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November 2014

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Dear Ag Industry Associate,

This month's Margin Manager features an article that addresses a common question which often comes up in trying to understand how positions on the exchange offset the risk an operation has in their local market. Would it ever be appropriate for a producer to protect against higher prices? Given that a producer is receiving revenue for their production, it is natural to assume that the risk they face in the market is always to lower prices. In our feature article, we explore how this may not always be the case.

We also review how margins have changed over the past month in the crop, hog, dairy and beef cattle industries, and how our clients are managing these fluctuating margins with new positions as well as through adjustments to existing strategies. With the holiday season now in full swing and 2014 quickly winding down, we look ahead to next year with a full schedule for upcoming margin management educational programs in 2015 . Please visit www.cihedging.com/education to learn more.

Sincerely,

Chip Whalen
Managing Editor
V.P. Of Education & Research
CIH

Managing Editor, Chip Whalen is the Vice President of Education and Research for CIH, a leader in Margin Management. He teaches margin seminars throughout the country and can be reached at cwhalen@cihedging.com

Upcoming Margin Seminars

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Futures and options trading involves the risk of loss.

Protecting Higher Prices Against Long Physical Ownership

Recently, we received a call from a lender who had attended one of our seminars with a concern reviewing a client's account statement. The lender's client was a crop producer who raises corn and soybeans, and the lender was questioning one of the positions in the client's account. The crop producer had purchased a call option against new-crop corn that was soon to be harvested this fall. Understanding from our class that a hedge should be in the direction of risk the client faces in the market, the question was obvious: if this client is growing corn, doesn't he want to protect against lower prices? How does a call option help him, therefore, if the market is moving lower given that the call will lose value in a declining market?

While the above statement is true, it raises a few questions regarding what the actual risk is in the cash market. For example, has the crop already been priced with a counterparty in the local market such as an elevator or ethanol plant? This may present a scenario where the producer would want to protect the equity in the sale that will not be realized until the corn is actually harvested and delivered to the counterparty.

As an example, let's assume that this particular producer had established a hedge-to-arrive contract with a local elevator back in the spring when they were planting their corn at a price of $5.00/bushel based on the CBOT December futures contract. By late summer, December corn had declined down to a low of $3.20/bushel. While the producer is still entitled to the $5.00/bushel sale they established on the hedge-to-arrive contract, they also are sitting on $1.80/bushel worth of unrealized equity at that point in time which cannot be secured because the crop is yet to be harvested and delivered to the local elevator.

One way of protecting this unrealized equity would be to purchase a call option on the exchange. For a fixed premium which at the time may have cost around 10 or 15 cents/bushel, the producer could have locked in the difference between where they established their sale at $5.00 back in the spring and where the market was now trading around $3.20 in the early fall. If the market were to continue declining, they would lose the fixed premium paid for the call option but they are still protected to lower prices through the hedge-to-arrive contract they have at their local elevator. If the market were to instead move higher though as it has during October and November, they effectively have locked in the difference between the strike price of their call and where they established the hedge-to-arrive sale less the cost of the call option's premium.

> ***"The starting point of any hedge is always to evaluate where the risk would be in the open market. In the case of revenue received for an operation's production, that risk may not always be to lower prices."***

What if they didn't previously establish a sale with a local counterparty such as with a hedge-to-arrive contract at the elevator? As another example, let's assume that this particular crop producer purchased revenue protection insurance on their corn ahead of planting. The general feature of this insurance policy is that they are guaranteed a minimum level of revenue per acre on up to a maximum of 85% of their actual production history, which we will assume in this example has averaged 180 bushels per acre historically. The average closing price for December corn futures is calculated during the month of February to establish the threshold at which the revenue protection will trigger. For this year, that average price for December corn futures during the month of February was

Protecting Higher Prices Against Long Physical Ownership

Continued from previous page.

$4.61/bushel. This means that if the producer is purchasing revenue insurance on 85% of their actual production history, they are guaranteed no worse than $705.33/acre ($4.61/bushel futures price * 180 bushels/acre * 85% APH), regardless of their yield or the price of corn at harvest. They therefore would receive an indemnity payment if their actual revenue per acre is less than $705.33 at harvest, which is determined by their actual yield multiplied by the average of December corn futures during the month of October.

Let's now assume it is late summer again and this particular producer has been advised by his crop scout that conditions were favorable during pollination and the corn is projected to yield at least 5% above historical trend. As in the hedge-to-arrive example, December corn futures are now trading at $3.20/bushel. Should prices hold at this level through the month of October when the average December futures price is recalculated for the purpose of establishing potential indemnity payments, this producer would be looking at revenue of $608/acre which would be equivalent to the $3.20/bushel December futures price multiplied by the 190 bushel/acre yield being projected in late September.

In this scenario, the crop producer is looking at a difference between their expected revenue per acre and the revenue guaranteed by their insurance of $97.33/acre. Dividing this by their expected yield of 190 bushels/acre would be the equivalent of 51.23 cents/bushel of unrealized equity in their insurance policy that they can't tap because we are not yet through the month of October. Another way of thinking about this is to calculate at what futures price there would no longer be an indemnity payment available, assuming the producer actually harvests a 190 bushel/acre yield. If the producer is guaranteed revenue of $705.33/acre and we divide this revenue by 190 bushels per acre, the resulting price is just over $3.71/bushel. Therefore, if the market is trading at $3.20/bushel in late September, there is over 50 cents/bushel in potential unrealized indemnity payments that could be protected by purchasing a call option or call spread to bridge this difference.

Given that the producer paid for the insurance back in the spring which now has real value, it would make sense that they might consider protecting this value through the exchange. Like the hedge-to-arrive example, if the market continues moving lower into harvest, they are still guaranteed minimum revenue through their insurance policy and they simply lose the premium paid for the option. If the market recovers however as it has done, then it may well be worthwhile to have purchased a call option to protect this value. Another historical example of protecting higher prices against long physical ownership would be loan deficiency payments or LDP's that were common in the past decade prior to the ethanol era. Future examples may include how a dairy producer would secure unrealized value in the Margin Protection Program or MPP. Regardless of the situation, the starting point of any hedge is always to evaluate where the risk would be in the open market. In the case of revenue received for an operation's production, that risk may not always be to lower prices.

Upcoming Margin Seminars

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Hog Margin Watch: November

Margins deteriorated slightly since the middle of the month with the exception of deferred Q3 2015 which held steady. Feed costs have been flat over the past two weeks, although hog prices have slipped during the second half of November. From a historical standpoint, margins remain at or above the 90th percentile of the previous 10 years. As such, forward profitability continues to project quite favorably for hog finishers. Hog prices have succumbed to recent pressure as it appears that much of the holiday demand is now over while concern over PEDv and its impact on pork supplies heading into 2015 continues to wane. PEDv accessions are still being reported by the USDA's National Animal Health Laboratory Network (NAHLN), although not at nearly the same pace as last year when the disease was new. While it remains early in the season, there appears to be less concern about how the disease will impact hog numbers through the spring and early summer. Feed prices meanwhile have held relatively steady over the past two weeks without much feature. Harvest is quickly winding down as winter weather sets in across a broad area of the Corn Belt. Soybean meal basis remains stubbornly high in the cash market, although the domestic crushing pace has picked up dramatically in recent weeks with strong margins available to soybean processors. Our clients have benefited from making recent adjustments to existing positions, particularly strengthening hog hedges. Adding flexibility back to feed hedges is also an area of focus that our consultants are working with clients on. Flexible strategies continue to be favored in deferred periods for new margin coverage.

The Hog Margin calculation assumes that 73 lbs of soybean meal and 4.87 bushels of corn are required to produce 100 lean hog lbs. Additional assumed costs include $40 per cwt for other feed and non-feed expenses.

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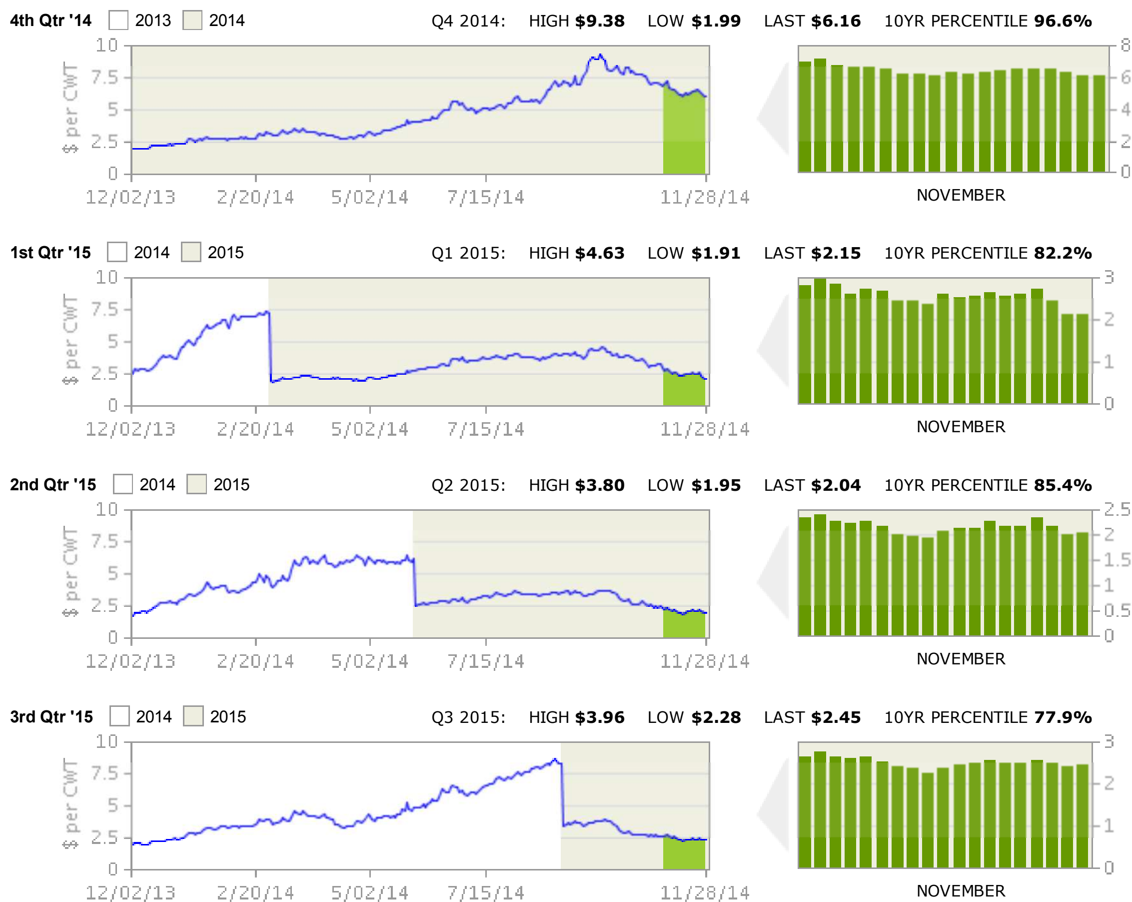
Continuing the trend established through the first half of the month, dairy margins further weakened since the middle of November as milk prices declined while feed costs held relatively steady. 2015 margins through Q3 are either above or near the 80th percentile of the past 10 years while spot Q4 is above the 95th percentile. USDA released the October Milk Production report, which reflected continued gains in both total milk production and production per cow. USDA reported October milk production in the 23 major states at 16 billion pounds, up 3.9% from 2013, with September revised production at 15.5 billion pounds up 4.3% from 2013. The September revision represented an increase of 22 million pounds from the preliminary estimate reported last month. October production per cow was pegged at 1,868 pounds in the 23 major states, up 51 pounds from 2013 and the highest production per cow for the month of October since the series began in 2003 according to USDA. The number of milking cows in the 23 major states for October was reported at 8.59 million head, up 89,000 from last year and 3,000 head more than September. Feed costs meanwhile held relatively steady in the second half of November as harvest winds down across a majority of the Corn Belt with winter weather setting in. Soybean meal cash basis remains stubbornly high across much of the country, although the domestic crushing pace has picked up substantially in recent weeks with strong margins available to soybean processors. Our clients have been busy making strategic adjustments on existing positions, specifically adding flexibility back to both milk and feed hedges. Flexible strategies continue to be favored in deferred periods for new coverage due to the weaker margins relative to spot values.



The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $7.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

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Beef Margin Watch: November

Beef finishing margins reversed the pattern witnessed over the first half of November by weakening in nearby periods where cattle has already been placed while strengthening in deferred periods where placements have not yet been made. Despite the strength in deferred periods, margins are still just above breakeven against the April marketing period and deeply negative for summer marketing periods due to high feeder cattle prices. Recent strength in corn futures appears to have limited strength in feeder cattle contracts, although live cattle futures also appear to be struggling at higher price levels. Recent strength in the dollar has caused concern for the future of beef exports while competing proteins such as pork and poultry may begin to sway domestic buyers more after the holiday season comes to an end. The October Cattle on Feed report also was construed as slightly bearish, with placements above market expectations. USDA reported November 1 on feed supplies at 10.633 million head, up 0.5% from last year when on average, analysts were expecting a 0.4% reduction from 2013. Placements in October totaled 2.357 million head, down just 0.9% from a year ago when the market was on average expecting a 4.2% reduction. Total beef in Cold Storage at the end of October was reported at 374.9 million pounds, down 14.8% from last year but slightly above September. Relative to the 5-year average, beef supplies remain historically low which should continue offering support to the market. Corn prices meanwhile have been relatively flat over the past two weeks, with harvest essentially over in much of the Corn Belt. Our clients have been active making strategic adjustments on existing positions, particularly adding flexibility back to feed hedges following recent corn strength. Opportunities to establish new protection on deferred placements remain limited by negative margins.

Live Cattle Marketing Periods:

Dec '14 2013 2014 — Dec 2014: HIGH **$20.81** LOW **($4.04)** LAST **$18.56** 10YR PERCENTILE **99.6%**

NOVEMBER

Feb '15 2014 2015 — Feb 2015: HIGH **$23.63** LOW **($2.95)** LAST **$19.11** 10YR PERCENTILE **98.8%**

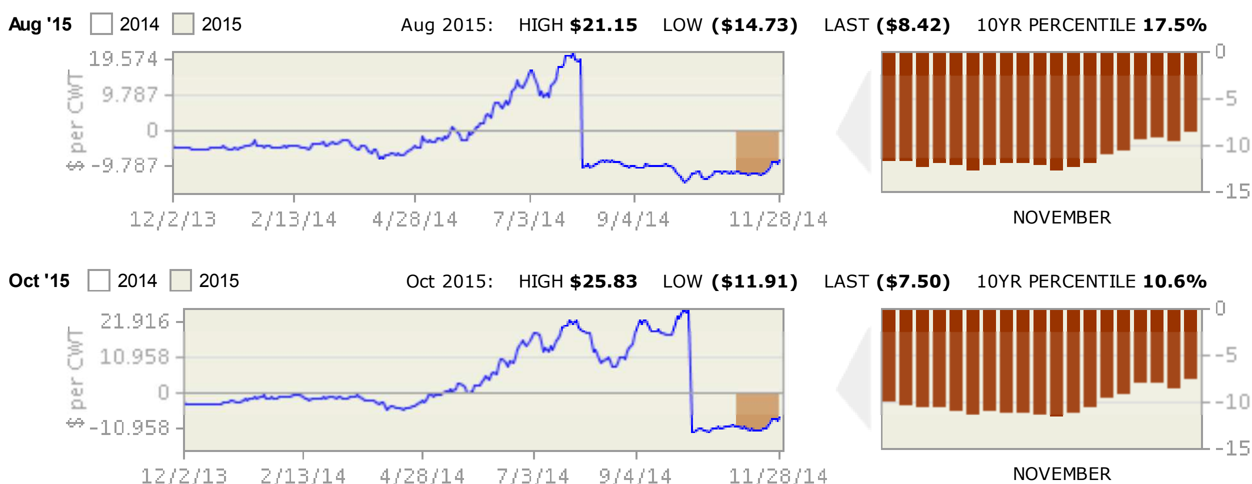
NOVEMBER

Apr '15 2014 2015 — Apr 2015: HIGH **$16.34** LOW **($6.59)** LAST **$0.31** 10YR PERCENTILE **75.1%**

NOVEMBER

Jun '15 2014 2015 — Jun 2015: HIGH **$7.24** LOW **($15.18)** LAST **($8.06)** 10YR PERCENTILE **24.9%**

NOVEMBER



The Beef Margin calculation uses Feeder Cattle futures to price inbound animals and assumes each will consume 55 bushels of corn and cost approximately $250 per head (for other feed and non-feed expenses) to gain 550 pounds and reach a market weight of 1,250 pounds.

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2015 Educational Program Schedule

Strategic Position Management
Feb 25 *(clients only)*

Beef Margin Management
Mar 11-12

Margin Management for Ag Lenders
Apr 22-23

Commodity Price Management
May 13-14

Crop Margin Management
Jul 8-9

Hog Margin Management
Jul 22-23

Dairy Margin Management
Aug 5-6

Margin Management for Ag Lenders
Oct 21-22

Dairy Margin Managment
Nov 18-19

Hog Margin Management
Dec 9-10

Crop Margin Management
Dec 16-17

Trading futures and options carry the risk of loss. All dates subject to change. Please check cihedging.com/education for more information and the latest additions to the schedule.

Corn Margin Watch: November

Corn margins have fallen slightly since the middle of November as farmers finished their harvest efforts for the year. Final production figures will be reported in January when NASS closes the books on this year's record output. The CBO recently reported the president's 2015 budget estimates which include funding for agriculture. The report contained estimates for 2015 planted acreage for the principle crops and initially pegged corn plantings at 90 million acres, down 900,000 acres from this past year. While still preliminary, this will serve as a benchmark when the expectation is updated in February and will provide a baseline for the March planting intentions report. On the demand side, ethanol production continues to exceed last year's weekly rates and is currently running 4% above last year. The current USDA expectation is for a slight 0.3% increase over last year. The EPA has yet to report an official decision on the biofuel mandate for 2015 but is expected to do so before the end of the first quarter next year. Exports have kept pace with the USDA expectation as exporters have sold 48.5% of the forecast compared to 48.1% on average for this point in the crop year. Shipments have been slightly slower than average with 19.1% of the forecast shipped compared to 21.7% on average. On the global front, South American weather has cooperated for planting. Forecasts over the next two to three weeks remain favorable for early crop development. Our consultants are working with clients to help make strategic adjustments to existing protection strategies that would increase the delta in current hedges to capitalize on the increase in price of late while retaining the opportunity to benefit further should prices continue to move higher.

The estimated yield for the 2014 crop is 180 bushels per acre and the non-land operating cost is $612 per acre. Land cost for 2014 is estimated at $243 per acre [1]. Basis for the 2014 crop is estimated at $-0.2 per bushel.

The estimated yield for the 2015 crop is 174 bushels per acre and the estimated operating cost is $615 per acre. Land cost for 2015 is estimated at $238 per acre [1]. Basis for the 2015 crop is estimated at $-0.2 per bushel.

[1] The Corn Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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Soybeans Margin Watch: November

Soybean margins have improved since the middle of November as demand continues to exceed previous expectations while harvest wraps up. Soybean exports have remained the hot topic with sales and shipments ramping up. Exporters have committed 82.6% of the USDA expectation for future delivery which compares to 62.3% on average for this point in the crop year. Shipments out of port are running at 39.5% of the expectation compared to 29.7% on average. Soybean meal sales and shipments are also quite strong which supports the current domestic crush projection. Transportation logistics for soybean meal remain, and has been the driver behind strengthening basis values of late. Soybean meal basis are nominally high for this period of the year and are now at a 10-year high. Regarding biodiesel production, the EPA has yet to report an official decision on the biofuel mandate for 2015 but is expected to do so before the end of the first quarter next year. The CBO recently reported the president's 2015 budget estimates which include funding for agriculture. The report contained estimates for 2015 planted acreage for the principle crops and initially pegged soybean plantings at 81 million acres, down 2 million acres from this past year. While still preliminary, this will serve as a benchmark when the expectation is updated in February and will provide a baseline for the March planting intentions report. On the global front, Brazil is estimated to have 80% of the intended crop planted which is slightly behind average. Weather forecasts remain favorable for early development and continued planting over the next two to three weeks. Our consultants are working with clients to help manage existing protection strategies. Some of our clients are considering adjustments to those strategies that would add delta to current hedges to capitalize on the higher prices while retaining flexibility to participate in higher prices should that continue.

The estimated yield for the 2014 crop is 52 bushels per acre and the non-land operating cost is $364 per acre. Land cost for 2014 is estimated at $243 per acre [1]. Basis for the 2014 crop is estimated at $-0.2 per bushel.

The estimated yield for the 2015 crop is 52 bushels per acre and the estimated operating cost is $365 per acre. Land cost for 2015 is estimated at $238 per acre [1]. Basis for the 2015 crop is estimated at $-0.2 per bushel.

[1] The Soybeans Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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Wheat Margin Watch: November

Wheat margins have increased modestly again since the middle of November and are currently at the best levels since the beginning of September. The winter crop is virtually 100% emerged and awaits snow cover particularly in the western plains as winter temperatures seem to be upon us. Crop conditions have deteriorated slightly with the most recent NASS report showing 58% of the crop is in good-to-excellent condition, down 2 percent from last week and off 4 percent from last year at this time. Condition ratings heading into the winter dormancy period have historically had little effect on the harvest potential as spring weather conditions are the key to yields. Damage to the crop is still expected from the bitter cold temperatures a few weeks back but won’t become real until the crop exits dormancy. U.S. exports have been stagnant over the past few weeks. French wheat remains the world’s cheapest supply, and remains the main competitor to world exports. Wheat shipments are running at 50% of the USDA expectation of 925 million bushels compared to 53% on average for this time in the crop year. The E.U. will remain the primary exporter as they work through the large harvest into next year. Geopolitical issues remain in the black sea region with Russia and Ukraine. While no formal conflict has begun, tensions are high and an escalation of the situation could affect the export picture and warrants attention. Our consultants continue working with clients to protect these forward margins with flexible strategies on existing coverage that will allow for potential margin improvement over time. Some of our clients are considering adjustments to current protection strategies that would capitalize on the rising prices while still preserving the opportunity to participate in higher prices should the market continue higher.

The estimated yield for the 2014 crop is 67 bushels per acre and the non-land operating cost is $366 per acre. Land cost for 2014 is estimated at $163 per acre [1]. Basis for the 2014 crop is estimated at $0 per bushel.

The estimated yield for the 2015 crop is 72 bushels per acre and the estimated operating cost is $328 per acre. Land cost for 2015 is estimated at $158 per acre [1]. Basis for the 2015 crop is estimated at $-0.25 per bushel.

[1] The Wheat Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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