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Market volatility – am I bovvered?

You can make money from an unpredictable grain market – and doing so doesn't have to be risky, writes **Jeremy Cole**.

Since early April, wheat futures for January 2008 have climbed from £90 to just over £100 before settling at £96.50/tonne. World weather was the cause and stoked the rumour mill causing global commodity markets to rise.

Given these rises, I would have thought more ex-farm grain would have been sold. At £100.50/tonne, January futures are equivalent to approximately £97 ex-farm – a fantastic price to lock into, especially compared to budgets and previous sales.

But many farmers hung on. Non-selling was blamed on dry world, European and UK weather in the belief that the market would keep rising. Some farmers had already sold some wheat at lower prices and dared not sell any more in case yields fell, with the danger that a default may occur.

Of this £16 price movement, how much did you capture? Making money or locking into a profit by selling physical grain on a rising market is an obvious move. There are no rules to stop you making money from a falling market, or even on a further rise, without selling further physical grain. The latter two, I can hear you say is risky speculation and getting into the realms of high rise dealing rooms, striped shirts and braces.

But it isn't. Speculation is what farmers do already by selling little and often or when the price seems good. In reality for every £1 the market moves up or down, your business gains or loses £1/t. The bigger the tonnage the bigger the Russian roulette you're playing. In many individual cases, over £1000 is made or lost for every £1 the market moves. And if the market falls then your business has lost potential.

With the 'turbo charged' Options that are now possible, with Time Value (TV), much more of this volatility can be tapped into for your benefit at very little cost. Previously, once an Option was set up, if the market moved against it, by a 1p or £100, the entire premium was lost and became a cost. Now, with TV, if the market begins to go against the Option, because the market changes for whatever reason, and the insurance is deemed to not be needed any more, then the Option can be sold back.

Many Call Options were taken out recently as markets rose to cover earlier lower priced sales or to increase the percentage of previous Option cover. They were then taken off as the weather forecast changed, indicating rain over the May Bank Holiday weekend. The market came off £3/t. Previously, if the Strike price was equal to or below the current Futures price, farmers could have done nothing but would be looking at a potential loss of the £5-6/t premium for a January 2008 Option. Now the net cost was about £1, as the TV was £4-5. This is because the time to expiration of the Option was just a few days less than when it was taken out.

Some growers were lucky enough to have seen a £1-3/t gain in a few days. They sold the Option back too, as they felt the market was going to fall back. Normally they would have received back £1-3 of their original £5-6 premium. With TV, they received the £1-3 as normal, plus the £4-5 TV. The net effect was a small gain – or at least their money back – and the ability to reposition themselves in the market again. The 'insurance' had done its job for free.

In a falling market, growers who like the current prices but dare not sell any further physical grain could look at a Put Option. This gives a gain if the market falls. This is the worry if grain is unsold. So if current prices look good to you, don't get an ulcer by over selling and risking the spectre of being bought in against later, just buy a Put Option. Grain is then underwritten. More seed growers are using Puts to guarantee margins, as prices are only agreed at time of movement.

This means that to hedge your grain position, which could be only for a few days, weeks or for seed growers, harvest, a £5-6 potential premium or cost, is in reality, if properly monitored, reduced to £2-3. If the level of insurance cover was only taken out on half of the crop, then this would be reduced to an average of £1-2/t. This is exceptionally good value.

Do what you feel is correct but be willing to change by selling the Option back as soon as factors alter your opinion. Don't be dazzled by high volatility. Volatility is good. It can make you money. Use it.

Jeremy Cole, Bsc Agri Econ (Reading) has run Agricole, since 1993. It is an independent grain brokering and marketing service for farmers, offering a weekly grain market report. For details, call 01954 719452.