RME Fact Sheet

Options on Futures Contracts

What Are Options?

There are two basic types of options on futures contracts: "calls" and "puts." A **call option** on futures contracts conveys the right (but not the obligation) to the buyer to purchase a specific futures contract (for example, a corn contract for December 1997 delivery month) at a particular price during a specified period of time. A **put option** conveys the right (but not the obligation) to the buyer to sell a specific futures contract at a given price during a specified period of time. The price for which the futures contract can be brought (in the case of a call option) or sold (in the case of a put option) under the terms of the option contract is referred to as the option's **strike price or exercise price.** The date on which an option expires--the date after which it can no longer be exercised--is the option's expiration date. The price of a specific option, that is, the amount of money paid by the buyer of an option and received by the seller of any option, is the **option premium.**

Where Are Options Traded?

Options are traded on the same exchanges as those of the underlying futures contracts. There are 11 different commodity exchanges in the U.S. as well as abroad. The major domestic agricultural crops are traded on the Chicago Board of Trade, the Kansas City Board of Trade, the Minneapolis Grain Exchange, the New York Cotton Exchange, and the Coffee, Sugar and Cocoa Exchange.

How Are Options Traded?

Options contracts are traded in much the same manner as their underlying futures contracts. There are several important factors to remember when trading options. Most important, trading a call option is completely separate and distinct from trading a put option. If you buy or sell a call option, it does not in any way involve a put option. Trading a put does not involve a call option. Calls and puts

are separate contracts, not opposite sides of the same transaction.

At any given time, there is simultaneous trading in a number of different call and put options- different in terms of delivery months and strike prices. Option delivery months are typically the same as those of the underlying futures contract.

Strike prices are listed in predetermined multiples for each commodity. The listed strike prices will include an at- or near-the-money option, at least five strikes below, and at least nine strikes above the at-the-money option. **At-the-money** is defined as an option whose strike price is equal--or approximately equal--to the current market price of the underlying futures contract. The five lower strikes would follow normal intervals. The nine higher strikes would include five normal intervals above the At-the-money option(s), plus an additional four strikes listed in even strikes that are double the normal interval. As prices increase or decrease, additional strike prices are listed as needed so that there are always five strike prices listed in normal intervals and four strike prices in double intervals above the current futures price, and at lease five strike prices below the current futures prices.

An important difference between futures and options is that trading in futures contracts is based on prices, while trading in options is based on premiums. The premium depends on market conditions such as volatility, time until expiration, and other economic variables affecting the value of the underlying futures contract. How various factors influence premiums and how and to what extent market price declines are offset by option profits are among the topics to discuss in detail with a
broker.

The premium is the only part of the option contract negotiated in the trading pit; all other contract terms are predetermined. For an option buyer, the premium represents the maximum amount he can lose, since the buyer is limited only to his initial investment. For an option seller, however the premium represents the maximum amount he can gain, since he faces the possibility of the option being exercised against him. Upon exercise, the futures position assigned to an option seller will almost always be a losing one, since only an in-the-money option will normally be exercised by the option buyer.

Why Should You Consider Options?

Amid the perceived complexity of options, there is one feature that is especially important to hedgers: options offer price protection without limiting profit potential. This follows from the fact that the buyer of an option has the opportunity, but not the obligation, to buy or sell a particular commodity at a certain price for a limited period

of time. The buyer's risks are known up front and are limited. For producers' that means obtaining protection against declining crop prices without giving up the opportunity to profit if crop prices increase.

Detailed Information

This summary is for general illustration purposes only. Please contact a broker of your choice for information specific to your operation.

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