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G85-768 Basic Terminology For Understanding Grain Options

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Basic Terminology For Understanding Grain Options

This publication, the first of six NebGuides on agricultural grain options, defines many of the terms commonly used in futures trading.

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In order to properly understand examples and literature on options trading, it is imperative the reader understand the terminology used in trading grain options. The following list also includes terms commonly used in futures trading. These terms are included because the option is traded on an underlying futures contract position. It is an option on the futures market, not on the physical commodity itself. Therefore, a producer also needs a basic understanding of the futures market.

GRAIN OPTIONS TERMS AND DEFINITIONS

AT-THE-MONEY

When an option's strike price is equal to, or approximately equal to, the current market price of the underlying futures contract.

• Put Option

If the strike price (of a specific contract) is equal to, or approximately equal to, the current futures price, it has neither value nor non-value. It is neutral or at-the-money.

• Call Option

If the strike price (of a specific contract) is equal to, or approximately equal to, the current futures price it has neither value nor non-value. It is neutral or at-the-money.

BASIS

"Basis" is the difference between the local cash price and the futures price for a specific time and location. In any forward pricing contract, estimating the "basis" is extremely important in evaluating the actual price to be received by the producer. For example, suppose the September corn futures contract settles at \$2.12/bushel and the local bid price on the same day is \$2.02/bushel. The difference between the futures price and the local bid price is the basis ($\$2.12 - \$2.02 = \$0.10$).

BEARISH

When the market perceives that prices will be lower. A downtrending market.

BREAK-EVEN POINT

When a specific option strategy compared to a futures price is neither profitable nor unprofitable. In a call option, the break-even point is the strike price plus the premium. The strike price minus the premium is the break-even point in a put option. When evaluating a break-even price for a specific strategy, a producer should consider "basis," commission costs, etc.

BULLISH

When the market perceives that prices will increase. An uptrending market.

BUYER AND/OR HOLDER

The holder or buyer who pays a premium for an option has the right, but not the obligation, to take a futures contract position at a specific price. A buyer may purchase either a put or a call option. For example, a Nebraska producer (buyer) pays a premium to buy a \$3.00 put option. He has the right, but not the obligation, to later sell (hedge) corn at \$3.00/bushel on the futures market.

CALL OPTION

This option gives the buyer the right, but not the obligation, to go long or buy a contract on the futures market at a specific strike price if exercised before the expiration date. An example might be a Nebraska cattle feeder who wishes to protect the price he will pay for the corn he plans to feed.

COMMISSION

Fees paid to a broker to complete an order for the customer.

CFTC

The Commodity Futures Trading Commission. A government regulatory agency that oversees and monitors the actions of the exchanges.

Commodity Exchanges

CBT--The Chicago Board of Trade - presently trading corn and the soybean options.

CME--The Chicago Mercantile Exchange presently trading live cattle and hog options.

KC--The Kansas City Board of Trade presently trading hard red winter wheat options.

MCE--The Mid-America Commodity Exchange - trading cattle and hog livestock options and wheat, soybean and corn grain option

MPLS--The Minneapolis Grain Exchange presently trading hard red spring wheat options.
CTN--The New York Cotton Exchange.

EXERCISE

The action taken by the buyer (holder) of either a put or call option when he enters a futures market at the strike price (exercise price) of his option. A holder (buyer) of a put would "sell" (go-short) the futures contract. A buyer (holder) of a call would buy (go-long) the respective futures contract.

EXERCISE PRICE AND/OR STRIKE PRICE

Interchangeable terms for the price at which a person may purchase or sell the underlying futures contract upon the exercise of an option.

EXPIRATION DATE

The last date that an option may be exercised or the last date that a holder of an option contract can enter the futures market at the specified strike price. It is also the last day that any action can be taken on an options contract. For example, the expiration date is the last day a contract could be offset. The date is critical to a producer. He must understand that a November option will expire in October 1 not November. Due to the uncertainty of corn harvest, a producer may decide to use a January option rather than a November option. To determine the expiration date see NebGuide G85-769 entitled *Options Contract Specifications on Grain Futures Contracts*.

EXTRINSIC AND/OR TIME VALUE

In most literature, time value is the more common term. Time value is the sum of money that buyers are currently willing to pay for a given option--the premium. Time value is an eroding asset and will generally approach zero as the life of an option contract nears the expiration date. Time value decreases simply because there is no longer time remaining.

FUTURES CONTRACT

A contract that is traded at the respective Exchange for future delivery of a specified commodity. Options are exercised against specific futures contracts.

FUTURES PRICE

The price of a specific futures contract being traded.

IN-THE-MONEY

If an option has intrinsic value, it is said to be in-the-money.

• Put Option

If the strike price (of a specific contract) is above the current futures price, the put has value and is in-the-money.

• Call Option

If the strike price is below the current future price (of a specific contract) the call has value and is in-the-money.

INTRINSIC VALUE

The dollar value (return) that could be realized if an option were exercised or liquidated at a given strike price. A call option has intrinsic value or is in-the-money if the strike price is below the futures price. A put option has intrinsic value if the strike price is above the futures price. For example, if a corn call option has a strike price of \$2.10 and the underlying futures price is \$2.18, the call option has an intrinsic value or is in-the-money by 8 cents. If a soybean put option has a strike price of \$5.25, the put option has an intrinsic value of 10 cents.

LIQUIDATION

An action (either buying or selling) which would offset an existing position. A holder of an option would either buy or sell an opposite contract to his existing option (call or put) that he has paid a premium to own.

MARGIN

The initial deposit made by writers and sellers to establish a margin account for the underlying futures contract. If the market moves against the futures contract, margin money is taken from the margin account.

MARGIN CALLS

Additional money that must be deposited as the market moves against an individual's position to insure performance of the contract. While buyers of puts and calls are not subject to margin calls, writers or sellers must deposit margin money to back the underlying futures contract in case the buyer decides to exercise his option.

NAKED WRITING

Writing a call or a put option in which the seller has not taken an opposite position in either the cash or futures market and thus leaves himself open to unlimited risk.

OPEN CONTRACT

The total number of contracts (futures or options) that are outstanding (open contracts) for a certain commodity.

OUT-OF-THE-MONEY

If an option has no intrinsic value, it is said to be out-of-the-money. An option that is out-of-the-money would not be worthwhile to exercise.

• Put Option

If the strike price (of a specific contract) is below the current futures price the put has no value and is out-of-the-money.

- **Call Option**

If the strike price is above the current futures price (of a specific contract) the call has no value and is out-of-the-money.

PREMIUM

The price paid by the buyer to obtain an option at a specific strike price. The premium is the maximum amount the buyer (purchaser) can lose.

PUT OPTION

Gives the buyer the right, but not the obligation, to sell a futures contract at a specified strike price during the options contract life.

STRIKE PRICE

The price at which a person may purchase or sell the underlying futures contract upon the exercise of an option.

- **Put**

The buyer sells a futures contract at a specified price.

- **Call**

The buyer buys a futures contract at a specified price.

CONCLUSION

Options contracts are purchased for a premium at a specific strike price. Generally, producers are buyers, or holders of options contracts. A put option is an option to sell. In a bearish market, a farmer may purchase a put option to secure a price for his harvested crop. A call option is an option to buy. In a bullish market, a livestock producer may purchase a call option to lock in the price of feed grains. Once an option contract is purchased, the farmer has three alternatives in utilizing his option contract. He can exercise the option, liquidate the option, or let the option contract expire. The action he employs will depend on whether the option is in-the-money, at-the-money, or out-of-the-money.

Producers can also be sellers or writers of options. Writers are either covered or uncovered (naked) writers. The writer of an options contract is subject to margin calls.

While the list of definitions and examples may not cover everything, it includes the basic terms a potential user of options contracts should know.

AGRICULTURAL GRAIN OPTIONS

This series includes the following NebGuides which may be obtained at your local Cooperative Extension office.

- *G85-768, Basic Terminology for Understanding Grain Options*

- *G85-769, Options Contract Specifications on Grain Futures Contracts*
- *G85-770, An Introduction to Grain Options on Futures Contracts*
- *G85-771, Evaluating Grain Options Versus Futures Contracts*
- *G85-772, Using Grain Options to Follow a Rising Market*
- *G85-773, Evaluating Pricing Opportunities with Grain Options*

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