FUTURES MARKETS: buying and selling uncertainties

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Ten-second quiz: What is the commodity that's traded on the cotton futures market?

You may get partial credit if you said, "cotton," but the best answer is "price uncertainty," says UA agricultural economist Dr. Robert S. Firch.

The same holds true for futures markets of other agricultural commodities, from wheat to hogs. The motive behind most buying or selling of futures contracts isn't the wish to own more or less of the product itself. It is the wish to have more or less risk riding on the product's cash price in the future.

The existence of a formal trading network for commodities futures helps at least two categories of people. One group is people who produce the commodities or buy and sell them. They can use the futures market to minimize the risk that the price will drop before they sell their crop or inventory. The other group is people who want to invest in the chance to predict future prices. They take on risk, so some of them win while others lose.

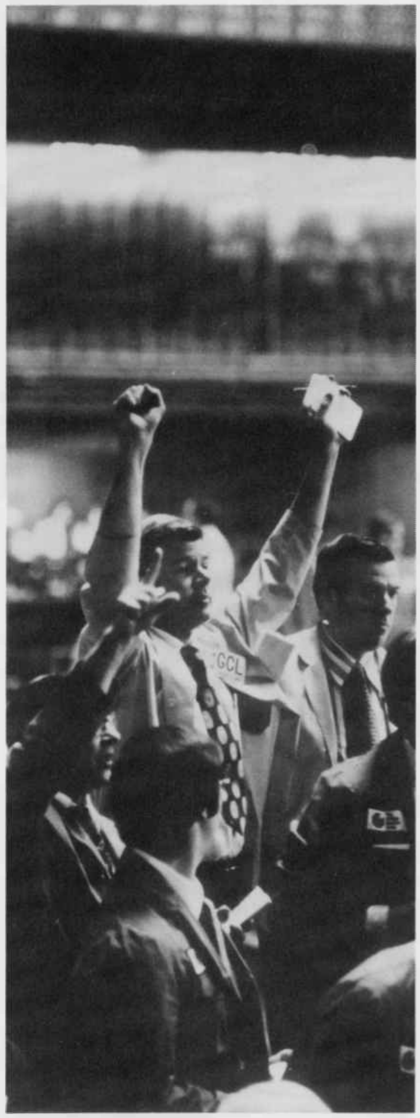
Firch described the uses and workings of futures markets to about 20 cotton farmers during three evening meetings at Marana High School in May. He plans to lead similar seminars elsewhere in the state this fall. "When cotton prices are low, that's when farmers are most interested in learning about marketing strategies," he notes. And cotton prices have been low for more than a year.

Firch advised the Marana audience to take a cautious approach to futures trading: "No more than five to 10 percent of farmers should directly participate in futures marketing, particularly in cotton, . . . and those five to 10 percent are people with a high level of marketing skills and judgment, and not a little luck going for them."

Instead, he suggested alternative ways for cotton farmers to protect themselves from prices that decline during the growing season. However, these marketing methods, such as forward-pricing part of the crop with a specific cotton buyer, are sensitive to changes in the cotton futures market, so an understanding of the futures market helps even those farmers who do not participate in it directly.

Futures trading is the buying and selling of contracts for the delivery of specified quantities and quality of a commodity at a specific time and place. For example, cotton futures contracts are each for 50,000 pounds of cotton, the average yield from about 45 acres in Arizona.

Transactions go through a commodities exchange, such as the Chicago Board of Trade or the New York Cotton Exchange. Only members of the exchange actually buy or sell the contracts. They do so only on the trading floor (the "pit"), usually with hectic hand signals and



Photographs: Action in the "pit," courtesy of Chicago Board of Trade.

shouting. Outsiders participate through the members who act as agents or represent brokerage firms.

Each futures contract becomes an agreement with the exchange. After a buyer and seller agree on a price, they each enter a contract (or close an old one) with the exchange and have no continuing obligation to each other.

In practice, about 99 percent of the futures contracts for agricultural commodities are canceled before the specified delivery date. That is, almost every trader by that date has evened up the number of contracts bought with the number sold, so his obligations to deliver the commodity and his obligations to accept delivery cancel each other out.

The possibility of carrying out the delivery has the effect of bringing the futures price in line with the commodity's current cash price as the delivery date approaches.

Firch explained how different groups use the cotton futures market.

A farmer who calculates at planting time that he can grow a crop for less than the going price of harvest-time futures contracts may want to lock onto that price by selling a contract. But of all the farmers who grow commodities traded on the exchange, less than five percent get directly involved in futures marketing.

People who buy and sell the crop, such as cotton buyers and grain elevator operators, participate in futures trading much more extensively than farmers. They use futures contracts as a hedge against price fluctuations.

Hedging works like this: A cotton buyer sells futures contracts for the same amount of cotton as he buys on the cash market. When he sells the cotton, he buys the futures contracts back. If prices have dropped, he loses money on the cotton, but makes it up in the futures transactions. If prices have risen, he makes money on the cotton but loses on the futures. The cotton buyer's profits are in the difference between prices paid to growers and prices received from mills, irrespective of changes in price over time.

The middlemen for other commodities also hedge against price drops. By avoiding the cost of covering this risk, they can live with a smaller spread between the prices they pay and the prices they receive, said Firch. And continuing, "This allows farm prices to be **higher**, and at the same time consumer prices to be **lower**, than they would be without an effective futures market."

The futures markets would not work if everyone wanted to minimize risks. Speculators keep the wheel turning. Their profit depends on their ability to predict price trends. For example, if one thinks that the going price for a particular contract is lower than conditions warrant, he buys it. If the price rises, he can sell for a profit.

About one-tenth of the speculators in the commodities futures markets are professional traders: They make the futures markets their main income source. Of the other nine-tenths, many are in high-income careers such as medicine or law, surveys have shown. As a group, these non-professional traders tend to lose money in futures trading. Stories about the exceptions help draw new traders into the market as others drop out.

"One way of viewing the futures market is as a way of transferring wealth from M.D.s and lawyers to professional traders," said Firch. "The hedgers don't end up paying for the professional traders' profits; the non-professional traders do."