



MGEX HRWI OPTIONS ANALYSIS

Hedging with MGEX (Minneapolis Grain Exchange) Hard Red Winter Wheat (HRWI) options offers flour millers and end users interesting opportunities for premium savings and additional time coverage. The following analysis shows the potential for option premium savings with HRWI options.

Options based on futures that are physically delivered reflect an imbedded value that is related directly to location. This imbedded "transportation option" represents between 10 and 13 percent of the total option premium. Therefore, assuming that KCBT and HRWI options will have the same implied volatility, HRWI options will trade at slightly lower values than KCBT options. The example below illustrates this pricing difference using Black's Option Valuation Model.

Pricing Example

A two-year average of the KCBT futures price and MGEX HRWI are used for the example. The table below reflects the value of an at-the-money December KCBT that will expire on November 22 versus a HRWI November option that will expire November 28 (priced as of July 23). As shown in the table, MGEX HRWI option provides six extra days of pricing coverage and costs 1.5 cents less per bushel (a savings of 4%), or \$30,000 on a 2 million bushel hedge.

Table 1. HRWI vs. KCBT Option Premium Comparison

	HRWI	KCBT
Market Price	636	678
Option Strike	636	678
Expiration Date	11/28/08	11/22/08
Days to Expiration	128	122
Interest Rate	6%	6%
Volatility	25%	25%
Option Premium	36.8	38.3

Options Analysis Summary

A hedger using MGEX HRWI options should expect, over time, to directly save 3-5 percent on option premiums. Plus, the hedger benefits from a longer time-to-maturity than that obtained with KCBT options. In the hypothetical example listed above, a direct savings of 1.5 cents per bushel translates into an annual savings of \$30,000 on 2,000,000 bushels of wheat.