

Some Hypotheses on the Success or Failure of Futures Contracts

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Taking Professor Gray's lead, and at the risk of being redundant, I would like to state my position with respect to why futures trading succeeds or fails by the following illustration. A student once taking his oral exam for his Master's degree was asked by his Major Professor, "What do you think current hog prices are?" The student being quick of mind answered by throwing the question back to the Major Professor, "What do you think?" The Major Professor astounded by this tactic stated: "I don't think — I know!" The student then responded, "I don't think I know either!" I am also in the position of the student, but even so I would like to advance some hypotheses and comments which I feel generally augment and supplement some of the points raised by Professor Gray's paper.

But first I would like to acknowledge that I found the paper interesting, though provoking, and well hedged. Certainly contract deficiencies, imbalance in market power, inadequate speculation, etc., can all have profound effects on the viability of a given commodity futures market. These characteristics determine attractiveness of the market to its potential customers.

An effective argument for the role of hedging is given. I would prefer however, to wait and see the empirical evidence to which Roger eludes before commenting on this issue. Let it suffice to say that hedging use certainly appears an important factor in the success of a commodity futures market.

I do, as a fundamentalist, however, find it somewhat difficult to believe the belly market could serve as a substitute for live

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hog futures. This is not to say that it cannot be done. It certainly would not appear optimal. The price relationships among bellies, other cuts, and by-products making up the value of hogs would not appear sufficiently stable to encourage high volume hedging of live hogs.

I would like to make some additional comments on the likely success of live hog futures and the changes it might help precipitate. Since farmers are the likely hedgers in commodity futures, most of my comments will be with this group in mind. You will recognize that many of these comments have been discussed or alluded to in Gray's paper.

The introduction of both cattle and hog futures trading was certainly a milestone for commodity futures. Many thought cattle futures would never get off the ground for they violated, to considerable degree, the long established criteria for successful futures trading. Among these were: inability to easily and adequately standardize, and the inability to store the commodity over a significant length of time. Yet, enough people felt there was sufficient economic grounds for the market; that these traditional limitations were not as severe as anticipated, and that they could be overcome. After getting off to a slow start, cattle futures have become a viable market. At this point most antagonists have re-evaluated the strength of the traditional factors for successful trading, and for the most part will agree that cattle futures do, on the whole, meet the necessary criteria as now conceived. In my mind, trading in live hog futures possesses similar "limitations". It is partially for this reason I am enthusiastic about this market.

I believe trading in live hog futures by various segments of the swine industry may significantly effect hog marketing in the next several years. The possibility of reducing market risks and expanding capital availability is open to farmers.

Contractual arrangements may increase, and packers may operate more efficiently. Just as the development of faster gaining meat-type hogs has had a significant impact on pork production, the development of the futures market as a marketing tool is likely to have a significant impact on the way we price and market hogs.

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Currently, however, trading actively in live hog futures is limited. Some believe that trading is too inactive to provide the fluidity the market needs for quick and equitable transactions. Partially because of this, and partially because of the biological and the economic nature of the commodity, there is and will undoubtedly continue to be a much greater proportion of selective rather than routine hedging such as exists in grain. What, then, will determine the potential use of live hog futures either directly by farmers or indirectly through packer hedgers. Two conditions are prominent:¹

- 1) *The importance of the commodity or enterprise relative to the total business.* Since hogs are a major enterprise in the cornbelt, this condition is met.
- 2) *The amount of price risk the operator is willing to bear.* Increasing specialization and increased debt of farmers lead to increasing interests in methods useful in reducing risks.

Successful farm operators depend, to a large extent, upon volume rather than market speculation to secure adequate returns. Larger, more specialized units are particularly vulnerable to market price fluctuations. As volume increases, capital requirements increase and debt rises. Much borrowed capital is generally in use. These operators who continually utilize their facilities to the maximum may be quite willing to forego chances of windfall profits from changing market conditions in order to protect returns arising from production. The fact that these changes are taking place should lead to greater use of live hog futures. To the extent that they are not far enough along would help explain the slow start of the live hog futures contracts.

In addition to the opportunity for hedging, a viable hog futures market offers several other effects.

Farmers may find that capital is more readily available; that bankers and other lending agencies are more willing to loan money on hedged commodities. This may make possible greater expansion of operations since borrowing capacity has been in-

¹The above assumes "traditional criteria" for successful trading are met and that contract mechanics and equitability have been worked out. Implicitly assumed is sufficient price instability in the basic commodity market.

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creased. It also encourages operations on even narrower margins than in the past.

The existence of a viable live hog futures market could provide some degree of price stability to the feeder pig market by placing a floor under feeder pig prices, provided sufficient producers have the alternative of feeding pigs to market weights at a profit. The existence of futures contracts for slaughter hogs provides the feeder pig producer with definite information as to the relative profitability of selling feeders or fattening hogs protected by hedging. If the spread between the current price of feeder pigs and slaughter hog futures becomes too great, the alternative of feeding will result in the removal of some feeder pigs from the market, thereby causing prices to rise. When the spread narrows, more pigs will be moved as feeders. These actions could place an effective "lower limit" on feeder pig prices.

That an active futures market will result in increased price stability in the live hog market is open to question. Insofar as operations may be planned on the basis of futures prices, and that producers may react by increasing and decreasing production to anticipated, rather than current or past price levels, increased cyclical market price stability may result. Contractual arrangements in hog production and marketing may be spurred by the development on contracts made possible by futures trading. The possibility of packers contracting with farmers for prices agreed upon well in advance of delivery of the live animals is a reality with the implementation of futures trading in live hogs. Currently, one large national packer offers farmers the opportunity to contract their hogs for a price agreed upon prior to delivery. An Indiana packer offers farmers contracts which specify price, weight, grade, and time of delivery, as much as four months in advance of marketing. The rate of such contractual developments will be an important factor in the growth of the live hog market since even though farmers can deal directly on the futures market for purposes of hedging, many will not, preferring to contract, thus, letting the contractor perform the necessary hedging operations. This has long been true in grain.

In summary, it appears the stage is set for continued growth and development of the live hog futures market, and that it will likely

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have the effect of stabilizing hedgers' incomes, at least to the extent that hedging represents protection against declining incomes; that it may serve to encourage increased production; and that it will likely provide for more efficient orderly marketing. Whether this will materialize in the short run is open to question.

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