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*The document has been prepared to introduce some of the key terms and concepts associated with futures and futures options trading. Investors are reminded that the risk of loss from trading futures or futures options can be substantial and these products may not be for everyone. Investors also need to consider the level of risk they are willing to accept and the suitability of any investment before acquiring a position. The following information is not to be construed as an offer to sell or a solicitation or an offer to buy any futures or futures options. It is simply provided to you as is, for general use and information purposes only by Union Securities Ltd. Please contact your USL broker for further assistance.*

## **MANAGING YOUR RISK GUIDELINES FOR HEDGERS**

Hedgers are trade participants who have an objective of minimizing price risk in an underlying commodity. Hedging is generally defined as acquiring an equal but opposite position in a futures market to one that is owned or controlled in a cash market. In actuality, the term hedging often refers to other strategies as well, but always with the objective of minimizing risk in a related market. Hedgers include a broad spectrum of participants that can include individuals from a variety of market sectors.

### **In the Cash (Physical) Market:**

A participant in this market is termed to have a “long” position if they own or anticipate owning a specific commodity. Conversely they are termed to have a “short” position if inventory requirements have yet to be purchased.

### **In the Futures Market:**

When referring to a futures market a participant who has acquired a “buy” position is termed to be “long futures” and has a commitment to ownership upon delivery by the seller. Conversely, a participant who has acquired a “sell” position is termed to be “short futures” and has a commitment to deliver (sell) at a set date in the future.

In actuality, the majority of futures contracts are not settled through a delivery process. In fact it is commonly accepted that less than 5% of all futures contracts undergo delivery. Futures Commission Merchants (brokerage houses) are required by their regulators to enforce strict guidelines for delivery of exchange traded futures contracts. These rules encourage speculators and other participants to exit their positions through the “offset” process usually prior to the delivery date.

The following are a few short guidelines to follow when trading futures for risk management:

### **1. Understand Why You Are Hedging**

When you enter into a hedge, record the reason for entering the trade. This will provide you with a reminder of the positions role in your management plan. It's always good to review the original reasons for establishing a hedge to help understand that your actions are right for your operation.

### **2. Discuss Your Hedge With Your Lender**

Since a hedged position may require substantial margin money, it's better to enter into a discussion with your lender before entering into a hedged position. That way, you're not faced with explaining hedging to your lender if at some point you require an emergency loan to meet a margin call.

### **3. Consider The Uncontrollable**

Avoid hedging 100% of a commodity until production levels are assured. Be conservative; commit no more than you are confident that will be produced or that you can deliver.

### **4. Maintain Good Trading Records**

Check the equity in your account regularly; maintain a written record of transactions, unfilled orders, stop loss orders. Avoid forgetting an open order only to find several weeks later that it has been filled.

### **5. Don't Hedge Too Fast**

Use a "scale up" or "scale down" approach. Averaging prevents over committing at any one price and gives a chance to take advantage of a better price opportunity at a later date.

### **6. If You Speculate, Open a Separate Account**

Carrying speculative and hedge positions in the same account can be confusing. Keep them separate. These approaches may also have important tax consequences.

### **7. Involve Your Partner**

When it comes to pricing, monitoring markets or record keeping, remember, "Two heads are better than one"!

### **8. Categorize Yourself**

Before establishing a hedge, decide whether you are a conservative hedger (leaves hedges on until physical commodity is priced) or a selective hedger (may place and lift hedge several times before physical commodity is priced). Don't wait until your first margin call to determine your hedging philosophy.

### **9. Maintain Course**

Hedgers have to maintain discipline. If you are a selective hedger consider using stop loss orders.

**10. Don't Blame Your Broker**

If you missed a chance to lock in an attractive price, don't blame your broker. You'll mature as a trader as you learn from your own mistakes. Remember, it's your account.

**11. Make Your Own Decisions**

Subscribe to a dependable information source. Use your broker as a source of facts and as an order taker. Commit your money only on the basis of your own judgment after you have analyzed the facts yourself.

**12. Learn to "Speculate" On Basis**

Cash basis levels of many commodities tend to follow seasonal patterns. By understanding these changes you can speculate on a widening or narrowing basis level when deciding to price in the cash market.

**13. Set Objectives**

When establishing a hedge, you should have an idea of any conditions that may prompt you to lift the position. There should be some point at which you would be willing to assume all the price risk yourself. Having an objective in mind before establishing a hedge gives you some discipline in deciding when to lift a hedged position.