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TRADING TECHNIQUES

Grain market fundamentals appear poised to buck the trend of the last year and push prices higher. Here, we'll demonstrate how to take advantage of bullish scenarios such as this one with a well-planned option selling strategy.

Selling puts to exploit bullish fundamentals

BY JAMES CORDIER AND MICHAEL GROSS

The rapid deflation of global commodities prices over the past nine months has left many futures markets consolidating at what many would consider depressed levels. Bailouts, stimulus plans, shrinking 401(k)s and Bernie Madoff have dominated the headlines, while commodities have quietly percolated on the back burner of the investment kitchen.

Now, as a few specks of light begin to flicker through the darkness, commodities may be positioned to take advantage of the early stages of a global economic recovery. While energy and metals are the media celebrities of the commodities markets, it is an old school commodity sector that may show the most promise for bulls in 2009.

Although demand for industrial commodities like oil and copper has dropped substantially during the global recession, necessities such as foodstuffs are less affected by economic conditions. Food is one of the last things populations cut back on in slowing economies, and grains — wheat, corn and soybeans — are the most basic of foodstuffs. (Soybeans are technically an oilseed,

but for purposes of this discussion, we'll treat them as grain.)

Grain market bulls already had a few factors working in their favor as 2009 got under way, including Argentine farmer unrest and some vague inflationary fears that helped to keep the more aggressive bears at bay. This allowed the agricultural markets to regain some footing as planting season approached. The U.S. Department of Agriculture (USDA) is projecting food inflation of 3% to 4% this year. It could be higher if the dollar depreciates. Many expect it will later in the year as the massive U.S. debt load begins to show itself in earnest.

However, the USDA's March 31 Acreage and Grain Stocks report was a boon for U.S. agricultural markets, especially soybeans. Of the eight major U.S. crops, the USDA showed a total drop of 2.8%, or 7.091 million acres, in planted acreage vs. 2008. Among the factors cited for the drop in acreage: Higher fertilizer costs, lower grain prices on the board (less profitability) and a decrease in available credit to farmers.

The report was somewhat supportive to corn and wheat. Wheat acreage, pegged at 58.6 million acres, is down 7%

from last year. Corn acreage at 85 million acres is down 1% from last year. Soybean acreage at 76.024 million acres is actually up 0.4% over last year. So why is this considered bullish?

It's bullish because even though it's higher, it fell short of expectations, which caught the market by surprise. Expectations are huge when you're in the forecasting business. Many estimates suggested that U.S. farmers would plant between 79 and 83 million acres of soybeans in 2009, a range that had kept a harness on soybean bulls focused on lower ending stocks numbers for 2008-09.

Quarterly grain stocks also seemed to hint at a possible price leader in any grain rallies over the second and third quarters of 2009. While wheat and corn both have higher supplies in storage than at this time in 2008, soybean stocks are down 9% over last year.

The news comes, however, as soybeans already find themselves in a year of tight ending stocks.

IMPORTANCE OF ENDING STOCKS

Two of the most important figures for soybean fundamentalists are ending stocks and the stocks to usage ratio.

Ending stocks are the amount of soybeans left over at the end of the previous crop marketing year (Sept. 1) after all demand has been met. In other words, it's the amount of soybeans still left over in the barn when they start bringing in this year's soybean harvest.

The stocks-to-usage ratio is this ending stocks figure divided by the previous year's total consumption. Stocks to usage is expressed as a percentage, and it is supposed to show how much total demand could be met if no soybeans were harvested this year. In other words, if stocks-to-usage ratio was 10% on Sept. 1, 2009, the soybean stocks in the barn would be able to meet 10% of next year's demand before we ran out of beans. This figure assumes that demand in 2009-10 will be the same as it was in 2008-09, which is rarely the case. However, it is a useful measure of supply and demand nonetheless.

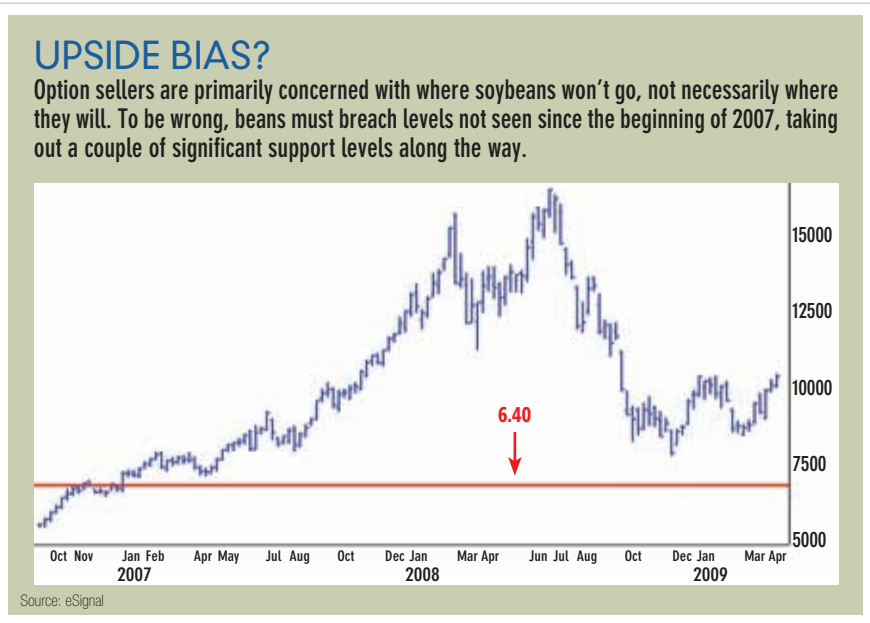
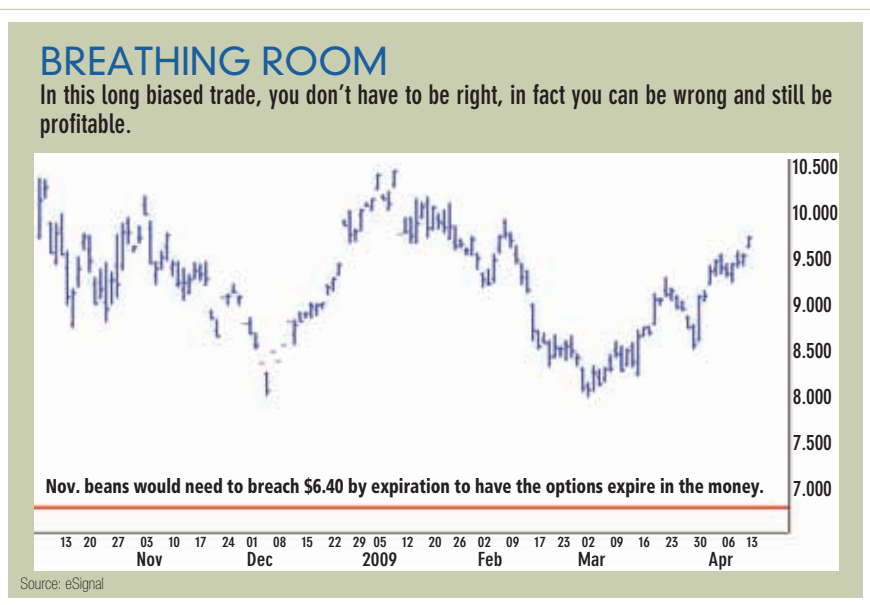
In February, projected 2009 U.S. ending stocks were raised to 210 million bushels by the USDA. While this is not large by historical standards (2006-07 U.S. ending stocks were 574 million bushels), it was higher than January's figure and led the trade to believe that declining demand would lead to further stock builds. This was a major contributor to soybean's near 18% price decline earlier this year.

On April 9, however, the USDA released its Supply and Demand Report showing U.S. soybean ending stocks are now expected to be only 165 million bushels. This is a full 20 million bushel drop from March's figure and is due mainly to a smaller than expected Argentine crop.

This would give 2009 the lowest U.S. ending stocks figure in five years. Additionally, 2008-09 U.S. stocks to usage ratio dropped to 5.5%, also the lowest since 2003-04.

SUPPLY (AND ANXIETY) SEASON

Brazil, the world's largest producer of soybeans, began harvesting its 2008-09 crop last month. While not always the case, it is not uncommon for prices to experience a price decline ahead of harvest in anticipation of this wave of



new supply hitting the market. This tendency has become prevalent enough that it has been labeled the "February break" by many in the trade. While we don't see it as reliable enough to actually trade from, the market's pricing of these new Brazilian beans almost certainly played a role in January and February's price weakness in soybeans.

By April, however, the market tends to begin focusing on the upcoming U.S. planting season. This is especially true of contracts traded at the Chicago Board of

Trade. Spring can be a time of anxiety for U.S. soybean farmers as rain, lack of rain, mud or cold can all appear at any time to stall or delay planting efforts. This uncertainty about the upcoming crop tends to manifest itself in spring-time prices. Seasonally, soybean prices will often firm into May or June, at least until the crop is safely in the ground. If soybean farmers do not add a few more million acres to their soybean plantings, there's no major reason to suspect this year will be different.

While all of the ag markets would most likely participate in any planting-related rallies or weather disruptions this summer, the soybean market appears to have the more bullish base fundamentals, which should make it the most sensitive to any type of crop development problems. While planting is projected lower for the 2009-10 season, corn and wheat ending stocks are adequate, if not hefty for the 2008-09 crop year.

PUTTING IT TO 'EM

All that being said, there is no basis for predicting a runaway bull market. Indeed, despite all the prognosticating, nobody knows what prices will do. Fortunately, with option selling in our trading arsenal, we don't have to know what prices are going to do. We only have to compose a fairly good idea of what price are not going to do.

At today's prices, soybeans will have difficulty attracting heavy short positions in the face of the current U.S. ending stocks number, the lowest U.S. stocks to usage in five years and lower-than-expected planted acreage. All this while heading into a time period that has traditionally supported soybean prices.

The traditional strategy of a bullish grain trader would be to buy the futures contract or, worse, buy call options and hope for some kind of planting delay or inclement weather threat in the summer. But what if these do not occur? Strip away all the technical terms and fancy buy/sell strategies and you are more-or-less gambling on the weather report.

There is a better way.

Rather than invest for an upward move in prices — which we do not know will happen — you can simply invest against a substantially lower move in prices. For example, November soybeans are near \$9.30 per bushel. If you think it will stay above \$6.40, you could sell a 6.40 put, and keep the approximate \$400 premium as long as it stays above \$6.40 through expiration (see "Breathing room," page 35). In other words, you are simply "betting," for lack of a better word, against a 30% decline in soybean prices over the next 90 to 120 days.

By selling puts, you don't need a weather scare or planting delay to make your position profitable. If a weather rally would occur, great. The option you sold will probably decay faster. But you certainly don't need it to do so. Instead, you have taken a position far from the money that is solidly based on the market's core underlying fundamentals.

If soybeans do decline by 30%, you could take a loss on the position. But short options can be managed using the same risk management techniques of a futures contract.

One caveat is that you do not over-position. Short options often have margin requirements that are substantially lower than the futures contracts. This often tempts traders, especially novice option sellers, to establish more positions than they would using the contracts themselves. A competently managed portfolio will avoid this temptation.

Still, it's important to keep in mind the

case for the bears. After all, global ending stocks remain adequate, near 50 million tons. Chinese buying could slow in the near term as the nation's effort to rebuild reserve stocks has reportedly reached completion. Global production for the 2009-10 crop year could top this year's figures.

Even all that, however, likely wouldn't be enough to drive prices 25% to 30% lower over the next few months (see "Upside bias," page 35).

The bears are entitled to their opinion, however, so let them have it. That's what makes the market work.

Besides, you need somebody to buy your puts. **FM**

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