MANAGING PRICE RISK

An Introduction to Cocoa Futures Markets
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PROGRAM

- Introduction to INTL FCSTONE
- The Commodities Market
- Hedging Theory
- Empowerment!
- Instruments
- Currencies
<table>
<thead>
<tr>
<th>Category</th>
<th>Subcategory</th>
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<tbody>
<tr>
<td>Agriculture</td>
<td>Precious Metals</td>
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<tr>
<td>Energies</td>
<td>Industrial Metals</td>
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<td>Fuel Charges</td>
<td>Dairy and Cheese</td>
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<td>Cotton / Textiles</td>
<td>Forest Products</td>
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<td>Renewable Energies</td>
<td>Freight</td>
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<td>Stocks and ADR</td>
<td>Livestock</td>
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<tr>
<td>Renewable Fuels</td>
<td>Foreign Exchange</td>
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</table>
GLOBAL PRESENCE

USA
- New York (HQ)
- Bloomington
- Bowling Green
- Chicago
- Des Moines
- Denver
- Indianapolis
- Kansas City
- Lawrence

International
- Asunción
- Beijing
- Buenos Aires
- Campinas
- Ciudad del Este
- Dubai
- Dublin
- Goiania
- London
- Maringá
- Porto Alegre
- Recife
- São Paulo
- Shanghai
- Singapore
- Sydney
- Winnipeg
- Bogota
- Mexico D.F.
The Stock Market
The Stock Market

[Diagram showing various company logos]
NY Cocoa Futures Exchange
1940’s
WHY DO WE HEDGE? (PROTECT)
HEDGING

“THE TRANSFER OF RISK”
Volatility
VOLATILITY

DEFINITION

Volatility refers to the amount of risk or uncertainty over the changes in the values of a product.
VOLATILITY

MY DEFINITION

“HEADACHES”
WHY IS IT VOLATILE?

- 1) WEATHER
- 2) MACRO ECONOMICS / POLITICAL UNCERTAINTY
- 3) SUPPLY and DEMAND Concerns
COCOA PRICE PERCENTILE RANGES
LAST 5 YEARS

ICE Cocoa Prices the Last 5 Years

Dollars per metric ton

Upper 10%
Upper 30%
Average
Lower 30%
Lower 10%

Month: May-11 to Mar-17
The Commodities Boom

The New Investment Vehicle
Commodities Index
Commodities Boom

2001

2011
PRICES

- Milk
- Fuels
- Meats
- Breads
- Cereals
- Orange Juice
- Cotton

- Equipment
- Coffee
- Edible Oils
- Mantequilla
- Metals
- Fruits

- **COCOA!**
Commodities Super Cycle

12-14 years of a Bull Market
18-20 years of Dormancy

- 1970 - 1982  Commodities boom
- 1982 - 2001  Dormancy period
- 2001 - 2014  Commodities boom
- 2014 - ?  Start of Dormancy period?
Commodities in 2015

SOURCE: FinViz.com
COMMODITY EXCHANGES
PRICING MECHANISMS

STOCK MARKET
A Share of a Company

COMMODITIES MARKET
A Futures Contract
The Futures Contract

The Central Pricing Mechanism for most of the world’s Raw Materials

- A legally binding agreement, to buy or sell a commodity sometime in the future.
Commodity Futures Markets
Exchanges

- Dōjima 1730 RICE
- Chicago 1848 CBOT
- Frankfurt 1867 Various
- New York 1872 Cotton
- London 1877 Various
- New York 1882 Coffee
- New York 1925 Cocoa
- New York 1914 Sugar
Economic Function of the Futures Markets

- Price determination of the basic raw materials in the world markets.

- Used as risk transfer vehicle for the underlying Commodity

  A HEDGE

- Used as an Investment Alternative.
COCOA EXCHANGES

- New York $ USD ICE US
- London £ UK ICE EUROPE
- Chicago € EU CME
The New York Cocoa Futures Contract (ICE US)

- 10 M/T Cocoa
- Delivery:

- Price Quotes
  - US$ / MT

- Market Hours
  - 4:15AM – 1:30PM (New York)

Futures & Options
El London Cocoa Futures Contract (ICE Europe)

- 10 M/T de Cacao
- Price Quotes
- £ / M/T

Delivery:

Market Hours
9:30AM - 4:50PM (LONDON)

Futures & Options
The Euro Cocoa Contract
(Chicago Mercantile Exchange)

- 10 M/T Cocoa
- Delivery:
- Price Quote
- € / TM
- Market Hours
  9:00AM - 4:50PM (LONDON)
- Futures & Options
Market Participants

Hedgers

Speculators

“Investors”
HEDGERS

- Producers
- Middlemen
- Exporters
- Importers
- Physical Brokers
- Industry
- Final Users
SPECULATORS

‘Investors’

- **Small Speculators**
  - Self guided traders, personal accounts

- **HFT high Frequency /Systems / Algorithmic Traders**

- **Large Speculators**
  - Managed Money “Guided Accounts”
  - Hedge Funds “Traditional”
  - High net worth individuals
  - Index Funds for Commodity Investors
INSTRUMENTS
INSTRUMENTS

1) Futures Contract

2) Options Contract (Insurance Policy)

3) Structured Products

4) Currency Forwards
Accessing the Markets
Opening of an Account

- Commission House
- Specialized Broker
- Account opening documentation
- Initial Deposit
Margins

- Good Faith Deposit
- Risk Barometer
- Margins
  - Initial
  - Variation
Accessing the Markets

Two Account Types

1) Futures and Options Account

2) Structured Products Account

“Over-the-Counter (“OTC”) Products or “Swaps” are only available to individuals or firms who qualify under CFTC rules as an Eligible Contract Participant (“ECP”) and who have been accepted as customers of IFM.”
1) Futures Account

- No minimum financial requirement
- Quick account opening
- Futures and Options only
- Standardized contracts only
2)  Structured Products Account

• Minimum financial requirement
  – $1M Equity
  – $10M Total Assets

PRODUCTS:
- Futures
- Options
- Fractions
- Futures Structures
- Currency Forwards
- Variable Options
- Exotic Options
- Currency Forward Options
- Conditional Stops
- Commodity Pricing in Euros
- Programmed Buying/Selling
- Currency Structures
Regulatory Agencies

- N.F.A. National Futures Association
- C.F.T.C. - The Commodity Futures Trading Commission
- United States Congress
HEDGING

“The Transfer of Risk”
<table>
<thead>
<tr>
<th>Name</th>
<th>Month</th>
<th>Symbol</th>
<th>Last</th>
<th>Change</th>
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<td>T-Bond</td>
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<td>U.S. Dollar Index</td>
<td>Jun 13</td>
<td>DXM3</td>
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<td>U.S. Dollar Index</td>
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<td>DXU3</td>
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<td>Euro FX</td>
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<td>Mexican Peso</td>
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<td>Mexican Peso</td>
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<td>^EURUSD</td>
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<td>^EURCAD</td>
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<td>Gold</td>
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Hedging your price risk…
…is shifting it to someone who wants it

I don’t want Risk…

I do!!!
## Economic Relationship

<table>
<thead>
<tr>
<th>Processor</th>
<th>Producer/ Exporter</th>
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</thead>
<tbody>
<tr>
<td>(Buys Physical Cocoa)</td>
<td>(Sells Physical Cocoa)</td>
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<tr>
<td>Short Physical</td>
<td>Long Physical</td>
</tr>
<tr>
<td>(has to buy Cocoa)</td>
<td>(has Cocoa to sell)</td>
</tr>
</tbody>
</table>

- **Processor**: Buys Physical Cocoa
- **Producer/Exporter**: Sells Physical Cocoa

- **Short Physical**: Has to buy Cocoa
- **Long Physical**: Has Cocoa to sell

- **Buy**: Buys Cocoa Futures
- **Sell**: Sells Cocoa Futures

...More stability in the cash flows of your operations!
# Scenario 1: Market Drops

<table>
<thead>
<tr>
<th>Processor (Buys Physical Cocoa)</th>
<th>Producer/ Exporter (Sells Physical Cocoa)</th>
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</thead>
<tbody>
<tr>
<td>Processor is losing money in Futures position BUT making money in physical purchases</td>
<td>Producer is selling cocoa cheaper in the physical market BUT making money in their futures position</td>
</tr>
</tbody>
</table>
## Scenario 2: Market Rallies

<table>
<thead>
<tr>
<th><strong>Processor</strong></th>
<th><strong>Producer/ Exporter</strong></th>
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<tbody>
<tr>
<td>(Buys Physical Cocoa)</td>
<td>(Sells Physical Cocoa)</td>
</tr>
</tbody>
</table>

Processor is losing money by purchasing physical Cocoa at a higher price BUT making money in their futures position.

Producer is making money in physical Cocoa BUT losing money in his futures position.
Basic Elements of Hedging

- No ownership Change
- Added flexibility in changing market conditions
- Futures markets maintain a positive correlation with the physical
LONG HEDGE

May 24  Price Sept Cocoa futures = £ 2.150
Processor (buyer) foresees need for 100 M/t July & August
Hopes to pay £ 2.150

HEDGE
Buy 20 July futures @ £ 2.150

August 1st  Price Sept. Futures = £ 3.000
Increase cost of £170,000,00

Hedge supplemented the £170,000,00
Futures Account

Market at £3,000

Futures Account BOUGHT 20 Contracts at 2.150

£170,000,00
SHORT HEDGE

Producer

- May 24  
  Price Dec. Cocoa futures = US$ 2.950

  Cocoa Producer needs to secure 100 M/t of production

  HEDGE
  Sell 10 December futures @ $2.950

- October 30th  
  Price December Futures = $2.100

- Income loss of $180,000.00

  Hedge supplemented the $180,000.00
Futures Account

Futures Account

SOLD 10 Sales at $2.950

Market at $2.100

$180,000.00
Commodity Options
“Insurance Policies”
“INSURANCE PRODUCTS”

OPTIONS

- Convey the Right to **BUY** or **SELL** for
- A Specific Futures and Commodity Product
- For a pre-determined time frame
- For a pre-determined price

“AN INSURANCE POLICY”
OPTIONS
“INSURANCE PRODUCTS”

TWO TYPES

CALLS = The Right to Buy
Price Rise Insurance

&

PUTS = The Right to Sell
Price Drop Insurance
PURCHASING
Price Rise Insurance
“CALLS”

CALLS = Acquires right to buy

- Acquires the right,
- but not the obligation
- to purchase a specific futures contract
- at a specified price
- within a specified time
BUYER SCENARIO
Price Rise Insurance

- Supply & Demand Concerns
- Possible weather concerns in Ivory Coast
- With only 2 months fixed
- Concerned with further drought fears
- Would like to protect without actually buying more Cocoa
Purchasing Price Rise Insurance
“Call Options”

ARABICA PRICES

Buy Sept. 2.200 Calls for 50
“Price Rise Insurance”
Cocoa Producer

- Cocoa unsold
- Protect against falling prices with PUT Options

“Price Drop insurance”
“Price Drop Insurance”

PUT OPTIONS

Buy $2.850 Puts for $45
OPTIONALITY

“Being Creative”

“Variable Sales”

“Variable Purchases”

“Covered Purchases”
“Variable Sales”
“Variable Sales”

Concept

- Market in a downward trend
- Producer does not sell in hopes of higher prices
- Producer looking for a strategy that can provide a minimum floor on prices in case of further price drops
- but with an Upside potential in case of a Rally in market prices
PRODUCER SCENARIO
Price Rise Insurance

- Sell Cocoa (FIX-The-Price)
- Buy Price Rise Insurance in case of a drought in order to increase the effective selling price.

“Variable Sales”
PRODUCER SCENARIO

1) SELL (FIX) COCOA

2) BUYS INSURANCE
PRODUCER ACCOUNT

- Sells Cocoa 2.150 Fixed Price
- INS. Cost 50 100 Day Price Ins. at 2.200
- Selling Price 2.100 Variable Price

  Price Move to 3.000

Option Generates + 800

Final Effective Selling Price 2.900

“Example does not include commission and fees”
“Variable Purchases”

“Covered Purchases”
Variable Purchases
Concept

- Bullish Market

- Processor does not buy in hopes of lower prices

- Customer looking for a strategy that can provide a lock on prices in case of a market rally

- But with downside potential in case of a drop in market prices
STRATEGY

- FIX COCOA PRICES (BUY)

- Buy Price Drop Insurance (PUTS) in case of a drop in prices in order to reduce cost of inventory
1) Buy Cocoa (FIX PRICE)
NEW YORK COCOA

2) BUY Insurance (PUT)
NEW YORK COCOA

3) Unexpected Price Drop
FUTURES ACCOUNT

- Fix Cocoa: $3,200
- Option Price: 60 (75 DAYS PROTECTION @ $3,100)
- Variable Price: $3,260
- Price Drops to: $2,800
- Option Generates: $300
- Final Price: $2,960 (11%)
Price Risk Management

EMPOWERMENT

- Sustainability  
  - Having a Price  
  - Managing the Price

“We need PRM”

“Knowledge is Power and Power is Knowledge”  
Francis Bacon 1597
STRUCTURED PRODUCTS
Structured Products

- Custom tailored Buying and Selling programs
- Assist in the Short, Medium and Long term price management
- Helps reduce the uncertainty over market prices and «Guessing»
- Assist in budget planning and control
- Can provide an additional marketing tool
- Provides more attractive pricing
Cocoa Processor/Producer needs to secure pricing for the entire pricing period of September, October and November New York with today’s pricing.

“We need an average of the entire month”
STRUCTURED PRODUCTS

“PROGRAMMED SALES”
TIME HORIZON

WEEKLY SALES ACCUMULATIONS

1 2 3 4 5 6 7 8 9 10 11
Ladder Program Sales

NEW YORK Cocoa @ 2.940

- **START:** May 27th, 2016
- **ENDS:** August 5th, 2016
- **Period:** 11 Weeks

- **First Level:** $2.940
- **Second Level:** $3.000
- **Third Level:** $3.060  \( \times 2 \)

“Example does not include commission and fees”
Programmed Sales
With Min Floor and Max Ceilings

London Cocoa @ 2.120

- **START:** May 25th, 2016
- **END:** Nov 30th, 2016
- **PERIOD:** 28 Weeks

- **MIN PRICE:** 2.120
- **MAX PRICE:** 2.240

"Example does not include commission and fees"
WEEKLY STRIPS

“Conditional Stops”
Minimum Weekly Price
“Weekly Insurance”

- September London Cocoa: 2.140
- 15 Weeks
- Minimum Floor Price: 2.100
- Cost: 30 M/T

“Example does not include commission and fees”
September London Cocoa Weekly Strips

WEEKLY STRIP

1st WEEK  2nd WEEK  3rd WEEK
HEDGING FRACTIONS
FRACTIONAL HEDGING

<table>
<thead>
<tr>
<th>BUYS</th>
<th>SALES</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 Tons</td>
<td>4 Tons</td>
</tr>
<tr>
<td>3 Tons</td>
<td>2 Tons</td>
</tr>
<tr>
<td>14 Tons</td>
<td>25 Tons</td>
</tr>
</tbody>
</table>

Standardized Contract = 10 M/T
CURRENCIES

Highest Volatility of the past 30 years
COCOA IN LOCAL CURRENCIES
“Compos & Quantos”

NEW YORK USD

LONDON
HEDGE BLEND WHEEL

Diagram showing the percentages of different pricing models:
- Fixed Price: 40%
- Variable Price: 25%
- Structured Price: 15%
- Synthetic: 10%
- "Wait": 10%

Legend:
- Red: Fixed Price
- Orange: Variable Price
- Green: Structured Price
- Purple: Synthetic
- Blue: "Wait"
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Hedging Solutions for the Cocoa Industry