

# THE CONCEPT OF FUTURES

## Dealing with Risk

Livestock producers face a great deal of risk. One is uncertain weather, which affects feed costs, the availability of feed and forage, rates of gain, conception rates, survivability of young animals and shipment. Another risk is the constant threat of disease. Livestock producers know that staying on top of animal health requires the best management in agriculture. Producers have managed such production risk with top notch husbandry practices. But no amount of husbandry can address market risk – the uncertainty of prices at market time, owing to shifting supply and demand factors. That’s where the futures markets come in. CME Group developed livestock futures to provide producers with forward pricing opportunities for managing market risk – to lock in profits, enhance business planning and facilitate financing – all the benefits that futures provide other sectors of the farm economy.

## What is a Livestock Futures Contract?

A livestock futures contract is a standardized agreement to buy or sell livestock at a date in the future. Each contract specifies:

- Commodity (live cattle, lean hogs, feeder cattle)
- Quantity of the commodity (pounds of livestock as well as range or weight for individual animals)
- Quality of the commodity (specific U.S. grades)
- Delivery point (location at which to deliver commodity, such as live cattle, or cash settlement in the case of feeder cattle and lean hogs)

The only aspect of a futures contract that is not specified is the price at which the commodity is to be bought or sold. The price varies: It is determined on the floor of the exchange as floor brokers execute buy and sell orders from all over the country, as well as on the electronic marketplace which operates simultaneously with the floor market. Market participants enter bids and offers that reflect the supply and demand for the commodity as well as expectations of whether the price will increase or decrease.

## Futures Language

**Bear:** one who expects prices to fall

**Bear Market:** a falling market

**Bull:** one who expects prices to rise

**Bull Market:** a rising market

**Cash Market:** a marketplace for the physical commodity, such as an auction

**Long Hedge:** balancing a “short cash” position (unmet need) with a long futures position

**Long Position:** inventory of product or a purchased futures contract

**Short Hedge:** balancing a “long cash” position (inventory) with a short futures position

**Short Position:** unmet requirement for product or a sold futures contract

## Who Can Trade Futures?

Anyone can buy or sell livestock futures contracts through the proper channels, including people who sell livestock futures but don't have any livestock to deliver. While many livestock futures contracts include an obligation to deliver, it is possible to remove that obligation at any time before the delivery date by buying back, or offsetting, the futures contract. Similarly, many people buy livestock futures with no intention of taking delivery of any livestock. They also remove the obligation to take delivery by selling back the contract. With cash-settled contracts it is possible to hold a contract until expiration without delivery worries.

## How Do Speculators Use the Futures Market?

Speculators have no intention of buying or selling actual commodities. They try to make money by buying futures contracts at a low price and selling back at a higher price or selling high and buying back lower. In doing so, they take on the risk that prices may change to their disadvantage. So, speculators provide risk capital and depth to the marketplace and make it possible for hedgers to use the futures market to reduce risk.

## How Can Producers Use the Futures Market?

Producers can use the future markets as a temporary substitute for a cash sale or cash purchase to be made at a later date, as a way to hedge their price risk. The possibility of actual delivery causes futures prices to line up with cash market prices of the commodity as the delivery month on a futures contract approaches.

## The Long and the Short of it:

- A trader who is long futures has bought a futures contract.
- A trader with a long hedge has bought a futures contract to protect against a price increase in a commodity the trader plans to buy later.
- A trader who is long cash owns and plans to sell a commodity later.
- A trader who is short futures has sold a futures contract.
- A trader with a short hedge has sold a futures contract to protect against a price decrease in a commodity the trader plans to sell later.
- A trader who is short cash needs and plans to buy a commodity later.

Producers don't want to take on the risk of changing prices in the cash markets, so they use the futures market to lock in a price ahead of actual merchandising. They transfer their risk to speculators. Most producers remove their obligation to deliver or take delivery on the futures contract just as speculators do – by offsetting their original futures position – but producers then sell or buy actual commodities in the cash markets.

## What is Hedging?

Hedging is buying or selling futures contracts as protection against the risk of loss due to changing prices in the cash markets. Hedging is a risk-management tool for a producer who is feeding livestock to market and wants protection from falling prices in the cash markets. Similarly, processors, who need to buy livestock, want protection against rising prices in the cash markets. Either way, hedging provides that protection. Producers use short, or selling, hedges for protection against falling prices. They sell futures contracts and, when they are ready to market their livestock, buy back the futures contracts and sell the livestock in the cash markets simultaneously. Usually they can offset a decrease in cash market prices with a gain in the futures transaction. Processors use a long, or purchasing, hedge when they plan to buy livestock and want protection against rising prices. They buy futures contracts and, when they are ready to purchase the livestock, sell back the futures contracts and buy the livestock in the cash markets simultaneously. An increase in cash prices would be mostly offset by a gain in the futures transaction.

## How are Futures Traded?

Livestock futures are bought and sold through futures brokerage firms that execute trades for customers via open outcry or electronically on the CME Globex electronic trading platform. Customers of brokerages can also trade directly on the CME Group electronic markets if they wish. Before trading, all customers must deposit a performance bond with their brokerage firm to “pre-pay,” in a sense, any losses they may incur on the futures contracts. If the value of the contract goes against their positions by a certain amount, they will be asked to deposit more funds before the start of the next day’s trading session. They also pay the

broker a commission for every “round-turn” (sell-buy or buy-sell pair of transactions).

## How are Hedges Offset?

Short hedgers who have sold futures contracts offset their hedges by buying back the same futures contracts at the same time they sell their livestock in the cash market. Long hedgers who have bought futures contracts offset their hedges by selling back the same futures contract at the same time they buy livestock in the cash market.

## Key Points

1. A futures contract is a standardized agreement stating the commodity, quantity, quality and delivery point or cash settlement.
2. Price is discovered in futures trading by the interaction of buyers and sellers, representing supply and demand, from all over the country and around-the-world.
3. Sellers remove their obligation to deliver on a sold contract by buying back a contract before the delivery date.
4. Buyers remove the obligation to take delivery on a purchased contract by selling back the contract before the delivery date.
5. A short hedge protects the seller of a commodity against falling prices.
6. A long hedge protects the buyer of a commodity against rising prices.