

## Do Live Cattle Futures Differ from other Existing Futures Contracts?

by  
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I want to compliment Professor Bakken on his scholarly and interesting paper. He has raised several points that will provide the basis for further discussion. I note that Professor Bakken closed his paper with the words, "the affirmative rests his case for the critics to assail." I had not really considered this a debate in the formal sense with me on the negative side — since I do not consider myself "anti-livestock futures." I do feel that we can accomplish more by looking objectively at the nature and characteristics of the futures market in live slaughter cattle, and to explore the adjustments, if any, in application, market strategy and logic. These appear necessary for enlightened and effective usage in testing the new market by hedgers, and by speculative interests. Perhaps differences in viewpoint or misunderstandings can thus be resolved and clarified.

In my opinion, Professor Bakken discards the need for serious study of the live cattle futures market in his statement that a "futures contract is a futures contract" and through his obvious and expressed faith in the ability of the futures market mechanism to adapt, given sufficient time, to whatever obstacles impede its progress temporarily. But I doubt that this will be much help to the cattle feeder who is relatively unfamiliar with the futures form, and is trying to learn if the market has potential as a management tool for his business; or for the Extension educator or classroom teacher attempting to increase understanding of the market; or even for the commodity broker trying to promote the futures market to cattle feeders on its hedging merit. With due respect to all futures markets, I find it difficult to agree with

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Bakken's view that they are a development of greater significance than the coinage of money, the Emancipation Proclamation, or the institution of private property rights. Certainly the record of failures and limited successes, along with numerous examples of notable success, in futures trading attest to the fact that all commodities at *particular times* are not equally adapted to successful trading in futures contracts. Whether success or failure at a particular time results from fundamental characteristics of the commodity in question, from inept specification of the contract, taxing regulations, or from temporary conditions of market environment, may be debated. The questions that I believe need discussion here are these: Do cattle, the cattle industry, and the cattle market possess characteristics (physical, institutional, or otherwise) that limit the present adaptability of cattle for futures trading in general, and for hedging in particular? And are there differences in live cattle futures which demand different information and approaches for most effective use of the market? Despite Professor Bakken's reassuring report, I'm not completely convinced that "a futures contract is a futures contract" — except in a legalistic sense. In other words, I feel there are characteristics of the cattle market that make live cattle futures different in some respects from other existing futures markets.

Later, I would like to suggest several aspects of the cattle market, and the futures market in live beef cattle which I feel warrant careful appraisal and discussion today. But first, some additional comments on certain points in Professor Bakken's paper.

I would first agree that all of the attributes often cited as necessary for successful futures trading (i.e. non-perishable, homogeneous, etc.) are not necessarily required for a successful futures market. But some of them may enhance the chances for success. And certain of them may limit progress of a market at certain times or cause failure — because of relationships to other institutional or physical characteristics of the market or commodity concerned.

Some agreement of the criteria for a successful futures market would be helpful today. What is a "successful" futures market anyway? Bakken cites eggs, butter, potatoes, and dressed poultry as commodities that have disproven the traditional guidelines for

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success. Many might question the degree of success achieved by some of these commodities. In my view, a successful futures market must be used for hedging or pricing roles by a significant number of buyers and sellers. I am sure this criteria may be too limiting or ambiguous. I hope there will be further comment on this point in our discussion later.

Professor Bakken brings out several other points with which I generally concur. His point that “wheat is not wheat” is a good one, and indicates that live beef cattle do not present unique problems with respect to delivery conditions. Although the ease and feasibility of delivery was one of the early concerns expressed by many people, numerous deliveries have been completed — and apparently without serious problems.

I also agree that the new markets will be subjected to many tests of its performance as it strives for full acceptance. But this is desirable, in my opinion, provided the markets are given ample opportunity to present their case. Certainly, as Professor Bakken points out, it takes time for a market and its participants to formulate rules of conduct, strategy, and expectations about market behavior.

I have a feeling that Professor Bakken’s discussion of the five ways of transferring rights and titles overstates the current position of contract and futures transactions in our economy. Since neither of us apparently has the factual data to prove the exact role of these transactions, I will only agree that they are of extreme importance. Perhaps the volume of speculative trading in some futures contracts inflates the relative importance of this method of actual commerce.

My major differences with Professor Bakken’s point of view are concerned with the latter portion of his paper. In discussing futures markets, he assigns as the primary role, “one of determining prices for the present, and projecting them into the future.” Providing the mechanism for registering specific prices for future delivery is, of course, essential to the hedging and speculative transactions that are conducted on the futures exchange. But I don’t believe the futures market has any unique ability to determine prices for the present, since the cash market price

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reflects an evaluation of the same known and expected market influences.

The discussion concerning the relationship between spot and futures markets seems not wholly consistent to me. Although each market is, indeed, a separate entity, I cannot concede the degree of independence suggested by Professor Bakken. Yet, after emphasizing the separate and independent nature of the markets, he states they are influenced by similar forces and comments that "The two markets closely resemble one another in the values or prices they establish as they course through time."

Nor can I agree with Bakken's view that the futures market is the dominant institution — although I must concede that his study and experience with futures markets far exceeds my own. One of the reasons cited for the position he takes is the faculty of the futures market to project prices months in advance. Although the mechanism for registering prices in future delivery months is provided as recognized before, this is not in itself a faculty for "accurate" projection of prices. Futures prices represent a discounting of current values into the future, considering known and expected market influences and risk that is removed or assumed in the process of buying or selling futures contracts. I believe few people would accept them as price projections per se, since sellers expect prices to decline or to go no higher, while buyers expect prices to rise or to go no lower.

I do not agree with Professor Bakken's suggestions that the delivery provisions are an unnecessary frill in a futures market. I hold to the traditional view that the possibility of delivery keeps the market in the world of reality. Without this juncture with reality, the two markets could indeed become separate and independent. And in the process, the futures market would shed its economic and commercial justification for existence.

I do not concur with the results of Bakken's admittedly limited inquiry concerning differences and similarities between the live beef futures market and other futures markets. I can only conclude, based on my own comparisons, that the brokers, traders, and market specialists surveyed were not overly familiar with the cattle industry and the cattle market. On the other hand, perhaps I lack familiarity with the traditional markets.

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Professor Bakken has not looked specifically at the hedging potential of the live cattle futures market at this time — something that I'm sure is of major interest to most of the group here today and which is my primary interest in the market. Although the merits of hedging with futures contracts are acknowledged in his paper, his faith in the futures market concept leaves him assured that the market will provide this potential. And he adds an additional benefit of hedging which I would surely have overlooked — “as an added source of income to the commission brokers and exchange.”

This concludes my direct discussion of Professor Bakken's paper. Despite my fairly critical comments on some points where our views are different, he has provided us with an excellent starting point for further discussion of today's topic.

I would also like to briefly suggest some other possible areas of discussion. Dr. Marvin Skadberg, who is participating in this conference, and I have tried to look at the new livestock futures market in some depth with respect to their present hedging potential.<sup>1</sup>

We feel there has been a general tendency to transfer conventional futures market logic to the live cattle market without a careful look at the nature of the market. And we feel some adaptation, some adjustment in application and expectation of market performance, is in order. In our opinion, live cattle and the cattle market possess characteristics that are basically different from those of most commodities traded with success in futures markets in the past. While we do not feel these differences present insurmountable obstacles to futures trading in live cattle, we do believe they limit the degree to which the market can perform hedging and pricing roles and that they increase the skill and understanding needed to effectively use the markets for hedging purposes. Without going into much detail, these conditions relate to the following:

<sup>1</sup> Futrell, G.A. and J.M. Skadberg, *The Futures Market in Live Beef Cattle*, M-1021, Cooperative Extension Service, Iowa State University, January, 1966; and Skadberg, J.M. and G.A. Futrell, “An Economic Appraisal of Futures Trading in Livestock” (paper presented at the annual meeting of the American Farm Economics Assoc. August, 1966).

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1. **Price-Quality Relationships** — Since the Choice grade encompasses a fairly wide range of quality and weight combinations, the price range for Choice steers in the cash market is typically rather wide. By contrast, the futures price represents a single point within this range. This is significant for two reasons. One is that the price relationships between the different combinations of weight and quality within the Choice grade are not constant. The other is that the cattle feeder is likely to have difficulty in accurately estimating the correlation between his cattle (when they will be ready for market) and the weight-quality combination represented by the futures price. These conditions make it difficult to closely estimate the price that is actually established by a futures contract sale.

2. **Production-Utilization Pattern** — Production and utilization of beef is a continuous process. And there is a great deal of flexibility in the weight and condition at which individual cattle can be marketed for slaughter. Cattle feeders and producers can respond to market conditions and prospects by marketing cattle with greater or lesser amounts of finish, after grain feeding or off grass, etc. This makes it very difficult to closely estimate month-to-month supply patterns with any degree of precision — even though total cattle numbers are fairly well known.

3. **Comparability of Cash and Futures Positions** — The cash and futures market positions are not comparable until the cattle in inventory achieve minimum prescribed weight and quality characteristics. Prior to that time the cash position is represented by feeder cattle in some stage of transition to the product specified by the futures contract. Thus, the cash position can be only partially hedged, since it involves hedging of a production process rather than inventory.

4. **Basis** — Basis, or price difference between cash and futures markets, has no consistent and significant relationship to time periods in the live cattle market. But basis resulting from locational and quality differences is very relevant. Transportation differentials can be readily determined. But basis due to quality difference between the animals hedged and the animals specified by the contract may be extremely difficult to estimate. And there is a good possibility of substantial error.

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5. Hedging Incentive — The economic incentive for hedging cattle feeding operations will likely be strong only if the futures market offers a greater opportunity for returns than can reasonably be expected from an unhedged position. And hedging away the opportunity for greater profit if the cash market turns out to be higher than the hedge position may deter participation.

6. Price Stabilization Possibilities — Stabilization of market supplies and prices is one of the frequently cited attributes of the live cattle futures market. I feel this is a very tenuous claim. Is there real evidence that this has resulted in other commodity futures markets, and what is the logic for expecting it to occur in the cattle market? If, in fact, stabilization is achieved, this would appear to weaken the economic incentive for existence of the market — since the price risk to produce would be materially reduced.

As indicated before, we do not feel these conditions preclude good hedging opportunities at times. We do believe it suggests that considerable skill is needed in evaluating hedging opportunities and completing the transactions most advantageously. It's been a pleasure to participate in this conference and I hope these remarks will help stimulate further discussion.

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