order that is to be executed immediately upon receipt at the best available price.

**Market-on-Close** — a designation added to an order specifying that it is to be executed as a market order within the closing range.

**Naked Option** — an option position in which the option holder or writer has no opposite cash or futures position.

**Nearby (Futures Month)** — the futures contract closest to expiration.

**Open Interest** — total number of futures or options (puts and calls) contracts outstanding on a given commodity.

**Opening-Only-Order** — an order to be executed at a price with the opening range of prices.

**Open-Order** — an order that remains in force until cancelled (good-till-cancelled).

**Option** — a contract that conveys the right, but not the obligation, to buy or sell a particular commodity at a certain price for a limited time. Only the seller of the option is obligated to perform.

**Option Buyer** — the purchaser of a call or a put. Also referred to as option holder. An option purchase may be in connection with either an opening or a closing transaction.

**Option Writer** — the seller of a call or put in connection with either an opening or closing transaction. Also known as option seller or grantor.

**Overbought (Oversold)** — an expression used when there is belief the market will not go higher (lower) because almost every trader interested in the market has already bought (sold).

**Out-of-the-Money** — a put or call which currently has no intrinsic value, that is, a call whose strike price is above the current futures price or a put whose strike price is below the current futures price.

**Performance Bond** — see Margin.

**Production Hedge** — act of hedging a growing crop or hedging livestock that are in the feeding phase.

**Premium** — the market determined value for a particular futures contract and for a particular price level or strike price. The premium depends on the strike price relative to futures price level, time remaining until expiration, and market volatility. The premium equals intrinsic value plus time value.

**Put Option** — an option that gives the option buyer the right to sell (go “short”) the underlying futures contract at the strike price on or before the expiration date.

**Rally** — an upward movement of prices following a period of downward or sideways price movements.

**Reaction** — a decline in prices following a period of upward or sideways price movements.

**Relative Strength Index (RSI)** — one of many measures of market momentum designed to help determine when a market is overbought or oversold. The index is based on moving averages of closing futures prices.

**Rolling Up/Rolling Down** — a tactic by which a hedger or speculator takes profits or cuts losses on an options position and then rolls up or down the strike price to either improve the hedge parameters or increase the profit potential on a speculative position.

**Round Turn** — the completion of a “sell and buy back” or of a “buy and sell back” set of transactions.

**Security Agreement** — a signed document, required by the lender of a borrower, that provides a guarantee to the lender that borrowed funds will be repaid. Part of a Three-Way-Agreement.

**Short** — the position created by the sale of a futures contract or option if there is no offsetting position.

**Short Hedge(r)** — a cash market participant who needs to sell the cash commodity in the future and is at a risk if prices decline. The cash market risk is offset by selling a futures contract that will profit by price declines.

**Speculate** — to assume a pre-existing market or business risk for the opportunity of making a profit.

**Spread** — a market position that is simultaneously long and short equivalent amounts of the same or related commodities.

**Stop Order** — an order that will become a market order when the market reaches a designated price. Sell-stops are placed below the current market and buy-stops are placed above the current market.

**Strike Price** — the price at which the holder of an option may exercise his right to buy (in the case of a call) or sell (in the case of a put) the underlying futures contract. Also known as exercise price.

**Technicals** — chart and related considerations used by traders to predict the direction of price movement based on the past history of price movements.

**Thin** — a market condition characterized by insufficient liquidity to insure easy entry and exit.

**Three-Way-Agreement** — documentation surrounding a producer’s hedging account that specifies the rights and responsibilities of the producer, lender, and broker. This allows the parties to function as a team and helps insure a successful hedging program.

**Time Value** — any amount by which an option’s premium exceeds its intrinsic value. If an option has no intrinsic value, its premium entirely consists of time value. Also referred to as extrinsic value.

**Underlying Futures Contract** — the specific futures contract that may be obtained (either long or short) by the exercise of an option.

**Volume** — the number of contracts traded in a particular trading session for a particular futures contract or contracts.

**Window** — an options hedging strategy available to people short the underlying cash commodity or fu-

tures whereby a call is bought and a put is simultaneously sold at a lower strike price to defray the cost of the call. The strategy maintains a maximum price via the call, but limits the downside pricing potential to the strike price of the put.

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