

# *Use of Commodity Exchanges by Local Grain Marketing Organizations*

Virgil A. Wiese

The subject which was given to me for my talk—"The Use of Commodity Exchanges by Local Grain Marketing Organizations"—is obviously too broad for one person to discuss in a half hour. That subject would take weeks of talk. Since my field is primarily the operation of country grain elevators, I am going to assume that "local grain marketing organizations" are country grain elevators, and talk to you from that viewpoint. It makes no difference whether the organization is an independent operator, a farmers' cooperative, or a group of elevators known as a line operation. All of these elevators use or should use exchanges in proportion to their volume of grain business. In my experience, those elevators which use organized exchanges the most seem to know the most about their business, and seem to be the most successful over years of operations. I use the words *know the most about their business* advisedly, because the country elevator business is of such complexity and has so many ramifications that no one knows or ever will know all about it.

## **Commodity Exchange Vital to Country Elevator**

There are many commodity exchanges through this country and they provide meeting places for buyers and sellers of almost every commodity under the sun. I must confine myself to grain exchanges because they are the only kind with which I am familiar and they are the ones which are the concern of and are used by country grain elevator operators.

Every country elevator is located within shipping distance and most of them are in the market area of several grain exchanges. These exchanges may not all deal in future contracts, but they all do business in cash grain, both on a to-arrive and on a spot basis. They all have competitive buyers and sellers, terminal elevator representatives, grain sampling and inspection services, and all or almost all the facilities and personnel which you have observed here in Chicago when you studied the cash grain market in operation.

**Vigilance and  
Knowledge  
Needed**

With what should a good country elevator operator concern himself regarding these cash markets? He should know everything that you have been shown or taught in your visit here yesterday and today. He should also know which markets usually have spot markets which net him a higher price than its to-arrive bids. He must know which markets charge such a high price for some of the services they render that he must not allow his grain to become subject to certain of their rules under certain given conditions. He must know the quality of the grain he has to sell and how the various markets penalize or pay him premiums for these various qualities. He must watch carefully as one market varies with another as to its prices of contract grades of grain because the best demand always shifts from one place to another. As certain industries come in and out of the market, as the export demand swings from the East Coast to the Lakes or to the Gulf, as feeders use up their local grain and require commercial grain—the various markets at grain exchanges vary with each other from day to day or from season to season and the good operator watches them carefully in order to market his grain to his best advantage.

So far I have been talking about cash grain and grain exchanges which deal with such cash grain. The principles involved and the actual workings of these exchanges are fairly well understood by the country grain trade as a whole and need no further elaboration. You have been shown the mechanics and given the theories of all this by men who know these things better than I, so I will give it no more consideration in this talk.

I now come to the use of the future markets in grain exchanges by country grain elevator operators. This use is not as well understood by country grain men as is the use of the cash markets, so the theories and practices should be taught them and used by all of them if they have any storage space in their elevators and the necessary money or credits to finance the use of that space. My reference to the use of the future markets refers, of course, to the practice of “hedging.”

**Elevator  
Operator Faces  
Several  
Alternatives**

First of all, why do we need to hedge? The country elevator business is the most competitive business I know, particularly since the farmer's truck has replaced the horse and wagon. A producer delivering grain, once that grain is loaded into a truck, does not care very much if a haul of a few miles farther is made or if the grain is dumped into the elevator at his nearest station. The handling margins that local country elevators take on grain is, in most cases of normal volume, insufficient to pay expenses—much less leave anything for profit. In my territory the average volume is about 200,000 bushels per year per elevator, and the average margin is about 3¢ per bushel. The resulting \$6,000 will not pay a manager, taxes, power, insurance, office expense, depreciation and other normal expenses, much less take care of shrinkage, an occasional loss when grain goes out of condition and those other risks which are always involved in every line of business. This means that the operator must do something else to pay the balance of his expenses and try to realize some sort of a net profit when the year is done. He has only a few major alternatives and all resort to one or more of them to make some extra money.

One alternative is the handling of sidelines. This goes well in some communities and not so well in others. Some communities feed very few livestock, so a feed business would not be profitable. Many are turning from coal to gas and oil heat as the handling of coal gets less and less profitable.

Most towns have dealers in all lines which an elevator might take on and competition in most side lines is so keen that the resulting volume is too small to make much profit. In other words, sidelines can't be counted on to carry much of the load except in outstanding instances.

Another alternative is speculation in the price of grain. Over the years, this is disastrous, as you all know. If the average person is more than 50% right in his idea of "what the market will do," he is mighty lucky or a lot smarter than most of the people I know. No matter how one analyzes the price probabilities of grain, conditions such as drought or rain, unexpected demand or lack of demand, or any of many other factors come about almost overnight, changing the price picture completely. But let us say that an operator is much better at forecasting price changes than I have given him credit for and that he gains oftener than 50% of the time. He pays mighty large taxes on his earnings but no one pays him back when he loses. His losses are his own but his earnings belong about 50% to the government. This tax load alone makes it impossible for an operator to speculate on price changes, profit, and keep his profits.

### **Income from Elevator's Storage Space**

The only other major alternative of making extra profit is the income that can be obtained from the use of the elevator's storage space. For the past 15 years, country elevators have been able to rent their storage space on a fixed basis to soybean processors or to the Commodity Credit Corporation as it (CCC) carries out its part of the "ever-normal granary." Soybean storage is only for a part of the year and if one depends on that source for storage income, his facilities are vacant and paying nothing for the rest of the annual period. We also do not know how long bean storage will be available. Processors now are telling us that they may not offer any this year. As the soybean industry grows to maturity, processors enlarge their own storage space and demand less from country elevators. Farmers acquire storage space on their farms for this easily stored commodity and withhold more and more from the market during harvest and help make the bean supply a more steady thing throughout the year than it used to be.

The revenue from the storage of government grain for the Commodity Credit Corporation is very irregular at best. Experience shows that the government only takes over an occasional crop and that storage for them cannot be counted upon year after year. Experience has also shown the country elevator that it is unwise to keep the same grain year after year because it deteriorates in storage and all revenue plus capital can be imperiled if the operation contracts for long-time storage and if he guarantees outturn grades and weights which he does under the "Uniform Storage Agreement."

### **The Country Elevator's Hedging Process**

All this leads up to the fact that country grain elevators must be able to "sell" their storage space year after year by means of hedging in the futures markets of organized commodity exchanges. That futures market which almost every grain firm or grain man uses is the futures market of the Chicago Board of Trade. His prices are almost invariably based on freight plus handling charges from his location to Chicago. If he is west of Chicago and is in the surplus grain territory, his prices are those costs deducted from the Chicago price. If he is east or in the deficit grain area, his prices are those costs added to the Chicago price.

Much has been written and more has been said about hedging. I am not the first to talk on the subject, but I may be able to put a little different angle on the subject as it applies to country grain elevators. Almost anything I have read or heard on the subject refers to hedging as an insurance against price changes. Insurance against price changes is of little value to a country elevator because that person can see no reason to pay commissions, insurance, and have money tied up in grain and hold that grain for no reason except to be assured that he will get no adverse price change. He can easily insure himself against such price change by selling his grain to-arrive at the time he buys it and with no expense or storage to bother with.

To the country operator who knows hedging, such operation to him is selling his elevator space at a very profitable rate by using the future markets of exchanges. I have seen many times when a good hedge operation would make as much per bushel in 30 days as soybean processors pay for six months of storage. Just this summer red wheat, which came to Chicago, sold 10 to 12 cents under the September future when it was quite possible to sell September wheat, store the wheat in an elevator and make that 10 to 12 cents within a 30- to 60-day period by delivering on the sale or selling the wheat when cash wheat reached the September level.

### **Example of Recent Hedging Possibilities**

An ideal hedge that is foolproof is one where distant futures are sold higher than current futures, when the cash article is selling at or below the nearest future, and when the sale is made in equal amounts to the bushels which the elevator operator owns in storage in his own elevator. The chance for such operation is by no means rare, either. It occurs almost every year and in almost every grain. It existed in wheat and oats this summer, in corn last winter, and seems to be shaping up in the new crop of corn which will be ready for market this fall. Referring to the red wheat which sold 10 under during harvest, March wheat could have been sold at a 9¢ premium over September. Add this to the 10¢ available from July to September and 19¢ storage would be made. Sometime during the year, cash wheat will probably bring a premium over the March and since most elevators have several outlets other than Chicago, probably it will be more profitable to sell it elsewhere than to deliver on March contracts. Thus, 20¢ to 25¢ per bushel is not too much to expect from the entire operation.

Then there are hedging operations of a more complex nature which sometimes pay off in a nice manner, but which take a pretty keen knowledge of markets and country conditions. The country elevator operator is sometimes in a better position to see these possibilities than is a terminal man. They usually have to do with premiums and discounts between one future and another in the same grain. An example of this is the recent movements in soybean future prices during the last month. When the last July bean future expired at the ceiling, it carried the September with it to a premium of about 23¢ over the November. Operators who had hedged their new bean purchases from farmers had mostly followed the usual custom and sold their purchases in November, expecting the distant futures to spread out more during harvest when hedges could be transferred to them at a better basis. Some of these operators in the bean belt knew that the bean crop was in early, was making satisfactory progress, and that September contracts could likely be satisfied from the new bean crop. So they transferred their hedges from the November back to September at 20¢ or better spread. The spread then narrowed to 8½¢,

so they gained about 11¢ by this operation before the beans had even started filling the pods on the plants. If these operators had sold their cash beans to arrive as they were bought, they would have made their small handling charge but that would have been all that was possible.

**Country  
Elevators  
Should Hedge**

These two examples of hedging possibilities have been available during the last two months. They occur from time to time as we go through the years but an operator has to be alert and learn to recognize them as they come along. Not only have I tried to tell you how country elevators utilize the future markets, but I have tried to do my bit in telling those who do not use it that they should. It is not a secret operation and no one has a monopoly on it. The more grain people who use futures facilities, the better the Board of Trade serves the grain trade, and the happier its members should be.

I would like to add a word of caution to operators who hedge erroneously. I see this so often in my dealings with country elevators and farmers. Some operators believe that they can store grain for farmers, sell it, ship it out, and protect themselves, by buying distant futures. They call this hedging. This always turns out to the reverse of the successful hedge, unless the distant future is selling at a discount under the current one and this is seldom the case. They only guarantee for themselves the loss which is inevitable as the cash price of the grain, and the bid on which they eventually settle with their customer, goes to the distant futures price as that future becomes more current.

**Hedging Is Not  
Speculation**

There is another practice which I would like to see disassociated with the term "hedging." Many times a year a farmer will come into my office—say that he has sold, for example, 5,000 bushels of corn and wants to buy back 5,000 bushels of some distant corn futures. He says that he is hedging his corn and his conscience is clear because that is a legitimate business term. Now I have no objection to that trade, because he is only holding the corn he raised for a higher market price and paying someone a carrying charge for storing it for him, but it should not be termed a "hedge." He will lose as often as he gains because the market is as apt to go down as up. If he loses, he decides that hedging is bad and if he is an influential member of the board of directors of a farmer's elevator, he is likely to go to a meeting of that board and get a motion passed that the manager is forbidden to hedge that company's grain. The Chicago Board of Trade, you educators in marketing, and all country grain men should combine to stop that kind of thinking. You people who know this subject may think that I place too much emphasis on this false theory but I have contact with producers and people who should be familiar with grain terms every day and if I conducted a poll, I warrant that 5 to 1 would say this last operation I have just described was "hedging."

**Use Futures  
Market  
Intelligently**

I have tried to describe in a brief way how country grain elevators use grain exchanges with most emphasis placed on their use of the future markets. I have not only told how some use it, but I have tried to show why more should use it, and use it intelligently, because it would be so much to their advantage. It can be readily seen how much advantage it would be to grain exchanges if the appropriate use of the futures markets were better understood by the country trade. I fully believe that the agricultural economics departments of every university should teach a course in the use of commodity exchanges with particular reference to the use of futures markets. Every short course in

elevator management should include lectures on “hedging” which would make the student curious enough about the possibilities of such operation to want to learn more about it.