INSURANCE

Substitution of a small but

certain loss (insurance premium)

for the possibility of a large

uncertain loss.

COMMODITY OPTIONS MARKET

Market in which producers may purchase the "opportunity" but not the "obligation" to sell or buy a ~~commodity~~ Futures at a certain price.

TWO MARKETS

- “INSURING” SELLING PRICE
- “INSURING” BUYING PRICE

Want right to sell corn for $3.00/bu.

Purchase right in options market by paying premium

If price when ready to sell is above $3.00
- sell for higher price

If price is below $3.00
- "collect on policy"

CALL OPTION

A contract that gives the holder the right to buy at a specified price

"To call from them"

PUT OPTION

A contract that gives the holder

the right to sell at a specified price

"To put it on them"

OPTION BUYER (HOLDER)

THE PERSON WHO OBTAINS THE

RIGHTS CONVEYED BY THE OPTION

OPTION SELLER
(GRANTOR OR WRITER)

THE PERSON WHO SELLS THE OPTION AND GRANTS THE RIGHTS CONTAINED IN IT

EXERCISE
OR
STRIKE PRICE

THE SPECIFIED PRICE AT WHICH THE OPTION PURCHASER MAY BUY OR SELL THE COMMODITY

THE UNDERLYING COMMODITY IS A FUTURES CONTRACT, NOT THE PHYSICAL COMMODITY

EXPIRATION DATE

THE DATE UPON WHICH THE RIGHTS OF THE OPTION PURCHASER EXPIRE

OPTION PREMIUM

THE MARKET VALUE
OF THE OPTION.

IN EFFECT, THE PRICE OF
THE "INSURANCE"

FACTORS AFFECTING PREMIUMS

- DIFFERENCE BETWEEN THE STRIKE PRICE OF THE OPTION AND THE PRICE OF THE UNDERLYING COMMODITY

- LENGTH OF TIME TO EXPIRATION

INTRINSIC VALUE

"POSITIVE" DIFFERENCE BETWEEN STRIKE PRICE AND UNDERLYING COMMODITY PRICE

FOR A PUT – STRIKE PRICE EXCEEDS FUTURES PRICE

FOR A CALL – STRIKE PRICE BELOW FUTURES PRICE

OPTIONS THAT ARE
SAID TO BE:

<u>"IN-THE-MONEY"</u>

HAVE INTRINSIC VALUE

<u>"OUT-OF-THE-MONEY"</u>

HAVE NO INTRINSIC VALUE

TIME VALUE

PORTION OF OPTION PREMIUM RESULTING FROM LENGTH OF TIME TO EXPIRATION

- USUALLY TIME VALUE DECREASES WITH LENGTH OF TIME UNTIL EXPIRATION

OFFSET AN OPTION

TO SELL AN EXISTING OPTION

CONTRACT IN ORDER TO LIQUIDATE

THE OPTION POSITION

MONEY FLOWS

Holding a soybean $7.00 put purchase

for a $0.15 premium

OFFSET

Current futures price is $6.50

Sell option at a $0.60 premium

RESULT

	40
Offset premium received	$0.60
– Original premium paid	–0.15
Net returns	$0.45

EXERCISE AN OPTION

TO CONVERT AN OPTION CONTRACT TO A POSITION IN THE FUTURES MARKET

MONEY FLOWS

Holding a soybean $7.00 put purchased
for a $0.15 premium

EXERCISE

Current futures price is $6.50

Receive a short (sell) futures market position at $7.00

Buy futures at $6.50

RESULT

Futures gain	$0.50
– Original premium paid	–0.15
Net Returns	$0.35