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Integrated Options, Forward and Spot Procurement Policies for Traded Commodities

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According to the financial theory, if the capital markets are perfect then trading financial derivatives such as futures, forwards, and options is a value-neutral proposition for a firm. Financial theory explains the use of financial derivatives, in practice, through capital market imperfections (i.e., transaction costs, information asymmetries and taxes) and managerial risk preferences. In this paper, we consider a publicly traded firm that operates in a perfect financial market with an objective to maximize the value of its shareholders, but experiences logistical costs while executing the physical delivery on options and spot procurement of a traded commodity. We show that the presence of logistical costs is a sufficient reason to buy options. Our analysis illustrates significant cost reductions in procurement when options and forwards are judiciously included in the procurement portfolio leading to better efficacy in supply chains. Furthermore, we develop conditions that identify the dominance of options over forward contracts.

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