3. Pricing Alternatives: Evaluate your Options

In addition to deciding when and where to deliver livestock, you must also consider the question of when and how to price livestock. What we often think of as "traditional live cattle markets include public markets (public auctions) and direct or country sales (direct cash or forward contract sales to stocker operators or cattle feeders, livestock dealers and order buyers or packers). Cattle producers in many states, including New Mexico, utilize alternative markets in addition to traditional methods.

Public Markets

Some public auctions in New Mexico are relatively small and serve local market areas but a few auctions are large-volume markets serving a regional area.

Large-volume markets may attract enough buyers and sellers to generate competitive bidding and the resulting prices probably reflect supply and demand conditions more accurately than when volume is small.

Advantages of public auctions include: (1) auctions serve local areas, (2) sales are regularly scheduled, (3) large and small producers are served, and (4) sales are bonded.

Disadvantages of public auction include: (1) relatively high marketing cost, (2) often-long distances to market, and (3) no forward pricing flexibility.

Direct or Country Sales

Direct cattle sales occur most frequently between larger cow-calf producers or stocker operators and commercial feedlots. Large percentages of feeder cattle are marketed by direct sales in New Mexico. Direct sales may be negotiated shortly before delivery of the cattle (spot or cash sales) or several months prior to delivery (forward sales). Forward sales usually involve forward contracts.

Advantages of direct sales include: (1) cattle remain on the ranch or in the feedlot until after they are sold, (2) the seller agrees to the delivery conditions which can be flexible, and (3) marketing costs are low, if terms of the sale are fair.

The primary disadvantage of direct marketing of cattle is the reduction of pricing efficiency. Lack of information about prices and terms of trade on live cattle sales can results in low pricing efficiency. The amount of shrink charged, weighing conditions, terms of delivery, and terms of payment tend to vary from ranch to ranch and feedlot to feedlot. This information is neither readily available nor published.

Larger auctions are still the primary sources of published price information. This then raises the question as to whether negotiated prices, often based on distant markets, can be considered as

fully representative of the actual supply and demand for cattle in New Mexico and surrounding interstate markets.

Forward Pricing Alternatives

Forward pricing alternatives are available. The decision is generally based on 1) price goals of the individual, 2) analysis of alternative ways of reaching those goals, and 3) market risk.

Without price goals, a livestock producer will probably not be able to make satisfactory pricing decisions. Goals must be set individually and be realistic for the person involved. If the goal is to always hit the peak of the market in either cash or forward pricing, there will be frequent disappointment. However, a goal of forward pricing at times when the cost of production plus a profit are covered can often be achieved. Any time a rancher operator produces feeder calves or buys feeder cattle, they are taking a market risk.

The ability to bear market risk, like the ability to bear production risk, is highly dependent on the producer's capital base. Producers who have a large equity base are able to bear considerable market risk without jeopardizing their business. Many producers who cannot afford risk are turning to methods of marketing and pricing, which reduce market risk.

Hedging, options, and forward contracting are three methods of forward pricing and reducing market risk. The use of these pricing alternatives expands the period of time in which pricing decisions can be made. It is not necessary to wait until the livestock reach market condition before price is established.

There are important differences between hedging, options, and contracting. When considering forward pricing, one should select the method that most closely fits his/her operation and expertise.

Forward Contracts

Stoker operators, meat packers, livestock marketing agencies and other agricultural firms offer forward contracts. A major advantage of forward contracts is working directly with a local buyer or agent, rather than dealing with the impersonal futures market. The major disadvantage is that the contracts offered by different firms or agencies have somewhat different specifications.

When forward contracting a specific contract is signed with a firm or agency for actual delivery of a specified class of livestock at an identified time and place. The price is often the price of the current futures contract closest to the expected marketing date plus or minus the local basis and some adjustment for basis risk. Understanding the terms of a contract and having some

expectation of future prices are very important when considering forward contracts as a pricing alternative.

The process of forming expectations of prices is often referred to as "price discovery". The price discovery process is the process of arriving at an educated guess concerning the price expected for a class of livestock sold at some future date, as previously discussed, using Commodity Futures/Basis as a Price Forecasting Tool.

One source of information regarding likely future prices is in the future markets. With an understanding of the terminology and mechanics of the futures market, a producer can regard the price of a November feeder cattle futures contract, for example, as the "gauge" for a forward contract price at the date the futures contract expires. This price should be adjusted for local supply and demand conditions (basis) and historical performance.

Historical market analysis and futures markets price analysis, as discussed above, can provide you with a reasonably good estimate of cash prices when forward contracting cattle. However, while this estimate may be as good as any, there is no guarantee it will be on target at market time.

Futures Market

A major advantage of futures market contracts is that all contracts on the futures market are standardized with respect to volume, quality, delivery terms, and other.

A principal reason for producers' participation in futures trading is to set a price for a commodity in advance. Any commodity traded can be sold as much as a year in advance. If subsequent market developments cause the producer to have second thoughts, he/she can get out of the deal readily by strategically purchasing an offsetting contract.

There are basically two groups of traders in commodity markets—the speculators and the hedgers. Each group has a different purpose for trading.

Speculator. A speculator is a market participant who tries to profit from buying and selling futures and option contracts by anticipating future price movements. Speculators assume market price risk and add liquidity and capital to the futures markets. They do not hold equal and opposite cash market risks. They want to be "long", or have bought when the value of the contract is rising or is expected to rise. If price are declining, they hope to have a "short" position, or have sold the commodity. They seldom own any of the commodity traded, nor do they have any desire to take or make delivery on a contract. The commodity speculator assumes much of the price risk the commodity hedger seeks to avoid.

Hedger. A hedger is an individual or company owning or planning to own a cash commodity – cattle, corn, soybeans, wheat, U.S. Treasury bonds, notes, bills, etc. - and concerned that the costs of the commodity may change before they intend to either buy or sell it in the cash market. A hedger achieves protection against changing cash prices by purchasing (selling) futures contracts of the same or similar commodity and later offsetting that position by selling (purchasing) futures contracts of the same quantity and type as the initial transaction and at the same time as the cash transaction occurs. Hedgers are individuals or firms that either use or produce commodities traded on the various futures market exchanges. They buy and sell futures contracts to avoid the risk of unfavorable price movement on the cash market. In order to be hedged, the producer must have a position in the futures market that is opposite to his/her position in the cash market.

As a hedger, a producer has some advantage over the speculator with equal market knowledge.

1. The purpose in trading is to set the price of the commodity in advance. Losses in a futures market position may be compensated for by gains in cash market positions.

2. Producers are primarily concerned about the long-term market trend. The successful hedger has put enough thought and time into the market to come up with a good long-range plan that is followed.

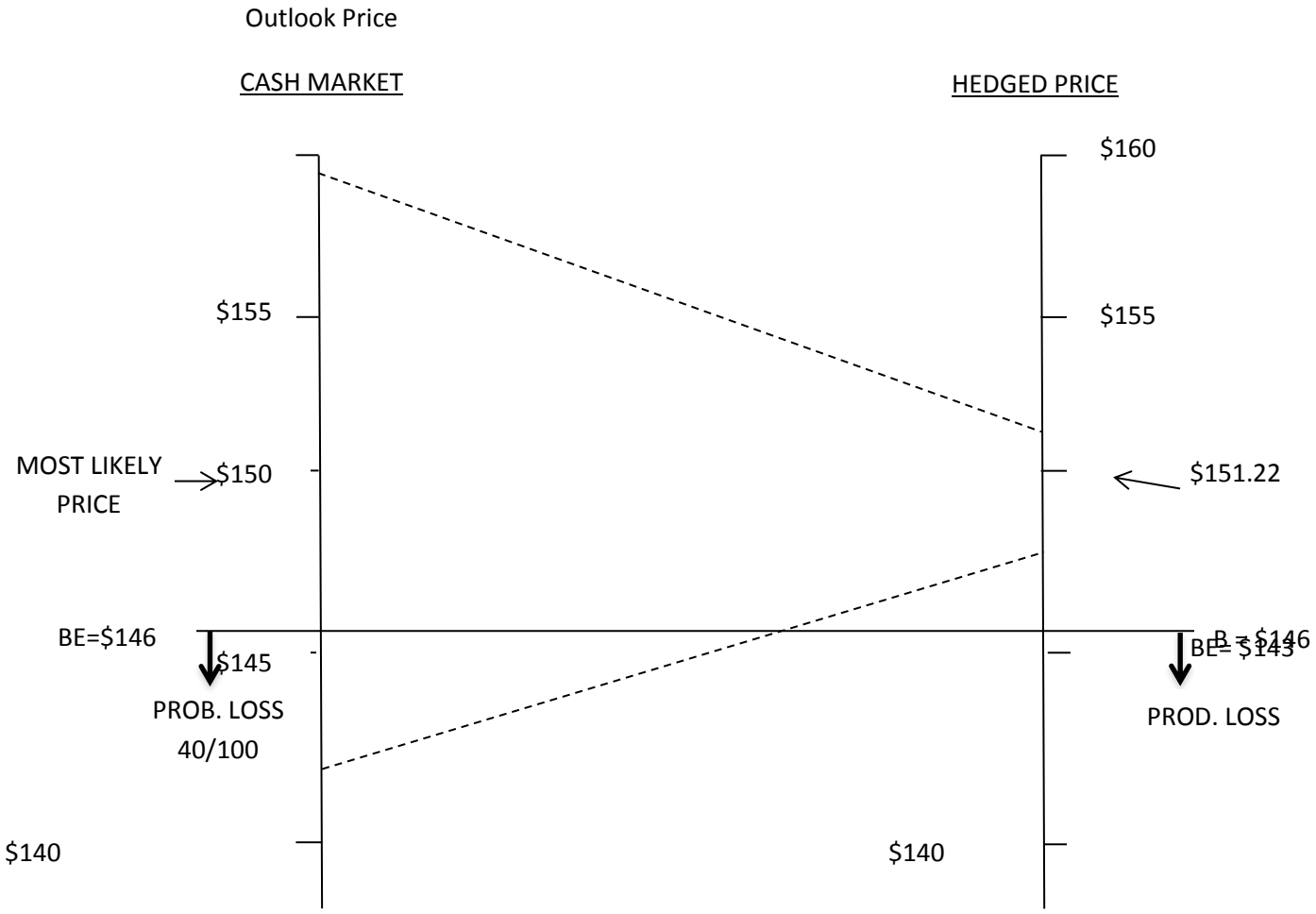
The key to hedging is the fact that price differences are much more stable and predictable than are the levels of cash prices in the future. For example the difference between Good grade steers at Clovis NM, Oklahoma, and Choice steers at Omaha, Nebraska, is much more predictable than is the overall price level for feeder cattle 6 months in the future. In a 6-month period, cattle prices may go up or down by $30/hundred weight or more, but Omaha and Brush prices will move in the same general direction and by a similar magnitude.

Thus, the intention of hedging in the futures market is to shift the risk of absolute price movement in the cash market to basis risk in the futures market. Figure 9 illustrates this “shifting of risk” between markets.

Figure 9: Market Risk/Basis Risk Relationship

MARKET RISK-BASIS RISK RELATIONSHIPS

November Feeder Cattle



Options on Futures Contracts

Many producers would like to have the protection that futures hedging or forward contracting can provide against an adverse price change, but may be reluctant to give up the opportunity to benefit from a favorable price change.

Options offer an alternative. Like futures hedging and forward contracting, buying options provides price protection, but unlike futures hedging and forward contracting, buying options does not involve a price commitment.

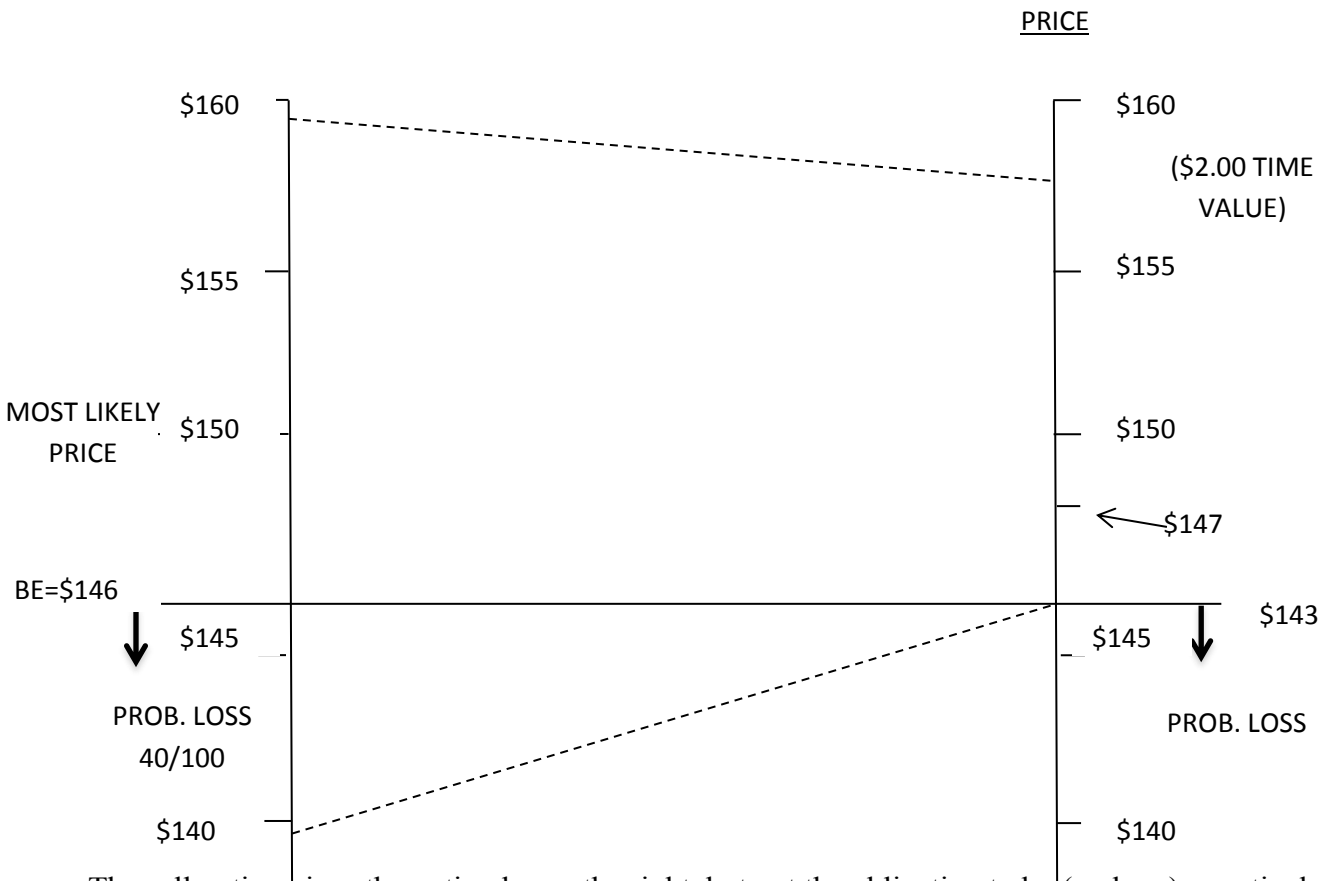
Simply stated, an option is a choice. The buyer of an option acquires the right, but not the obligation, to buy or sell an underlying futures commodity under specific conditions in exchange

for the payment of a premium. It is entirely up to the buyer whether or not to exercise that right; only the seller of the option is obligated to perform.

There are two basic types of options—the call option and the put option. Figure 10 illustrates market risk- option risk relationships of options on futures contracts.

Figure 10: MARKET RISK-OPTION RISK RELATIONSHIPS

November Feeder Cattle



The call option gives the option buyer the right, but not the obligation to by (go long) a particular futures contract (such as a live cattle contract) at a specified price at any time during the life of the option. The buyer of a call obtains the protection against rising prices without giving up the chance to benefit from lower prices.

The put option gives the option buyer the right, but not the obligation, to sell (go short) a particular futures contract at a specified price at any time during the life of the option. The buyer of a put obtains protection against declining prices without giving up the chance to benefit from rising prices. Figure 10: Market Risk/Options Risk Relationship

If an option buyer exercises his right to acquire a particular futures position, an opposite futures position at the same price is assigned to someone who has sold an option.

Trading in call options is completely separate and distinct from trading in put options. Buying or selling a call in no way involves a put. Buying or selling a put in no way involves a call.

Call options and put options are used for different purposes. Buying calls provides protection against rising prices; buying puts provides protection against declining prices. Call and put options are NOT opposite sides of the same transaction. Figure 11 makes a comparison of futures contract to options on futures contract. These basic contract distinctions are important to keep in mind.