Hedging

(Continued From Page 1)

ahead of the game. If the bears are wrong, the farmer who hedges will earn less than he would on the open market The reason for hedging, according to many bankers and farm economists, is the ability to predict an acceptable level of profit, even if hindsight reveals that profit to be lower than it might have been In the Midwest, many farmers are able to borrow money only because they routinely lock in a profit by hedging on the futures market Locally, ag bankers say hedging isn't employed by very many farmers as a management tool. But they foresee the day when more and more farmers will be using it

Hedging isn't something to step into lightly, we were told by one banker. It takes a lot of careful thought, and a good record keeping, system A farmer who wants to hedge should arm himself with as much information as he can possibly get. Eventually, the hedger winds up talking to a commodities broker, like Reynolds Securities in Lancaster, or Rosenthal & Co. in Allentown. To find out what goes on in a brokerage office, we visited the Rosenthal firm on a recent market day.

One thing a visitor learns, shortly after noon, is that commodity brokers don't eat lunch If a man were to spend his entire working career with a commodities brokerage firm, chances are good that he'd never go to a business lunch.

From about ten in the morning until after three in the afternoon, all four brokers in the Rosenthal office were on the phone talking to customers and traders. They constantly scanned TV screens bearing the latest computerized quotations from commodity markets around the country. Periodically, they read financial news reports as they came in over a teletype machine.

Firms like Rosenthal are always busy on market days, but lately they've been even busier. Trading in commodity futures throughout the country is at a record level.

Since organized trading in futures began in this country more than 100 years ago, it has passed through several periods of rapid growth. During the last decade, both volume and the number of commodities traded have increased dramatically. In certain years, the dollar volume of trading on the Chicago Board of Trade alone has approached that of the New York Stock Exchange Now, there are 20 licensed exchanges in the U S., doing business in the neighborhood of $200 billion a year.

This impressive figure represents the dollar volume of all the commodities traded. They range from soybeans and grain sorghum to plywood, and they have one thing in common: Those speculating in them can make--or lose--a fortune in a matter of minutes

This is the glamorous aspect of futures trading--the ability of speculators to make money by playing the market But at least as important is the businessman on the other end, the hedger, who uses the futures market to protect himself against financial loss.

A new study by the USDA's Economic Research Service (ERS) took a look at hedging in the livestock futures market. What it found could encourage more cattle and hog producers interested in minimizing financial risk this way.

The exchanges where commodities are bought and sold grew out of the need for advanced sales by merchants who accumulated farm stocks.

Until development of the commodities market in the mid-1800's trading was chaotic--corn, wheat, and other crops would pour into the big marketing cities at harvest time. This created a glut, and in turn, low prices for farmers.

At other times of the year, the situation was reversed. Stocks of commodities were depleted, and demand drove prices sky high.

With the changing patterns of commodity movements, the main business of the exchanges today is the trading of commodity futures--which are contracts for the sale and purchase of yet-to-be marketed products. Selling crops this way provides wide dissemination of information on price expectations and thereby facilitates a more even flow of products to market. Today's futures prices reflect conditions which eventually influence the retail prices of eggs, bread, beef, pork, and other products several months hence

Unlike many other commodity futures, livestock trading is of relatively recent vintage. It was not until November 1964 that trading in live cattle futures opened on the Chicago Mercantile Exchange. Trading in live hogs began 15 months later

Since then, livestock futures trading has literally grown by leaps and bounds. Between 1965 and 1972, the volume of cattle futures increased from 2.7 billion pounds to 38 6 billion pounds. Trading in hog futures went from 71 million pounds in 1965 to almost 11 billion in 1972

In terms of dollar volume, livestock futures trading is now more than a $16 billion annual business

Why would a cattle or hog feeder use the futures market? A major reason is to attempt to reduce risk from the sharp price fluctuations common with livestock.

For example, to use the standard contract size of 40,000 pounds, a cattle feeder may put 40 head of cattle in a feedlot. He plans to feed them to 1,000 pounds each and then sell them. Hedging this, he would be able to fix the price for the cattle when they are placed in the feedlot, 4 months before the finished cattle are actually sold

He would do this by selling a futures contract calling for delivery 4 months hence. In this way, the price risk may be partially shifted to a speculative buyer of futures.

Chances are that this contract will never be fulfilled. Instead, it will be terminated by an offsetting transaction in which the seller--the cattle feeder--will buy back an equal amount of cattle futures on the exchange before the original contract comes due. By maintaining opposite positions in cash and futures during the feeding period, the hedger hopes to offset what happens in the cash market by what happens in futures. A loss in cash will mean a gain in futures, and vice versa.

Normally, traders have tended to talk about hedging as if the cattle feeder always sold a full animal for every animal he had on feed. In actuality, however, the hedge is usually "incomplete"--that is, only part of an animal is sold for each animal on feed. Another way of saying this is that the feeder trades in smaller quantities on the futures market than he does on the cash market.

According to the ERS study, the cattle feeder can best shift his risk by selling about three-quarters of a steer for every steer in the feedlot Over the years, the study said, this "minimum risk hedging level" has resulted in the greatest stability of return to the feeder.

The study also indicated--not surprisingly--that the futures market can be an effective way for livestock feeders to reduce risk Yet in spite of the rapidly increasing volume of livestock futures trading, it represents only a small fraction of cattle on feed in the U S In 1969, less than 5 percent of the 11 million head of cattle on feed at the time were covered by futures contracts.

Why don't more cattlemen use the futures market? According to an ERS economist who specializes in futures, one reason is lack of familiarity--futures trading is little known and even less understood.

Another factor is past experience. In its brief history, the livestock futures market has not always treated the "short" hedger (the one who is selling, who is literally short in the futures market) favorably. This is partly because rising livestock prices have characterized the market in recent years. When prices are going up, it is logically to the producer's disadvantage to fix a price for his cattle in advance. When prices are declining, he gets more by "selling forward" in the futures market.

The ERS study found that live cattle and hog futures can "give reason for concern about price bias" against the short hedger. Historically, it said, prices have tended to rise over the life of the contract, resulting in losses to short hedgers. Over the period analyzed in the study -- from March 1965 to March 1971 -- increases in futures prices averaged about 30 cents per pound per month for both cattle and hogs.

If this tendency were to persist, price biases of this magnitude would present a serious barrier to hedging. But the study concludes that this is not likely to be the case.

Some economists now foresee a general lowering of livestock prices.

They reason that sooner or later the strong demand for beef, coupled with record high prices, will cause cattlemen to overexpand. Slaughter supplies will become greater than the market can bear, prices will drop, and cattlemen will no longer hold extra heifers for herd expansion. This in turn will put even more cattle on the market, continuing the cycle of lower prices

It's now anticipated that by early 1974, cattle prices will be down from current levels. Though many things could happen to upset this forecast, there is general agreement that the short hedger may soon find the market in a position to treat him better.

Meanwhile, futures trading in livestock and other commodities has not escaped criticism. Among other things, there have been charges that operation of the commodity exchanges is open to various abuses, including price manipulation and other collusive and deceptive practices. In

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