

## A Packer Considers a Long Term Approach to Futures Contracts

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Today, we have been told of the development of futures trading in livestock and meat, and hedging has been explained to us. My attempt will be to discuss *how a packer can make use of futures* and this may not necessarily be how our company uses this market. Another member of the panel has described short term inventory hedging benefits, therefore, I will *briefly talk about long-term approaches to the futures contract*.

In the meat processing industry, we are concerned chiefly with beef and pork, therefore, cattle and hogs. When we look at the volume of contracts being traded on the exchange, we find there are not enough live hog contracts being bought and sold to exert appreciable influence on the hog kills of the processing plants throughout the country. However, a major packer has recently initiated a contracting program for live hogs that is being hedged in the futures market. It is believed that this program will benefit both the producer and the processor by eliminating the uncertainty of price risk to the producer, preserve the producer's independence of action, and provide him with another method of marketing. If the program is successful, it will enable the processor to operate more efficiently because he will be assured a supply of hogs. Speculation is eliminated in this program by transferring market risks from producers and processors to others who elect to carry the risk. By doing this, the processor will neither profit nor lose if prices of live hogs rise or decline. This procedure will result in a more consistent supply of hogs. Improved efficiencies will be evident which should offer opportunities for profit to the pork processors.

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As stated earlier, the volume of live hog contracts traded in the futures market at this time is hardly enough to support this program for one average processing plant, let alone the pork processing industry, yet the volume of live cattle contracts is beginning to offer the beef industry the opportunities outlined.

When we study the beginning of the futures market, we learn that hedging was not used in the early beginning, but was initiated only after twenty years of futures trading. When we look to the live cattle futures contract, we find all phases of the industry are offered something that can become a highly effective tool of management, and will provide useful economic insights into market positions of the future. Live cattle contracts, or any futures contract, represent management aids to our industry only if we understand what makes up a contract, how a contract is executed, how a contract may be used, and how to evaluate the associated risks. When a cow is bred or a feeder is purchased for the feed lot, neither the rancher nor the cattle feeder is guaranteed a sale price. The same is true in the processing business when you buy cattle with reference to the beef carcass, so, therefore, by the nature of our business we are all speculators. If we compare a live cattle futures contract to cattle feeding as an investment one must conclude that in terms of risk there is no difference.

In an attempt to adapt live cattle feeding or contract feeding to the processing industry, we are immediately reminded that both Government and public sentiment may not favor packer cattle feeding. If packers, however, are to achieve the goals in beef processing that were outlined earlier in the hog contract, they must feed or contract and have fed, a reasonable percentage of their processing capacity or sales commitment. This can and is being done by operating feed lots or buying feeder cattle and guaranteeing a feed lot operator a price at slaughter with or without hedging these animals on a futures market. In this case, a hedging program would be the same for a cattle feeder as it would be for a beef processor, depending on where the profit would be assigned. If a feeder, the profit would be in the feed lots. If a processor, in the beef box. For example, if one buys feeder steers weighing an average of 700 lbs. at \$26.00/cwt.

## EXPERIENCE IN THE PRACTICAL USE

(\$182.00 per animal) puts on 350 lbs. gain on each, the value is increased to \$276.50 per head. This results in a necessary selling price of \$26.33/cwt. at slaughter.

If cattle go on feed December 1, 1966, they will be ready for slaughter in approximately 140 days or during the month of April. By selling April contracts for \$27.83, which you may or may not be able to do in the near future, a profit of \$1.50/cwt. delivered, can be assured or \$15.75/head for the feed lot or the beef operation, depending on ownership or where profit would be assigned. The risk has been transferred, and certainly a well informed lending establishment would look favorable toward financing such an operation. The market rise or decline at time of settlement of the futures contract will give a profit or loss to the holder of the futures contract. The seller of the contract will have "locked in" a profit regardless of market conditions prior to settlement in April or at an earlier date if he decides to lift his hedge.

The futures market offers the processing industry another opportunity, especially, if beef packers or their officers were to be prevented by law, from cattle feeding. From a long term investment, a futures contract can be envisioned as a load of cattle. The investor has acquired the right to 25 cattle for a \$300.00 margin plus a \$20.00 commission. He need hire no labor, buy no feed, own no land, amortize no equipment, pay no vet bills, have no death losses, wade in no mud, repair no equipment, have no frozen water lines, etc. You can remain in your comfortable office and operate your present business if you are astutely aware of market conditions and as mentioned earlier, invest in the futures market on a long term basis. This can be done by maintaining a knowledge of cattle population by seasons present, and in the future, the basic economy of the consuming public, and the competitive influences from other meats. We can determine our beef requirements at a processing plant for a given month or months in the future, what per cent we want to put on feed now and for use in the months ahead. With this information we try to fill our orders. The cattle feeders, follow much the same pattern. They anticipate a market price for cattle at time of slaughter before putting cattle on feed. When there is

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prospect of profit they buy feeders. If the reverse obtains they sell feeders, and not feed. This same approach can be used in the period following the month the cattle are required in the beef operation to give some latitude to the paper cattle feeding program.

This could work as follows, when a cattle population decrease is predicted, then the operator should approach the market from the long side. In a period of abundant supply of cattle, the operator should approach the market from the short side. In either case, if properly evaluated, the results could be the same. In months when there are doubtful results, do not enter the market. An example of this action may be: In the month under consideration the predicted value of live choice steers is \$29.00/cwt. and the futures market quoted price is \$27.65/cwt. resulting in a margin of \$1.35 less .08 commission or a net margin of \$1.27/cwt. which is \$317.50 for each contract of 25,000 lbs. This is the same as \$13.34 for one 1,050 lb. live steer.

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