

**Challenge: Client wanted to create a simplified tutorial lecture for one of its in-house experts that could be targeted to brokers and risk managers of large financial institutions. Writer spent one month studying futures and options theory, but did not have any previous experience in derivatives or commodities trading.**

### Managing Risk in the Coffee Futures Market

INTRODUCER: When most of us in a gathering such as this, think of coffee – no, I’m sorry, it is not coffee break time yet. Well, aside from coffee breaks, perhaps we think about the commodity itself; its fluctuating value and the opportunities for profit and loss.

Commodities, like equities and bonds may be considered tools which investors may use to make a profit or to cover the risk of a possible loss – what we call “hedging.”

Ms. Nancy Loeb has been trading in the coffee market for 22 years. Aside from being alert at all hours of the day or night, Nancy has managed to provide her clients with consistent risk protection while often generating unexpected cash flows.

In bear market, Nancy has employed three basic strategies that consistently achieve predictable results – as long as the market stays bearish. For you bulls out there – did Bob show up today? Well, just in case you think we’re going to see an upswing soon – again, Nancy has another three strategies that bring stability if not income to a portfolio as long as the market moves in a bullish fashion.

Finally, for most of us – the Delta Force in trading - Nancy has easy-to-understand methods whereby you may achieve your goals whether the market goes up or down, just as long as it goes somewhere – the faster the better.

Now that I’ve promised you the moon and the stars - before the lawyers rush up and drag me off – here’s Nancy Loeb, our guest speaker from the New York Board of Trade.

Nancy: Thanks (name of host). You really don’t have to worry about the lawyers. I’ve got them back in the coatroom on intravenous double espresso – they’re doing just fine.

And I hope you all here are doing fine as well, sipping your own, favorite blends from the coffee wagon that was provided by our host (name of hosting company). You know, be it espresso, cappuccino, double latte, whatever – from Starbucks to Cup-Full-O-Nuts, we consume over 66 million tons of coffee each year in the US alone. But I’m not going to sell coffee to you today – and I’m not going to buy any either.

Today, I’m going to tell you about coffee futures and options and how you can use these to meet specific risk management objectives. Obviously, if you think a market is going down – or up, you want to protect yourself if the market goes up – or down. But you can also think the market will do a lot of up and down in a short time – something we call volatility, or maybe you believe it will just sit there like a lox doing nothing for a long period of time – that’s called stagnancy. For each of these conditions, up, down, volatile

or stagnant, we have a concrete strategy employing coffee futures and options. So you just have to figure out what you *think* is going to happen and then use one of these strategies to cover your risk if you're wrong, and the opposite thing happens. That's called hedging. You can also call it, "insurance."

When you go out to buy insurance, say car insurance – you don't believe you're going to have an accident. But you hedge belief with insurance. The insurance company figures out the risk and charges you a fee based on that risk. That fee is the cost of hedging your bet that you won't have an accident. In my teenage daughter's case, for instance, that fee is very high.

In the coffee market, we use futures and options just like you use car insurance.

The New York Board of Trade (NYBOT) -- the parent company of the Coffee, Sugar & Cocoa Exchange (CSCE) and the New York Cotton Exchange (NYCE) -- has sent me here to answer general questions about futures and options markets and to demonstrate their risk management function.

Futures and options markets have proven their value time and again as risk management tools. In the next half hour, I'm going to help you understand how to use them.

Exchanges measure price **volatility** -- the magnitude and frequency of coffee price movement-- for a specific commodity to determine its suitability for futures/options trading. The greater the volatility, the greater the need for risk management

Cash market volatility makes futures and options necessary tools for risk managers. Risk managers (Hedgers) utilize a futures market to transfer risk and help reduce the effect of cash market volatility on their bottom line.

The same coffee price **volatility** that makes futures and options markets **necessary to risk managers** creates **opportunities for investors**. Since volatility measures the frequency and size of price movements in both directions, it affects all levels of the marketing chain and brings in market users with opposing price goals. As the levels of volatility and risk management activity in the futures market increase, the speculative opportunities on both the buy and sell side of the market often expand as well.

Cash price swings affect everyone in the marketing chain in a different way. For example, the sharp price increase that benefits an exporter shipping 2500 bags of a new and smaller crop of Costa Rican coffee, can be harmful to the dealer who must pay the higher price.

That same dealer who has paid a higher price for the 2500 bags of Costa Rican coffee could then be vulnerable to a loss if prices decline and the value of the stored inventory is diminished before the coffee is sold to a roaster.

Because it is difficult to quickly adjust the supply/demand equation, a fundamental cash market event (weather, political policies, labor contracts, crop predictions, etc.) can be reflected immediately and dramatically in the coffee futures markets. Therefore, the futures market can help risk managers throughout the marketing chain protect the bottom line, in rising and falling markets and in the near and longer term.

From the moment on June 30 when a dealer agrees to deliver coffee to a roaster on September 1, a lot can happen in the market place. That delivery point is fixed, but the price is unknown. The two parties can enter into a price-to-be-fixed contract, but they both remain exposed to some of the effects of price volatility.

Whatever they choose to do in the cash market, they can reduce their risk exposure through the effective use of coffee futures and options, that is, hedging.

Let's say you sell coffee. Then you would be sensitive to falling prices. So, you may take a position in the futures market that protects your **selling** price. You might sign a contract to deliver coffee at an agreed-upon price on some date in the future. That's called a "futures contract." In return for the guarantee of your price tomorrow, the buyer would pay you a fee - today.

But what happens if coffee prices rise dramatically? You would risk the loss of profit that you could have made, had you not signed the contract! Your cost of insurance in such a transaction, therefore, is the risk that you would not make that extra profit, if prices go up.

Let's say you simply hate losing profit like that. In that case, you might use a different contract. This contract allows you to sell the coffee at a specific price in the future, but if you don't want to sell the coffee at that time – because the price has risen higher – you don't have to sell it. On the other hand, if the price falls – the other person has to buy it at the price you agreed. In a sense, you "put it" to that buyer and the buyer gets stuck with your expensive coffee. This contract is called a "put." Easy to remember, right?

Now, obviously, no fool is going to let you put it to him for free. He's going to want some money today, in case you have to put it to him tomorrow. So instead of getting money today, like a futures contract, you pay money today in a put contract. That money is your hedging fee – your cost of insurance against a fall in prices.

So far, we've been talking about people who grow and process coffee and who are using coffee futures as hedges in their business. But what about people like you and me, who have nothing to do with coffee except as a pleasant beverage?

What can we do, to use the volatility of the coffee market to provide insurance for our own investment strategies – strategies that range from our protecting the value of our 401K plans to the need to raise money for a child's education or for buying a house?

Is there a method by which you can employ something so esoteric as the coffee market to provide market insurance in a risky financial world? I think there is. And soon I hope you will think so also. Here's an example.