Getting Long On Short-Dated New Crop Grain Options

BY HOWARD SIMONS

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Will Rogers once quipped that the secret to investing was to buy stocks that went up; if they did not go up, well, do not buy them. Futures and options contracts have a similarly clear test for commercial traders: If they allow you to do what you already do faster, cheaper and better, then use them.

CME Group's suite of Short-Dated New Crop corn, soybean and wheat options meet this test, and if early trading in 2013 is any indication, will take their place alongside standard grain options eventually.

As one active speculator noted, "Short-Dated New Crop Options on corn, soybean and wheat futures complement CME Group's already deep and liquid agricultural options complex, which includes standard or serial options, weekly options, calendar and other spread options and the newly-listed MGEX-CBOT wheat spread options."

Launched in June 2012, Short-Dated New Crop Options are based on the new-crop months – July wheat, November soybeans and December corn – but use expiration dates for earlier contract months. For example, conventional December 2013 options for corn expire on November 22; by contrast, short-dated versions for May, July and September expire April 26, June 21 and August 23, respectively.

The Key Advantage

The "faster, cheaper, better" requirement is met through options mechanics. Any option price contains a time premium affected by both the time remaining to expiration and implied volatility.

As one commercial hedger observed, "The greater the price volatility and/or the longer the time to a contract's expiration, the greater the cost of using options. Thus the CME Group's Short-Dated New Crop options to allow us to manage new crop risk at a reduced cost during targeted timeframes in the growing season."

The targeted time frame aspect is critical. The growing season is filled with known events happening either at scheduled times and dates, such as U.S. Department of Agriculture reports, as well as over longer time frames, such as pollination in corn and pod-setting in soybeans.

These events affect new-crop prices much earlier than the expiration cycles of standard options and follow each other in a series. If conditions change drastically during the growing season, as happened with the 2012 drought, Short-Dated New Crop Options will reflect those changes with lower initial cost and greater leverage than standard options.

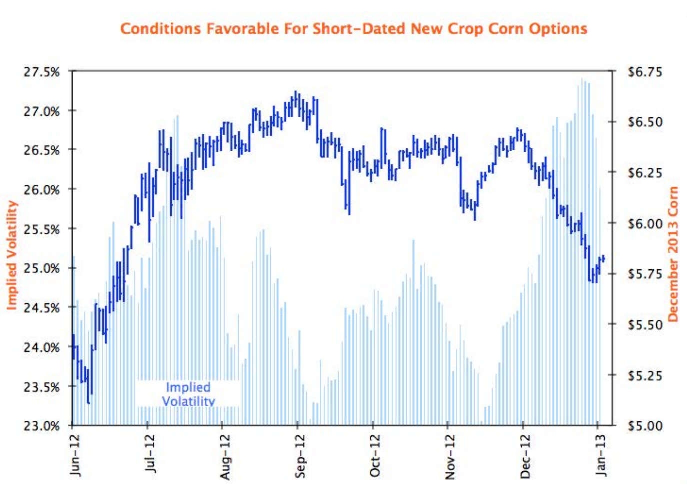
"These options will enable commercial grain customers to expand their offering of minimum price contracts," a grain elevator manager said. "Elevators can hedge themselves against minimum price contracts using these options."

A Look at Corn

Short-Dated New Crop Options for December 2013 corn started trading January 2. Some of the more active contracts so far include May $5.50 puts, July $6.20 and $6.40 calls and July $5.50 puts. Total open interest climbed quickly to almost 13,700 contracts, indicating remarkable acceptance for a still-new product and also not surprising, given the value of the contracts.

The market is getting it right. A chart of December 2013 corn since the start of the 2012 drought shows two things clearly:

- Prices remain in their general downtrend of the past month; and
- Implied volatility for the December contract has expanded considerably



The market is absorbing both the impending harvest in South America and the beginning of the U.S. spring planting intentions cycle - hence the expanding implied volatility. This rising volatility will increase the time premium for standard expiration options more than it will for Short-Dated New Crop Options.

In addition, the events determining the first shift in the price trend in either direction will happen within the July Short-Dated New Crop expiration cycle and quite possibly within the May expiration cycle as well. The corn market's gravitation to the $5.50 put strike is logical, given its role as a strong support level; the same can be said for the $6.20 and $6.40 resistance levels for the call options.

Short-Dated New Crop Options are suited perfectly to market conditions and events such as this. Others will follow for soybeans and for wheat in 2013. Traders have recognized it quickly and as the long and successful history of grain trading confirms, liquidity begets liquidity.

"Cultivating liquidity in these products is a tremendous priority to us and we are totally committed to helping the CME grow the open interest in them," said Noel Blue, Director of Institutional Business Development for Futures International, LLC. "As the dynamic of the agricultural markets continues to evolve, I think it is critical to integrate these into your risk management strategies going forward."

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