A Cattle Feeder Views Futures

by
Kenneth Monfort
Greeley, Colorado

First of all, about two and one-half years ago I attended another meeting of this group where I very eloquently told you that live cattle futures would not work, that you should concentrate on beef futures. I trust that your knowledge of the trading volume has proven how erroneous my judgement was at that time.

The next part of my case in establishing myself as an expert and, therefore, worthy to talk to you took place shortly after the opening of trading in live cattle. After careful and complete analysis by me, I decided that I, personally, would buy some futures. I, therefore, became part of the lifeblood of the free enterprise system — a speculator.

As often happens with speculators, the market went against me. However, it did not worry me since, after all, I was an expert and had studied the specifications for delivery very closely. I came to the startling conclusion that I could, indeed, get myself out of the mess I was in by taking delivery, and having the cattle custom killed. This part of the story is history. The cattle did not yield or grade anywhere near what they were suppose to have, so I did not do very well economically. I mentioned this to several people associated with the exchange, and everyone I ran into said, “there was one way to recuperate this loss.” I decided to sell some cattle. In this way, I would let someone else take delivery of the cattle when I sold them. The time came for this to happen, and the market went against me. So, I called an order buyer in Chicago, and I suggested that he should buy me some cattle to deliver on this sale I had made. I had it figured out that they should cost me about 25¢ per pound. He
said that they would cost me well over 26¢. I was in the process of telling him how ridiculous he was when he said, let me tell you what happened. Last month some nut took delivery on some cattle, and he raised so much hell that he succeeded in completely revamping the whole thing. I never had the nerve to tell him, I was the nut that had raised hell. Therefore, whether I am qualified to speak here or not, I think the Exchange owed me the privilege to express myself. Now, let me talk about hedging and how it affects the cattle futures.

The cattle feeding business has historically been a high risk business. Many of us have tried in the past, and will try in the future, to minimize their risks by buying and selling on a consistent basis. In this way they will try to get the average of the market and afford themselves some protection from the violent swings of the market. There are many risks in the cattle business! Besides the tremendous price gambles and fluctuations, the feeder is faced with risks on feed costs, sickness, death losses, adverse weather conditions, tight money, etc. Recently, we have learned of new problems, hide quotas, consumer boycotts, and consumer resistance to buying high priced cuts. In short, the cattle feeding business has enough risk inherent in it even without our price risks to be a natural for a hedging operation. If we, as feeders, can pass on some of our risks to the professional risk assumers, the speculator, it makes good sense. Now, just what is the potential of hedging in the cattle business?

If we count only cattle in the feed lots of this nation, we see a potential of some eight million head of cattle. This translates into a potential of 320,000 contracts. This means that at this time only 1 1/2% of the potential is currently hedged, if we assume that all of the sales are hedge sales. In other words, the potential of this market has barely been tapped. The potential is there. This potential is limited only by the ability of the feeder, the willingness of the feeder to use this market, and by the availability of risk money from speculators.

Let us now look at the decisions the feeder must make before determining that he should or should not hedge his cattle. Let us look at it in the light of the current market situation. Consider Greeley, Colorado, as the site of a mythical feed lot. A
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Feeder must decide what it will cost him to feed cattle. Currently, a 700 lb. steer will cost a feeder in Greeley, Colorado, around 26¢ per pound delivered to his feedlot. This figures out at $182.00 per head. Four hundred pounds of grain will cost roughly $100.00. Death loss and interest will amount to another $10.00, making a total cost for an animal at market time of $292.00.

The steer should be ready for market in April. The current April option, (Nov. 30, 1966) is quoted at around $27.40 delivered to Chicago. The feeder must figure a price relationship between Chicago and his own market. It would be silly for us in Greeley, Colorado, to figure how much it would cost to market steers in Chicago, since we never ship them there. We use as a basis, the historical average difference between the Chicago and the Greeley market during the month of April. We come up with a figure of $1.25 under Chicago. Therefore, our price, based on a $27.40 futures price, will be $26.15 in Greeley. Assume on a 1100 pound steer, we arrive at a figure of $288.00 which is $4.00 under our estimated cost on that steer. This is without adding the cost of our hedging operation.

Ten days ago, we had a considerably lower cost on our feeder steer and the hedge could be put on profitably. Maybe tomorrow this will again be possible. The feeder is faced with a day to day decision. He not only makes this decision when he buys his feeder cattle, but actually he must make such decision every day that he owns cattle. It is conceivable, for instance, that the cattle that we could profitably hedge today, could profitably be hedged three months from now, after they are through their feeding period.

In short, hedging provides a tool for the feeder who wishes to minimize his market risk, and assure profitability. It can be a workable and usable tool if the feeder is able and willing to figure his costs and relate these costs to the market on a day to day basis. What are the problems involved in hedging for the producer?

One of the apparent and acute problems involved in hedging is the additional amounts of money required. Cattle feeders have historically extended their borrowings to the maximum. Often times, their credit is based to a large extent on amounts borrowed,
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rather than on the risk. When this is the case, the feeder must decide whether that extra investment in margin for a hedging operation is justified. I realize, of course, that you might suggest that since the risk is lower, the banks should be more willing to loan additional funds. I couldn't agree more. I can give you a rather lengthy list of bankers who wouldn't agree with me. It is only fair to note that banks involved in significant cattle feeding lines of credit are as of now, not really familiar with the normal hedging operations, particularly, with hedging operations in the cattle business. These banks have for the most part done a remarkable job of financing cattlemen. It is the biggest growth industry in all Agriculture. I honestly believe that time will change the attitude of bankers with respect to hedging. Perhaps, in fact, a loosening of the current tight money situation would do this rapidly. It is hard to tell just how the banks would react if a surplus of loanable funds were made readily available.

Permit me to raise another point that I am sure you will hear more of this afternoon. This is the contracting of fat cattle by packers. The packers then hedge this commitment. Our packing plant in Greeley is currently involved in this type of operation to a rather limited degree. This has several advantages for the cattle feeder.

Firstly, he no longer must look at the day to day variations of the market. Secondly, he does not have to assume the risk on the differential between the Chicago futures market and the fat cattle market in Greeley. Thirdly, the packer is the one who must put up the margin money involved in the hedging operation. This allows the feeder to concentrate on producing the best possible product, and keeps him from being involved in, you might say, "playing" the market.

When the feeder determines to hedge his livestock, he is letting someone else assume the risk. He is also letting someone else assume the bulk of the profit if the market should turn out to be a profitable type of affair at the particular time.

I would like to close by telling you what I think about the future of the cattle industry. I have already established that I am certainly no expert. I believe that there are certain things happening in the cattle business that may be of interest to you.
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here. You have all heard of consumer boycotts, the higher price of food, etc. True, many food items have gone up, but let us look in particular at the beef situation. The same might apply to many other agricultural items. The current retail prices for beef are too low to allow everyone that has to handle that beef to make a profit. The price level is such that there are just not enough dollars to split between the retailer, the packer, the feeder, and the rancher for them all to cover their costs of production, let alone to make a profit. It is rather obvious that the retailer, the chain store if you wish, is in the best bargaining position for making a profit. Their profits are not higher than should be in my opinion. I wish they were higher. It would be easier to get along with them. The packing industry is next in line, and their profit picture is bleak. On the average, they are still sufficient to cover their cost of operation. Eventually it gets back to the feeder and the rancher to split what is left, and there just is not enough money to split so both operations can be profitable simultaneously. The rancher has consistently lost money for the last five or six years. He has stayed in business basically because his land values have inflated. He has been able to refinance his land. This is apparently coming to an end. The rancher is now faced with the prospect of being forced out of business. To make ends meet, he is selling too many of his brood cows and replacement heifers for slaughter. This is creating a small surplus of beef now, but it endangers future beef production potential. This cycle of the cattle business must soon end. We will see higher prices in the years to come, and we will very well see shortages of beef in the not too distant future. The consumers must soon realize that the cattle industry in America has been subsidizing them, and that this will have to stop if they are to expect the quality and quantity of beef to which they have become accustomed.

I hope higher prices will occur, in the markets of America, whether that market place be the Mercantile Exchange in Chicago, the A & P Supermarket in Teaneck, New Jersey, the auction sale ring in Dodge City, Kansas, or the feed lot in Greeley, Colorado.


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