COMMODITY HEDGING

Hedging in commodities markets

– By Prof. Simply Simple

COMMODITY HEDGING

- Commodity hedging means reducing or controlling risk arising out of fluctuation in raw-material prices
- Commodity hedging is done by taking a position in the futures market that is opposite to the position in physical market
- Any buyer or seller facing the risk of volatile commodity prices can do commodity hedging after compliance with regulatory requirements.

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Hedging is a two-step process.

For instance, a wheat farmer can sell wheat futures at current prices to protect the value of his crop prior to harvest

- ***If there is a fall in price, the loss in the cash market position will be countered by a gain in the futures position***
- ***Thus, the farmer meets his objective of ensuring certainty in his revenue***

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Example…

- **Assume it is the month of July and the farmer expects a drop in the selling price of corn**
- **His corn production of 15000 baskets is likely to be ready in September**
- **The current price (July) is $4.50 per basket**
- **To hedge his risk, he sells three 5000 basket <u>futures contracts</u> on October corn for more than the current price...say $5 per basket**
- **When September arrives, prices have fallen down to $3.90 a basket**

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- So, he is now going to receive a much lower price on his corn
- To offset this potential loss, he buys corn futures for $4.60 per basket
- If you remember, he had sold corn futures at a price of $5 and he is buying it back at the lower price of $4.60. This is because the price of corn futures has also now come down with the fall in price of corn
- So, in the futures markets, he has earned a profit of $0.40 due to the difference in his selling and buying prices ($5 sale price - $ 4.60 buying price = $0.40 gain)

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- Though, he is forced to sell the corn at a reduced price of $3.90 per basket, his <u>effective selling price</u> <u>works out $4.30 per basket</u> ($3.90 + $0.40 profit from futures)
- So, his sales revenue comes to $64500 ($4.30 X 15000 baskets)
- He would have lost $6000, if he had not hedged i.e. profit from futures ($0.40 X 15000 = $6000)
- So, between his cash and futures positions, he has effectively reduced his losses from the price decline

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Hope you have now understood the concept of commodity hedging.

Thinking of Investment

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