

Case History of Hedging

Virgil A. Wiese

Good afternoon, fellow grain elevator operators. I have been asked to expand a little on how my company used the futures markets and the carrying charges which this market gives us to help us sell our space profitably. Probably many of you know as much about our subject as I do, so I would like to keep this discussion as informal as possible—have you stop me and comment—or ask questions as you care to so that between us we might be able to develop something of interest to all.

While my title was given as Chairman of Lowell Hoit and Co., this talk on hedging will necessarily be about our subsidiary corporation known as Federal-North Iowa Grain Co., which runs about 100 grain elevators throughout Iowa, Illinois, and Indiana. I am quite familiar with this operation as I live in Champaign and work in the office there which controls and manages our Illinois and Indiana line.

All of us are rapidly becoming well acquainted with a very real fact of our business lives which is that the government is going out of the business of renting storage space for its surplus commodities—it has no further use for our space which they encouraged us to build and is leaving us to our own resources to make a living for ourselves as we used to do before the age of Commodity Credit Corporation. Now, we of the legitimate grain trade must carry the cereals, the proteins, the vegetable oils and the livestock feed for the entire country and a large part of the world from crop to crop and to be prepared to carry some from year to year in case some year's production should be a partial failure.

To carry this produce we must have the space, the money, and credit and the knowledge of how to do so at a profit.

If we store commodities—and I shall now confine myself primarily to grain and soybeans—we probably will need to borrow money from our bankers and they are unwilling to lend on grain carried speculatively or as I call it—“open.” They want borrowers who have proved through the years that they make a regular income regardless of market fluctuation and who will not be wiped out by sudden fluctuations which occur with more or less regularity because of drought, wars, foreign demand, or other factors which unexpectedly enter the picture. They want borrowers such as we grain men all want to be—who know how to, and who do shift the risk of market changes to the speculators, who make it their business to make personal gain by changes in price. . . .

Let me show you one of the methods we use to guide our hedging operations. These are basis charts—they are not records of price levels, but are complete records of the difference between cash and futures prices for the past several years. I'll illustrate my points with charts for the period between July 1960 and June 30, 1962. . . .

You can see on the charts the way the basis moves—from consistent discounts at harvest to much smaller discounts, and sometimes even to premiums when the delivery month draws near. The pattern is never exact but it is much more predictable than price levels. This is the essence of hedging. The price level itself is disregarded and the hedger finds himself a student of price relationships. The charts of past basis action are not maps to follow blindly, but are effective guides to an alert operator. . . .

In the charts, the base line in each case is the cash price of the contract grade of grain F.O.B. railroad cars in the Campaign territory. I might mention that the cash prices in each territory will be different—you must compute your own basis relationships—but I will also tell you that there are few, if any, areas of the country where the prices will not bear a similar relationship to the Chicago futures prices.

Now, . . . the straight zero line is always the cash price on my charts. I make them this way just because it is easier. With the cash price as the bottom line of my chart, I don't have to run all up and down on a graph paper. The lines never get much farther than this.

Now, cash is a constant, at a consistent discount in harvest. We are just a little past the bulk of the wheat harvest here in July 1960, and we're looking at the December contract. This wheat future went down through October and the basis was making a good profit and then the hedge went sour—don't think that sometimes they don't. We might have to change this into later futures before the basis narrows and get our money out of it.

In early '61 as I remember, we had a great big, bull market in wheat and the speculators carried the futures to such premiums that the wheat hedge was no good.

We should have made our storage by October—and there are times you must be ready to jump. I suggest that when you see that you have made all that seems reasonable, sell it out. In our territory we don't want wheat after October anyway. We'd like to stop right here in mid-October, make this quick hedge profit—we made 12¢ a bushel on our wheat from the first of July until

the middle of October—then get rid of that wheat and get into the soybean harvest.

So in 1960 here are November soybeans at a 16¢ premium over cash. Of course we wouldn't hedge in November at harvest—we would use November if we bought from farmers during late summer. When we buy in October we will probably hedge in March.

So we take this quick wheat profit and go into beans. Maybe in October we can put on a bean hedge at a 21¢ premium over the cash and we will come out late in December at 4¢. We have made 12¢ in wheat, the same space, the same money; we have made perhaps another 15¢ in soybeans, then we come into corn, all the same year.

Now, in 1960 you could have been hurt in corn, because we had a terrific glut in November. Suppose we put out hedges early as we buy from farmers ahead of time. We buy the December corn and it is going to come down a bit, but we've got to be awfully careful in harvest not to take this punishment in October and November before the basis comes back and we start gaining again. So you keep your beans until you have made the big profit, then you can put some corn away. If you have a drier and the corn comes in good and dry, you can carry corn almost for the crop year.

In November we want to buy corn right at the height of the harvest. If you hedged corn and bought from a farmer early, you should sell out all your cash before harvest because you know you are going to get plenty of corn to refill during the glut.

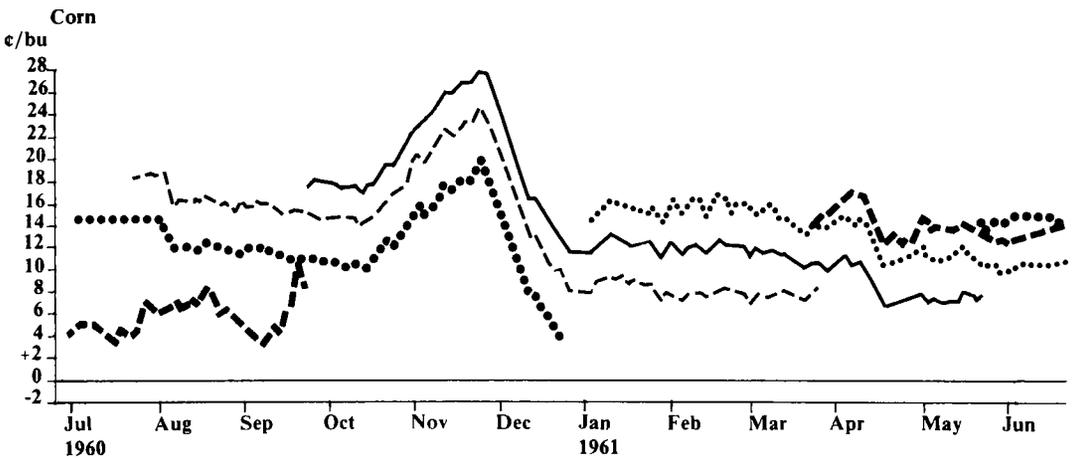
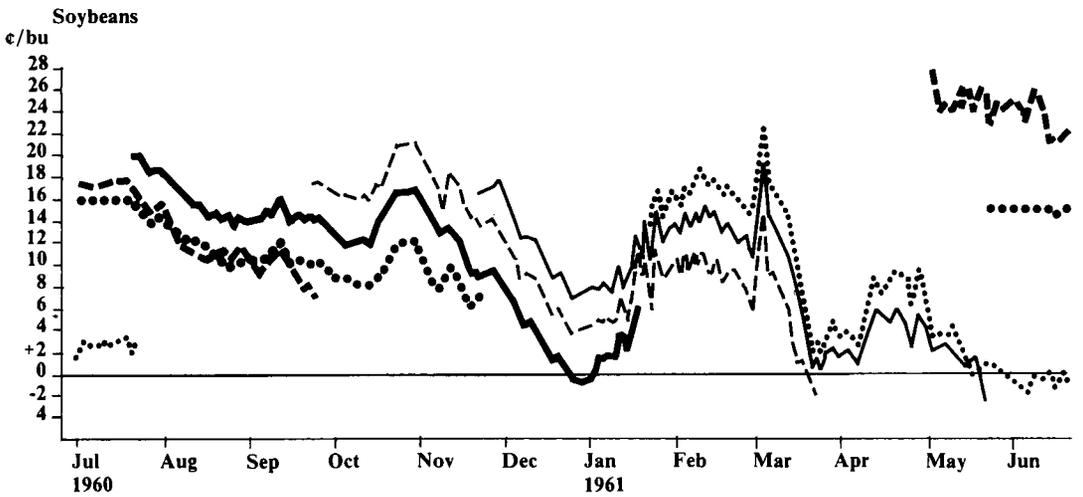
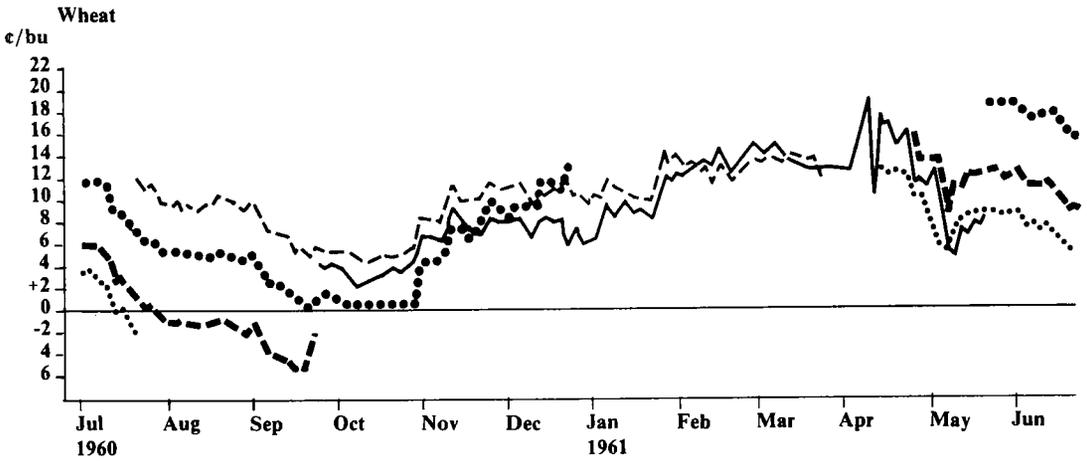
When the basis gets up here [pointing to November 1960] start putting your corn away again. If you're hedged in the December and get to where there's a 5¢ premium into March, maybe you will put it into March—or if you think 3¢ more is enough to get into May, you will move the hedge to May.

Presume you move the hedge into March and about the time March expires we move into July. There was a 14¢ basis to December; here is another 5¢ into March, which makes 19¢; here is another 4¢ to May making 23¢. You keep going to a more distant future still carrying this corn if it is good enough, or you can trade corn. Now, we in the country can trade corn. We can ship out 17½ percent moisture corn and get some 15 percent in place of it later on and maybe wind up with some 14 percent corn that we are going to put away in June. You can come along here until September expires at about only 5¢ above cash, so you can sometimes take a 25¢ operation per bushel out of this corn hedge.

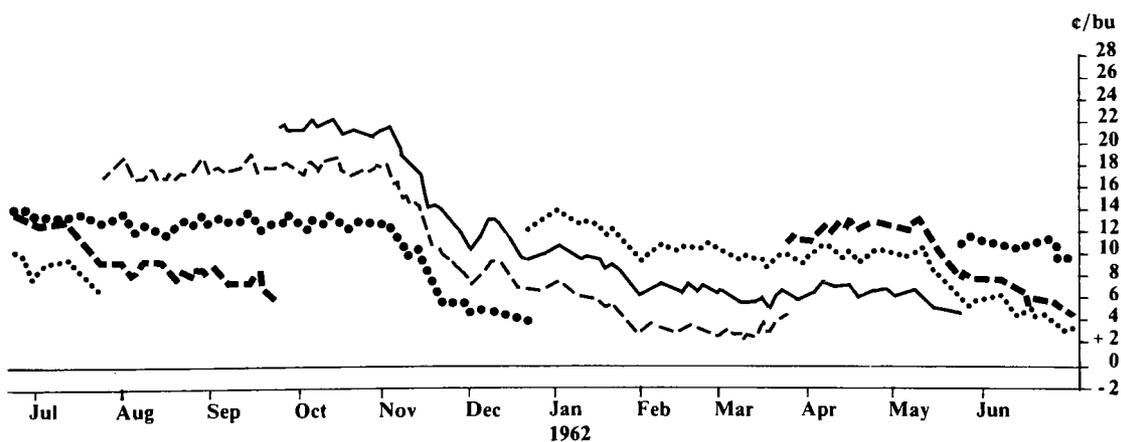
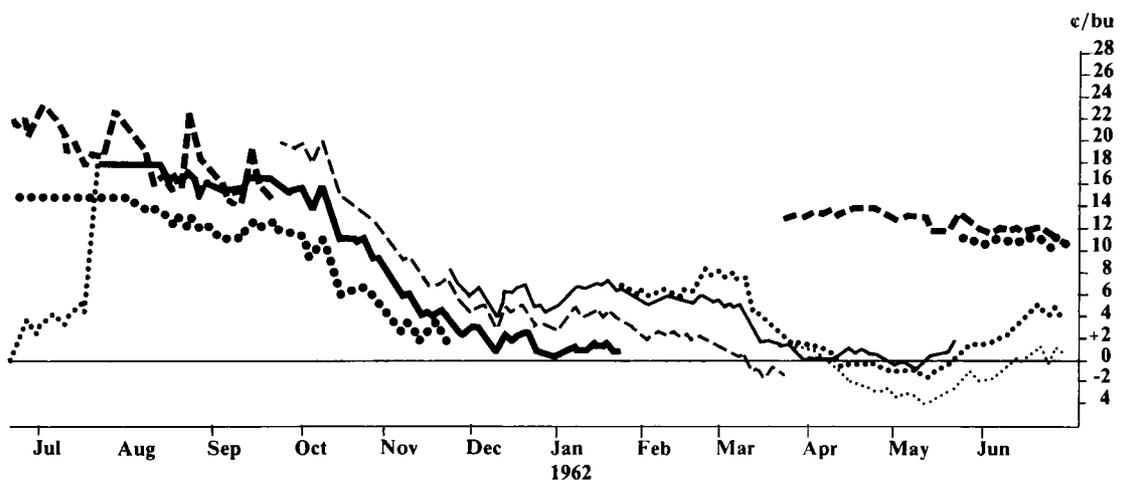
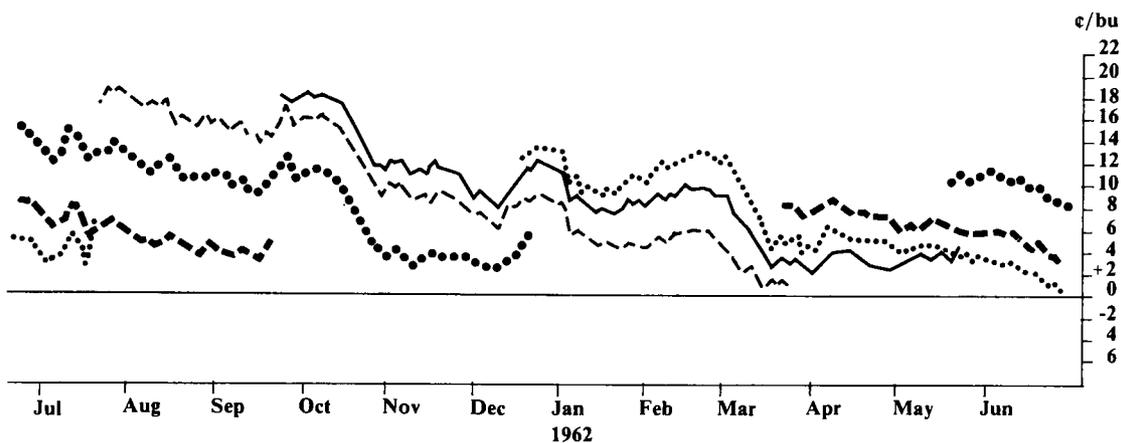
. . . I have hit this pretty roughly, but our profit is in this basis change. It is not in the 3¢ a bushel, because it costs us that much to handle it. It is not in speculation, because you are going to win half the time when you speculate and the government is going to take half of what you make when you win and when you lose they are not going to pay you anything back. You've just got to make it every year.

Now, this pattern is never the same but always the basis narrows down from

Basis—Champaign, Illinois



—————	Jan	Aug
-----	Mar	-----	Sep
-----	May	Nov
.....	Jul		



harvest on. It did in '61; you get into 1962, it comes together from harvest on. Look at soybeans, from wide basis at harvest on down here to the premiums in '62.

Now, these are track prices at Champaign or Monticello, or Bement, or some other place in my neighborhood. You can see that sometimes we get above the futures price. This morning Bill Schultz was talking about delivering in Chicago. They are stymied up here when this grain gets in the terminal elevators because there is not much of anyplace to go at very much of a premium. They can go out at some premium, two or three cents a bushel is a pretty good premium over a future here, but you've got a loading out charge to pay out of that.

But we down in the country, you and I, don't intend to deliver on Chicago contracts. We have only delivered once on futures contracts to my knowledge. Grain can be delivered in carlots on the last three delivery days of any month. They make it as hard for us as they can, I grant you, but we have always got that insurance that we can come in here to Chicago and deliver on futures contracts in case the rest doesn't work.

Those who own grain in Chicago are hamstrung with only delivery or sales out of town, which have to compete with arrivals. We don't expect to come here to Chicago, and that is how we in the country got these great big basis swings. Here are cash prices above the futures in both wheat and beans because we go to Decatur, we can go to Louisville, we can go to St. Louis, we can go to the Gulf. There are many places where we as country operators are free to ship and which give us so much more profit and so much more latitude than the terminal elevators in Chicago.

Floor: Isn't there some storage in there that you aren't mentioning anything about, too, when you sell a future.

Wiese: This I am calling a carrying charge. I am talking as a grain man who owns his own elevator and is trying to sell the space that he owns by hedging. Now, if he wants to say that I am going to charge my operation to storage and cut down my carrying charge profit, that could be done, I assume, but that is not the intent.

There is no storage to my knowledge. Once in a while, soybean processors pay for some storage, but outside of government paying for storage, there is no storage that I know of, of any consequence other than using this hedging operation to make storage out of our facilities. To do it we've got to have the space, the money, insurance and the cost of doing it, and that has to be deducted from these profits or carrying charge increases which I am talking about. . . .

Floor: At harvest, do you like to start hedging in December or go into March?

Wiese: I want to go further away if there is any decent carrying charge into the future months. I wouldn't go to December corn here in October and November 1961 with the thought that I could ever do any better than I could by going into March or even into May. In December of that year I'd probably go into May, with the thought that later on I would probably go into July. But

I avoid inverse months, and we often see them, particularly in the bean and wheat markets.

We see May wheat at a discount under March a lot of times, because the government is going to take the wheat in between March and May and we are afraid they are going to dump, so then you have to be very careful. In early 1961 we can see where this wheat has inverted itself here a few times. That so often happens and we have to know that it is dangerous.

So, always whenever you think there is a satisfactory carrying charge, jump to the furthest option and take advantage of it. If it should invert you are all to the good.

Floor: Do you sell every day? I mean, if you buy 10,000 bushels a day, do you sell 10,000 bushels of futures, do you do that every day?

Wiese: I keep a long and short position at all times. I know how much space I've got and I know how much money I've got and how much I can keep. I will go into the corn harvest and when the basis widens as it did so dramatically in October and November 1960, I say: "Boy, here is where I hedge," and here is when I am buying the bulk of my corn, too. As my long cash positions come into me from the various elevator managers, I sell the futures to cover them.

Floor: You mean you just let it accumulate from day to day and then, boom, you sell all at one time?

Wiese: No, if I buy 5,000 corn one day I sell five in futures; if I buy 13,000 corn the next day, before the opening I have the order in for ten and three. I just sell that close. I sell round lots and job lots both, and I just continue to keep my position even by selling futures rather than by selling cash.

Now, when I have sold futures against all that I can hold in the elevator, then I revert to selling track again. If I've got corn still out in the country that I bought back in July or some early month and it is not yet even delivered to me—in my own mind, I apply that corn against this hedge. I get my money out of the cash corn that has come in earlier and if the farmers want to keep this corn I've bought until December, I will hedge that corn in December. If I'm long, I don't wait until the corn is in my elevator—I want to even up my long position with future sales.

Floor: You are using a very profitable year as an example of hedging during a harvest, but I think if you will recall the last two years your basis was about as wide when we were buying this corn early as it was during harvest. Go to your next year—

Wiese: That is right.

Floor: So maybe you might want to do a little of both.

Wiese: Let's look at 1960. Everything I have bought here in July to be delivered in the fall I have hedged. It is a lot easier to hedge than to fuss around selling track corn early in July—and you don't know where the good market is going to be. I would never think of selling cash corn during this period and I

don't care what year I am using. Sometimes St. Louis is the market, and maybe some local fellow is going to come along and it will be a two cent premium, or there may be reason to come to Chicago, and so these are all future cash sales in my mind.

Then I say, well, now, we're getting pretty close to harvest, it might be we may get this action—a widening of the basis—so I am going to sell cash in September or October. Here in 1961 I will do the same thing, even though I don't need to. The movement in corn harvest of 1961 was not big, and there was no big variation in cash and futures in this year, nor was there any of consequence in 1963.

We have had quite a thing in beans in 1963. We followed a pattern almost like in 1960. With the bull market in beans when they went to three dollars, the cash pulled away from the option and we had a little punishment to take if we had hedged them previously. But all at once—and I am talking 1963 now, not 1960—the vegetable oil market collapsed, President Kennedy was assassinated, and the cash bean market went from \$3.00 to \$2.70.

The processors had been trying to base their bids on the end products and were laying back during this \$3.00 bean market in October, but they are still willing to pay nearly as well as they did previously for cash. So since the period of the assassination, the bean market has fallen but the products have held pretty well. We have made 6¢ to 7¢ a bushel on all our hedged beans during the past two weeks. It has been a very sudden thing so now I am getting ready to get out of my beans. I don't believe they are worth carrying much longer, although some years I might carry them.

Floor: How do you decide when to get out of this? Let's look at a short hedge. It is, I believe, the 11th of December and you have your elevators holding both corn and soybeans, and they are hedged; I would imagine that you are hedged way out in front of you right now.

Wiese: yes.

Floor: That is to say the May-July corn, May-July beans, that is probably how you are hedged. From this point in time forward do you decide to sell out the cash and take in the futures and close up shop, so to speak?

Wiese: All right, that is a real good question. This morning when Bill Schultz drew this stair step on corn, he had a cent and a half per month or per delivery month, which he says is not a satisfactory carrying charge in Chicago because Chicago storage is almost two cents a month. That is nearly what we are coming to in the country now on beans. I think we were about three cents under January track when I was home Monday, and I have a hunch that if this bean market doesn't go up—of course it did go up considerably today—we might get January price track in our territory before the end of this year. Well, January price track means almost fifteen cents above January delivered Chicago. That is about all I want. I don't think I am going to play around any longer with this little cent and a half stair step, because I don't believe it is going to be worth interest and insurance and all that. I think I am going to run

early this year if, within the next week or two weeks, it does what I think it might.

Let's see if I have answered the question.

Floor: Yes, except I will ask the question what do you think about corn from this day forward?

Wiese: I think that corn has not nearly seen its potential. I wouldn't think of getting out of corn now. I think now is a good time to still put corn away even though the basis has gone up three or four cents in the past two weeks. I think that corn will be so tight next summer compared to the July futures that there may be another ten cents in corn.

Floor: What makes you think that?

Wiese: I don't think the government is going to sell corn as freely as it has in the past couple of years. I think the government is going to demand a higher basis—their agents are being very stubborn about their sales at the present time. I think farmers are being very stubborn about corn sales. I think they are going to hold tight this year, tighter than usual; that is the feeling that my managers give me. I believe that we have less corn bought for January than we normally have, and I think that the general public feels that there is so much corn in this world that they are not going to buy the futures too freely, we are going to export a lot of corn. Put all those factors together, add the fact that the basis is not nearly as high now as it has been in the last two years, and you have my reasons for staying with corn.

That is not a very good answer, but all we can do is use our best judgment.

Floor: Then you will use your best judgment about what is going to happen to the basis between now and next summer?

Wiese: Oh yes. I change my mind every day. I am just like a woman. That is my best judgment now.

Floor: Virgil, do you have time on the blackboard there to show the boys the little stair steps on beans that you are talking about when you make up options.

Wiese: Well, the stair steps are on these charts. Look at October 1960. Here is the November and then there are four and a half cents between it and January, and then here are four cents into March, and then we come into December and here are three cents into May, and here we come again two cents into July. Now, I didn't count all the cents, but there are quite a few, aren't there? There must have been a total of fifteen cents that comprised those stair steps there.

But, of course, this isn't all that I count; the stair steps are between options here in Chicago. Our country opportunity over and above the Chicago opportunity is in this much greater cash-futures basis.

Floor: I would like to ask you to explain a little. You said you buy cash grain at so much under futures. Now, you mean this is a calculation that you make in your mind, or is this the way you establish your bid or—

Wiese: No, we can't buy cash grain at any price other than a competitive price with everybody else, but cash grain is always bought at a discount under options if it is a hedge.

Our buying, if we use the three-cent margin, is always three cents under this straight black line, in case of beans a little more, oats a little less, but never has cash grain been bought in my time that it wasn't bought at some discount or another under the options.

Does that answer it? Of course, if there is not enough discount, I will ship it out, I wouldn't hedge it and hold it.

Floor: That is what I wanted to find out.

Wiese: I won't do this if there is not a profit in it.

Floor: I think what he meant was this: I mean, I don't know what track price downstate would be, but I imagine about \$1.15, wouldn't it?

Wiese: I suspect so, yes.

Floor: And the July closed at twenty-five, I believe, today.

Wiese: That is ten under.

Floor: It doesn't make a bit of difference what either one does from now until July.

Wiese: We want the basis to narrow more. I think generally we have been around four under on July corn.

Floor: It got pretty close together in the last couple of years, didn't it?

Wiese: Yes, I think so. Here is July 1961 and it is six or seven, and here is May, and here is July only three cents here at the end of June 1962, so there is the past two years from seven to three under. If it even gets as good as the last two years we've still got five or six cents in our corn.

Floor: Now, is the straight line what you figure that what you can sell corn for, or what you are paying for it?

Wiese: That is what we can sell it for, that is our track price at all times. This is all in addition to what I call the country profit.

Floor: Do all country operators have driers?

Wiese: Not all of them, no. In fact the majority do not have driers. Where we have driers we can keep the identical corn. Where we do not have driers we have to change the corn, as I explained. In normal cold weather we can hold corn a month or two months and get the cream out of this corn hedge, if we put it away in November, by the end of December we've gotten the cream of that corn hedge and we could even do that with reasonably damp corn.

Floor: You don't have your money invested very long until you have made the profit?

Wiese: No. That is the reason I say that to run these elevators as intelligently and cheaply as possible, you get the cream off the wheat, then get the cream off the soybeans, then get the cream off the corn, and then if we—

Floor: Go to Florida.

Wiese: Yes, then go to Florida. But if you've got plenty of money and plenty of space you can get this last five cents out of corn.

Floor: How can you get the beans out soon enough to make room for corn when both crops come in at almost the same time?

Wiese: There is almost a forty-five day lag in the two crops in our territory from the height of the season to the height of the season.

I carry a lot of hedges on the farmer's money, meaning that I have sold my options during the glut, but I still have enough coming in by the end of November to fill what space I am going to have and I fill all of my turning room and any kind of space that I might have, even though I can't turn, and then move the glut out of the way in the following month. Now, you see it is a tight move, yes, but you've got almost two months which you can play with. Your working space that you are going to need next spring can all be filled at this time and the beans moved out of the working space later.

Floor: What would happen if we all get very efficient, like you on this hedging and selling and are—

Wiese: I am quite worried about that. And I don't mean just a little bit. I said all these people have built flat storage and they are getting driers and they are going to be forced to go into this operation now, because the government is not going to pay them. A lot of them don't know how yet, a lot of them haven't got the money and perhaps not the credit, and maybe they won't, but enough of them are doing this. We have had such a tremendous increase in storage space in this United States, and I am talking both country, sub-terminal and terminal, that you have hit the very deep worry of my business career. If everybody does it we are going to close up those options; we are going to stop the gluts and how are we going to sell our storage space? Then we are going back to buying our grain on a ten-cent margin instead of three, because that is going to be the only other answer.

Floor: You say that you usually have about a forty-five day lag between your soybeans and corn?

Wiese: Between the height of the moves.

Floor: Now, how would I work a hedge in my case for my soybeans? I have about a fifteen- to thirty-day lag between soybeans and corn.

Wiese: Where are you?

Floor: Southern Missouri. My corn is out fifteen to thirty days before the soybeans come in.

Wiese: You've got to stick to beans and you cannot do anything with corn in your neighborhood, because your corn is going to come in here [pointing to a narrow basis on the corn chart]. Then you would have to sell your corn at the worst possible time, so you cannot hedge corn in you territory if you intend to use the same space for beans.

Now, we operate some elevators down in Carbondale, and I know what your problem is and we cannot do it there either. So then you have to confine yourself to two crops, because the corn glut in this United States comes after you are done and you cannot sell your corn during the glut period; you've got to sell it quick and get your premiums.

Floor: That is right. My big problem is getting enough cars to ship it out as fast as I can get it in.

Wiese: That is not only yours, that goes all the way to Chicago and through Iowa and everyplace else.

Floor: If I have to hold it I am out of luck.

Wiese: You have to sell track.

Floor: The glut will get worse in corn, won't it?

Wiese: I am afraid picker-shellers are going to roll this corn in so fast that it is going to increase this bulk for us materially. What we are going to do for space and cars I don't know.

Floor: This is a little off the subject, but I want to ask this question: I understand that some of the terminals are going into some of the country areas and building a big elevator and maybe they put four or five little country elevators out of business. Do you think that is going to happen generally?

Wiese: Gentlemen, I don't know. I hear that, but I haven't seen that happen yet. I haven't seen any elevator, no matter what its size, in a country location that can operate any cheaper than a small country elevator operator with one manager. Figures that I have seen make it sound like you could, but your per bushel cost doesn't seem to be any lower than the small elevator's per bushel cost. The farmers still go where they can get the service and where they can get unloaded. We operate an elevator at one certain point, of 300,000 or a little more capacity, which is bigger than the normal country elevator. Some other people came in, built another elevator of that much capacity or more, and that is a town that probably ought to have had 100,000 capacity to start with, but I can't see that the larger elevator or the superior knowledge or anything else has hurt any elevator that is surrounding it. I can't see that they have operated on any cheaper costs or that their per bushel profits have been anything better. The only thing is they have got an advantage of storage on the hedging operation, but I don't believe they are going to put the little elevator operator out of business. Maybe you have had different experience than that.

Floor: I feel like you do, but I have talked to people that feel it is going to happen the other way.

Wiese: Twenty-five years ago people used to say: “Virgil, young man, all these little elevators are going out of operation and we are going to concentrate these big points here and here and here,” and I said, “Yes, I suppose that will happen.” But, it hasn’t. The next twenty-five years will probably bring more, but this is no new theory. It seems like in every company, no matter how big it gets, the costs continue to climb with the volume.

Floor: In the expiring month contract, when it is delivery time, what is the maximum that the basis could be track Chicago before a person would run over and buy—

Wiese: You ask what is the maximum basis over the option?

Floor: The maximum premium that you can have on a basis over the option in a delivery month. In March what is the most the cash corn could be over March corn on March 15th?

Wiese: Are you talking about Chicago?

Floor: Chicago.

Wiese: Well, I suspect about three and a half cents would be the loading out charge and all charges connected with cash that would make it still be deliverable. If the basis was over three and a half, they would certainly sell the cash rather than deliver on futures.

Floor: Then by the same token would three and a half under be the minimum that it could be?

Wiese: Oh no, if it is two over and it is in a Chicago position and you don’t want the corn any more—you don’t want to move it into another option—you will deliver the corn even if it is over two. Of course, if it is one over you will be more apt to do it, and if it is anything under the option you’d never think of doing anything but delivering it in its Chicago position.

Floor: So you could say the maximum would be three or three and a half and the minimum would be one or two?

Wiese: Thereabouts, yes. I am talking about just a commercial elevator, not Corn Products or someone that is going to use it.

Floor: Do you ever take a long position and a short position on the other side thinking that the two are going to meet for you and miss it?

Wiese: You mean not hedge as much as I buy, or vice versa?

Floor: Yes.

Wiese: Sometimes accidentally I do, and I always wish that I hadn’t. Oh, I don’t want to say that we keep a hundred percent hedged at all times. It is

almost an impossibility. Sometimes if I feel real bullish I will tell my man who is handling this that he can be long a couple of cars of corn or something like that.

And if we stored for quite a period and we want to be careful and take care of our shrinkage, I will be long two or three or four thousand bushels of grain. We are under the Federal Warehouse System at all of our stations and we kind of dread having those boys come out and measure our corn and find us short of what we have issued receipts for, so we normally will keep a little long rather than any short, but sometimes I get scared to death.

Floor: It might be more comfortable being a little long than short.

Wiese: Yes, that is true. And another thing, let's say that all of the futures people—all the thinking of the world—say that December corn at \$1.16 is the proper price for corn. They are probably right. I know that the cash is going to come up to that \$1.16 some day. It is more likely to happen than the \$1.16 come down to my corn. Maybe I am wrong, but in a country position odds are that cash is going up more than the futures are coming down.

Floor: I notice that a company just recently got into the poultry business. They were large grain users at one time—what do they see, being in the grain business and then all at once shifting over to some livestock feeding?

Wiese: I don't think that is any different than Corn Products buying out Best Foods or Swift and Company, who are primarily livestock processors, going into the soybean meal business. I think it is just diversification, hoping for more profits from some other line. We in the country grain business have been going into fertilizer. We have gone into selling seed corn and trying to make up a little of that deficit that this three-cent margin I talked about leaves us.

Ragsdale: Virgil, that was a masterful job.

Ragsdale: I would like to remind you folks that these figures are Mr. Wiese's own figures. If you live in a different part of the country yours will be different from these, so don't be trying to get rich on these figures. You better do your own, isn't that correct?

Wiese: Yes, but they will follow the same pattern.

Ragsdale: Right, but they won't be exactly the same figures.

Wiese: That is right.