

## *The Miller's Use of the Commodity Exchange*

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... In outlining the use of the commodity market by millers, there will be instances where millers use the markets in their role as grain merchandisers as well as processors. Grain operations, particularly in wheat, go hand-in-hand with the processing of flour and other products.

Our company operates twenty flour mills with a total daily capacity of 46,500 cwts. and 151 elevators, terminal and country, which with the elevators at the flour mills give total storage capacity of over 20,000,000 bushels, and five feed mills of about 700 tons daily capacity. The properties are located in the states of Illinois, Iowa, Nebraska, Kansas, Oklahoma, Colorado, Idaho, Utah, Oregon, and California.

Basically, the use we make of the commodity market would be called *hedging*. What is a hedge? Webster defines the term *hedge* as "to protect" and as an example uses the following: "such as building a fence or hedge around one's home as a protective measure."

### **Supply and Demand at Work**

It is a well-known fact that grain prices fluctuate actively from day to day and, in fact, from minute to minute. Over a period, the swings between the highs and the lows may be substantial. Fundamentally, if not wholly, these fluctuations are a result of the interplay of the forces of supply and demand, usually natural, but sometimes artificial as, for instance, the present case of government loan and price support policies. The flour miller has to determine whether as a policy he will assume the risks of such price changes or try to secure some kind of protection against them—that is, to follow a hedging policy. Obviously, if he follows a no-hedge policy, he is a speculator and, as such, would have no need for expensive manufacturing or storage facilities to carry on speculative activities. His speculations could be consummated on the commodity or futures markets with more dispatch and with no need to incur the expense of the capital required in the ownership of fixed assets.

In the operation of the grain and milling business, large sums of money are required. While substantial capital is provided by stockholders and, in some cases, bondholders, and is the base of the financial structure, nevertheless, large sums are borrowed from banks to meet seasonal peaks. Whether one hedges or not is oftentimes a predominant determining factor with the banks whether credit is given or not.

## **Hedging a Vital Necessity**

In our operations, we follow substantially a hedging policy to the extent that hedging facilities are available and are effective. Our borrowings from the banks reach many millions of dollars. I am sure it could safely be said here that without hedging facilities through the commodity markets or some other function being available equivalent to the hedge provided in the futures markets, financial credit by the banks would not be extended to the grain and milling trades to the extent that it is today. A hedging policy is also of benefit to the stockholders because hedging minimizes the risk of large inventory loss that would otherwise occur in the event of large swings in the price of wheat.

I like to compare hedging with double entry bookkeeping where for every debit there is a credit. In the operation of a hedge, for every purchase there is a sale and for every sale there is a purchase. They are equal and opposite transactions in the cash and futures markets.

With us, the beginning of the crop year is June 1. At that time we would have, in the case of wheat, probably a million or two million bushels of wheat futures sold against cash wheat we own and hold in store not otherwise committed. At the same time, we could have an additional one, two, or three million bushels owned and held in store but committed by way of sales of an equivalent amount of flour or cash wheat for later delivery.

Under normal conditions, new wheat starts to move in our area in June and the movement becomes quite heavy in July. By that time, our purchases of cash wheat usually exceed sales of flour reflected in bushels of wheat. Therefore, to the extent that actual or cash wheat purchases exceed flour sales a hedge is placed for the excess usually by selling July or September futures. As the movement increases and the market price has been affected by the movement to where large and small flour buyers think the price is right, such buyers make commitments or purchases of flour for their needs for up to four or six months hence. At that time, flour sales would exceed purchases of cash wheat. The need of maintaining a balanced position, that is, of getting under cover, forces the purchase of futures, either July, September, or December as the circumstances dictate to cover the excess of flour sales over wheat purchases.

When sufficient cash wheat has been bought to cover the requirements to make the flour sold, and the hedges have been removed, then the round turn on the futures market has been completed by both the purchase and the sale of futures, leaving the mill with cash wheat owned equivalent to what it would take to process the flour sold. This same kind of activity at different levels and different volumes continues throughout the year.

Inasmuch as our operations are largely in the Southwest and West, I shall use the Kansas City market in giving examples of what happens in individual transactions involving the hedging market. The principle is the same in all other markets and comparable transactions.

The intent of the use of the hedge from the flour mill angle is not entirely limited to protection alone. When cash wheat is purchased, it is of a specific kind and grade and may be bought at a discount or at a premium as compared with the futures. Therefore, it is hoped that at the time when a sale of wheat or flour is consummated that the cash wheat will have a value as compared with the hedge or futures greater than it was at the time of the purchases of the cash wheat and the sale of futures. On the other hand, if the flour is sold first and the futures are bought to cover the sale, the hope is that later when the cash wheat is bought, cash wheat will then have a value as compared with the hedge or futures *less* than it was at the time of the sale of the flour and the purchase of futures.

In the case of grain operations not confined to the processing department, the wheat bought in June generally is hedged first in the July futures, then as the season advances these July futures are bought in and the September sold; later the September is bought in and the December sold; later the December is bought in and the May sold; presuming that cash sale is at a higher price than the purchase which provides carrying charges for the warehouse on the grain handled. For instance, as of July 31, 1953, cash Soft Red wheat was selling in Kansas City at \$209¾ and the December futures sold at \$2.13¼ showing a carrying charge of 3½¢, September to December; March futures closed at \$2.16, or a 2¾¢ carrying charge December to March.

**Hedging Not  
Necessarily  
100% Protection**

There are situations where the hedge is only relative, particularly where operations are far removed from the commodity exchanges, and prices of cash wheat do not move in consonance with the futures prices, such as west of the Continental Divide, on the Atlantic Coast area, et cetera. Uncertain hedging value also prevails, as I shall discuss later, where Hard Winter wheat is hedged in a market where there is a threat that soft winter wheat may be delivered on a futures contract. Spring wheat purchases and sales hedged in Minneapolis have a close relationship because spring wheat is the only type of wheat deliverable on Minneapolis futures contracts. In the Central States area, soft winter wheat purchases and sales have a close relationship with hedges in the Chicago market. Prior to this year, hard wheat purchases and sales hedged in Kansas City had a close relationship. This year, soft wheat has been delivered in quantity on Kansas City futures contracts with the result that the Kansas City futures market at this time reflects soft wheat prices more than hard wheat values. This is because at the relatively lower price at which Soft Red Winter wheat is selling as compared to hard wheat, it is almost certain that Soft Red Winter wheat will be delivered on a futures contract instead of the higher priced hard wheat. Both No. 2 Soft Red Winter wheat and No. 2 Hard Red Winter wheat are deliverable grades on Kansas City futures contracts, with a 1¢ premium being paid for delivery of No. 1 and a 3¢ discount being charged if No. 3 grade is delivered. Let me give you some examples of price differences presently existing at Kansas City.

On July 31, the cash market for Soft Red Winter wheat in Kansas City was \$2.08¾ to \$2.09¾ and the September futures were selling at \$2.09¾. At the

same time, the cash price of ordinary hard winter wheat, heretofore the usual grade delivered on Kansas City futures contracts was selling at \$2.18 to \$2.19¼ and hard winter wheat of higher protein content ranged in price up to \$2.23¾ to \$2.40¾. This higher protein hard wheat was, therefore, selling at from 14¢ to 31¢ premium over the September futures.

The partial explanation for the development at Kansas City of deliveries of soft wheat in quantity for the first time is as follows: It is not a new situation that Soft Red Winter wheat deliveries are permissible. The rules permitting delivery of either soft wheat or hard on Kansas City futures contract have been as at present for some years. But during the free and open market period before government loan and price support policies were inaugurated or became effective, there were practically no Soft Red Winter wheat deliveries in Kansas City. The switch that came about has been turning in the direction it reached in 1953 for several years. A surplus of Soft Red Winter wheat above export and domestic needs has been built up in the Central States area. These surplus stocks have become a heavy influence on the Kansas City and other markets because of the willingness of soft wheat farmers to sell at heavier discounts under the government loan than are the hard wheat farmers. The hard wheat farmers, being larger operators, have become more accustomed to putting wheat on the loan, more facilities, comparatively, have been available to utilize the loan program, and hard winter wheat is looked upon as less vulnerable to damage and deterioration when stored.

It is, therefore, obvious, that under these circumstances, the forces of supply and demand affecting price as they do, the surplus of Soft Red wheat above demand is reflected in futures prices. At the same time, large quantities of hard winter wheat are effectively withheld from the markets through the operation of the loan program so that the better grades and varieties of hard wheat that are offered for sale sell at variable premiums. Under these conditions, futures bought or sold for protection of purchases and sales of the higher priced hard wheat grades do not provide a positive or sure hedge but one of only relative value. At least, the futures market certainly does not provide a hedge for the premium of 14¢ to 31¢ that I mentioned a few moments ago.

At other times, and under other conditions, again depending basically on the supply and demand existing at the time, Soft Red wheat will sell at a premium over hard wheat; low protein hard wheat will sell at a premium over high protein, etc.

Regardless of these factors, we have made and are making sales of wheat futures each time we purchase cash wheat and we make a purchase of wheat futures each time we sell cash wheat or flour. The only exceptions to this would be where cash wheat purchases match up at the same time with sales of either wheat or flour which usually occurs between the close of the futures market one day and the opening of that market the following business day.

**Producer and  
Consumer Both  
Benefit**

There is no question that because of the existence of the hedging facilities which we have through commodity exchanges, regardless of those hedges not always being fully 100 percent effective, the consumer and the farmers as well as the processor benefit therefrom. The protection against the risk of price changes that these hedging markets afford makes it possible for the miller to sell his products and to buy his wheat on a smaller profit margin. Without this

protection, because of the increased risk, the margins charged the consumer would have to be substantially greater and the method of handling or relieving the farmer of the load as at present would be changed to where the farmer could sell only at such times as the buyer would be willing to take on a load of variable size, and then probably at lower prices.

I shall not attempt to analyze the workings of the futures market or to portray the part of others that contribute to the trades we make when handling our hedges through the exchanges. Other speakers on this program will discuss those matters. I do, however, want to mention a few sidelights.

In day-to-day operations, you might say that our approach to using the hedging market, like many others, is as though the market as such was a machine or a separate entity. Many times on most business days we are sending in many buying orders and many selling orders, sometimes very little time intervening between a selling order and a buying order, and on such business we are completely in the dark as to who is on the other side of each trade and why.

### **Speculation a Must in Affording Liquidity**

Of course, we know that there are many flour millers and grain handlers like ourselves trading exactly as we are, which provides part of this machinery. Those active in export business also contribute very substantially in the flexibility of the markets; but no one acquainted with the markets would discount the great value of the speculators in this picture. With many millions of bushels traded in each day, sometimes 20 or 30 million or more on the Chicago Board of Trade, it would seem to be perfectly clear that grain elevator or other hedging of wheat would not always be there to fit the need of the flour mill wanting to buy wheat futures against sales of flour. When you realize that last year on the Chicago Board of Trade alone there was an average of over 215,000,000 bushels of wheat futures traded in each month, the complexity and breadth of the market immediately becomes evident. Even being as close to the market as we are, and users of the markets at all times, we are occasionally astounded at the efficacy of the market under, for instance, a situation where receipts of cash wheat are very light, there is nothing outstanding in the news, but still when a substantial amount of flour business is done, it is possible to go into the futures market and cover commitments amounting to several millions of bushels with only a comparatively small change in the futures market price. This, of course, demonstrates the tremendous part that those speculatively inclined play in the commodity exchange picture.

Flour mill operations today, even with the assistance of commodity exchanges, are most difficult, and one of the most important contributing factors to this difficulty is the necessity of operating in what is in effect a nonfree market. I have reference to the tremendous influence governmental policies exert on the normal forces of supply and demand. The exchanges do an outstanding job and are of great value even in the face of government loan programs, et cetera. With government activities affecting prices, supplies, and distribution of grains, particularly wheat in this instance, we find ourselves confronted with a situation equivalent to being a participant in a game of cards and having the rules of play changed in the middle of the game after the hands have been dealt. This is a situation I fear may not be improved or changed in the near future.

The hedging market as a facility as it is known today did not develop overnight. I have been a member of the Kansas City Board of Trade since 1917, and of the Chicago Board of Trade for many years. In earlier years, flour mills did not use the market as a hedge as generally or universally as they do today. As a matter of fact, there were many in the industry thirty or forty years ago who would not only be long cash wheat early in the season but would buy the futures as well, rather than to put a hedge on their stocks. At that time, also, there was a different policy on the part of bakers and flour buyers as to flour purchases. Flour was generally purchased for prompt shipment or within thirty to sixty days. As bakeries expanded in size, there was a demand upon the millers for more uniform flour and for longer commitments on forward flour sales. Up to that time, use of the hedging market by millers was usually confined to hedging of stocks of wheat purchased. Later when the bakers demanded long-time commitments of flour, millers found need for using the hedging market to protect sales of flour requiring wheat in excess of wheat stocks. The buying policies of the large flour buyers, which have become even larger today and account for a substantial proportion of all of the flour business, do not follow a uniform buying policy as far as anticipation of requirements is concerned. However, during recent years the largest volume of flour business done has been negotiated on a long-time commitment basis. Purchases entered into on the basis of the market price on the date of shipment or for short-time commitments are now generally made during a waiting period to strike a market suitable for long-time commitments.

It is quite apparent that with the flour trade generally setting such a pattern of procedure, flour mills or processors have an absolute need for a protection facility which they have through the commodity or grain futures markets. Now let me give you illustrations of the use of the hedging market by a miller.

### **Hedging Modus Operandi**

As of today, we are using the Kansas City September futures as a basing factor. At the close of the market Friday, July 31, September Kansas City closed at \$2.09¾. On the Kansas City "cash" market, that is the market where actual wheat, as distinguished from futures contracts, is bought and sold, No. 1 Soft Red Winter wheat was selling at the September futures price to 1¢ discount or for \$2.08¾ to \$2.09¾ a bushel. No. 1 Hard wheat, low protein, was 9 to 9½¢ premium over September, or \$2.18¾ to \$2.19¼. No. 1 Hard, 12.00% protein, was 10-23¢ premium over September, or \$2.19¾ to \$2.32¾; No. 1 Hard 13.00% protein wheat, 13-27¢ over, or \$2.22¾ to 2.36½; No. 1 Hard, 14.00% protein, 14-31¢ over, or \$2.23¾ to \$2.40¾. The market on No. 1 Soft White wheat from the Idaho area was quoted at \$2.36½ or 26¾¢ premium over September. The variation in the price, which in final analysis is a variation in the premium or discount, on wheat of the same grade and protein is entirely due at this time to the difference in the baking quality of the different lots.

A flour sale made today on a contract requiring the use of, we will say, 13.00% protein top quality wheat would mean a wheat cost of \$2.36¾. The sale is consummated and September futures purchased at \$2.09¾. The flour sale has, therefore, been made basis a wheat cost of 27¢ premium over the Kansas City September futures. The amount of the premium, or in other cases, the discount, is the important amount for a miller to keep in mind. When the actual cash wheat required to fill this flour contract is available and is purchased, the concern is not whether the September futures price is up or

down but what has happened to the basis; that is the premium or discount. If, in our example, the cash wheat is purchased on an unchanged premium basis of 27¢ over the Kansas City September futures, the miller's transaction is then completed as calculated. On the other hand, if he has to pay an additional 2¢ premium when the wheat is purchased, and since it required about 2.35 bushels of wheat to make 100 pounds of flour, he has received approximately 5¢ per cwt. less than he anticipated on his flour sale. If, however, the premium or basis has declined 2¢ so that the premium is only 25¢ over September when he purchased the wheat, he has or will receive about 5¢ per cwt. more than he anticipated.

With the premiums existing as they do today on hard wheat, elevator operators generally would not buy hard wheat for storing, delivery, or carrying charge purposes. They would own only a sufficient quantity of this kind of wheat to meet their merchandising purposes.

In the case of the Soft Red Winter wheat, however, there is quite a little bit of ownership of this variety for carrying charge purposes, with also the expectation that some advance in premiums might occur when receipts become light. Elevator operators in this instance would perhaps sell the September futures against their purchases of Soft Red Winter cash wheat and later transfer to more distant futures as the carrying charge reflected in the futures is suitable.

It is obvious that at the present time the buying power for the protein hard wheats is provided almost solely by the flour mills. The low protein, or what is called "ordinary" wheat, is utilized to some extent for family flour but substantially for export.

### **Cash Wheat Prices Tied to the Futures Market**

The main point that I desire to make is that with the possible exception of West Coast wheat, transactions in wheat all over the country, regardless of variety, location, grade, or protein are based upon some futures market. This applies whether it is f.o.b. Chicago, Kansas City, Minneapolis, delivered f.o.b. Atlantic Seaboard, delivered the Border for export to Mexico, et cetera. It is surprising how automatic and effective the system works. At this time of the year, if we get a quotation for wheat in Montana, it is usually quoted as "basis the Minneapolis September futures delivered Portland or Minneapolis." If we are trying to buy wheat in Oklahoma, we are quoted a price basis Galveston export either as related to Kansas City or Chicago September futures. If wheat is bought in Omaha, it is priced so much under or over Kansas City or Chicago September futures f.o.b. Omaha. And so it goes all over the country.

I hope that I have succeeded in demonstrating to you the inestimable value that the commodity or futures market is to the producer or farmer through the provision of a market and complete information regarding the market, to the consumer because of the minimized spread as between producer and consumer on the part of grain handlers and processors, and, also, to the handlers and processors of grains. It should be noted here, however, that because we do not now have complete, nonfree markets, the value of hedging markets to the flour milling industry in certain areas of the country is threatened. In the Southwest this year it has been more than a threat; there has actually been a reduced value to the industry.

The commodity markets as such are really delicate pieces of machinery. The rules and regulations laid down by these markets are vital to the functioning of the markets. In spite of the threatened loss of value of these markets to the milling industry, I am enough of an optimist to say that I have great confidence in the ability of the officials of the exchanges in making such rules and regulations as are necessary to meet changing conditions that affect the markets whether through natural or artificial causes. I am sure the exchanges will do just that.



