Section II
Basic Pricing Tools

Chapter 13: Hedging vs. speculation

Learning objectives

- Understand the difference between hedging and speculating
- Who hedges?
- Speculation: good or bad?
- Who speculates?

Key terms

Hedging: To buy or sell a futures contract on a commodity exchange as a temporary substitute for an intended later transaction in the cash market.

Speculation: The holding of a net long or net short position for gain, which is not a normal part of operating a business.

Traders of futures and options contracts are either "hedging" or "speculating." Both hedgers and speculators play important roles in the market. While both are important, Commodity Challenge emphasizes the use of futures and options for risk management purposes (hedging), and not for speculation.

We need to understand the difference between hedging and speculation.

Hedging

The term hedging refers to the commercial use of futures (and options) contracts as commodity pricing and risk management tools. A hedger is someone who buys or sells futures contracts as temporary substitutes for intended later transactions in the cash market. Two simple examples of hedging include a grain elevator and a hog finishing operation.

Grain elevators post bids to farmers and buy grain nearly every day. When a grain elevator buys 10,000 bushels of corn from a local producer, they face the risk that market prices will fall before they sell the

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corn (to an exporter, ethanol plant, etc.). To protect against falling prices, the grain elevator will hedge price risk by selling two corn futures contracts (5,000 bushels per contract) at the Chicago Board of Trade. The elevator has no intention of delivering corn to the CBOT – the futures position is held until the physical corn is actually sold. When a cash sale of corn is completed, the futures contracts are bought back.

Hog finishing operations feed a large amount of corn. If corn prices increase, their input costs increase, making the business less profitable. To hedge against rising prices, the hog finisher could buy 5 contracts of corn futures (25,000 bushels). The hog finisher has no intention of taking delivery on these contracts – they are simply a substitute for cash corn purchases that will be made in the months ahead. As physical corn is purchased to meet hog feeding needs, futures contracts are sold.

As these examples illustrate, hedging with futures is a useful risk management tool for producers. Hedging serves several important purposes:

- Hedging reduces price risk. Grain buyers (the hog operation) and sellers (the elevator) can use the futures market to protect themselves against price changes.
- Hedging separates buying and selling decisions. Note how the grain elevator did not have to make a quick decision about where to sell the physical corn.
- Hedging gives greater freedom for action. The hog finisher did not need to buy and store large quantities of corn to hedge his price risk.

These examples illustrate two basic types of hedges used in the futures market; the short hedge and the long hedge. A short hedge involves the sales of futures against cash ownership (e.g. the grain elevator selling futures against a purchase of corn). The short hedge protects against falling prices. A long hedge involves the purchase of futures contracts against cash market sales, or input needs (e.g. the hog finisher purchasing futures to hedge input costs). The long hedge protects against rising prices.

Who hedges?

For most companies that trade or process grain - elevators, processors, and exporters - hedging is standard operating procedure. That means that every bushel of grain purchased is hedged with the sale of futures contracts, and every sale of cash grain is hedged with the purchase of futures contracts. Hedges are placed regardless of market opinion! These firms seek to profit from grain handling and processing margins, and not from speculating on price changes.

Grain producers and food manufacturers are also hedgers, but their hedging activities are more selective and based on price expectations.

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Speculation

A well-functioning futures market needs speculation. Speculation adds liquidity to the market, and liquidity allows hedgers (and all traders) to buy or sell futures contracts with little price effect. Speculation provides liquidity, and liquidity reduces hedging costs.

A speculator can be defined as someone who buys or sells commodities for profit and, unlike a grain elevator, their activities are not a normal part of operating a business. Speculators try to "buy low and sell high" (or vice-versa) to make a profit.

Many people will say that speculation is gambling, but there is a clear distinction. Gambling deals with make-believe risks. It is a form of entertainment. For some people, playing poker for money or betting on ball games are amusing activities. These make-believe risks, and the gamblers who take them, serve no economic purpose (except, of course, for the casino).

Unlike the make-believe risks in gambling, commodity price risks are real. Changes in weather, economics and policy affect prices. The speculator freely accepts these risks from hedgers. By taking these risks, speculators play an important role in commodity markets, and in the economy.

When thinking of a speculator, instead of the image of a gambler, think of an entrepreneur. This is a better comparison – entrepreneurs are risk takers whose role is good for society.

Is speculation bad? Public criticism can be heavy. The objection to speculation generally centers on three beliefs, (1) speculators manipulate market prices, (2) speculation causes frequent and unwarranted price fluctuations and, (3) speculation depresses cash prices. Does the evidence support these beliefs?

Speculation clearly adds to the volume of futures trading, and a number of studies have explored the impact of futures trading on cash prices. Most studies show that futures trading has a stabilizing influence on cash prices. Why would futures trading stabilize a cash market? More futures trading leads to more market price information, and this information is spread quickly to all players in the market. More information allows buyers and sellers to make more informed decisions, and the end result is cash prices that more closely represent supply and demand.

Who speculates?

Speculators come in all shapes and sizes, from individuals trading for their own account to professionally managed commodity funds. Managed commodity funds (aka managed futures) are managed in ways similar to a stock or bond fund. Money is pooled from a broad number of individual investors. Professional traders leverage the money and actively trade the market, sharing profits and losses with investors (net of management fees, of course).

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The past decade has seen the emergence of a new type of commodity speculator; the passive, long-only investor, sometimes called an index speculator. This new type of commodity speculator might include hedge funds and pension funds. Their buy and hold strategy is a way to protect against inflation.

Further reading

Self-Study Guide to Hedging with Grain and Oilseed Futures and Options (handbook), CME Group, April 2012 http://www.cmegroup.com/trading/agricultural/self-study-guide-to-hedging-with-grain-and-oilseed-futures-and-options.html

10 Reasons to Invest in Managed Futures (handbook), CME Group, April 2013 http://www.cmegroup.com/education/files/RT-177_WhyMFSS_HR.pdf

Exercise #13

Go play the game!

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