

Economic Purposes of Futures Trading

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In a competitive market economy, there is general agreement among economists that a market for a product would be perfectly competitive if:

- (1) Many buyers and sellers met openly, and no one individually controlled the market;
- (2) The commodity was standardized so all knew the grade and quality of the product being traded; and
- (3) Buyers and sellers could enter freely and participants had full knowledge of available supply and demand for their product.

While no market meets the ideal, futures markets come closer to it than most others. Because of their highly competitive nature, futures markets provide three important economic benefits:

- (1) With many potential buyers and sellers competing freely, futures trading is a very efficient means of determining the price level for a commodity. This is commonly referred to as *price discovery*;
- (2) Futures markets permit producers, processors, and users of commodities, debt instruments, and currency markets a means of passing the price risks inherent in their businesses to traders who are willing to assume these risks. In other words, commercial users of the markets can *hedge*, which is to enter into an equal and opposite transaction in order to reduce the risk of financial loss due to a change in price and, by doing so, lower their costs of doing business. This results in a more efficient marketing system and, ultimately, lower costs for consumers; and
- (3) Since futures markets are national or worldwide in scope, they act as a focal point for the collection and dissemination of statistics and vital market information.

Cash and Forward Markets

In the days before credit was readily accessible, some stores carried the sign, "cash and carry," meaning: pay your cash and carry away the merchandise you purchased. That, in its simplest form, is the *cash market*. The buyer finds the precise commodity that suits him--perhaps an orange that has ripened to the proper degree--pays his money and becomes the owner of the merchandise. It's a time-tested market system, and the one most widely used in all forms of business to transfer title to goods.

Sometimes, cash markets can be modified and improved to serve a particular purpose. For example, a person who goes to the newsstand to buy a magazine may find it is more convenient to contract with the publisher for delivery at home. This modification is called a *forward contract*, and such contracts are widely used in many types of business. The buyer and the seller agree today on a description of the product that will be delivered in satisfaction of the contract. The buyer makes payments as agreed, and the seller will deliver the asset at a designated site on a specified date.

The system works quite well when the cost of producing the commodity is known and the selling price is presently acceptable to a buyer. However, with commodities that compete in world or national markets, such as coffee, there are many relatively small producers scattered over a wide geographic area. These widely dispersed producers find it difficult to know what prices are available, and the opportunity for producer, processor, and merchandiser to ascertain their likely cost for coffee and develop long range plans is limited. Futures trading, used in the Midwest for grains and similar farm commodities since 1859, and adapted for coffee in 1955, provides the industry with a guide to what coffee is worth now as well as today's best estimate for the future.

Prices and Price Factors

In a competitive market system, buyers and sellers determine prices for commodities through their transactions in the marketplace. The prices at which sellers offer to sell their goods and buyers bid to buy

them are based on their best current assessments of the supply and demand for the commodity.

Usually, no one knows the exact total supply of a commodity. For example, in the United States most commodities are produced by many firms. Storage and ownership also are fragmented. The total supply available usually is an estimate, as is new production, and inventory figures are not precise. In addition, the quality of the commodity frequently is not known. Thus contributing to the complexity of determining an appropriate price.

Even with its problems, the U.S. commodity price reporting system generally is better and reports are more available publicly than commodity reports from many other countries. Since most commodities trade internationally and are affected by incompletely reported situations in other countries, U.S. markets must cope with such unknowns.

Demand is even more difficult to measure, based as it is on what people may decide they wish to buy. Changing prices may alter consumers' intentions regarding the quantity of a close substitute commodity they want--or whether they want it at all. The availability of a substitute may change the demand picture for the original product as well as for the related one. However, prices for goods in the marketplace play a vital role in our economic system and help to efficiently allocate scarce resources.

Markets and prices play vital roles in our economy system and help to determine our standard of living. Markets are the nerve system of our decentralized economic system; prices are the impulses conveyed throughout the system, enabling us to respond stimuli and produce goods and services efficiently and changing prices force to adjust and moderate our consumption patterning. In other words, price influences production and consumption. Price is a rationer; if the price is right, the supply of a commodity should balance the demand for it--production should match use.

If the price is too high, some who may have planned to use a product may decide to use less, go without, or they may select a substitute--eat chicken instead of beef, for example. If enough users are priced out of the market, price may turn down which may encourage more use and discourage production.

If the price is too low, users will deplete existing supply and a shortage may develop. Subsequently, prices may rise, which will tend to discourage marginal buying. Should price remain relatively high this would likely promote production or attract additional supply of good.

Processors and merchandisers are guided by the prices that people are willing to pay for their goods. Their marketing decisions are made independently, based on estimates of what consumers are willing to buy and how much they are willing to pay. Once in the marketing system, goods are channeled from point of production to processor and distributor and on to the consumer. Futures trading does not enter directly into these channels; it supplies information on price which reflects buyers' and sellers' current view on a commodity's value and provides a means to transfer the price risk of holding these items in inventory for later sale.

Collecting Information

In an active futures market, the demand for information by traders is enormous. Futures exchanges tend to become collection centers for statistics on supplies, transportation, storage, purchases, exports, imports, currency values, interest rates, and other pertinent information. These data, which are compiled and distributed throughout the exchange community on a continuous basis, are immediately reflected in the trading pits as traders digest the new information and adjust their bids and offers accordingly. As a result of active buying and selling of futures contracts, the market determines the best estimate of today and tomorrow's prices for the underlying commodity. In effect, prices are discovered at futures exchanges. Prices determined via this open and competitive process are considered to be accurate reflections of the supply and demand for a commodity, and for this reason they are widely used as today's best estimate of tomorrow's cash market prices for a standardized quantity of a commodity.

Discovering Prices

Price discovery is the process of arriving at a figure at which one person will buy and another will sell a futures contract for a specific expiration date. In an active futures market, the process of price discovery continues from the market's opening until its close.

Futures markets, because of low transaction costs and frequent trading, encourage wide participation, lessening the opportunity for control by a few buyers and sellers. Because they are freely and

competitively determined, futures prices are generally considered to be superior to administered prices or prices that are determined privately.

Futures contracts are standardized as to quantity, quality, and location so buyers and sellers only bargain over price. Because of this standardization, commercial interests are better able to compute local cash prices. This contributes to local market efficiency and to consistency among markets. In many commodities, futures prices have earned a role as key reference prices for those who produce, process, and merchandise the commodity. Since cash and futures prices reflect similar price-affecting factors, their price levels tend to rise or fall together.

Transferring Risk: Hedging

Commodity production and marketing involve sizable price risks, and risk represents a cost which affects the value of a commodity. While there is no way to eliminate uncertainty, futures markets provide a competitive way for commodity producers, merchandisers, processors, and others who may own the actual commodity to transfer some price risk to speculators who will willingly assume such risk in hopes of making a profit.

The process of hedging involves the concurrent use of both cash and futures markets. Since futures and cash prices tend to move together (that is, parallel to each other), and at contract expiration converge to one price, it is possible for a cotton merchant, for example, to hedge an unsold inventory of cotton with a sale of an equivalent amount of futures contracts. Since the merchant owns the commodity, he would have a loss if prices fell. To hedge, the merchant would sell futures contracts. Now if prices drop, the cash market loss will be at least partially offset by a gain on the futures contract. When the merchant sells his inventory at the lower cash market price, he will simultaneously lift his hedge by buying back his futures contracts at the lower price. The gain on his futures contracts should roughly equal the merchant's loss in the cash market.

Conversely, a cotton mill owner who wanted to sell a customer a quantity of cloth for delivery some months from now, but does not own enough cotton to produce the cloth, could hedge by buying enough futures contracts to cover the forward sale of cloth. He now has a price for raw material to which operating and production costs can be added to arrive at a base price for cloth. Quoting such a price before buying the cotton would make him vulnerable to a price rise, but having bought futures in a quantity equivalent to his needs, he has some assurance that a rise in futures prices would lessen the impact of a rise in the cost of the actual cotton.

Here are three examples of how hedging helps the cash market work better:

1. *Hedging stretches the marketing period.* For instance, a livestock feeder does not have to wait until his cattle are ready to market before he can sell them. The futures market permits him to sell futures contracts to establish the approximate sale price at any time between the time he buys his calves for feeding and the time the fed cattle are ready to market, some four to six months later. He can take advantage of good prices even though the cattle are not ready for market.
2. *Hedging protects inventory values.* A merchandiser with a large, unsold inventory can sell futures contracts that will protect the value of the inventory, even if the price of the commodity drops.
3. *Hedging permits forward pricing of products.* A jewelry manufacturer can determine the cost for gold, silver or platinum by buying a futures contract, translate that to a price for the finished products, and make forward sales to stores at firm prices. Having made the forward sales, the manufacturer can use its capital to acquire only as much gold, silver, or platinum as may be needed to make the products that will fill its orders.

These are just a few ways that futures markets are used by commodity owners. Adapting basic principles to individual situations tests the ingenuity of hedgers and demonstrates the management flexibility provided by futures trading. But market users should be forewarned that hedging is not an academic exercise. It requires skill and knowledge acquired only by study and experience.

Finally, while a hedge transfers price risk, it also denies the opportunity to gain from favorable price movements in the cash market. For this reason, options on the actual commodity and/or options on futures contracts are popular among people who seek price protection, but who do not wish to miss a favorable price movement. With the payment of a premium, the buyer of an option can acquire the right, but not the obligation, to buy or sell a futures contract at a specified price within a specified period of time

(as stated in the option contract). In this way, for example, the holder of a put option can protect against a drop in the value of that inventory, but remain free to gain from an increase in the price of the commodity held in inventory.

There are many factors to consider in deciding whether to hedge with futures, buy or sell an option on a futures contract, or simply forward contract in the cash market. A detailed discussion of this topic goes beyond the scope of this brief publication. For more information, consult your library or contact the exchange which trades the commodity of interest.

Other Economic Benefits

The opportunity to hedge theoretically makes it possible for hedgers throughout the marketing and processing chain to operate on narrower profit margins which may be caused by market competition.

For example, if the wheat miller has protected his inventory with a hedge, he can add on his milling margin and offer a firm price to the baker. Because the hedge lessens his chance of significant loss from an adverse price change, he can theoretically sell to the baker at a lower price. The baker who also hedges can reduce his risk and thus has more flexibility in matching any reduction in price which the market dictates.

Narrower at risk margins permit lower prices, resulting in considerable savings for consumers. Conversely, narrower at risk margin also may enable producers to increase their profits.

Another benefit of hedging involves financing. While some bankers refuse to consider hedges as a factor in commodity loans, others make it a regular policy to do so. Bankers, particularly those who lend to commercial borrowers, say that hedgers can borrow a greater percentage of the value of their commodity, usually at lower interest rates, than can non-hedgers. The lower cost financing thus permits higher profit margins for the hedger and possibly lower prices for the end-user.

What Futures Do Not Do

Futures trading is not intended as a way to transfer ownership of the actual commodity, so few traders deliver on futures contracts. Cash markets normally provide the most efficient way to exchange ownership of a commodity; futures markets are a way to forward price the commodity and to lessen the risk of ownership.

Several academic as well as trade studies have concluded that the futures markets do not "cause" cash market prices to rise or fall. Both the cash and futures markets respond to the same basic supply and demand factors. Because futures trading has low transaction costs, participants are able to actively and immediately express their views on their estimate of projected likely prices. New information is continuously injected into the market via last sale prices for various futures contracts. This results in expectations about price movements being first noticed in the organized exchange traded futures markets. On the other hand, the cash market tends to respond to situations in its local geographic area while the futures market tend to additionally consider broader national, as well as international implications to events. But the regulatory force of arbitrage--which is the simultaneous purchase and sale of identical goods in two markets at different prices to capture a riskless profit--keeps all markets in rough balance. Either price may move first or furthest.

Futures markets do not promise that commodities will trade at some specific price at a future date. Suppose that, on June 15, December silver trades at \$5.00 an ounce. The quotation does not say that a trader can enter the cash market in December and buy or sell silver for that price. It does imply that, on June 15, a binding contract guaranteed by the clearing corporation for that specific exchange was entered into by a seller of the contract to deliver a standardized grade and quantity of silver in December (if the expiration date was the December contract) at an approved warehouse and receive \$5.00 an ounce. As we mentioned earlier, only a small percentage of exchange traded futures contracts result in the actual delivery of the underlying assets. Most are offset prior to expiration. In this case, offset means that the obligation to perform under this contract can be extinguished by buying back the contract on the open market at a price higher or lower than it was originally entered into by the selling party.

The Role of Speculators

Price has a rationing effect. In other words, when supplies of a commodity appear greater than present demand or need, prices tend to decline. If supplies appear to fall short of fulfilling demand, prices trend

upward. Estimating market supply and demand conditions are the challenges faced by market participants.

Market analysts such as economists who study commodity markets have concluded that speculators play an essential role in futures trading. Speculators are a source of immediate liquidity for the markets, which is a characteristic of a continuously active market. However, the mere presence of speculators is but one component of a healthy market. Another active group of participants are hedgers. These are individuals, firms or institutions which have or use the underlying commodity in their business and use the futures markets as a means of transferring price risk associated with their inventory.

Take grain, for example. The cost of storing grain until it is needed is built into futures prices. Speculative activity, gauging the size of the crop and the need for storage, along with other factors such as interest rates helps to determine the cost for storing a commodity--which helps to determine the size of the built-in carrying charge.

Much trading is "at the market," the price then current in the trading pits. A trading pit is the area at an exchange where members congregate to trade specific commodity futures contracts. At trading pits on the floor of an exchange, orders are exposed to competing bids and offers. In busy, high-volume markets, there are many "resting" orders--orders held by a broker in behalf of a customer to buy or sell at prices higher or lower than the current market price. The interplay among market participants, and the activation of resting orders causes prices to move up and down, and along with market determined interest rates will affect the cost of holding the underlying commodity in inventory. Merchandisers and processors watch price changes carefully, looking for favorable hedging opportunities. The result of this action is a viable, liquid market.

A speculator is an additional buyer of commodities whenever it seems that market prices are lower than they should be. Consumers consider this to be against their best interest. Conversely, when it appears that prices are too high, a speculator becomes an active seller, arousing the ire of producers.

One fact that often is not considered is that few speculators agree on what is too low--or too high. Some may want to sell at a particular price, others may want to buy at that price, and some may not be interested at all. Therefore, there usually are willing buyers and sellers in the market at all times.

Individual speculators tend to trade smaller number of contracts than hedgers and to hold market positions for a shorter time, so several may be needed to offset one large hedge order. The maximum number of contracts which can be held by any one speculator is limited by exchange rules and the CFTC.

Regulation of Futures Trading

In the legislation establishing the CFTC, Congress recognized that futures markets serve a national interest. Congress sought to assure that there will be orderly futures markets, operating fairly, and that prices determined at these markets will be free of distortion.

The CFTC oversees exchange rule enforcement and conducts its own surveillance of trading in futures and related cash markets as part of its mission to prevent market abuse and to enhance the operations of the market. The Commission approves the regulations and rules of the futures exchanges and requires exchanges to enforce them. Each futures contract is reviewed by CFTC economists and trading experts to confirm that its terms are consistent with cash market practices, it may serve an economic purpose, and it is not contrary to the public interest.

The *National Futures Association (NFA)*, a "registered futures association" under the Commodity Exchange Act, has been authorized by the Commission to register all categories of persons and firms dealing with customers. Before registering a new person or firm, the NFA conducts a thorough background check of the applicant to determine whether they should be precluded from conducting commodity business.

Firms that handle the money of customers who trade futures or options are required to keep customers' equity accounts separate from the firm's accounts, mark customer accounts to the present market value at the close of each day, and place any funds due a customer in an account separate from the firm's own fund or account. This segregation of funds protects clients' funds in case of a firm's separate financial difficulty. The industry has an outstanding record for protecting customers' funds, due in part to these rules.

The CFTC offers a reparations procedure for persons who have reason to believe that they have suffered a loss due to a violation of the Commodity Exchange Act or CFTC regulations in their dealings with

introducing brokers (IBs), commodity trading advisors (CTAs), commodity pool operators (CPOs), futures commission merchants (FCMs), or associated persons (APs) affiliated with these registrants. The reparations program is an alternative to the industry arbitration procedure and to normal civil court remedies. Decisions may be appealed to the Commission itself and to a U.S. Court of Appeals.

The responsibility of the CFTC might best be summarized by saying that its purpose is to ensure fair practice and honest dealing in futures trading, in order to permit accurate price discovery and opportunity for efficient hedging through competitive, manipulation-free markets. While futures trading can be very beneficial to hedgers and very profitable to some speculators, it is definitely not for everyone. In fact, the majority of people who speculate in commodity futures or options lose money. If you are considering speculating in commodity futures or options, be sure that you have speculative capital that you can afford to lose, thoroughly check on the firm and individual with whom you are considering doing business, review the disclosure information which must be provided before you open an account and educate yourself on how the market works. If you need additional information, please call the CFTC's Office of Public Affairs at (202) 418-5080 or the National Futures Association at (800) 676-4632.

How to Read Commodity Futures Price Tables

Price is the key statistic generated by futures markets, although the volume of trade and the number of outstanding contracts (open interest) also are important. Prices are available from a variety of sources, including many daily newspapers. Most papers also report volume and open interest.

Since the policies of wire services and newspapers vary to some extent in their format and terminology, this publication will describe price reporting formats in general terms, using as an example Table 1.

Table 1. CBT Corn Futures Prices

-GRAINS AND OILSEEDS-

Corn (CBT) 5,000 bu.; cents per bu.

□	Open	High	Low	Settle	Change	Lifetime High	Lifetime Low	Open Interest
May	252.00	252.75	250.75	278.00	.....	285.00	228.00	4233
July	258.00	258.75	256.50	258.00	-.25	285.50	232.50	141648
Sept	262.75	263.50	261.50	262.00	.....	270.50	238.00	33922
Dec	266.25	267.50	264.75	266.75	.....	268.00	235.50	141307
Mr 96	272.50	273.50	271.00	272.75	.....	274.00	249.50	14723
May	276.25	277.00	275.00	276.75	.....	277.75	259.50	1352
July	278.25	279.25	277.25	278.75	.....	280.00	254.00	7351
Dec	253.75	253.75	252.75	253.50	.....	258.50	239.00	4373

Est. vol 38,000; vol Wed 38,592; open int 348,967 + 987

The **open** or opening price is the price or range of prices for the day's first trades, registered during the period designated as the opening of the market or the opening call. In the table shown, May 1995 corn on the Chicago Board of Trade (CBT) opened at \$2.52 per bushel. Many publications print only a single price for the market open or close regardless of whether there was a range with trades at several prices.

The word **high** refers to the highest price at which a commodity futures contract traded during the day. The high price for March 1996 corn was \$2.73 per bushel.

Low refers to the lowest price at which a commodity futures contract traded during the day. The low price for March 1996 corn was \$2.71 per bushel.

Some publications show a **close** or **closing price** in their tables. The closing price is the price or range of prices at which the commodity futures contract traded during the brief period designated as the market

close or on the closing call --(i.e., last minute of the trading day).

Because the last few minutes of trading are often the busiest part of the day, with many trades occurring simultaneously, the exchange clearing house computes a **settlement** price from the range of closing prices. The settlement price, which is abbreviated as **settle** in most pricing tables, is used by the clearing house to calculate the market value of outstanding positions held by its members. It is also frequently used synonymously with closing price, although they may, in fact, differ.

The **change** refers to the change in settlement prices from the previous day's close to the current day's close. The - change for July 1995 corn indicates that the previous day's settlement price must have been 258 (i.e., 258 +).

The **lifetime high** and **low** refer to the highest and lowest prices recorded for each contract maturity from the first day it traded to the present.

Open interest refers to the number of outstanding contracts for each maturity month. Some newspapers do not include this information.

At the bottom of the table is another line of information. **Est. vol.** indicates the estimated volume of trading for that day was 38,000 contracts. **Vol. Wed.** means that the trading volume for the previous day was 38,592 contracts. **Open Int.** refers to the total **open interest** for all contract months combined at the end of the day's trading session. The 348,967 open contracts represent an increase of 987 contracts from the open interest of the previous day at the close.

The third line of the table reads as follows: "Corn (CBT) 5,000 bu; cents per bu." This line means that the table applies to the Chicago Board of Trade (CBT) corn contract; the contract size is 5,000 bushels; and the prices shown in the table are in units of cents per bushel. Thus, 252 cents means \$2.52 and of a cent per bushel.

Some publications may differ slightly in their report format. The *Washington Post*, for example, report grain prices in dollars per bushel rather than cents per bushel. Also, newspapers may often group futures contracts by exchange, whereas the *Wall Street Journal*, and others group them according to the type of commodity (for example, metals, grains, food-stuffs, financial, etc.).

Option price tables are set up differently than futures price tables. To understand an option price table, it is first necessary to understand basic option terminology. There are two types of options, "call" and "put" options.

A **call option** gives the buyer the right, but not the obligation, to buy a commodity (or a futures contract, in the case of an option on a futures contract) at a pre-established "strike price" or "exercise price" prior to the expiration date of the option contract.

A **put option** gives the buyer the right, but not the obligation, to sell a commodity (or a futures contract, in the case of an option on a futures contract) at the strike price in the contract prior to expiration of the contract.

The purchaser of an option (call or put) pays a **premium** to the seller (also called "writer" or "grantor") of the option. Depending upon the buyer's objective in purchasing the option, the premium represents either the cost of price protection (for a hedger) or the cost for an opportunity to profit from a favorable price movement in the case of a speculator. The premium is the cost of the option.

The size of an option on a futures contract is equal to the size of the underlying futures contract. In the following gold option table, the size of the contract is stated in the table heading. Also, the heading is the pricing unit for the contract. In the case of gold, the pricing unit is dollars per troy ounce.

An option customer has to make several decisions before buying or selling an option. Among the important ones are:

- 1) Whether to buy or sell a call or a put option;
- 2) Which expiration month to use; and

3) Which strike price to choose.

4) Is the present option premium appropriate for me to realize my profit goals.

An option's premium consists of its **time value** and its **intrinsic value**. The intrinsic value of an option is the difference between the strike price and the price of the underlying futures contract or zero, whichever is greater. For instance, if an April gold call option has a strike price of \$300 an ounce, and the April futures price is currently \$320, the call option has an intrinsic value of \$20 an ounce and is **in-the-money**. If the futures price were \$260 an ounce, the call option would be out-of-the-money by \$40 an ounce and would have an intrinsic value of zero. If the option has several months to go before expiring it is then considered to have time value, although in dollar terms this may be relatively low.

When an option is **out-of-the-money**, the premium or market price of the option totally reflects its time value--the amount an option purchaser is willing to pay for the possibility that the option will become profitable prior to the date when the option expires.

The likelihood of an option moving into the money depends upon the time remaining until the option's expiration and the price volatility of the underlying commodity. Professional traders use sophisticated models to measure price volatility and to compute what an option's premium should be. Some of the factors they consider are:

- 1) The strike price;
- 2) The price of the underlying futures contract;
- 3) The time remaining before the option expires;
- 4) The volatility of the underlying futures contract; and
- 5) Short term interest rates.

Table 2. Gold Option Price Table

GOLD (CMX) 100 troy ounces; dollars per troy ounce.

Strike Price	Calls-Last			□	Puts-Last		
	Aug-C	Oct-C	Dec-C		Aug-P	Oct-P	Dec-P
290	21.00	26.50	□	□	0.40	3.00	4.80
300	11.90	19.30	□	□	1.20	5.30	7.1
320	1.00	8.50	13.70	□	10.00	13.50	15.00
340	0.20	2.80	6.80	□	29.40	28.50	28.00
360	0.10	1.00	3.50	□	49.40	46.20	44.00
380	0.10	0.60	1.70	□	69.40	...	62.00

Est. vol. 5,800, Fri vol. 3,729 calls, 2,267 puts.

Open interest Fri. 42,755 calls, 31,931 puts.

However, the actual premiums paid for options are arrived at through competitive bidding and offering and can differ from theoretical values. In the gold option price table (Table 2), there are three expiration months listed for both calls and puts--August, October, and December. In the far left-hand corner of the table is a series of strike prices that may be chosen, ranging from \$290 to \$380 per troy ounce. The price of an October call option with a \$320 strike price is \$8.50 per ounce (or \$850 for 100 oz. contract). The price of an August put option with a \$290 strike price is \$0.40 per ounce (\$40.00 for the contract).

The bottom two lines of the option price table indicate today's estimated volume for calls and puts combined, but show the previous day's actual volume and separately indicate open interest for calls and

puts.

As you can see, understanding the futures markets requires some effort to learn the details. Therefore, consult other texts on this subject before considering speculating in the futures markets.

CFTC Publications

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