Part IV

Experiences in the Practical Use of Futures Contracts in the Marketing of Livestock
An International Grand Champion-Modern
Financing Live Beef Cattle Futures Contracts

by
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For the year ending September, 1965, livestock feeders in California placed 2,319,000 cattle on feed. During the same period there were 2,282,000 cattle sold out of feed lots. If we assume an average market value of about $200 per head, sales out of feed lots during this 12 month period generated about $455 million.

Our feed lots have continued, particularly in the last few years, to feed about 1,000,000 head of cattle at all times. Gross sales of slaughter cattle should approximate sales made during 1965. Our feed lots have continued to decline in numbers, but increase in capacity. As of October 1, 1966, we had remaining 531 feed lots with capacity of 1,905,000 head of cattle, that is, an average capacity of 3,600 which isn't too meaningful. On the above date, there were 1,094,000 animals on feed. We usually see our feed lots stocked with 850,000-1,200,000 head or 50-65% of capacity. Based on these figures, it is a reasonable conclusion that livestock feeding in California is both a substantial business in dollars and numbers of animals involved, and is a business that is operating the year round on a fairly high level of capacity, which is probably not the case in some of the other cattle feeding areas.

Of further interest to people is that California is about 50% deficient in producing the livestock needed for our consumer market. She is also 50% deficient in producing the feedstuffs for our great cattle, dairy, and poultry enterprises.

The Bank of America has had a long involvement with California's agriculture. In the last five years, for example, branches have annually loaned somewhere between $250-$400 thousand
FUTURES TRADING IN LIVESTOCK

to borrowing customers who are in the cattle business, that is, our total loans made throughout the year to range outfits, stocker cattle operators, and feeders. I think this year we will wind up with something around or short of three million dollars. These fluctuations in loans are mostly accounted for by price levels and numbers of cattle on feed.

Because of all these things, we enthusiastically endorse the idea of price insurance as it is evolved by producers' through live cattle future contracts. Because of our historic leadership in financing agricultural production in the state, because of the scale of the magnitude of this feed lot industry in our state, and because Californians eat more beef per capita than the people of any other state in the nation, production is subject to seasonal fluctuations causing scarcity and abundance of supplies of livestock and livestock feedstuffs. Consequently, on January 11, 1966, just a few months after active trading began in West Coast live cattle futures contracts, we issued a policy letter, and abbreviated instructions to all our agricultural branches on the subject of "Live Cattle Futures Contracts."

I would like to tell you the basis on which we finance live cattle futures contracts. First, we have an understanding that we will meet all the initial margin requirements, and all the margin calls that our livestock producer might run into. We do not place the hedges. We do not get into the mechanics of hedging. We want our livestock customer to select his own broker, they have this relationship, then they go into the commodity markets to do their trading. We supply the money.

The requirements are briefly these: We deal with known customers who finance their livestock operations through us. Our producers go voluntarily into the market to hedge their position but not to speculate; that they be on top of the futures market in addition to being a livestock operator, either a feeder or a cattleman; that they be experienced cattlemen, and by this we mean someone who has had good experience, not bad experience; that they have some provision for feeding out their cattle, whether they be stockyard cattle at the moment, or whether they be in a feed lot; that they are willing to assign their interests in the hedging accounts which they have with their brokers. The
EXPERIENCE IN THE PRACTICAL USE

brokers must agree to supply us with certain reports to keep us informed about what is going on in that account.

Now, the reports we ask the broker to give us are these: we want a confirmation of the initial orders to brokers on what our client has instructed them to sell in March, April, etc. We want monthly settlement reports when contracts are closed in order to determine how our producers came out. This is required because we hold notes, and we want proceeds to pay off our loans.

We have another document that is called a security agreement, an assignment of hedging accounts, which have been approved by our legal department. This is an assignment that is acknowledged by the broker. It simply tells us that brokers are aware we have an interest in the proceeds which build up in this margin account, hopefully, that is.

We in the bank have been making loans on storable commodities for many years, utilizing warehouse receipts and other like instruments. However, as bankers, we are frank to admit that we are literally babes in the woods when it comes to dealing with futures contracts in the commodity markets. While we have our share of speculators and hedgers on the West Coast, our bank has never been called upon before to finance non-professionals, located throughout California, in their ventures into the commodity markets.

When trading in live cattle futures contracts began late in 1964, many of us were quite excited about the possibilities this new tool offered the livestock industry. We encouraged all of our major livestock feeder borrowers to sell a few contracts, so as to gain some experience in handling this new weapon. Unfortunately, as Ken Monfort and others have touched on, several things combined to make these initial ventures less successful than was originally hoped. Our feeders, cattlemen, bankers, small packers, and even some broker representatives were a long way from being intimately familiar with the whole process of getting into this kind of market. There was poor advice, inadequate timing, incomplete counseling, and certainly, indecisive action. Concurrently, with all these things, you would think this would be enough to happen to an individual; but the West Coast cash market and the Chicago futures market didn’t move
FUTURES TRADING IN LIVESTOCK

sympathetically. When the time came to close out these positions, and you remember that we were indecisive, there was a loss on both the futures and the cash market. These experiences were financially disastrous to some people. These experiences added to the clamor that arose for a West Coast delivery point. Late in 1965 we got a Western contract and a western delivery point which called for delivery in Artesia, California, which is near Los Angeles. In the year that has gone by, there has been a marked decline in trading in the Western Contract. Many of our livestock people are back trading in Chicago, in spite of their poor experiences of a year and one-half ago. At the same time, all of them are hopeful, for an improved Western Contract.

It is apparent that a campaign must be mounted that strikes at several fronts if futures trading in live beef cattle is going to contribute anything substantial to the livestock industry on the West Coast. We need an improved contract. We need to educate cattlemen. We need to educate the bankers a great deal more if they are going to be of real assistance to their customers. More advertising is needed to tell about the advantages, and to overcome the inherent suspicion that is always lurking whenever someone apparently offers a “free lunch.”

What has been our experiences to date? Frankly, far poorer than we had hoped. Our branches were canvassed the first two weeks in October. They were financing only about 250 contracts on the basis outlined in our policy letter. Additionally, other credit-worthy customers who have sold some 225-250 contracts were financed in other ways. Hence, on the 15th of October there was probably no more than $400,000.00 outstanding in the form of commercial and secured loans made for the purpose of meeting margin requirements. Since our lending policy was put into effect, I estimate that we have lent somewhat less than one million dollars to livestock people to meet their needs for margin requirements.

In the face of such poor trade usage, what is the Bank of America’s opinion about live cattle futures? Since I am also representing the Agricultural Committee of the California Bankers Association, I am speaking for all the major California bankers which are interested and active in agricultural banking.

[150]
EXPERIENCE IN THE PRACTICAL USE

We are basically in favor of programs that would tend to stabilize a business such as cattle feeding which up to now has been a speculative business, and which would provide some future price insurance for sellers of livestock inventories. We will continue to review and endorse those programs which (1) are acceptable to the principals in the commodity involved, and (2) which offer some opportunity for banks to legally extend their services to livestock customers in a mutually helpful and profitable manner.

In the last several weeks the exchange has been offered many suggestions to improve the marketability of the Western Contract. It is our conviction that the existing contract should be changed to reflect the desires of the trade. Without the strong support of livestock feeders and packers, your Western Contract performs no function. An industry generating sales of 500 million dollars would seem to have great potential for methods which would aid the marketing process, and reduce the risks from price fluctuations. You can count on us to do our part, but first, the livestock people, whose livelihood depends on their decisions, must be enthusiastic about the contribution that futures contracts can make to their business.

Since the study conference held on November 30, 1966, at which Minger’s paper was given, the Western Cattle Futures Contract has been discontinued. The reason for its discontinuance was explained by Mr. Harris—President of the Exchange, in the following statement: “As the market matured it was apparent to all that one central market, heavily traded and fluid, would best serve the industry. Modern communication facilities have made it possible and desirable for all hedgers to use one market with sufficient speculation to make it liquid at all times, so hedgers may have easy, instant and economic entry and egress. Studies of correlations between various U.S. regions indicate it is feasible to hedge cattle produced in any area. On July 7, 1970, the Board of Governors of the Chicago Mercantile Exchange voted to add Guymon, Oklahoma as a delivery point for live cattle futures contracts, and Peoria, Illinois was designated as a delivery facility when new futures contracts are listed. Beginning with the February 1971 futures contract for live hogs, Peoria, will

[151]
FUTURES TRADING IN LIVESTOCK

also serve as a par delivery point. The selection of Guymon, Oklahoma was dictated by an increase in the production of feed grain in the Southwest, especially in the Texas-Oklahoma panhandle where about 25 per cent of the nation’s fed cattle were finished within a 150 mile radius of Guymon. Peoria was selected to facilitate deliveries from the States of Illinois, Indiana and Eastern Iowa. Effective with August 1971 cattle contract, the governing body of the Chicago Mercantile Exchange voted to eliminate Kansas City, Missouri, as a delivery point because of the infrequency of futures contract deliveries made there. Omaha, Nebraska was decided upon as the new par delivery point effective with the August 1971 contract in the event that the Chicago stockyards might be closed for cattle as it was for hogs.