

## Functions of the Futures Market

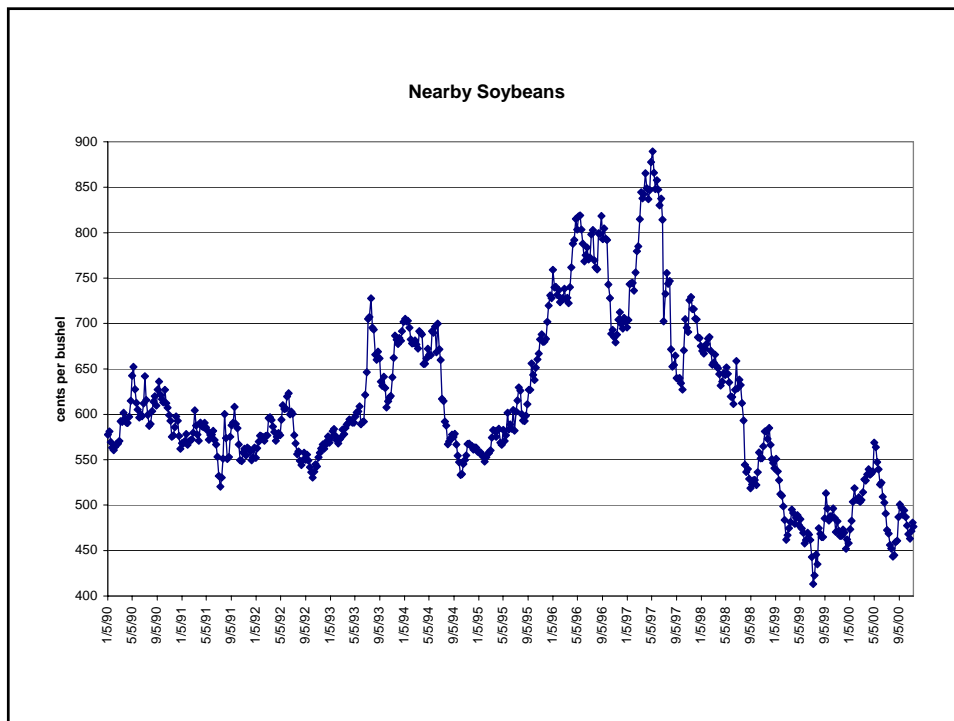
- Price discovery:  
Price action in the futures market is transparent. All prices are publicly reported as soon as a transaction takes place.
- Price risk management:  
Futures markets are used to protect against price risk in cash markets.

## Two Kinds of Traders

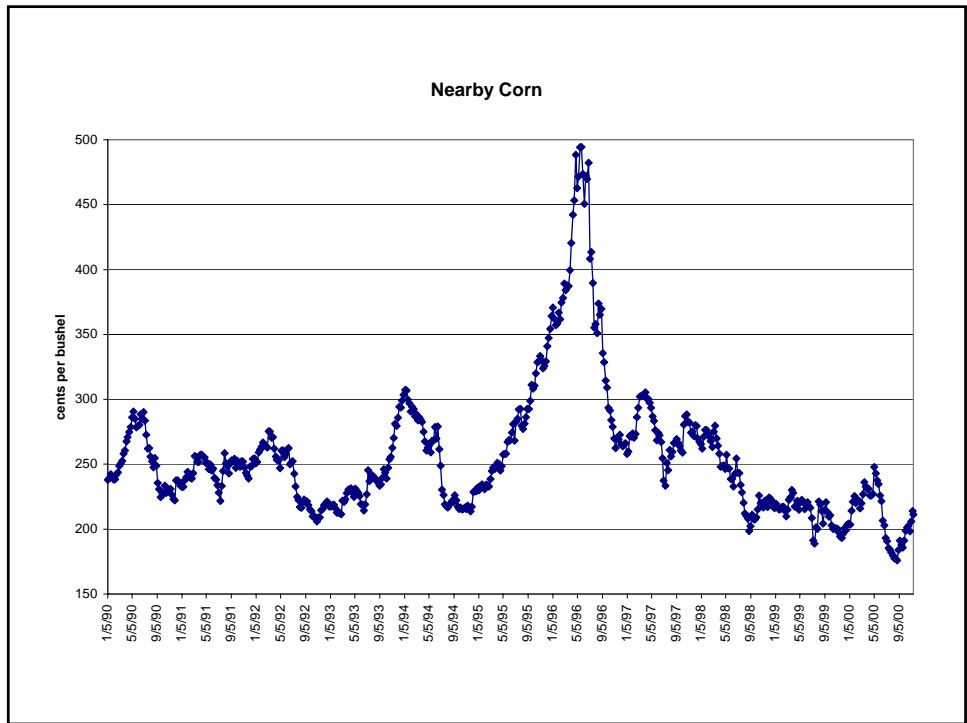
- Speculators  
Care about futures prices, and try to profit as futures prices change. Often a pretty short planning horizon.
- Hedgers  
Care about relative prices. Look for price protection by developing a position where losses in one market are offset by gains in another market.

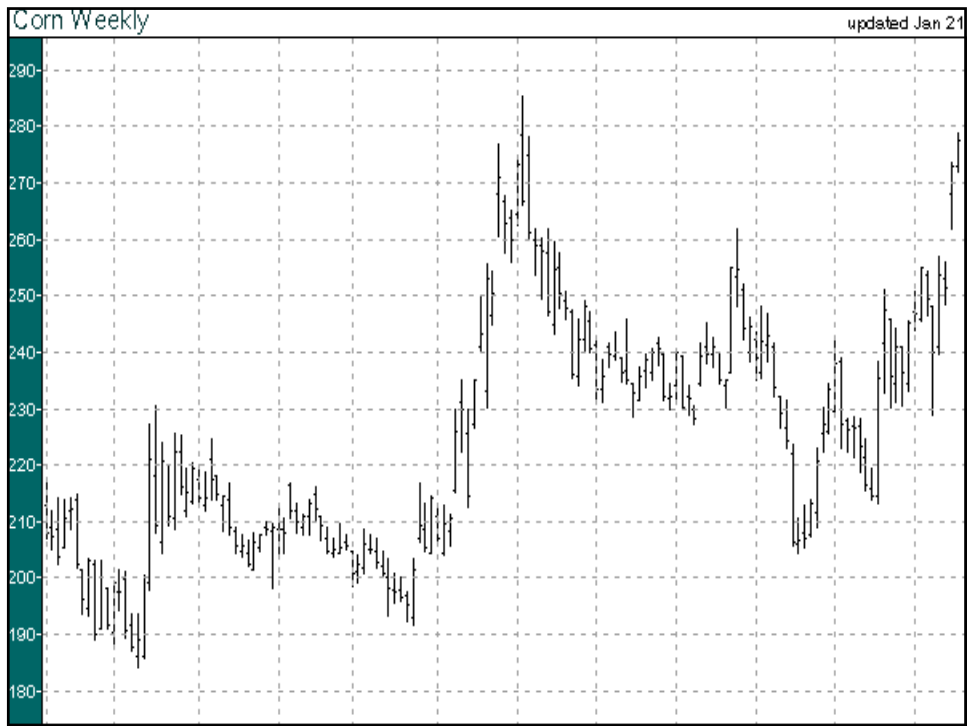
# FUTURES CONTRACT

- Legally binding commitment to make or take delivery of some commodity on a predetermined date at a negotiated price
- Everything except price is standardized:
  - Quality
  - Quantity
  - Delivery location
  - Delivery date











How are grain prices determined?

LOCAL ELEVATOR:

Grade Grain  
Condition Grain  
Store Grain

**Reveal the first public price for grain**

SUBTERMINAL ELEVATOR:

Linked to local elevator by rail, barge, or truck  
Often do not buy directly from farmers  
Major function is to concentrate grain into large shipments

**Reveal second public price for grain.**

Basically the local elevator price plus transportation and handling costs.

TERMINAL ELEVATOR:

Sell to export markets and processors. Do not buy from farmers.

**Reveal third public price for grain.**

Sub-terminal price plus transportation and handling costs.

EXPORT TERMINAL ELEVATORS:

Very concentrated industry. Over half of the U.S. export capacity is owned by Cargill, Bunge, and Louis Dreyfus.

**Offer the export price** to compete in the international market.

## Futures Market

- Sends price signals to the entire system
- Actively used at all levels of the grain market chain EXCEPT the farm
- Is unique in its application of financial leverage

# FUTURES CONTRACTS

- Traded on margin
- Marked to market daily
- Allow for offsetting legal obligation

Date	Price per Bushel	Action	Margin Action	Account Balance
Initial margin = \$500				
Maintenance margin = \$350				
17-Jan	\$2.50	Buy July corn	Deposit \$500	\$500
18-Jan	\$2.48			\$400
19-Jan	\$2.46			\$300
			Margin Call \$200	\$500
20-Jan	\$2.47			\$550
21-Jan	\$2.40			\$200
			Margin Call \$300	\$500
24-Jan	\$2.43			\$650
25-Jan	\$2.45			\$750
26-Jan	\$2.49			\$950
			Withdraw \$450	\$500
27-Jan	\$2.51			\$600
28-Jan	\$2.55	Sell July corn		\$800

## Margin Management

- Individual traders margin accounts are managed by their brokers.
- The brokers are held accountable for their customers positions in the futures markets.
- Minimum margins are set by the exchange. Brokers may require larger margins from customers.
- Brokers may require traders to post more than their margin requirement in their accounts.
- Margin accounts do not earn interest. However, money can often be moved between a margin account and a money market account

## Market Participants

- Floor Brokers:
  - Largest group of traders in the pits
  - Fill orders for outside speculators or hedgers
  - Responsible for filling orders rapidly with little or no price concession
  - Some take orders from several firms, others specialize

- **Professional Speculators:**

- Mostly trade for their own account
  - **Scalpers** – always presenting a bid and an offer, do not hold positions long and almost never have positions overnight, buy and sell constantly, MARKET MAKERS
  - **Pit Traders** – Larger positions and hold for a longer period of time, typically do not hold positions over night, try to anticipate large orders
  - **Floor Speculators** (day to day scalpers) – Take huge positions and hold for several days, POSITION TRADERS, often deal in multiple markets, deep pockets and can take or make delivery  
THUS WATCH CASH MARKETS

- **Non-professional Speculators**

- **General public** – Largest single group of traders
  - Place orders with account executives or associated persons at local brokerage houses
  - Some make their own trading decisions, some trade on the advise of a broker
  - Some join a club or commodity fund
  - Typically hold:
    - » 25 – 30 percent of financial market positions
    - » 30 to 50 percent of grain positions

## Facilitators of Public Trade

- Associated Parties:
  - Futures Commission Merchant (FCM)
    - Firm or person soliciting outside orders
    - Brokers and account executives
    - Must register with the Commodity Futures Trading Commission
    - Certified attesting to their integrity

- Commodity Trade Advisor (CTA)
  - Individual or corporation who advises others regarding trades
  - Provide information for pay
  - May advise or manage individual discretionary accounts, commodity pools, or FCM's
  - CANNOT POOL INDIVIDUAL INVESTORS INTO A SINGLE ACCOUNT
  - CTA's must register with the CFTC

- **Commodity Pool Operator (CPO)**
  - Solicits and pools together funds from several traders so risks and returns are shared
  - Many pools hire a CTA for advise
  - CPO's must register with the CFTC and the SEC