

Hedging with Grain Futures

By using grain futures contracts, you establish a forward price for your crop. This may be anytime anytime prior to when you expect to sell grain in your local cash market. For example, at planting time for wheat, you may decide to use futures to establish a forward price for the wheat to sell at harvest. Or, you could use futures to price grain in storage that you will sell at some

To be concrete, let's assume that today is April and you are planting your corn crop which will be harvested and sold in November in your local market. You have decided to forward price some of your production. In April, you observe that the December corn futures price is \$2.80 so you can lock in the price by selling the December corn futures contract through a futures broker.

Once the contract is sold, you will be required to deposit *margin funds* with your futures broker so that you will adhere to the terms of the contract. If the price were to increase, your futures position would begin to lose money so you may need to send more money to cover the losses. Conversely, if the price falls, money will be added to your account.

The combination of your futures position and your sale of corn in the cash market will yield a net price for your corn. This price takes into account any profits or losses on the futures position as well as the cash price received for corn. Let's now consider what happens in November to see what happens to your net price for corn under different price scenarios.

Lower Prices in November

In November let's say the December corn futures price has fallen to \$2.35. At this point in time you can offset the futures contract by simply buying back the December futures contract for a price of \$2.35. Because you had originally sold the contract for \$2.80 and you bought it back for a lower price, you will earn a profit of \$0.45 (less broker commission).

This profit of \$0.45 can be applied to the price you sell corn for in your local market. Let's assume the local price for corn is \$2.45 so your net-price is \$2.90 (\$2.45+\$0.45).

Net-Price from Selling a December Corn Futures Contract at \$2.80.

	Lower Prices in November	Higher Prices in November
December Futures	\$2.35	\$3.10
Profit on Futures	+\$0.45	-\$0.30
Cash Corn Price	\$2.45	\$3.20
Net Corn Price (cash price+futures profit)	\$2.90	\$2.90

Higher Prices in November

What if instead of falling, the December corn futures price had been higher at harvest? Suppose

December corn futures price is \$3.10. You buy back your December contract at that price a loss of \$0.30, which you would have already paid through any margin calls. At the same time the price for corn in your local market will be higher because of the higher futures price. Let's assume the local price for corn at harvest is \$3.20. Your net-price for corn is \$2.90, which is simply your local price of \$3.20 less the loss on the futures contract of \$0.30.

Net-Price is the Same

In either case, no matter whether the market moved higher or lower than what was contracted, your net-price is still the same: \$2.90. This occurs because the corn *basis* was always the same. The basis, which is the difference between the cash price and futures price, was \$0.10 no matter whether prices were higher or lower. In the real world, the basis may vary somewhat but it is usually predictable. Therefore, you can be reasonably confident of getting a specific price for your grain once you establish a price level using a futures contract.

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