Hedging lumber with futures

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The most common and basic type of hedging is the price protection hedge. In general, the cash market position is established first, and the futures position is established later to reduce the risk from an adverse price movement. So if it is a long cash position initiated first, the hedge is called an inventory hedge; as when carrying inventory, the concern is that prices would fall before the lumber is sold. To initiate the inventory hedge in lumber, the hedger goes short Random Length Lumber futures in board foot about equal to the cash position. The size of the lumber futures contract is 110,000 MBF (thousand board feet); and the deliverable lumber grade is Random Length Western Spruce-Pine-Fur (SPF) 2x4s.

A CASE STUDY

A lumber wholesaler is carrying 110,000 MBF of lumber inventory.

Cash inventory cost: $260 per MBF
Nearby May lumber futures: $280 per MBF
Freight costs: $50 per MBF

The wholesaler sells short one May lumber futures at $280 to initiate a hedge. And adding on freight costs of $50 per MBF, it would be locking in an anticipated local selling price of $330 per MBF, leaving a profit of $20 per MBF.

By the time the company has found a buyer, the market price has fallen $10 per MBF. It then bought back the short May futures position for a $10 per MBF profit. The lumber inventory was sold at $345 per MBF. While the gain in the futures market was offset by the loss in the cash market, the company however managed to sell the lumber for the $25 per MBF estimated profit. If the Western SPF 2x4 price had risen instead, the loss in futures would also be offset by selling in the cash market at a higher price; and the $25 per MBF anticipated profit margin would still have been realized.

BASIS TRADING

Aside from the above common hedge, another lumber hedge of interest is known as basis trading. Basis trading is an exploitation hedge, in which the hedger takes advantage of unusual or seasonal circumstances. Let's say the lumber wholesaler above understands that the 2x10 Random Length Lumber usually trades $25 per MBF over futures (2x4 Random Length Lumber) in early spring, but has been trading at $60 over futures. The wholesaler believes this is not going to last much longer, or the price difference between the two grades are to narrow. He would try to exploit the situation by forwarding sell the 2x10 lumber at the current price at, for example, at $330 per MBF; and he simultaneously buys one of the nearby May futures contract $270 per MBF, looking for the two prices to come in. On the date of the delivery of the cash 2x10 lumber, he closes out the long May futures, which has risen to $310 per MBF, but cash price only rose slightly to $340 per MBF; the difference in the two prices has narrowed to $30.

Gain in futures: $310 - $270 = $40
Loss in Cash: $340 - $330 = $10

Profit from the strategy (narrowing basis):
$40 - $10 = $30

As long as the spread between futures and cash narrows, the hedger stands to make a profit. So if the spread widens out, the hedger would suffer a loss.

For more information about lumber hedging, or commodity/financial futures, please contact us.