

# Marketing Alternatives for Feeder Cattle

Are you a feeder cattle producer worrying if this year's gross revenues will be enough to cover production expenses? Would you like to find a way to make certain that your operation will cover these expenses and perhaps even lock in a profit? You may be able to achieve this goal using a combination of feeder cattle market alternatives.

Marketing is usually the most difficult management task that the feeder cattle producer has to perform. Proper marketing can make the difference between profit and loss in the feeder cattle business. As is true of production programs and management practices, many marketing alternatives are available to the feeder cattle producer. Most producers spend much of their time and effort improving production practices while spending very little time on the marketing of their product. However, time spent marketing feeder cattle in today's complex economic environment can pay larger dividends than time spent on improving or implementing many production practices.

Feeder cattle producers have more flexibility in marketing than they often realize. Currently, at least six viable alternatives for marketing feeder cattle (600- to 800-pound yearlings) are available. These include private treaty sales (farmers, order buyers, etc.), local auction barns, telephone and video auctions, satellite video auctions, futures hedging, and futures options. In addition, other market opportunities, which may require some development, include forward contracts, participation contracts, and retained ownership with sale as fed cattle.

## Market Alternatives

The expanded number of marketing alternatives available to today's feeder cattle producer provide opportunities to make a wide range of market choices. Each market alternative has unique features. The primary features that may be used to describe feeder cattle markets include competitive bid price, market knowledge, convenience and simplicity of sale arrangement, market cost, market planning, and market price protection. Feeder cattle producers select those markets which comple-

ment their management objectives. Producers may choose one or more market alternatives to sell their feeder cattle. These marketing alternatives provide the opportunity to obtain the most profitable price or prices for feeder cattle. Note that this does not mean the highest price.

A feature that is becoming increasingly important to feeder cattle producers is price protection. Feeder cattle markets may be divided into two price protection categories: markets without price protection and markets with price protection (Figure 1). A distinguishing feature of markets without price protection is that the seller willingly accepts the going price when he or she is ready to sell. In sharp contrast, the use of markets with price protection allows the seller to manage price risk and choose to accept a price that will meet a given price objective (break-even price, production costs plus profit, etc.).

## Markets Without Price Protection

The market alternatives without price protection are primarily cash market sales. They include private treaty sales (farmers, cattle producers, or order buyers), local auction barns, telephone and

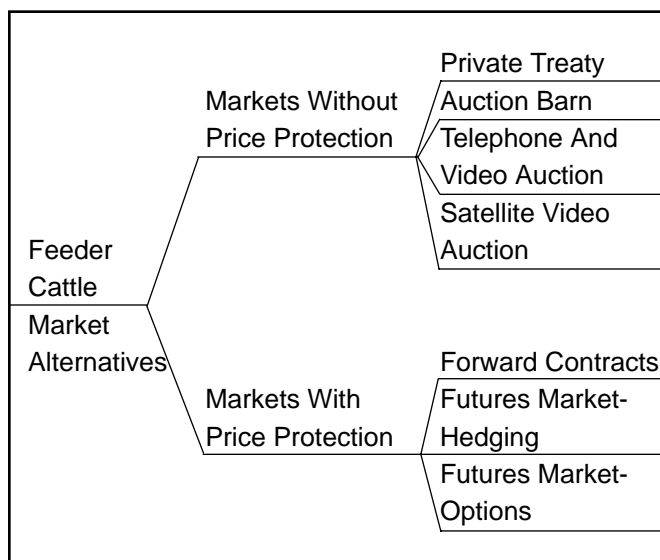


Figure 1. Feeder cattle market alternatives

video auctions, and satellite video auctions. Selling in the cash market is usually easy since it requires a minimum of planning and market knowledge.

**Private Treaty.** Private treaty feeder cattle sales include primarily sales between either producers or a producer and an order buyer. This sale represents a private negotiation between the buyer and seller. The use of private treaty sales has been common practice for many years.

The cost of private treaty sales is minimal, and the seller controls the marketing process. However, this marketing method requires the seller to be knowledgeable about market prices and practices. Also, the producer accepts the risks associated with cash payment.

**Local Auction Barn.** The local auction barn is often the simplest and most convenient feeder cattle cash market. This market alternative will usually attract a reasonable number of buyers, which allows the seller to receive a competitive price for feeder cattle. The local auction barn also permits the seller to bring to market a wide range of feeder cattle (varying in size and quality).

Reliable and prompt cash payment is available from this marketing alternative. However, the cost of this service is usually higher than that of other marketing alternatives. Cattle are typically sold on a flat commission (percentage of gross receipts or dollars per head) plus additional fees for yardage, insurance, and other services.

**Telephone, Video, and Satellite Auctions.** Telephone and prerecorded video auctions and satellite video auctions require more planning and market knowledge than using the local auction. A major advantage of these market alternatives for feeder cattle producers is that they increase the potential number of buyers and sellers. They also can be less expensive to use and often attain higher market prices for good quality feeder cattle. However, the seller must offer truckload lots (60 to 70 head) of uniform, good quality feeder cattle to ensure competitive bidding from buyers.

Telephone and prerecorded video auctions have been successful in many locations where groups of producers form feeder cattle marketing associations. The marketing association provides adequate numbers of feeder cattle. The large numbers of cattle attract many buyers, which enhances competitive bidding. These sales often involve communication between the buyer and seller before the announced sale date.

Satellite video auctions offer advantages to both the buyer and the seller. The buyer is able to purchase truckload quantities of reasonably uniform and healthy feeder cattle right off the farm. Feeder

cattle that are healthy and spend less time under stressful conditions usually show higher performance in the feedlot. In addition, the seller benefits from minimum stress and shrink (selling more pounds of beef) as compared to the local auction market. The seller can also eliminate transportation costs and reduce the total cost of marketing cattle. Telephone and video auctions and satellite video auctions frequently attain higher sale prices than other cash market alternatives.

Producers should be aware that private treaty sales, telephone and video auctions, and satellite video auctions sometimes use a sliding price scale based on weight. Producers should be able to closely approximate the average sale weight and should be knowledgeable of the appropriate magnitude for the price slide.

For instance, a \$3.00 per cwt. price slide would result in reducing (increasing) the market price by \$1.00 for every 33 $\frac{1}{3}$  pounds above (below) an estimated sale weight. Therefore, the seller should make sure that the estimated weight is reasonably accurate and the magnitude of the price slide is consistent with price adjustments seen in the feeder cattle cash market (local auction market or other reported sales).

In other words, the agreed-upon price slide for 700- to 800-pound, medium-frame #1 feeder steers should be consistent with the price difference observed from the sale of 700- versus 800-pound, medium-frame #1 feeder steers in other markets (see local Fed-State Livestock Market News, USDA). Note that the price slide is often sensitive to such factors as feeder cattle grade, weight, sex, and the time of year for a given location.

## Markets With Price Protection

Feeder cattle markets with price protection were developed in response to the mutual need of sellers and buyers to avoid widely fluctuating prices. The use of markets with price protection allows the feeder cattle producer to shift some of the market price risk to others. Forward pricing market alternatives such as forward contracting, futures hedging, and futures options are the typical markets which provide price protection to the feeder cattle producer. These marketing alternatives require more intensive planning and market knowledge than cash marketing alternatives.

**Forward Contracting.** Forward contracting is simply a contractual arrangement between a feeder cattle buyer and a seller to exchange feeder cattle for a prearranged price at some future date. This marketing alternative allows the buyer and seller to eliminate price risk.

Forward contracts, if they do not contain rigorous constraints, can be attractive because of the ease and convenience of developing and fulfilling the contract. To use this marketing alternative, the producer needs to know costs of production, stocker weight, weight gain, and profit objectives. A major disadvantage of a forward contract is default risk.

More intricate forward contracts that allow for cash market interaction are possible. These are sometimes called **participation contracts**. These contracts usually guarantee a fixed lower-limit price and offer up to 100 percent of the increase if prices happen to rise. A major shortcoming of this marketing alternative is that it is not always available, particularly in the Southeast, where few feedlots exist.

**Futures Market Hedging.** The hedging marketing alternative involves using the futures market. One such futures market is the Chicago Mercantile Exchange (CME), where a feeder cattle contract consists of a 50,000-pound lot of 700- to 799-pound, medium-frame #1 and medium- and large-frame #1 feeder steers. Trading contract months are January, March, April, May, August, September, October, and November.

Trading on the futures market is neither simple nor magic. Futures contracts are bought and sold in the futures market by hedgers (producers and merchandisers) and speculators. A hedge is a means of managing price risk by taking a position in the futures market opposite to that held in the cash market. To speculate is to assume a pre-existing market or business risk for the opportunity of making a profit.

The bids and counter-bids offered by the hedgers and speculators result in an estimate of the value of a given commodity at some future date. The bid is based on currently available demand and supply information for the commodity. This estimate of value will change frequently during the course of a trading day (3 to 4 hours) as new information (adjustments in fed cattle market prices, feed prices, substitute meat prices, weather, trade policies, etc.) becomes available and traders' expectations about future prices change. After receiving new information, traders evaluate price opportunities or reevaluate their positions. Some will buy and others will sell, depending on their respective pricing opportunities, objectives, and outlook.

When you buy or sell feeder cattle futures contracts, you are required to deposit funds in a margin account with your broker. The deposit represents a small percentage of the value of each contract. Additional margin deposits may be necessary if the futures price moves against your position in the market—if you're going short and the futures

price increases, or if you're going long and the price decreases. The amount of the margin requirement will be mostly offset by the adjustment in the cash market. This margin requirement ensures financial integrity to the futures market. Bankers who understand the futures market will work with producers in setting up a margin account to meet any margin calls.

**Understanding Basis.** Basis is the price difference between the cash and futures market prices. The variation in the basis between the cash and futures market is caused by the changes of the prices that clear each market. As you might expect, the basis is affected by many factors, such as transportation and marketing costs and seasonal demand and supply pattern of the local market. The basis, however, is more predictable than feeder cattle cash prices. Historical price information should be used for your location and type of cattle (grade, sex, weight, etc.) to estimate an appropriate basis for your market situation for a given month.

Knowledge of the local basis for feeder cattle is necessary to determine whether the futures market price will result in an acceptable target market price. For example, it is October and you plan to sell feeder cattle in May. The May feeder cattle futures contract is trading at \$75.00 per cwt. The basis (local cash minus futures) in May, using the May feeder cattle contract based on recent history, is \$3.00 per cwt. under. That is, the local cash price averages \$3.00 per cwt. less than the May futures market price in May. Adjusting the futures market price of \$75.00 per cwt. by the basis value of \$3.00 per cwt. under results in a net price of \$72.00 per cwt. ( $\$75.00 \text{ per cwt.} - \$3.00 \text{ per cwt.} = \$72.00 \text{ per cwt.}$ ). The producer may choose to accept this price if it covers production expenses and a reasonable profit.

What is the basis going to be at the delivery date? No one knows with certainty. A review of historical basis information for a given month and local market area will give a reasonable estimate. In essence, the hedger accepts basis risk rather than price risk because basis risk is generally smaller.

**An Example of Hedging.** In October, a feeder cattle producer has 150 weaned calves and is using a winter grazing and supplemental feed program on 100 acres. The producer believes he will be able to produce 120,000 pounds of feeder cattle for sale next spring. Feeder cattle futures contracts are bought and sold on the CME in 50,000-pound units, so the producer estimates he may use at most two contracts (100,000 pounds). Purchasing more than two contracts would result in speculating on those contracts above his anticipated production. So the

producer would not have enough cattle to sell in the cash market to offset an undesirable price change.

The producer estimates he needs a target futures market price (sometimes called a price objective) of \$65.25 per cwt. to cover production expenses, basis, and to earn a reasonable profit. He contacts a local futures market broker, who receives a commission for each transaction, and discusses market conditions and alternatives. Current May feeder cattle futures contracts are at 6350 (\$63.50 per cwt.). The producer waits for contract prices to rise to 6525 (\$65.25 per cwt.). When contract prices reach 6525, the producer sells two feeder cattle contracts with delivery set in May. In the market, selling contracts is called "going short"; buying is called "going long." The local basis in May is \$2.00 per cwt. under. In this example, the producer estimated he needed \$63.25 per cwt. to cover total production costs and a reasonable profit. He also estimated that the cash price in May would average \$2.00 per cwt. less than the futures market price. Therefore, the target futures market price is \$65.25 per cwt.

It is important to recognize that during some years the futures market may not offer the producer an opportunity to choose to accept a futures price that meets or exceeds the target futures market price. The producer may want to consider accepting a futures price that is less than the target market price if he expects the futures price to further decline.

Let's assume it is now May, and May feeder cattle futures prices have dropped \$5.25 per cwt. (down to \$60.00 per cwt.). The cash market price is \$58.00 per cwt. The producer buys two May futures contracts at 6000 (\$60.00 per cwt.) to cancel the short positions he took last October. As a result, he makes \$5.25 per cwt. ( $\$65.25 - \$60.00$ ) in the futures market because he sold May futures contracts at 6525 (\$65.25 per cwt.) last October. This sale results in a realized price of \$63.25 per cwt. ( $\$58.00$  per cwt. in the cash market +  $\$5.25$  per cwt. in the futures market =  $\$63.25$  per cwt.), which covers the production costs and a reasonable profit.

**Hedging Wrap-up.** To achieve the price protection provided by hedging in the futures market, a feeder cattle producer simply takes the position in the futures market opposite to the one held in the cash market. In other words, a producer wanting to establish a price on a group of weaned calves that will be sold as feeder cattle in the future may choose to sell a futures contract (go short). The producer trades the futures contract that will mature closest to but not before the anticipated

cash market sale date. So, if prices decline, the feeder cattle producer will make money in the futures market that will counteract the loss in the cash market. However, if the price goes up, the feeder cattle producer will lose money in the futures market but will make money in the cash market.

It is important to remember that hedging is a market strategy to be used to reduce market price variation. By hedging, the trader tries to fix a price and ensure price stability. If the market price goes up, the hedged producer gives up windfall profits for stability.

The concept of hedging is simple. But gathering the necessary production costs and market price information is time-consuming and cumbersome. Furthermore, knowing when to place the hedge in order not to lose the opportunity for the best price in the market is a difficult decision to make. Feeder cattle producers who want to reduce market price risk should strive to attain a futures price (also called a target market price or price objective) that covers the costs of production and includes a reasonable return on investment. Those producers using the futures market for the first time should study the market and seek professional assistance. These measures will help improve the chances of a successful trade.

**Options.** Another method of managing the price risk for feeder cattle is the use of options. A feeder cattle option is a legally binding contract that gives the option buyer the right, but not the obligation, to buy or sell a feeder cattle futures contract under specific conditions in exchange for the payment of a premium.

Option buyers seeking price protection pay a premium, but there is no margin requirement. Option sellers, those willing to accept the risk of declining or rising prices, are required to meet margin requirements as prescribed by the exchange. Option premiums, the price of an option paid by an option buyer, are determined in a competitive market of the respective commodity exchange (trading pit of Chicago Mercantile Exchange, etc.).

The two types of options are calls and puts. The call option conveys to its buyer the right to buy, while a put option conveys the right to sell a futures contract at a later date. These memory devices may help you to distinguish between calls and puts: the call option suggests "call from them" or "buy from them" while the put option implies "put it on them" or "sell it to them." Be careful not to misunderstand these two instruments. Each type of option requires both a buyer and a seller (Figure 2). Puts and calls are not opposite sides of the same transaction.

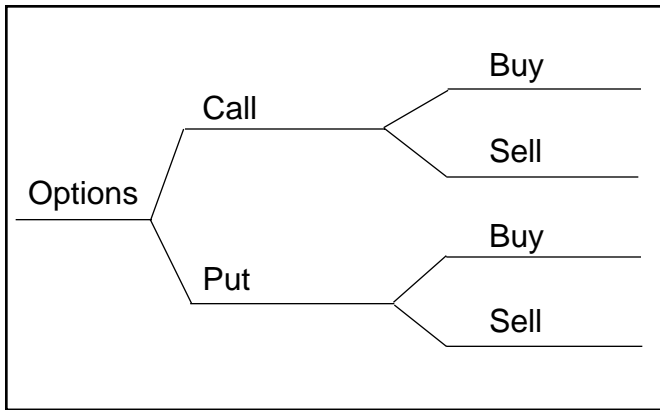


Figure 2. Futures market options

A **call option** gives the option buyer the right, but not the obligation, to buy a certain futures contract at a specified price during the life of the option. The buyer of a call option receives protection against rising prices without giving up the chance to benefit from lower prices. Therefore, a feeder cattle buyer, such as a fed cattle producer or feedlot operator, would be interested in the purchase of a call option and would be an option buyer.

The opposite position, the option seller (seller of a call option in this example), is generally someone who is willing to accept the risk of rising prices. The option seller does not expect a rise in prices associated with the given commodity for the amount of the premium paid by the buyer of the call option. The commodity exchange will receive the premium paid by the buyer and deposit it in the margin account of the option seller. The option seller will retain the entire premium if futures prices do not rise. However, if futures prices rise, the option seller pays for the price increase through deductions from the margin account. If the price rise exceeds the premium, he will have to pay out more than the premium. In essence, the option seller must post margin money and face margin calls. A strictly regulated clearinghouse oversees all transactions and guarantees performance of all contracts.

A **put option** gives the option buyer the right, but not the obligation, to sell a given futures contract at a specified price during the life of the option. The buyer of a put option obtains protection against declining prices without giving up the chance to benefit from rising prices. The feeder cattle producer may be interested in the purchase of a put option. The option seller for the put option works similarly to the option seller of the call option described above. In other words, someone must take the opposite position.

Let's look at a simplified example of buying a put option on a feeder cattle futures contract.

Feeder cattle option contracts specify the same units (50,000 pounds) and time periods as futures contracts.

In October, a feeder cattle producer buys two May feeder cattle put options with a strike price of \$70.00 for a premium of 210 (\$2.10 per cwt. or \$2,100 = two contracts at 500 cwt. per contract at \$2.10 per cwt.), which gives him the right to sell May feeder cattle at 7000 (\$70.00 per cwt.). He is a buyer of put options. The strike price is the price at which one may buy or sell the underlying futures contract upon the exercise of an option. The futures market price must decrease below the \$70.00 strike price for the feeder cattle producer to profitably exercise the put options. In October, the May futures market price was \$72.00 per cwt.

May corresponds with the expected length of his stockering program (240 days to carry weaned calves from 400 to 799 pounds). If, in May, the feeder cattle futures market price is 6500 (\$65.00 per cwt.), the producer could exercise his right to sell at 7000 (\$70.00 per cwt.) or he could sell the option to someone else. The local basis in May is \$2.00 per cwt. under. The local cash market price in May is \$63.00 per cwt.

In this example, the feeder cattle producer would have realized a market price of \$65.90 per cwt. from buying the put option (\$63.00 per cwt. in the cash market + \$5.00 per cwt. in the futures market - \$2.10 per cwt. for the put option premium = \$65.90 per cwt.). The realized price of \$65.90 per cwt. exceeds the target market price of \$65.25 per cwt.

Alternatively, if in May, the May feeder cattle futures price trades at 7800 (\$78.00 per cwt.), the producer would not exercise the right to sell at 7000 (\$70.00 per cwt.). He would simply let the option expire. This example assumes that the price movement (increase) in the futures market price is also observed in the local feeder cattle cash market. The local cash price would be \$76.00 per cwt. In this scenario, the producer should realize \$73.90 per cwt. for his feeder cattle (local cash price minus premium paid or \$76.00 - \$2.10). So in this scenario, depending strictly on the cash market (doing nothing) would have resulted in the largest dollar increase, but the producer would not have been protected against declining prices.

## Putting It All Together

A feeder cattle producer who buys stocker calves in October and sells feeder cattle in April is interested in comparing the prices that various market alternatives could deliver. Which alternative—selling in the cash market, placing a hedge (that is,

going short or selling an April contract), or purchasing a put option—will give the best price?

Let's examine the effect of a \$10.00 per cwt. price increase with these three market alternatives. Table 1 describes a situation where the futures market feeder cattle price increases from \$80.00 to \$90.00 per cwt. between October and April.

On October 10 the feeder cattle producer has three alternatives: In the cash market he may do nothing and hope to sell for \$85.00 in April. In the futures market he may hedge by selling an April futures contract at \$80.00. Or in the options market he may purchase an April put option for \$2.00 per cwt. with a strike price of \$80.00 per cwt. The futures market basis (cash minus futures market price) for April is \$3.00 per cwt. under.

It is now April 15, and it is time to sell the feeder cattle. In all three alternatives, the feeder cattle will be sold in the cash market. Remember, a \$10.00 per cwt. price increase occurred in the futures market between October and April. If the feeder cattle producer had chosen to do nothing in October, he would now sell the feeder cattle at \$87.00 per cwt. in the cash market. If the producer had placed a hedge in October (sold an April contract), he would now buy an April futures contract at \$90.00 per cwt. and sell the feeder cattle for \$87.00 per cwt. in the cash market. However, if he had purchased an April put option at \$80.00 per cwt. during October, he would do nothing and let the put option expire and sell the feeder cattle for \$87.00 per cwt. in the cash market.

The results of a \$10.00 per cwt. price increase for these three alternatives ranged from a cash price of \$77.00 to \$87.00 per cwt. Doing nothing and selling in the cash market resulted in the highest alternative sale price at \$87.00 per cwt. Hedging the feeder cattle in the futures market resulted in \$77.00 per cwt. (\$87.00 cash market - \$10.00 loss in the futures market). Buying an April put option in

the futures market resulted in a market price of \$85.00 per cwt. (\$87.00 cash market - \$2.00 premium for the put option).

When the market price increases, it is obvious that the alternative of doing nothing and selling in the cash market is optimal. However, seldom do you know with certainty that the market price is going to increase. Hence, the other two marketing alternatives provide the producer with market price risk protection from declining prices.

Conversely, let's now examine the effect of a \$10.00 per cwt. price decrease with these three market alternatives. Table 2 describes a scenario where the feeder cattle futures price decreases from \$80.00 to \$70.00 per cwt. between October and April.

Again on October 10 the feeder cattle producer has the same three alternatives described earlier: doing nothing now and selling in the cash market, placing a hedge by selling an April futures market contract at \$80.00 per cwt., or buying a futures market put option for \$2.00 per cwt. The futures market basis (cash minus futures market prices) is \$3.00 per cwt. under for April.

It is now April 15, and it is time to sell the feeder cattle. Remember, all cattle will be sold in the cash market and a \$10.00 per cwt. price decrease occurred in both the cash and futures markets between October and April. If the producer had chosen to do nothing in October, he would now sell the feeder cattle at \$67.00 per cwt. in the cash market. Note that the cash market price is exactly \$3.00 per cwt. below the futures market price of \$70.00 per cwt. That is, the basis is \$3.00 per cwt. under. If the feeder cattle producer had placed a hedge (sold an April futures contract for \$80.00 per cwt.) in October, he would now buy an April futures contract for \$70.00 per cwt. and sell the feeder cattle for \$67.00 per cwt. in the cash market. However, if he had purchased an April put option with an

**Table 1.** Feeder Cattle Price Increase from \$80 Per Cwt. to \$90 Per Cwt<sup>1</sup>

Cash Market	Futures - Hedge	Futures - Options
<b>October 10</b> Do nothing, hope for \$85.00	<b>October 10</b> Sell April contract at \$80.00 Lock-in price = \$77.00	<b>October 10</b> Buy April put at \$80.00 - \$2.00 - \$3.00 = \$75.00 price floor
<b>April 15</b> Sell feeder cattle for \$87.00 in cash market	<b>April 15</b> Buy April contract back at \$90.00 Sell feeder cattle for \$87.00 in cash market	<b>April 15</b> Let option expire (Lose \$2.00 premium) Sell feeder cattle for \$87.00 in cash market
<b>Results</b> \$87.00 per cwt.	<b>Results</b> \$87.00 - \$ 10.00 = \$77.00 per cwt.	<b>Results</b> \$87.00 - \$2.00 = \$85.00 per cwt.

<sup>1</sup>Feeder cattle market analysis assumes basis is \$3.00 under and \$2.00 premium on October 10.

**Table 2.** Feeder Cattle Price Decrease from \$80 Per Cwt. to \$70 Per Cwt<sup>1</sup>

Cash Market	Futures - Hedge	Futures - Options
<b>October 10</b> Do nothing, hope for \$85.00	<b>October 10</b> Sell April contract at \$80.00 Lock-in price = \$77.00	<b>October 10</b> Buy April put at \$80.00 - \$2.00 - \$3.00 = \$75.00 price floor
<b>April 15</b> Sell feeder cattle for \$67.00 in cash market	<b>April 15</b> Buy April contract back at \$70.00 Sell feeder cattle for \$67.00 in cash market	<b>April 15</b> Exercise option at \$80.00 (Buy \$70.00 April contract) Sell feeder cattle for \$67.00 in cash market
<b>Results</b> \$67.00 per cwt.	<b>Results</b> \$67.00 + \$10.00 = \$77.00 per cwt.	<b>Results</b> \$67.00 + \$10.00 - \$2.00 = \$75.00 per cwt.

<sup>1</sup>Feeder cattle market analysis assumes basis is \$3.00 under and \$2.00 premium on October 10.

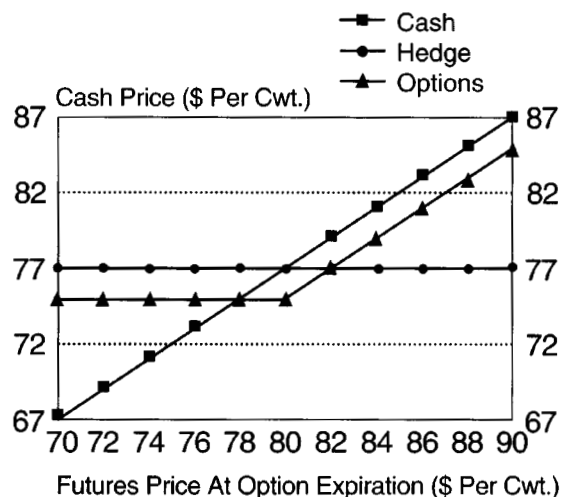
\$80.00 per cwt. strike price in October, he would now exercise the put option (sell an \$80.00 per cwt. April contract) and also sell the feeder cattle for \$67.00 per cwt. in the cash market.

The results of a \$10.00 per cwt. futures market price decrease for the three marketing alternatives ranged from a cash price of \$67.00 to \$77.00 per cwt. This time, doing nothing and selling in the cash market produced the lowest market price at \$67.00 per cwt. Hedging the feeder cattle in the futures market resulted in the highest market price at \$77.00 per cwt. (\$67.00 cash market + \$10.00 gain in the futures market). Buying a put option in the futures market resulted in a market price of \$75.00 per cwt. (\$67.00 cash market + \$10.00 gain in the futures market - \$2.00 premium for the put option = \$75.00 per cwt.).

Thus, with a futures market price decrease, hedging the feeder cattle in the futures market is preferable. However, seldom do you know with certainty that the market price is going to decrease. Thus, as illustrated, using the futures market by either placing a hedge or buying a put option provides the producer with market price protection from declining prices.

Illustrated in Figure 3 is the relationship of the cash price received and futures price at expiration for the three feeder cattle marketing alternatives. The previously described scenarios of price increase or decrease may be viewed by beginning with the \$80.00 per cwt. futures price at option expiration. When the futures market price increases (moves to the right), the highest market price received is the cash market alternative. Conversely, when the futures price decreases (moves to the left), the highest market price received occurs for the hedged market alternative.

Regardless of a futures price increase or decrease, the put option alternative is always second best. The market price for the put option alterna-



**Figure 3.** Feeder cattle marketing alternatives, assuming basis is \$3.00 under and \$2.00 premium.

ive ranges from \$75.00 to \$85.00 per cwt. The market price floor established by the put option is \$75.00 per cwt. between \$70.00 and \$80.00 per cwt. for the futures price at expiration. When the futures price at expiration increases above \$80.00 per cwt., the market price received for the put option increases correspondingly but is always \$2.00 per cwt. below the cash market price alternative. The hedge alternative is a constant \$77.00 per cwt. (\$80.00 futures market - \$3.00 basis), while the cash market price received ranges from \$67.00 to \$87.00 per cwt.

Obviously, no one knows with certainty if the futures market price will increase or decrease. Thus, a feeder cattle producer can gain market price risk protection with either the hedge or put option market alternatives. The hedge market alternative should be used to guard against plummeting prices at a price that will meet the producers' price objective (cost of production, management fee, capital replacement, etc.). The put option market alternative should be used when the producer

wants to establish a price floor and have an opportunity to benefit from any price increases. Therefore, the choice between the hedge and the put option marketing alternatives depends on what an individual prefers: an acceptable market price that has no opportunity of price adjustment or a lower acceptable market price that may increase with market price increases.

## Proving a Profit

The basic market alternatives available to the feeder cattle producer have their advantages and disadvantages. None of these marketing alternatives will provide the highest feeder cattle price year after year. Therefore, to take advantage of price opportunities, the producer must become a market watcher. Watching the market will require 15 minutes each day to gather and evaluate market information. Of course, as the producer becomes interested and successful, he will spend more time on this aspect of the operation. This small investment of time can pay large dividends and perhaps help avoid catastrophic market situations.

Anyone can sell, but few producers can market feeder cattle with skill. Profit is often the difference between employing a well-researched market strategy and accepting what the cash market will provide. When developing marketing strategies, the producer should explore the price opportunities of alternative markets and the potential boundaries of expected price movements. The key to making the feeder cattle enterprise profitable is matching a reli-

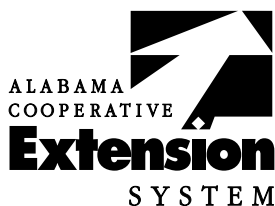
able production program with a well-researched market strategy. The feeder cattle producer can greatly improve profits and gain price protection by using marketing strategies.

In most instances, bad markets cannot be blamed for financial losses. A thoughtful producer offsets the hazards of bad markets by following well-laid plans and safe marketing practices. Reliable and effective marketing practices do not come to a person naturally—they must be learned through study and experience. There are no magical formulas for making a profit with feeder cattle, but a thorough examination of price opportunities in alternative markets will increase the chances of realizing a profit.

Numerous terms frequently used in futures hedging and options are not mentioned in this publication because of limited space. This effort covered only those terms essential to present the concepts of hedging and options in the futures market. Many trading techniques and sophisticated strategies have been developed for use in the futures market. For more information on these topics contact the author or a professional commodity broker analyst.

## For Further Reading

This publication is a portion of Chapter 2 in Extension publication ANR-1100, *Alabama Beef Cattle Producers Guide*.



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