Hedging with lean hogs futures

Hog producers can use a short hedge to offset their risk of prices falling by the time they are ready to sell the livestock.

A producer initiates the hedge by selling futures contracts to cover the livestock they plan to sell, and when the hogs are ready for the market, they buy back the short futures contracts and simultaneously sell the hogs in the cash market. The short hedge allows the producers to lock in a price for their hogs so long as the basis turns out as expected. The lean hogs futures contract size is 40,000 pounds or approximately 200 hogs at current hog carcass weight.

EXAMPLE

In April, a hog producer expects to have 1,000 hogs ready for market by October. The October futures price is currently trading at $88/cwt. However, he feels uncertain over the outlook of hog prices, but going through historical data, he expects the basis (futures minus local cash) to be $2 under futures. He decides to sell short an October Lean Hog futures contract at $88/cwt to cover his production.

	Cash Market	Futures	Basis
April	Expected $86	Sell Oct $88	Expected -$2

By October, if futures price declines to $82/cwt and the cash price is $80/cwt, the hedger buys back the October futures and realizes a gain of $6/cwt

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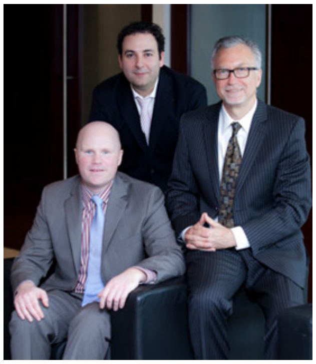

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($88 - $82); he then sells the hogs in the cash market for $80/cwt. The net price received from hedging is $80 plus the $6 futures gain, or $86/cwt.

Instead, if October futures price rises to $92/cwt by October, and the cash price to $90/cwt, the hedger buys back the short October futures contract at $92/cwt for a loss of $4/cwt ($88 - $92). He then simultaneously sells his hogs in the cash market for $90/cwt. The net price received would be $90 minus $4, the loss in futures, or $86/cwt.

The main reason the hedger is able to lock in the expected cash price of $86/cwt is because the basis turns out as anticipated at $2 under the October futures, regardless of higher or lower futures prices, as shown in the scenarios above.

If instead the basis is stronger than expected, the net outcome would be skewed. For example, say the futures price drops to $84/cwt by October and the cash price is at $83/cwt. The buy back of the October futures contract would produce a gain of $4 ($88 - $84); and the net cash received after selling the hogs in the cash market would be $87/cwt, an improvement of $1 due to the firmer basis. The opposite could also be true if the basis ended up being weaker than expected.

For more information about hedging with lean hogs, or commodity/financial futures, please contact us.

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