



FUTURES TRADING

BUYING FEEDER CATTLE ON THE FUTURES

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Characteristic of the cattle business, long and violent periods of liquidation and economic depression usually are followed by rapid price recovery. Boosted by a continually inflating economy, cattlemen, the meat industry and consumers often are shocked at the rapidity and magnitude of price recovery.

The commodity futures market reflects the slow realization of the magnitude of price recovery in the cattle industry as herd build-up begins. On such a recovery market, distant commodity futures contracts often lag behind current cash markets and outlook forecasts. The commodity futures market often responds timidly to changed supply situations in the distant contract months, although the near contract trading months may approach pandemonium.

Understanding and anticipating this response can be used to advantage by feedlots, custom feeders and stocker operators. For example, during August and September 1978, the October and November feeder cattle futures contracts were \$2 to \$8 per hundredweight below the cash market. Feeder cattle supplies were down 10 to 12 percent from year-ago levels. Rangeland response to recent rains was allowing producers to begin restocking cow herds. Higher feeder cattle prices were expected in the spring and good small grain winter pasture conditions were anticipated. Cattlemen needing

fall feeder-stocker cattle could not expect much decline in feeder cattle prices during October and November.

To get 400- to 600-pound feeder cattle, buyers had to be very aggressive. Large numbers of quality feeders had not been on the market. To wait for a lower cash market into mid-October or November seemed a high-risk proposition.

Under such conditions, when location of quality feeder-stocker cattle becomes difficult and expensive, using the commodity futures market to buy cattle may be the best alternative available. A par delivery unit on the feeder cattle contract is 42,000 pounds of about 70 Choice feeder steers averaging between 550 and 650 pounds. Each lot is inspected, graded and weighed by a USDA grader. Most producers receiving delivery of feeder cattle have been satisfied with the quality and uniformity of the lots, some even pleasantly surprised.

How To Get Delivery

A buyer or long hedger (or speculator) may receive delivery by holding the earliest bought, long contract. That is, the long position or "buy" contract has been held longer than any other long, open position. When the sell trader or short hedger decides to deliver, the earliest purchased, long-contract holder will be notified of the delivery.

A "long" position on the futures market is established when the trader buys a contract and

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the product (in this case feeder cattle) is owed to him. A "short" position on the futures market is established when the trader sells a contract and owes the product to the market.

Delivery usually is made at the decision of the seller. The buyer or long trader, however, can force delivery by holding the contract beyond the maturity date. The maturity date or last trading day of a contract is usually the 20th day of the contract month.

Delivery — Where?

Delivery of cattle can be made at any of 11 locations. Deliveries are permitted at Omaha, Nebraska; Sioux City, Iowa; St. Paul, Minnesota; Greeley, Colorado; Kansas City and St. Joseph, Missouri; Dodge City and Wichita, Kansas; Oklahoma City, Oklahoma; Amarillo, Texas; and Billings, Montana. A buyer needs to know the various rate charges from each of these delivery points to the desired destination point and have transportation available upon notification of delivery.

The buyer cannot specify where delivery will be made. This is the decision of the seller or short hedger. If the delivery is not made to Omaha or Sioux City (the only par delivery points), the delivered lot will be discounted either 50 or 75 cents per hundredweight. Therefore, the buyer or long hedger will be compensated this much for cattle not received at one of the par delivery points.

Delivery — When?

On the first day of the contract month, deliveries may begin. For example, deliveries on the August 1978 cattle contracts could begin August 1. There are two exceptions to the first-day-of-the-month rule. Delivery must be on a business day — Monday through Thursday. Delivery day must not be a holiday or the day preceding a holiday. Delivery days extend six deliverable days beyond the final trading day of a contract.

Basis Consideration

Basis is a very important decision-making tool. The long hedger needs to understand and use basis even if delivery is to be taken. Basis is the difference between the local cash price and the futures market price on market day. For example, if the futures price for feeder cattle is \$63 per hundredweight and the local cash market price is \$65 per hundredweight, the basis would be \$2 per hundredweight. If the futures price is less than the cash price, the basis is added to the original futures contract value as shown in Example 1.

Example 1. Feeder Cattle Long Hedge

Futures Market			Cash Market		
			<i>Time of Hedge</i>		
Bought October contracts at \$60/cwt					
			<i>Market Day</i>		
Sold October contracts at \$63/cwt			Bought feeders on cash market at \$65/cwt		
			<i>Net Price</i>		
Futures Contract Price	± Basis	= Net Price	Cash Price	± Futures Profit (Loss)	= Net Price
\$60/cwt	+ \$2/cwt	= \$62/cwt	\$65/cwt	- \$3/cwt	= \$62/cwt

Example 2. Feeder Cattle Long Hedge

Futures Market			Cash Market		
			<i>Time of Hedge</i>		
Bought October contracts at \$60/cwt					
			<i>Market Day</i>		
Sold October contracts at \$65/cwt			Bought feeders on cash market at \$63/cwt		
			<i>Net Price</i>		
Futures Contract Price	± Basis	= Net Price	Cash Price	± Futures Profit (Loss)	= Net Price
\$60/cwt	- \$2/cwt	= \$58/cwt	\$63/cwt	- \$5/cwt	= \$58/cwt

In this example, with a basis of \$2 per hundredweight and the cash market higher than the futures, the basis must be added to the original, futures-hedged position to get the \$62 per hundredweight net price actually paid for the feeder cattle. In other words, \$3 per hundredweight was made on the futures trade because the contract was sold for \$3 per hundredweight over the buy price. If the \$3 per hundredweight profit is subtracted from the cash purchase price of \$65 per hundredweight, the same \$62 per hundredweight outcome is obtained.

Had the futures price for the feeder cattle been \$65 per hundredweight and the cash market price \$63 per hundredweight, the basis would be a negative (-) \$2 per hundredweight. The basis would be subtracted from the original futures hedged contract value if the futures price is more than the cash market price. This is shown in Example 2.

One may question whether basis is important if delivery is going to be taken. Although the original intent may be to force delivery, the manager should be flexible enough to continually examine his position. For example, if the average transportation costs from the futures delivery points to the desired final destination are higher than the basis, cancel the futures

hedge by selling off-setting contracts and buy feeder cattle locally if possible. This example is simplified. Quality and weight adjustments also should be considered. However, basis is important in making the final decision to force delivery or to cancel the futures position and buy the cattle locally. If basis is more than transportation and location costs, take delivery. If transportation and location costs are higher than basis, buy feeder cattle on the local cash market.

Accepting Delivery

In deciding whether to accept delivery of feeder cattle, the manager compares marketing costs on the cash market to marketing costs on the commodity futures market. Cash market costs that should be considered include the order buyer's fee or location costs, transportation charges and quality discounts if there is a variation in grade and shrinkage. Futures market costs to consider include basis, transportation charges, quality discounts specified by the futures market, par delivery discounts of the futures market and shrinkage.

A self-explanatory decision guide (page 4) has been developed to simplify deciding whether or not to accept delivery of feeder cattle.

Market Safeguards

Because the commodity futures market offers a reasonable alternative for purchasing cattle during periods of short supply, the number of long hedges and forced deliveries may become excessive. There are safeguards to insure that all contracts can be honored, since the short side of the contract probably will be held by a speculator not owning cattle.

The Commodity Futures Trading Commission (CFTC), the regulatory arm of commodity futures, monitors the traders. The CFTC determines the number of large versus small traders, whether traders are hedging or speculating, and the balance of short hedges versus long hedges. This gives some indication of the demand for delivery and how easily delivery can be made. The information on this open interest is available monthly in a CFTC information sheet entitled "Commitment of Traders."

There are some built-in flexibilities within the trading rules of the Chicago Mercantile Exchange (the exchange that trades feeder cattle futures). For example, if long hedges become excessive to the point that delivery capability may become questionable, trading can be limited to contract liquidation only. This means that no new contract can be made. Trading is limited to off-setting a position already held.

The Chicago Mercantile Exchange (CME) also can expand the delivery period if deliveries become excessive. An October contract delivery requirement, for example, could be extended through November if necessary. This would allow the short speculators a chance to locate, purchase and deliver cattle of the required sex, weight and quality.

If anyone should try to abuse the market by gaining control of the long or buyer side, the CME could increase the contract margin requirement to 100 percent of the value of the contract. Since margin requirements usually fall within 5 to 8 percent of the contract value, this could become an effective deterrent to such predatory action.

Conclusion

The commodity futures market can be used effectively to purchase uniform, high quality feeder cattle. At times when the basis is larger than transportation costs, when cattle are unattainable or location costs are excessive, buying feeder cattle via the futures market may be a reasonable alternative. Before employing such a tactic, however, the cattleman should have a good working knowledge of commodity futures trading.

Accepting Delivery Decision Guide

Information Needed:	\$ per cwt
1. Market day basis (Cash — futures)	_____
2. Transportation costs from futures delivery point	_____
3. Transportation costs for purchased cash feeders	_____
4. Futures market quality discount (number of head) (cwt/animal) (\$ different Choice vs. Good) cwt per contract	_____
5. Cash market quality discount (number of head) (cwt/animal) (mkt. \$ dif. Choice vs. Good) cwt per contract	_____
6. Order buyer fee or location costs	_____
7. Par delivery discount	_____
8. Estimated shrink (shrink %) (\$/cwt)	_____

Delivery Acceptance Calculations

- A. $\frac{\text{_____}}{\text{(6) order buyer fee}} + \frac{\text{_____}}{\text{(3) transportation}} - \frac{\text{_____}}{\text{(5) cash discount}} + \frac{\text{_____}}{\text{(8) shrink}} = \frac{\text{_____}}{\text{marketing costs on cash market}}$
- B. $\frac{\text{_____}}{\text{(1) basis}} + \frac{\text{_____}}{\text{(2) transportation}} + \frac{\text{_____}}{\text{(4) futures discount}} - \frac{\text{_____}}{\text{(7) par delivery discount}} + \frac{\text{_____}}{\text{(8) shrink}} = \frac{\text{_____}}{\text{marketing costs on futures}}$
- C. If A is *greater* than B, accept future delivery.
- D. If A is *less* than B, lift hedge and buy on cash market.

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