Cattle Pricing and Risk Management

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Pricing Considerations
- Risk
- Market Outlook
- Profit Target or Breakeven

Evaluating Pricing Alternatives
- Cash
  - High risk/highest return potential
  - Bullish market outlook

Cattle Marketing Alternatives

Basic Pricing Alternatives
- Cash
- Short Hedge
- Put Options
  - At-the-money
  - Out-of-the-money
- Synthetic Put
- Fence

Risk Management with Futures/Options
- Combining a futures market position with a cash market position to reduce risk
- Risk management is costly and is a cost of doing business
- Each producer has different risk management needs
A Futures Contract

A commitment to make or take delivery of a given commodity at some time in the future.

Futures Market

Buy
Obligation to take delivery
“go long”

Sell
Obligation to make delivery
“go short”

Feeder Cattle Futures

Contract Size: 50,000 lbs
650-849 lb. Med/Large #1 Steers
Cash Settled to CME Feeder Cattle Index
Contract months: JAN, MAR, APR, MAY, AUG, SEP, OCT, NOV
Daily Trading Limit: $3.00/cwt.

Matching Contract Size

1 Feeder Cattle Futures Contract equals:
- 67 head of 750 pound steers
- 77 head of 650 pound steers
- 111 head of 450 pounds steers

General Futures/Options Considerations

Effectiveness of both depends on basis
Futures
- Simple and cheap
- Establish fixed prices
- Margin calls

Basis

Basis: The difference between two prices.
- The relationship between local cash and the futures price
Basis = Cash Price - Futures Price
Feeder Basis = Cash Price - CME Feeder Index
Factors Affecting Livestock Basis
- Location
- Season
- Animal weight
- Animal quality
- Animal gender

Feeder Futures Index and 650-700 lb. Steer Price, OKC


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Cattle Marketing Alternatives

Med/Large Frame #1 Steer Basis, OKC
- 400-500 lb. Steers NOV
  - Max (2005,2006) 31.81
  - Min (2008) 16.35
- 500-600 lb. Steers NOV
  - Max (2004) 19.33
  - Min (2007) 9.22
**Evaluating Pricing Alternatives**

- **Cash**
  - High risk/highest return potential
  - Bullish market outlook

- **Short Hedge**
  - Risk limited to basis risk
  - Highest minimum price coverage
  - Similar to forward cash contract
  - Bearish market outlook

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**General Futures/Options Considerations**

- Effectiveness of both depends on basis
- Futures
  - Simple and cheap
  - Establish fixed prices
  - Margin calls
- Options
  - Protect downside
  - Maintain upside potential
  - More costly than futures
  - No margin calls
  - Time limitations
Options Market

Options on Futures Contract

Put

Call

Right to sell futures

Obligation to buy futures

Buy

Sell

Buy

Sell

Put Call

Obligation to buy futures

Right to sell futures

Evaluating Pricing Alternatives

Out-Of-The-Money Put Options
- Less costly
- Provide disaster coverage for major wrecks
- Slightly bearish to moderately bullish

At-The-Money Put Options
- Most costly
- Moderate breakeven/profit coverage
- Moderate/highly bearish, limited price declines

Cattle Marketing Alternatives

Evaluating Pricing Alternatives

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Synthetic Put (Short Hedge + Buy Call)
- Relatively costly
- Allow “Plan B” change in plans or outlook
- Maintain minimum price

Fence (Buy Put + Sell Call)
- Cheapen put option cost
- Use with probable trading range
- Slightly bullish/bearish, limited upside
Cattle Marketing Alternatives

Other Considerations
- More Complex Futures/Options Strategies
- Cash Marketing Risk Management
- Cash Forward Contracting