Part I

DESCRIPTION

It is difficult to imagine a duller way to start a book than with a section titled "Description." The term has the least possible sex appeal. Yet, description is what the first part must be about. The first objective of description is to put everyone on an equal footing of knowledge about terms and processes; to develop a sufficient familiarity with the events that are taking place on the trading floors of exchanges, in the customer rooms of commission houses, and in the offices of merchants and processors that the reader can see past the actions to their purposes, to their relationships to the commerce of commodities, and to their economic meaning.

A second objective is to put the reader in a participant role. Trading in commodities is a great and exciting game. To fully appreciate it one must cast oneself in the role of a player; this is a subject ideally suited to a world of Walter Mittys. It is well and good to philosophize about the social and econmic implications of football but it is more fun to imagine that one is a Galloping Ghost in Memorial Stadium or a Bart Starr on a sub zero day in Green Bay.

To play you must know the rules; so describe we must.

CHAPTER 1

Introduction

Interest in Futures Trading. The institution of futures trading is old and big. Organized trading in commodity futures dates back more than 100 years and in some years the dollar value of the volume of trading on the Chicago Board of Trade alone has exceeded that of trading on the New York Stock Exchange. There are fifteen supervised exchanges in the United States and a larger number abroad, scattered from Canada to the Argentine, Japan, India, Australia, and the principal European nations. There is a long list of commodities that are or have been traded on organized exchanges.

Futures trading is little known and less understood. Only a small percentage of people know what futures markets are or have seen one in operation. More people have heard of futures markets. But people who have seen markets are even more mystified, if this is possible, than the people who have not even heard of the markets. There is a mystery about these markets that seems difficult to penetrate.

The largest of the markets is the Chicago Board of Trade. One need only stand on the visitors' balcony, watching the trading and the expressions on the faces of the other visitors to gain a sense of mystery and confusion. The trading floor is two stories high and the size of a football field. On an ordinary day some six hundred people are present, a few are sitting at telephones but most are on their feet and in motion, some walking and some running. There are several dense concentrations of people standing on steps that form hexagonal pits. Here, the action is frantic with as many as 300 men shouting, waving their arms, and signaling with their fingers simultaneously. In isolation, as on a television camera, one trader bellows at the man next to him with such vigor that his face turns red, and waves both hands, a trading card, and a pencil in his face. The other reciprocates, both write quickly on cards, and turn to repeat the

whole process to other traders or to the pit in general. A few feet away messengers run from telephones and other communications machines to the pits and back. Incongruously, there are other people, apparently participants who stroll about chatting with other people similarly engaged or quietly watching, oblivious to the din surrounding them. High on the end walls there are huge electronic scoreboards with flashing numbers that seem to relate to a multiplicity of scores somehow ascertained from the action in the pits. But nothing is shown about which team has the ball. The visitor is told that the players do know what they are doing and the action somehow relates to a real world of commerce in grains, oilseeds, cattle, and chickens. The visitors shakes his head and walks away. It *is* possible for one who has seen and heard to be more mystified than one who has not.

The mystery is not lessened as the casual observer learns a bit more. Next he discovers that the players are trading in wheat, corn, etc. for delivery in various months in the future as March, May, or December. Ah, so; this helps. But then he learns that only a very few of the trades are ever consummated by actual delivery, say one or two percent, and that the total quantity traded far exceeds the quantity that moves to and through the market where the trading takes place and even exceeds the total produced and used in the United States.

Then the trading must be in paper, a veritable blizzard thereof. But the paper is for real because our friend has heard that his family physician paid for a vacation trip to Hawaii from profits made in cocoa. Perhaps he also knows that his grandfather got done out of the family farm by the LaSalle street gamblers who conned him into buying wheat options.

A final thing contributing to this mystery is that the game is of complete fascination to the relatively few people who understand and play it. The people of the markets defend futures trading with an almost religious fervor. To them, it is a major contribution to the economic productivity of the nation and the epitome of sophistication in economic development. What is there here that makes working for a living at this thing such great sport?

Why the Interest? The size of the institution of futures trading and the mystery surrounding it by no means explains the breadth of interest in futures trading. It has been the subject of public controversy throughout most of its life. On Oct. 5, 1947, while discussing the high and rising price of wheat, the President of the United States said, "The cost of living in this country must not be a football to be kicked about by gamblers in grain." A few days later his Attorney General alluded to traders in grain as "greedy men blinded by the lust for money, trafficking in human misery." The legislatures of the various states passed numerous bills limiting futures trading during the latter part of the 19th century. A law prohibiting futures trading was passed in Germany in 1896 and repealed four years later. The first national U.S. law regulating grain futures trading was passed in 1921 and immediately declared unconstitutional. The Grain Futures Act was passed in 1922. This law was extensively amended in

1936 and renamed the Commodity Exchange Act. This law was amended extensively through 1968.

The extreme fluctuations in commodity prices, and rapid increases in food prices beginning in mid-1972, resulted in numerous legislative proposals in the Congress. These culminated in the passage of The Commodity Futures Trading Act of 1974. The Act is a complete revision of over 50 years of federal regulation. It brings all exchanges and commodities under regulation and establishes an independent five member Commodity Futures Trading Commission.[1]

The justification of legislation is "that the transactions and prices of commodities on such boards of trade are susceptible to speculation, manipulation, and control, and sudden or unreasonable fluctuations in the price thereof frequently occur as the result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce . . ." Until the 1974 Act, the focus of legislation was on the price effects of futures trading. The new legislation has a broader focus, including positive aims of growth and development of markets.

It is said that every golf shot makes someone happy, either the hitter or his opponent. And so it is with prices except that the appropriate word seems to be unhappy. Every price change either reduces revenue to the seller or increases cost to the buyer. Widely fluctuating prices appear to be offensive to many people with orderly minds whether they be businessmen, government employees, legislators, or the public. A price that changes frequently is automatically suspect. It is also annoying and troublesome to processors and many merchants. Futures trading is blamed for all three price changes; too low, too high, and too swinging. The focus of futures trading is on prices and prices are always misbehaving for someone.

A second source of interest in futures trading stems from businessmen who use futures markets in their production, warehousing, merchandising, and processing activities. These people trade in futures contracts as an adjunct to their ordinary business activities. Skill in commodity futures trading is essential to the successful operation of many kinds of businesses. In addition, skillful use of futures markets enables some firms to make larger earnings than their competitors who do not use this tool. Unskillful or misguided use of futures markets is often the root cause of the failure of firms who use commodities traded in futures markets in their businesses. The use of futures markets can be a major source of unsuccess as well as a tool for achieving success.

Skill in the use of futures markets in connection with commodity businesses requires relatively rare talents and is difficult to develop. Futures trading activities become the nerve centers of many businesses and receive a large amount of attention. The people who do the trading are highly paid, the importance and

[1] Because of the length of the name and the frequency with which it is used, we adopt the letters CFTC when referring to the commission.

rarity of their skills gaining the most meaningful kind of recognition—money. A processing plant may cover a city block and be several stories tall; an impressive collection of equipment, housing hundreds of people performing complicated tasks making exotic products. Deep in the bowels, in a single room, a handful of traders make some of the most important decisions affecting the profit of the company. These are the people who work under the greatest uncertainty and stress and are among the highest paid employees.

Third, futures markets are of academic interest as a form of commerce and market organization. A part of the academic interest stems from the controversy that has always surrounded the institution; academicians are attracted to and like controversy. More importantly, futures markets are a highly developed, sophisticated system of exchange that is open to close observation. The competitive condition of openness to observation is more closely met in these markets than in other exchange processes. In view of these characteristics of sophistication and openness it is surprising that the academic attention is as limited as it is.

Fourth, futures trading is a direct source of income to a large number of people. The operation of the mechanics, the plant so to speak, is big business. The facilities must be provided and the rules must be written and enforced. Trading and prices must be reported and recorded. Exchanges have numerous employees, large capital assets, and substantial operating budgets.

The actual trading is done by professional speculators, scalpers, pit traders, and brokers. The brokers act, in large measure, on instructions from commission futures merchants. The commission houses act on behalf of non-members principals—the trade and the public—for commissions. They take and execute orders, handle funds, keep records, consult with customers, analyze markets, and assemble and disseminate information. They employ a lot of people.

Finally, markets are of interest to the public. People are drawn to markets by the mystery, glamour, and excitement and many stay to play the game. The largest number of people interested in commodity futures trading are speculators. In their breasts, as in most of us, beat hearts that contain, as well as love and compassion, a substantial amount of avarice. Commodity futures markets are a last frontier of large earnings from a small stake. There is ease of entry. Commission houses are readily available and interested in new business. Units of trading are small so that a position can be financed with a small amount of money—a few hundred dollars puts the beginner in business. Price variations are large in relation to the equity capital required. Price moves in excess of initial margins occur frequently so that if the speculator does the right thing he doubles his money quickly. That he is unlikely to do this very many times in succession so that he makes a lot of money is neither here nor there. It is possible, some people have done it, he has a shot, hence the enticement.

This cynical attitude toward the greed of speculators looks to a second cynical view; that markets are in the business of holding out an unattainable will-of-the wisp so that they can draw in and gobble up the public money. Neither attitude

is fair or accurate. Speculators are made of better stuff. For avarice let us substitute ambition and add venture and competition. As an hypothesis let us say that the speculators will venture all to gain a lot; that they will accept the long odds against them in exchange for a shot at the top. And further, that they will play the game for its own sake.

Commodity trading is a great competitive game. There is abundant information available to all; there are no effective inside secrets. There are no dominating power positions; each man is as good as the next. The players who are right win and those who are wrong lose. The name of the game is skill; skill in forecasting prices, skill in trading, and skill in capital management.

Cheap Expertise. By way of incentive to study, the thought that knowledge about commodity futures markets is a short cut to becoming an expert is offered. As noted, futures trading is a mystery to most people and relatively little academic attention has been paid to the system. There are many people knowledgeable about pieces and parts of the institution and about various phases of trading, but there are not many who are broadly knowledgeable about the market. One who masters the jargon that is a part of the mystery and masters some rudimentary concepts of being long, short, and spread, open interest, hedging, basis, bearish and bullish, leverage, margin requirements, position and trading limits, and the like has penetrated deeper than most and can make quite an impression.

This is easy to do. The development of skills with which to effectively operate in futures markets is not simple because the level of skill possessed by people active in markets is high. But the concepts are simple. The mystery is a façade and the rewards for penetrating it are satisfying.

The Plan of the Book. The book is structured into four major parts: Description, Economics, Use, and Market Operation. This seems to be the most workable order for starting from scratch and working through to changes that need to be made in the markets so that they can better fulfil their missions. There is no "best way" to approach the subject. It is desirable to know about all parts before one studies each part but this is, of course, impossible. A beginning must be made somewhere. One might start with the regulation of markets and work toward the economics, or with market activities of trade firms and work toward the reasons for success and failure, or proceed from a speculation orientation.

The reasons for starting with description were noted above. But to be complete, one more reason should be mentioned: It is desirable to avoid incorporating mistaken concepts as well as to describe the markets accurately. A major fault in much that has been said on this subject is a tendency to place trading in a vacuum; to fail to relate activities back to their commercial and economic roots. The markets are not a world unto themselves but a part of the commercial world of commodity production, marketing, processing, and use. They are financial institutions that serve as a means of raising capital and as investment media. The high level of development and the stylization and formaliza-

tion of the trading processes have all too often obscured this relation to the real world. At the beginning of study there is an Alice in Wonderland feeling about futures markets that is difficult for the student to shake. In much that has been written it is apparent that the authors failed to get out of the land of Oz. Perhaps we shan't either.

The purpose of the second part; the economics of futures trading is to describe the economic functions so that users can put their own operations in perspective relative to the total process. The persistence of the markets for more than a century and the recent growth in futures trading makes it clear that these markets play significant roles in the economic processes. Had they not, they would have long since disappeared. This is particularly convincing in the light of the strenuous political opposition that they have encountered.

This section includes a brief discussion of the history and development of futures markets, the competitive characteristics of the markets, the risk shifting and equity financing functions, the role that markets play in price establishment, and the forces establishing price relationships between cash and futures and among futures prices.

The third part relates to "how to make a buck." The objective is to outline the problems of people in relation to market use, develop guidelines for problem solution, and put the solutions in a context of the economics of futures trading. Effective use of markets can only be made by people who understand the economic background of the trading processes.

This section includes hedging, arbitrage activities of warehousemen, merchants, and processors, pricing procedures of primary producers and commodity users, and a discussion of how to speculate in commodity futures. All of this is rather more than can be accomplished in a single volume. Thus, discussion is limited to principles with some illustrations. The most pretentious part of the whole volume is the "how to speculate" section. The presumption is that what is meant is how to speculate successfully and this is quite another matter. Pitfalls in speculation are emphasized because ways to "louse up" seem to be the things that are most widely known.

The objective of the fourth part is to call attention to some of the things that might be done to improve the way that markets work. Futures markets are increasing in number and in size. This is true because the functions to be performed are increasing. There is a vast potential for further growth and it is by no means certain that markets are optimally organized, governed, and regulated to exploit this potential.

This section includes evaluation of market performance, evaluation of market regulation with particular regard to protection of the public, price distortion, manipulation, position limits, and margin requirements, and some recommendations for accelerating market growth.