What Put Options Don’t Tell You

The debacles associated with “segregated funds” left a bad taste for some about using futures as a risk management tool. They are now in favor rather of doing nothing, cash forward contracting or buying options. Options, especially puts, establish a floor under prices. This safety net might help some sleep better at night—but at what cost?

Buying puts has been long touted as a way to prevent a catastrophic loss should the government intervene or crops are better than anticipated. You’ve heard the tales of farmers who hold grain and miss an opportunity. Years ago, before I had a grasp of technical and fundamental factors, I’d buy puts and roll them up to higher strike prices, paying more and more premium. If prices continue higher, I’ve been told, I should be glad it cost me only 50¢ to make $1. Been there, done that, and I don’t like it. Here is why.

My staff researched a scenario of buying puts beginning May 8, when early planting and favorable weather led us to think that 162 bu. per acre yield and record acres would result in a surplus of nearly 2 billion bushels. They penciled in buying $5 put options on May 8, when December futures were trading $5.26½ for a premium of 29¢, and holding those put options as prices continued higher. Even when prices closed lower at $5.06 on June 15, that would have been OK—we thought prices were headed for $4 or less. Now we know the rest of the story.

Prices reversed June 17, giving technical signals to exit hedges. The drought wasn’t in the picture yet. A strategy of rolling the puts with every 50¢ increase dictated rolling the $5 up to $5.50 on June 25 as futures hit $6.00. On June 28, futures hit $6.50, rolling up to $6 at a cost of 36½¢. The madness of paying more to gain price appreciation continued, rolling to $6.50 (July 6), $7.50 (July 27) and finally $8 (Aug. 22), for a total cost of 92¼¢ (see table).

If prices trade at $8 at option expiration, the cost goes up $1.30 for a final price of $6.70. If prices rally into fall, gaining 50¢ for every dollar might not be that bad. The odds are you’ll run out of patience and money by the time the rally ends.

If a program sounds too good to be true, find out the exit strategy, cost and risk. Technical analysis (charting) can be a great tool to determine when to pass off and when to accept price risk. Based on a major buy signal, I lifted all hedges in all grains from June 17 through 20. It wasn’t easy to exit coverage when most were suggesting it was a second chance to sell our big crop 50¢ higher, but I chose to accept risk with insurance not that far below.

At press time, renewed sell signals were forming as end users found it difficult to justify owning $8.50 corn. It could be a long fall, however. ■

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The Real Cost of “Rolling Up the Puts” (May to August 2012)

Put Cost on Indicated Date (All prices approximate based on closing price)

Strike Price	May 8	June 25	June 28	July 6	July 27	August 22	Cost
CZ 500 puts	29¢	13¢					16¢
CZ 550 puts		28½¢	18¢				10½¢
CZ 600 puts			36½¢	20¢			16½¢
CZ 650 puts				37½¢	11¼¢		26¼¢
CZ 750 puts					42¢	19¢	23¢
CZ 800 puts						37¾¢	?
						Total	**92¼¢**
						Cost per contract	**$4,612.50**