

NCCC-134

APPLIED COMMODITY PRICE ANALYSIS, FORECASTING AND MARKET RISK MANAGEMENT

Discussion of Paul Peterson's and David Lehman's Comments

by

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Suggested citation format:

Thompson, S. 1995. "Discussion of Paul Peterson's and David Lehman's Comments." Proceedings of the NCR-134 Conference on Applied Commodity Price Analysis, Forecasting, and Market Risk Management. Chicago, IL. [<http://www.farmdoc.uiuc.edu/nccc134>].

DISCUSSION OF PAUL PETERSON'S AND DAVID LEHMAN'S COMMENTS
NCR-134 CONFERENCE, APRIL 25, 1995

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Both Paul and David discussed issues related to maintaining and developing successful futures contracts. Paul focused on cash settlement issues in livestock futures; David focused on the soon-to-be-introduced Crop Yield Insurance contract. There is no doubt that this contract is innovative and that many of us understand how it might provide valuable risk management opportunities for agriculture. However, it remains to be seen whether this contract will attract much trading interest. It is clear that very few new agricultural futures have survived, much less flourished, since the introduction of livestock futures. At the same time, trading in existing agricultural futures, particularly grains, is very high relative to historic norms. My comments will focus on why so few new contracts are successful. I will also offer implications for future research on contract design and on risk management strategies in the food and agricultural sector.

Futures trading has typically evolved from active forward markets. The jump to trading futures from trading forward contracts may be a big step for most firms, but it is just one step. They make this decision because futures afford **more pricing flexibility at lower transactions costs** than currently used strategies or than other alternative strategies. I don't think that we generally take a good, thorough accounting of the transactions costs involved with adopting futures-based risk management strategies and comparing these costs to the returns from trading futures. Nor do we do a good job of examining the costs and returns of alternative risk management strategies. It is not likely that firms will adopt a completely new risk management strategy if it would involve high transactions costs or would result in small added benefits. High transactions costs or small added benefits may occur if:

- the corporate culture is not geared to an open market strategy for price risk management and may prefer more private means of negotiating price. This appears to be increasingly important in the livestock industry. It is also clearly the case in some of the food ingredient markets such as HFCS.
- basis risk is high in the physical product handled by firms. This may really be a problem in the future as firms trade more differentiated products.

Another constraint to success of a new futures contract is, as Paul mentioned, the existence of an active cash market to discover prices by exchanges or by researchers. I do not believe this necessity has been adequately considered. Any new contract needs an accurate source of cash market information (or the equivalent if we're talking about yield contracts) to form

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judgments about futures prices. When a new contract is proposed to the CFTC the proposal must include some information about current and expected price behavior. The Exchange also develops marketing material for prospective traders based on current and expected price behavior. If this reported price information bears little resemblance to actual transaction prices, or if there is little reported price information on which to base judgments, then futures traders, and particularly speculators, are likely to be at a loss regarding informed judgments. If the information on which they base their futures positions is flawed or biased, and does not represent actual market conditions, traders will find this out the hard way at the first contract expiration. Without an informed basis for making decisions, traders are unlikely to take highly leveraged positions on futures markets. I wonder what will be the basis for making judgments about crop yield well in advance of planting? How about early in the growing season? How many speculators will be attracted to an environment without much reliable information? Certainly the high fructose corn syrup (HFCS) contract met its demise in part because there was no reliable published cash price series on which to base speculative positions. HFCS speculators learned this the hard way in the expiration and delivery of the first contract. There was virtually no trading of the HFCS contract after the first contract expiration.

Finally, there remains the question about total firm risk management strategies. What is to explain the phenomena that the existing grain futures contracts appear highly successful, but no new contracts appear to be able to get off the ground? I would argue that many food and agribusiness firms can find internal ways to manage risks more effectively and more efficiently for products not traded on futures. This is because they are:

- increasingly more vertically and horizontally integrated
- operating in more concentrated markets where they have market power
- trading or manufacturing differentiated products that do not face perfectly elastic demands. Costs variations may be passed on to consumers or absorbed in profit margins.

Corn, soybeans, and to a lesser extent, wheat are the ULTRA commodities, still traded as homogeneous products by many firms under conditions that most approach perfect competition internationally (petroleum products are also in this group). As long as time zone problems do not interfere too much (or maybe even if they do), there will remain active futures markets for these products in the U.S. and throughout the world. There may even be futures markets developed for different grades or varieties of these commodities if the underlying cash market is sufficiently liquid. But, I argue these markets are increasingly anachronisms, and that our research should be directed towards whole firm risk management strategies, and less towards price risk management for an individual commodity. The Exchanges would do well to take a similar perspective. There may be important implications for what type of futures contracts will be beneficial in such an environment, what are the transactions costs to users in adopting them for risk management, and how can these transactions costs be minimized. The CYI contract is a good start in this direction.