

## COMMODITY HEDGING



vEcoSys

**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.**





## COMMODITY HEDGING

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 futures contracts 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 effective selling price works out \$4.30 per basket  
( $\$3.90 + \$0.40$  profit from futures)
- ❑ So, his sales revenue comes to \$64500 ( $\$4.30 \times 15000$  baskets)
- ❑ He would have lost \$6000, if he had not hedged i.e. profit from futures  
( $\$0.40 \times 15000 = \$6000$ )
- ❑ So, between his cash and futures positions, he has effectively reduced his losses from the price decline



## COMMODITY HEDGING



Hope you have now understood the concept of commodity hedging.



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