Western Beef Resource Committee

*Third Edition*

# Cattle Producer's Handbook

Marketing Section 843

# Commodity Options as Price Insurance for Cattle Producers

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Most cattle producers are familiar with insurance, insuring their buildings against fire, their equipment against accidents, and their lives against death or injury. Insurance trades a small but certain loss, the insurance premium, for the possibility of a large but uncertain loss.

In cattle production, one of the greatest risks faced is that of unfavorable price change. Prices for cattle have been so uncertain that many times prices that were expected to be profitable—when decisions were made regarding facility investment, breeding, or feeder cattle purchases—ended up unprofitable instead. Additional risk may be incurred on the feeding side as unfavorable grain price increases may "wipe away" anticipated profits.

Because of these risks, producers might want to "insure" feeder cattle, fed cattle, or feed against unfavorable price movements, while still being able to take advantage of favorable prices. Cattle producers have this opportunity by using the commodity options market.

## What Is the Commodity Options Market?

The commodity options market is simply a market in which producers may purchase the opportunity to sell or buy a commodity at a specified price. Purchasers in these options markets have the "opportunity" but not the "obligation" to exercise their agreement. Therefore, the markets are appropriately named "options markets" since they deal in an option, not an obligation.

Just as cattle producers may purchase the right from an insurance firm to collect on a policy if their buildings burn, they can purchase the right to sell commodities at a specific price in case prices drop below the specified price. A separate market exists to purchase the right to buy commodities at a specified price in the case prices move higher.

For instance, if one desired to buy the right to sell feeder cattle for $65 per hundredweight (cwt), the feeder cattle options market might provide the opportunity. By paying the market determined premium, a producer could then collect on the option if prices are below $65/cwt when the cattle were actually sold. If prices are higher than $65/cwt, the cattle are sold for the higher price, and the cost of the premium is absorbed.

While this is a simplified version of the actual way in which producers operate in the options market, the concept is a simple one. Just as with other types of insurance, by paying a premium, insurance can be purchased against price declines or increases. A producer could collect on the option only if the price moves in an unfavorable direction.

## The "In's and "Out's" of Options Puts and Calls

Two types of commodity options are a call option and a put option. The call option gives the holder the right, but not the obligation, to buy the underlying commodity from the option writer at a specified price on or before the option expiration date. The put option gives the holder the right, but not the obligation, to sell the underlying commodity to the option writer at a specified price on or before the commodity expiration date.

The call option and the put option are two distinct contracts. A put option is not the opposite side of a call option. Distinguish the two types of options by remembering that the holder of the put option can choose to "put-it-to-them" that is, sell the product, while the holder of the call option can "call-upon-them" to provide the product.

## Buyers and Sellers

In the option market, as in every other market, transactions require both buyers and sellers. The buyer of an option is referred to as an option holder. Holders of options may be either seekers of price insurance or speculators.

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