ADDING MGEX HRWI FUTURES TO HEDGING STRATEGIES

Finding the right trading strategy can be challenging, especially in volatile markets. Below is a strategy to consider that reduces basis risk through a combined use of traditional, physically delivered futures contracts and MGEX (Minneapolis Grain Exchange) financially settled Hard Red Winter Wheat agricultural index (HRWI) futures contracts.

This example shows how HRWI hedgers can use a combination of traditional physically delivered wheat hedges and the complimentary MGEX HRWI futures contract to reduce basis risk. The HRWI futures contract reflects country-level elevator bids. This offers a more stable country-level basis than traditional delivery-based wheat futures contracts.

Incorporating new components into a hedging program is often difficult. However, hedgers do not need to radically alter their hedging routine to benefit from the improved basis offered by the MGEX HRWI futures contract. Hedgers can dedicate a small portion of their hedging to the index futures contract and reduce their overall basis risk as illustrated below.

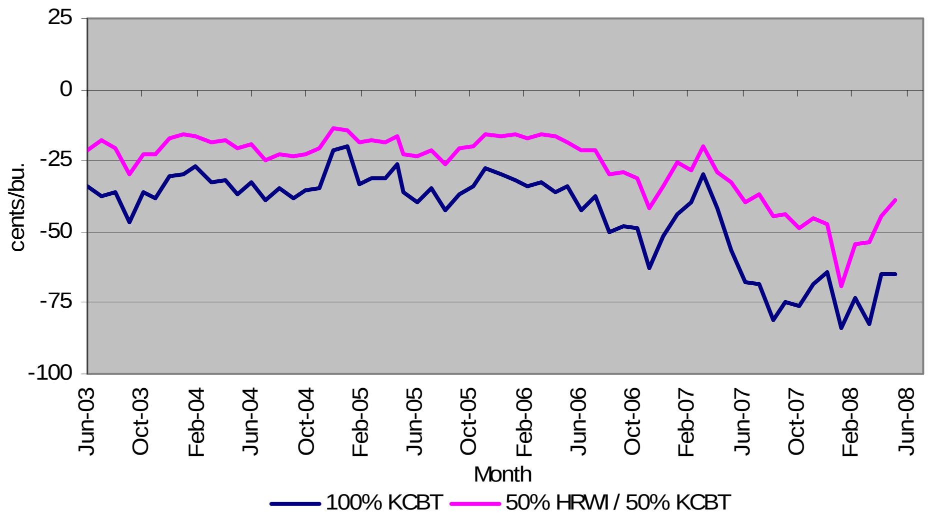
Western Kansas is a major production area for hard red winter wheat, and hedgers in that area can benefit from the low basis variability offered by the HRWI futures. Table 1 shows the basis statistics for hard red winter wheat in Western Kansas at various levels of hedging in the traditional KCBT futures and the MGEX HRWI futures.

Table 1. Hard Red Winter Wheat Basis Statistics, Western Kansas, 2000-2007 Crop Years

	100% KCBT	25% HRWI	50% HRWI	25% HRWI	100% HRWI
Average	-43.4	-35.0	-26.6	-18.2	-9.8
St. Deviation	16.3	14.0	12.0	10.5	9.6
Basis Range	63.3	59.0	55.1	54.7	57.0

Dedicating a relatively small portion of the hedge (25 percent) can make a meaningful difference in basis variability. A 100 percent KCBT hedge has a historical basis range of 63.3 cents; whereas, a 50 percent KCBT / 50 percent HRWI reduces the basis range to of 55.00 cents. As measured by the standard deviation, the 25 percent HRWI (75 percent KCBT) hedge reduced basis volatility by more than 2 cents per bushel from 16.3 to 14.0 cents (14 percent decline). A more stable basis results in more predictable hedging outcomes. A Western Kansas hedger can reap these benefits by simply placing 25-50 percent of their hedges in the MGEX HRWI futures. The dampening effect on basis risk is illustrated in Figure 1.

Figure 1. Western Kansas, Hard Red Winter Wheat Basis, 2000-2007



Additional basis stability can be achieved by placing a portion of wheat hedges in MGEX HRWI contract. In addition to the HRWI, MGEX offers index futures contracts for Soft Red Winter Wheat (SRWI) and Hard Red Spring Wheat (HRSI). These futures contracts should be viewed as complimentary tools to traditional physically delivered futures contracts for hedgers. Potential users of the MGEX wheat index futures contracts should not take an “all or none” approach to the index contracts. Rather, they should incorporate them as additional risk management tools to enhance current hedging strategies.