Getting Long On Short-Dated New Crop Options

Will Rogers once quipped 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.

The suite of short-dated new crop options (SDNC) meets this test and if early trading in 2013 is any indication will take their places alongside standard grain options. 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."

SDNC are based on the new crop months – July for wheat, November for soybeans and December for corn – but use expiration dates for earlier contract months. For example, while December 2013 options for corn will expire on November 22, 2013, you will have options on the December contract expiring on the May, July and September dates of April 26, June 21 and August 23, 2012, respectively. For more information on SDNC option cycles, please see www.cmegroup.com/trading/agricultural/short-dated-new-crop-options.html.

The Key Advantage

The "faster, cheaper, better" requirement is met by SDNC through option 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."

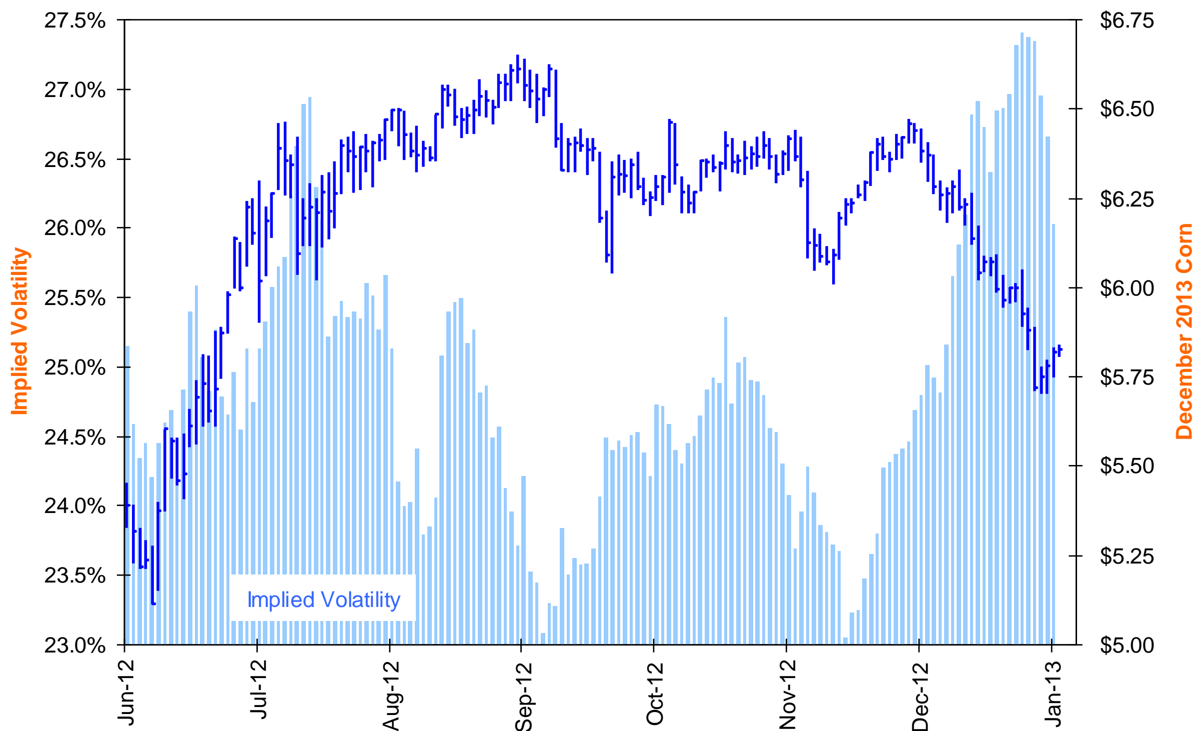
The targeted timeframe aspect is critical. The growing season is filled with known events happening either at times known exactly, such as USDA reports, or generally, such as pollination or pod-setting. These events affect new crop prices much earlier than the expiration cycles of standard options and follow each other in a series. If conditions change drastically during the growing season, as happened with the drought in 2012, SDNC will reflect those changes with lower initial cost and greater leverage than standard options. As one grain elevator operator said, "These options will enable commercial grain customers to expand their offering of minimum price contracts. Elevators can hedge themselves against minimum price contracts using these options."

A Look At Corn

SDNC for December 2013 corn started trading on January 2, 2013. Some of the more active contracts so far include the May $5.50 put, July $6.20 and $6.40 calls and the July $5.50 put. Total open interest has climbed quickly to almost 13,700 contracts, on one level a remarkable acceptance for a still-new product and on another level unsurprising given the value of SDNC.

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

- 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 Southern Hemisphere harvest and the beginning of the U.S. 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 SDNC. In addition, the events determining the first shift in the price trend in either direction will happen within the July SDNC's expiration cycle and quite possibly within the May SDNC's option expiration cycle. The 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.

SDNC's are suited perfectly to market conditions and events such as this. Others will follow for soybeans and for wheat during 2013. Traders have recognized it quickly and as the long and successful history of grain trading confirms, liquidity begets liquidity. As Noel Blue, Director of Institutional Business Development for Futures International, LLC, puts it, "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. 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."