

CALLING UP CALL OPTIONS

By Dave Kurzawski

Writing an article about how to hedge against the rising price of Class III milk during one of the biggest bull markets in milk's history is kind of like telling you not to smoke in bed as we stand outside your burning house; its advice not well received. Nevertheless, times like these may be the best time to discover tools you can use to protect against rising costs in the future. One tool that conjures up memories of Algebra class - and gets very little press because of that fact - is Call Options.

Call options allow milk and cheese buyers to take an active role in the price they pay for their milk, without limiting downside potential. What's the catch? There is no "catch". There are simply guidelines and rules for using call options effectively. And there are only certain times – under certain market conditions - when buying call options is a viable strategy to hedge milk purchases.

A call option gives the option buyer the right to buy (go "long") the underlying Class III futures contract at a predetermined price – the strike price. As a hedger, you will usually be a buyer of a call option – a buyer of price insurance. But before you decide to protect your price, you need to understand and be comfortable with the process.

Strike prices are available in 25 cent increments on both sides of the Class III futures price for any given month. For example, there's the \$16.00 strike, \$16.25 strike, \$16.50 strike and so on and strikes are listed both below and above the futures prices. The closer the strike price gets to the current class III futures price in a given month, the more expensive it becomes (intrinsic value). Using an insurance industry analogy, the strike price is the *deductible*. In other words, the lower the Class III ceiling price you desire in a given month, the more price protection your company receives and the more money you pay to buy that protection. As a milk buyer, you should really only concern yourself with strike prices above the futures market prices.

The money you pay to buy call options is the *premium* – again, using the insurance industry analogy (plus brokerage commissions and fees). The premium is derived by a mathematical formula that takes into consideration a number of variables, including intrinsic and time values, and futures price volatility to name a few. While you don't need to know specifically how the premiums are priced, you should be aware of what a reasonable price is and when to buy.

The amount you pay in premium to buy call options is your risk exposure – period (so long as you do not exercise the option). If the announced Class III price is below your strike price, your call option will expire worthless and you will lose your premium. From

a hedge standpoint, this is good. Think about our insurance analogy. You don't hope to cash in on your car insurance yet you happily pay for the coverage every month. Milk price protection in the form of call options is no different.

How do you decide a reasonable strike price; a reasonable ceiling price? First, you need to gather information on what your pain point - there is no sense in setting a ceiling price \$1.00/cwt above your breakeven. Once you have a healthy ceiling number in mind, your broker should know current premiums and market direction to help guide your decision.

Can't find a good broker? Remember to: (a) keep a lid on premium expenses, about 35 cents at most, which may hinder your ability to go out more than seven or eight months (time value), and (b) buy when you don't think you need the protection; buying call options should be one of the most counterintuitive action you take to protect your milk price. You may also want to consider the volatility of the market. If the class III market is giving you motion sickness, it's probably not a good time to be a buyer of call options.

Think about it another way: if you were to try to buy flood insurance while floating on a Barco lounge in your basement, your insurance agent probably wouldn't sell you any - but if you could get it, you'd pay dearly. Likewise, when Class III prices are rising, premiums for call options are more costly. Word to the wise, buy your insurance on a sunny day.

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