

Basic Livestock Futures, Part 2: Mechanics of Futures Trading



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This Fact Sheet is part two of a three-part series that discusses the fundamentals of livestock futures markets, the mechanics of futures trading, and the principles of hedging livestock. Part two focuses on the mechanics of futures trading and addresses such questions as: how do you choose a broker and open a futures trading account; what happens when a futures order is placed; and what types of futures orders can be used?

Basic Livestock Futures, Part One (OSU Extension Facts 430) discusses the fundamentals of futures markets and futures contracts. Basic Livestock Futures, Part Three (OSU Extension Facts 432) discusses the principles of hedging livestock with futures.

Choosing a Broker

Livestock producers must trade futures through brokers with membership on the appropriate exchanges. Since the broker is a very important element in futures trading activity, a great deal of care should go into the choice of a broker. Emphasis is placed on choosing a broker for hedging purposes. There are several basic criteria for a good hedging broker. First, a producer should choose a broker who specializes in commodity trading rather than stocks. This does not mean that the broker should trade commodities exclusively. But, commodity markets are different from stock markets and are too complex to be a "sideline" activity for a stock broker.

A good understanding of futures markets is a necessity for a good hedging broker but is not enough to insure successful hedging. The broker should also have a complete understanding of hedging. This may seem obvious, but there are many good speculative brokers who do not understand hedging. Since they do not understand exactly what their hedgers are trying to do, they are not much help. Speculative brokers will often lead their hedgers into speculation because the speculative motive is what they as brokers understand.

Speculative trading, because it usually involves more frequent trading, may result in more income for brokers than hedge trading.

Regardless of their background, good hedging brokers will almost always have an understanding of production agriculture. Hedging, after all, is a method of pricing livestock. A broker who does not understand the livestock business could have difficulty understanding the pricing objectives of the livestock hedger. A broker may encourage a forward pricing hedger to lift or offset a hedge simply because of a past or expected future price trend. This is a sure tip-off that they are not a good hedging broker. There are few cases in which a hedge should be lifted prior to completion of the hedge. In those cases, the initiative for lifting the hedge should come from the producer. The broker should be the one who cautions the producer that when a hedge is lifted prior to completion, the producer has returned to a speculative price position on the livestock.

The broker's primary responsibility is to efficiently execute the decisions which the hedger has made. A good broker may provide market information and be able to assist the hedger in making some decisions, but the final responsibility for decision making is that of the hedger. Brokerage firms may be classified as either "full service" or discount. Full service brokers may offer services such as marketing information, 24-hour office hours, and newsletters. Discount brokers may offer fewer services beyond the execution of customer orders. Today, many discount brokers offer additional services as well. Shopping around for the services needed and comparing commission fees among brokerage firms may greatly improve the fit between a producer's needs and the broker's services.

Opening, Using and Margining the Futures Account

A livestock producer must open an account with the broker before beginning to trade futures contracts. The

producer will be asked to provide certain financial information similar to that required by a bank when making a loan. This insures that the producer is financially able to fulfill commitments which might be made in the futures market. The producer will be asked to sign a customer's agreement. The customer's agreement should be read carefully as it spells out the legal responsibility of the customer to fulfill obligations made by the broker in the contract.

Once an account has been opened with a broker, the hedger may give the broker the first buy or sell orders. There are many types of orders that a hedger may use. The most common type of order used by hedgers, particularly for beginning hedgers, is the "market order." A market order instructs the broker to execute the order at the best price possible at the time the order reaches the exchange floor. The broker can inform the hedger of current price levels before the order is placed. A market order is executed within two to three minutes of the time when it is placed. Figure 1 shows the typical sequence of events that occur between the time you place an order and the time trade confirmation is received. In most cases (except for rapidly moving markets), the hedger will have a pretty good estimate of the price at which a market order will be executed before it is placed.

More sophisticated pricing orders include price limit orders and stop orders. Price limit orders are filled only when they can be filled at or better than the price specified by the customer. Fills on price limit orders are guaranteed only if the market moves through the price specified by the customer. Stop orders are activated when the market reaches a price specified by the customer. For example, a stop order to sell (buy) June Live Cattle at \$75.00 turns into a market order when the June Live Cattle contract can be sold (bought) at \$75.00 or less (more). These types of orders are only a few of many kinds that may be utilized by futures traders. More important than the order's name is the principle of accurate communication between the hedger and broker.

Once an order has been executed and a delivery contract has been made, the hedger must make a security deposit with the broker to insure the performance of that contract. This security deposit is called an initial margin requirement and amounts to about 5-10 percent of the total value of the commodity represented by the contract. For example, a \$1500 margin requirement would amount to 5-1/4 percent of the total value of a 40,000 lb cattle futures contract valued at \$70.00 per cwt. This margin deposit insures that profit made in the futures market will be available for withdrawal at any time without concern about the ability to collect. Minimum margin requirements for each futures commodity are set by the exchanges and may change over time. Individual brokerages may require more than the minimum margin amount. Comparison of

margin requirements when shopping for a broker is a good idea.

A hedger experiences "paper losses" in their futures account any time they lose money by offsetting futures commitment at current price levels. For example, if a hedger sold a live cattle futures contract at \$70.00 and the current price of that contract is \$71.00, \$1.00 cwt or \$400 per contract would be lost by offsetting the contract at the current price. If such "paper losses" amount to more than 25-30 percent of the initial margin amount, the hedger will be asked to make an additional deposit in the amount of the total paper loss. In this example, the hedger would get a "margin call" for \$400 which would have to be deposited with the broker.

"Paper profits" accrue to the hedger any time the market provides an opportunity to offset a futures commitment at a profit. For example, if a hedger sold a futures contract at \$70.00 and the current price is \$69.00, the hedger would have a paper profit of \$1.00 cwt or \$400 on a 40,000 lb contract. Paper profits may be withdrawn from the hedger's account with the broker at any time. The hedger knows with certainty he has the ability to withdraw "paper profits" and collect actual profits when offsetting a profitable futures position only if those who have paper losses deposit money to cover their paper losses.

There is sometimes a lag of a day or two between the time a margin is made and the time the additional deposit is received. There could be losses during this time. The initial margin deposit provides a buffer against the possibility of a negative margin position. Thus, if there is a great deal of price variability in a futures market, initial margin requirements can be expected to be higher than for a more stable market. Margin requirements may also be raised if the market value of a commodity rises.

Many brokerages will accept interest bearing securities for initial margin. This may eliminate or reduce interest costs associated with futures accounts. However, net interest cost or interest foregone is a cost of futures trading. It is equally important for the hedger to realize the chance of making substantial margin deposits during the course of a hedge and thus be prepared to make any deposits necessary to successfully complete the hedge. The ideal way for a hedger to handle this margin call is through their banker. In such cases, the hedged livestock serve as collateral for the margin loans. A margin call, although a loss in the futures market, implies an equal increase in the value of the hedged livestock. So, the value of the collateral will be increased in direct proportion to the need for margin money.

Many bankers will meet all margin calls for customers under binding agreements, called three-way agreements, which protect both parties. Some of the requirements of the bank are that they will loan money for margin only in cases where they have also loaned

money to finance the production of the livestock. Thus their margin loans are to protect the previous production loans. Another logical requirement may be that the hedger not be a speculator in any other commodity, contract month, etc. as this would affect overall risk position. Also, the hedger must assign any profits in their futures account to first go to the bank for repayment of the loan. And it generally holds that the bank has first claim to receipts from sale of the livestock to cover operating loans and/or margin loans. Such financial arrangements can simplify the margining process for the hedger and may assist in following through to the completion of a successful hedge.

Three-way agreements not only facilitate the producer's hedging program, but may offer other advantages. Many lenders, recognizing that a properly managed hedging program reduces the risks associated with production loans, may offer incentives to encourage producers to use risk management programs. An OSU survey of lenders financing cattle feeding operations found that producers using risk management programs may receive lower interest rates on operating loans or lower equity requirements on cattle purchases (Eilrich, Ward and Peel).

Hedging Versus Speculation

The futures transactions of hedgers and speculators may be quite similar if not identical. This causes producers to confuse hedging with speculation. This similarity of futures activity has caused many of the uninformed to incorrectly refer to hedging as gambling. The objective of the hedger is opposite that of the speculator. Thus, it is important for the hedger and those with whom they do business to understand the distinction between hedging and speculation.

To speculate means to take a risk in hopes of making a profit. A livestock producer is a speculator by committing operating costs, capital, labor, and management ability to producing livestock without knowing whether the prices received will cover these costs. The producer takes the risk of losing those committed costs in hopes of making a profit. They also speculate that the selling price will more than cover production costs. Likewise, a speculator in the futures market takes a similar risk in hopes of making a profit. The futures market speculator buys a contract hoping to sell it later at a higher price resulting in profit. They speculate that the selling price will more than cover the buying price. Alternatively, a speculator might sell a futures contract, as a hedger might do. In this case the speculator is hoping for a falling market which would yield a profit while risking a higher and unprofitable price.

Hedging, in contrast to speculation, means offsetting an existing risk rather than taking on a new risk. The

most straightforward type of hedging is forward pricing. Forward pricing in the futures market is achieved by offsetting risk. The cattleman committed to producing cattle will lose money if prices fall below production costs before he can sell them. So taking a position in the futures market that will make money if prices fall is selling a futures contract. The two risks are offsetting. The futures market speculator has no cattle and thus has no risk to offset the futures market risk. So a speculator who initially sells a futures contract is taking on an added risk. The hedger who makes an identical futures transaction is reducing risk by offsetting the risk already taken on the cattle.

This concept of offsetting price risks is the basic distinction between hedging and speculation. Thus, hedging transactions in the livestock futures market must be closely related to production decisions on the farm or ranch. If the futures transactions of a livestock producer are not related to the livestock production, they are simply raising livestock and speculating in futures as a sideline.

The distinction between hedging and speculating has additional implications as well. Since speculators are taking on risk and hedgers are reducing risk, brokers distinguish hedging and speculative trading accounts. Speculative accounts often have higher margin requirements because of the risk associated with speculation. In other aspects, hedging may also affect the financial backing of a producer's cash operation. Lenders who understand hedging and the associated risk management may increase the level of financial backing or offer reduced interest rates on operating money for hedged producers.

A final implication of hedging versus speculating relates to the tax treatment of futures transactions. Internal Revenue Service policy may change over time, so little can be said here with certainty. Generally, profits or losses in futures markets associated with a legitimate hedge are treated as ordinary income or business expenses while speculative profits or losses are treated as capital gains or losses. It is important that a hedger keep detailed cash and futures market records to verify hedging activities. Producers should never mix hedging and speculative activities in a single trading account.

References

Eilrich, Fred, Clement E. Ward, and Derrell Peel. "Lender Preferences for Price Risk Management for Fed Cattle." *Current Farm Economics* Vol. 65 - No. 2, Department of Agricultural Economics, Oklahoma State University, June 1992.

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