

## MERCHANDISERS' CORNER

By Diana Klemme

# The story of 'Clownie,' or 'How I learned to let go and move on'

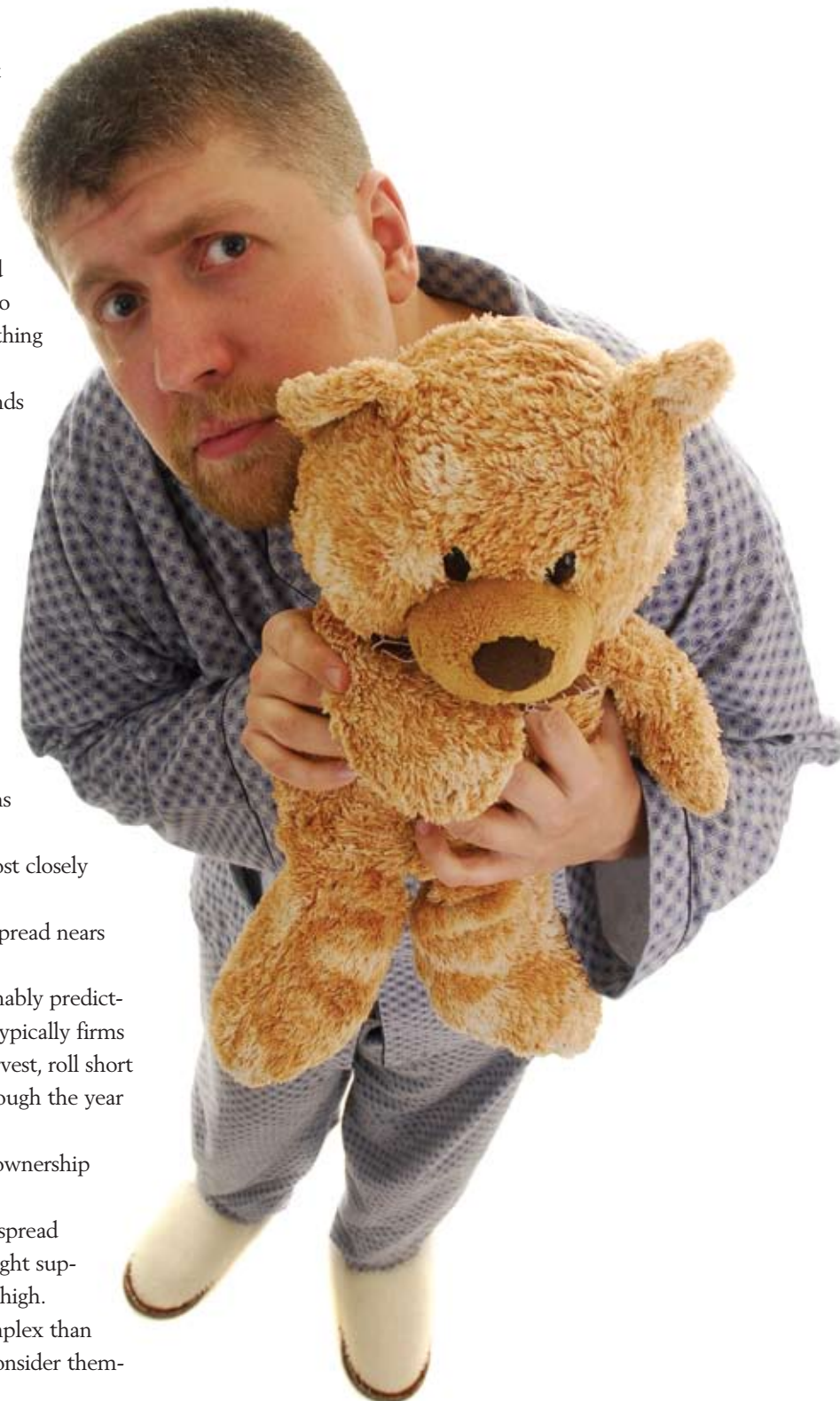
**A**s a little girl I had a small cloth clown that I carried everywhere. He was soft and familiar and infinitely comforting during the numerous trials of my childhood. But Clownie became grubby and beat up, and lost much of his stuffing despite my mother's secret attempts to patch him for me. I still loved him, but one day I recognized that it was time to keep my old friend in my room and carry something else with me.

Managing merchandising risks this year reminds me of my beloved clown. The old familiar ways and strategies are reassuring, and it's a little frightening to recognize they may not be up to the demands of these markets. It can be unsettling that it could be smart — even necessary — to bring some new tools and strategies into the mix to complement the old ways.

Most merchandisers and managers are conventional hedgers ("CH"), using strategies that reflect principles you learn in Basic Merchandising:

- Hedging means equal and opposite positions in cash and futures.
- Keep short hedges in the futures month most closely corresponding to the cash transaction.
- Roll short futures forward when a futures spread nears "full carry."
- Basis tends to be fairly repetitive and reasonably predictable. It tends to be weakest at harvest and typically firms when farm selling declines. Buy grain at harvest, roll short hedges forward and liquidate inventory through the year to earn the carry.
- Go short the basis and ship Delayed Price ownership when basis and futures are inverted.
- Futures prices provide signals for basis and spread expectations: High prices typically reflect tight supplies where spreads are narrow and basis is high.

Real world merchandising is much more complex than that, of course, but most managers would still consider them-



selves conventional hedgers. Nowadays futures and basis don't always react the way we expect. The bull markets of 2007 and 2008 reflect global agricultural supply and demand, fueled by the explosive growth of investment capital buying commodity futures. Despite record-high futures, spreads repeatedly move close to Full-Carry and basis is setting record lows in some markets for wheat and soybeans. At the same time, a smaller market such as Minneapolis wheat soared to inconceivable levels and affected basis and spreads in other commodities.

Conventional strategies and tools by themselves don't seem up to the task of adequately managing this year's risks. But putting "conventional hedging" on the

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shelf the way I retired my old stuffed clown is too drastic. CH will remain the right tool for most merchandisers in most crop years.

Venture outside your comfort zone this year and at least check out other strategies. First, define the different issues, factors and risks your business faces in these unconventional markets:

Cash and futures prices are not tracking as conventional markets would anticipate. That adds risk.

Investment capital in commodities doesn't respond to supply/demand signals. It provides steady new buying that can leave cash prices lagging. Expect this sector to continue to grow.

There is no limit to how high the basis can go when supplies are tight. Harsh lesson #2: there is no economic floor to the basis. And harsh lesson #3: Short hedgers cannot take their inventory to the delivery market to fulfill short futures (at zero basis). The good news is that extreme basis volatility also creates opportunities.

Financial requirements to buy grain and maintain short hedges in bull markets can exceed past requirements by many multiples. Underfinanced firms can find themselves forced into bad cash contracts when futures soar.

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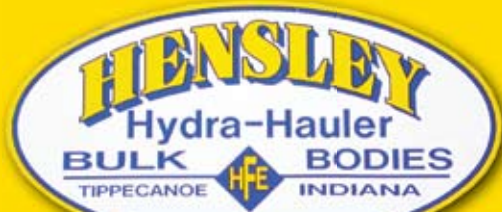
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## MERCHANDISERS' CORNER

your buyers and sellers is much higher these days.

**Redefine "good" basis:** Selling "cheap" basis is fine as long as you're buying it even cheaper. Looking at past sales and objectives can be an expensive mistake in extreme markets.

**Inventory repos:** Credit lines are the limiting factor for a lot of elevators this year. Some managers have hesitated to use innovative financing such as inventory repo's, where a financial entity buys inventory in-store, takes over the short hedges, and pays for the grain against warehouse receipts. These transactions include a buy-back clause for the elevator to regain ownership at a defined time at a defined basis. Most years conventional hedgers don't need additional financing and most bor-

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rowers hesitate to risk their relationship with their lenders. But this is the year where these new tools aren't only OK; they may be essential for some firms' survival.

**Bear-spreads:** CH would suggest that when futures carries are narrow, keep short hedges in nearby futures and sell inventory when returns don't cover costs. But in extreme markets, outside factors may limit your choices. Buyers may back away, for example. To protect against falling basis in rising futures, consider also bear-spreading futures; buying the deferred and selling the nearby month, if the carry isn't already wide. If basis falls hard, eventually the futures spread should weaken and the gains help offset basis loss.

**Underhedging your cash position:** This is common in financial markets, uncommon in agriculture. This earns some revenue on your unhedged bushels in bull markets to help offset interest costs, contract risk, basis slippage or other costs. In bear markets your loss on unhedged bushels is mostly offset by the interest you earn from withdrawing and putting to use the open trade equity on your short hedges. The challenge is to quantify how much to underhedge without taking on more risk than you offset, and the percentage isn't static. A 3% underhedge, for example, on 100 bushels would earn \$1.50 on a 50¢ rally on the 3 bushels. The interest cost on the 97 hedged bushels at 7% would be \$3.40 for 12 months. On the downside, the 3% under-

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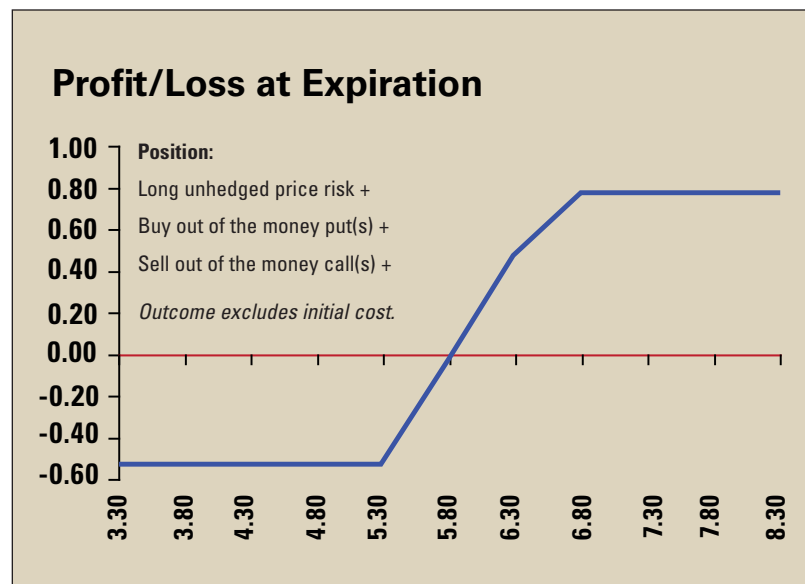
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hedge loses \$1.50, offset by the interest on excess margin funds of approximately \$3.40 (assuming 12 months at 7%).

Or you can hedge your position 100%, perhaps to satisfy loan covenants, but pay a small fee to someone else to provide protection that eliminates the interest cost or earnings on your hedges. This is a lot easier than managing the percentages yourself.

**Options:** You can use options instead of futures to hedge price risk, but understand the risk profile and the net costs. Being long puts + short out of the money calls, lessens your margin requirements if futures rise, and provide market gains to help offset a falling basis, contract defaults or other risks of bull mar-



kets. Your protection against lower prices has a 'deductible' and some initial cost. But where a credit line is limited, options can be an important tool.

Another strategy is to maintain conventional short hedges and buy some deep out of the money call options for a small cost. A \$1 rise in futures might add 15¢ to the time-value of each deep out-of-the-money call with a 15% delta factor, for \$750 of revenue per 5,000 bushels. This assumes the rally occurs well before expiration. The calls aren't meant to capture a rally cent for cent but to earn some money, at a low cost, to help offset risks. (These values are just for illustration; option analytic programs can forecast actual outcomes based on strike prices, premiums, and days to expiration.)

These are just a few of many nonconventional approaches that can expand your ability to manage the unusual risks of our new markets. Perhaps one or more will be a comfortable enough fit for you to add to your old standbys. ■

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Diana Klemme is a longtime contributor to FEED & GRAIN. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at diana@grainservice.com

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