

# Cotton swaps for smart growers

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**W**hen cotton prices are low, as they are now, most cotton farmers do everything in their power to cut expenses and increase yield. But smart farmers are also making sure their income is protected from further falls.

Income from the cotton market has been falling since the highs of 2003. That means the focus is very much on how to minimise losses. It seems more important than ever to have risk management strategies in place and to consider every marketing alternative.

The price of the National's Cotton Swap currently stands around A\$320 per bale (see Figure 1). Rather than locking in physical sales to merchants, some farmers are selling cotton swaps or taking out options as their preferred price protection mechanism.

### WHAT ARE THE BENEFITS?

Despite some good rainfall and more certainty over water allocations than in recent years, there is still concern among many farmers over the availability of water to finish their crops.

Cotton swaps and options provide the farmer with the flexibility to trade out of the contract without the hassle of dealing with cotton merchant costs involved in changes to any physical cotton committed for delivery.

Cotton swaps and options also provide the farmer with the ability to participate in any changes to basis levels over the course of the season.



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A cotton swap is a contract between the National and the farmer that fixes the price of an agreed quantity of cotton for a future date. Cotton swaps are offered for a term of up to three years forward (allowing hedges to be put in place until 2007) in both \$US and \$A.

Options can provide valuable protection against downward fluctuations in cotton prices. Payment of a premium for the cotton option can be made up front or at maturity of the option. If the price of cotton drops the holder of the option is protected from falls in the cotton

**FIGURE 1: Cotton swaps near month continuous**

SOURCE: National Australia Bank

price. But if the price increases, farmers can still take advantage of any upside in the cotton price (less the cost of the premium).

The National's cotton swaps are cash-settled, meaning no physical delivery of the cotton is required. Therefore, farmers can take advantage of the swap's protection against cotton price falls by locking in a forward selling price on the swap while still shopping around for the best cash price available for the physical commodity later in the season.

Of course, users of swaps and options are also exposed to falls in basis levels. For this reason, farmers may wish to hedge a price that covers production and keep alert for opportunities to fix good basis levels in the cash market.

Most farmers would only use these products on a portion of their crops to protect a minimum income while still bearing the potential advantage (or disadvantage) of price movements on the unhedged portions of their crop.

Many farmers protected themselves against an adverse movement (a fall) in cotton prices by selling July '05 and '06 cotton swaps at \$540 per bale and \$525 per bale respectively back in late 2003. At the same time cash prices for July '05 and '06 were \$545 and \$550 per bale respectively.

In historical terms, \$550 is in the top 15 per cent of swap prices seen over the past 10 years in the cotton industry.

Many clients of the National closed out their cotton swaps after it became evident they were not going to plant last year because of concerns over water supply.

Alternatively, some clients that had water closed out the cotton swap and have redirected their resources into other summer crops such as corn, sorghum and soybeans.

Finally the more pro-active farmers have been purchasing call options (the right to buy rather than sell cotton) against their swaps. By doing this they have locked in a minimum cotton price, while at the same time re-establishing exposure to market rallies attributable to either cotton futures (rise) or foreign exchange (fall) movements. A similar strategy might potentially be employed against any cash sales that farmers may have already made.

As swaps and options may be used up to three years in advance, opportunities should be available to farmers if they keep an eye on prices and contracts, and think ahead.

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