Exchange Views of Speculation

Robert K. Wilmouth
President
Chicago Board of Trade
If I had to list the problems that commodity exchanges in general—and specifically the Chicago Board of Trade—will face during the year ahead, the subject of margins and speculation would have to rank near the top of the list. So I’m delighted to have this opportunity to talk about this Exchange’s viewpoint regarding speculation.

In discussing this subject today, I intend to focus on some of the problems which the Exchange faces on a daily basis regarding margins and speculation—my purpose being to make you more aware of these problems, and of the types of questions relative to them, which we are frequently asked, particularly by congressmen in Washington.

I can say without reservation that I have never previously seen in Congress as much interest in any subject as has been expressed in the area of speculation over the past several months—an interest fueled by the silver saga that occurred here and in New York during the fall and winter months of 1979 and 1980. Thus I have chosen a question-and-answer format and have listed several basic and simple questions regarding the subject of speculation. My reasons for selecting this type of format were twofold: first, by attempting to answer these questions in very simplified terminology, I intend to express this Exchange’s views of speculation. But secondly, I have the hope and expectation that as seminars such as this one develop, those of you who are far more knowledgeable in this area will be able to give some thought in the research you might be doing to some of the questions I pose.

One of the hypotheses which congressmen frequently make is that if, for example, in the silver crisis, the government had controlled margins—implicitly, if the government had imposed higher margins on silver during this episode—speculation would have been reduced. So the question that I find myself frequently forced to answer is: would higher margins reduce speculation? The answer that we have come up with says that it would reduce the transfer of speculative risks, that is, price risks, from the cash market to the futures market. This is so for two fundamental reasons. First, higher margins make that risk-transfer process definitely more costly for farmers, for country grain elevators, for merchants, for processors and exporters who have traditionally relied on this marketplace for protection against price risk via hedging. (Because we deal largely with the Senate Agricultural Committee and the House Agricultural Committee, I like to use analogies with respect to farming.) Secondly, I think it’s very safe to say that higher margins would certainly discourage individuals with venture capital from speculating. So the answer to this question is very simple but, hopefully, very effective.

Another question. Would higher margins make it more expensive to transfer price risks? Again, consider an example—the example of a country grain elevator that has just bought a half million bushels of grain from the farmer at harvesttime and has to store it until the spring or summer. To protect itself against the loss if prices decline, the elevator sells 100 futures contracts. If the margin requirement is, let’s say, $1,000 per contract, then that elevator must come up with $100,000. That’s a normal and reasonable cost of doing business, and nobody can really argue with that. But what if the margin requirement was increased tenfold? That may sound ludicrous to some of you, but that’s the number which some Washingtonians have come up with in some of the discussions I have had with them. If that’s so, then the elevator would need not
$100,000, but $1,000,000 for margin purposes. Even if a lender were able to provide that much credit, the added interest cost would certainly be a disincentive to hedge.

If higher margins are going to make hedging prohibitively expensive, the elevator will have to pay lower prices to farmers, or, conversely, charge higher prices to their customers, or do both, in order to have that adequate cushion against the risk of falling prices. Elevators, it seems to me, generally have more control over the price they pay for grain than over the price at which they sell grain. Farmers would almost certainly be among the losers if hedging grain were no longer affordable.

Another question that constantly pops up is one that all of you have a good academic answer to, but which is difficult to explain to someone on the street. Can’t hedgers who want to sell simply do business with other hedgers who simultaneously want to buy, thus eliminating the need for the middleman or, in this case, the so-called speculative investor? It is true that many futures transactions do involve hedgers taking opposite positions. But there are numerous times—and I guess the most noteworthy one which comes to mind is following harvest in the case of grains—when there are far more hedgers who want to sell than who want to buy, and there are other times when there are more hedgers who seek to buy than those who seek to sell. Therefore, without speculative participation, hedging simply will not work anywhere along the line.

Few in Washington like to listen to a lobbyist. Certainly most congressmen don’t. They want professional answers to their questions. Therefore, when, in a discussion on speculation, I hear the frequently asked question—“Can it be concluded then that speculative participation causes prices to be less volatile?”—I respond by citing professional sources. One example I refer to is Roger Gray’s study in which he says (though I’m not quoting him verbatim) that the most effective job of price determination is performed on those markets that have the most speculation. Another answer to that question lies, strangely enough, in an Advisory Committee formed initially when the CFTC was established in 1974-1975. That committee said effectively the same thing, though perhaps not in that specific terminology. Therefore, it seems to me that one can certainly conclude that speculative participation does cause prices to be less volatile. There is ample evidence—and I hope there will be more of it issuing from research seminars such as this one—that inadequate speculation in markets causes prices to be more volatile.

Often overlooked but nonetheless axiomatic in futures markets is the fact that net speculation and net hedging are at all times exactly equal and opposite. Participation by speculative buyers is greatest when the majority of hedgers want to sell; and participation by speculative sellers is greatest when the majority of hedgers want to buy.

Another question: is market liquidity the major benefit of speculative participation? We always use the simplistic story that if we don’t have speculation, we don’t have liquidity; and if we don’t have market liquidity, we might as well shut the doors because there’s no place for people to do business. I think the most conclusive testimony to the importance of market liquidity is the fact that, given a choice of markets in which to trade, hedgers consistently
prefer those markets in which there is the most active speculative participation. In such markets, hedging is more efficient and more effective.

One of the things we did on at least 15 occasions between September 1, 1979, and March 30, 1980, with respect to silver was to raise margin requirements. In fact, we consistently raised margin requirements across that period except on one occasion when we thought the market had peaked. We were wrong. We diminished margins for a period of about two days before we saw the error of our ways and once again increased margins. The question is: why would an increase in margin requirements discourage speculative participation? The answer: because higher margins would increase the capital investment needed to buy and sell futures contracts, and thus reduce the opportunity for an attractive return on investment. In this regard, individuals who invest in commodity futures transactions are not any different from anyone else who makes an investment. They seek the highest possible investment return they can get, consistent, of course, with the risks involved. When unnecessarily high margins make commodity investment less profitable, there will be fewer investors. Remember we are talking about—according to some congressmen, at least—the possibility of increasing margins as much as tenfold to diminish speculative investment. Again, I would have to say that market liquidity would surely suffer.

Historically, during periods when market conditions have dictated higher margins for purposes of assuring contract integrity, has speculative participation declined? Did that happen in silver? The answer is: yes. But I must “hedge” that answer somewhat by saying it is difficult to determine to what extent the decline was due specifically to the higher margins imposed, and to what extent it was due to market conditions which led to the raising of margins. Margin increases are generally a response to volatile and uncertain markets and to supply/demand conditions which, aside from the matter of margins, tend to discourage speculative futures trading. Many investors are simply unwilling to accept the degree of risk entailed in such markets.

What about the frequently heard contention that speculators aggravate major commodity price swings, both up and down? Again, relying on some statistics we have, we are safely able to say that no evidence supports that contention. In fact, not only does the evidence not support it, it says the direct opposite. Not only do fewer speculators participate in these kinds of markets (because of the risks previously mentioned) but frequently those speculators who do participate are on the opposite side of the market. They are net sellers when prices are rising, and net buyers when prices are falling. They temper rather than aggravate the price movement.

Let me cite two good examples: one, which I’ve used consistently since the day I came to the Board and which is well supported by statistical data, is the increase in soybean prices back in 1973 from just over $4.00 per bushel to more than $12.00 per bushel. As prices climbed throughout that period of time, speculators became net sellers, while the hedgers, who were seeking protection against prices going even higher, were predominantly net buyers.

Another case in point deals with a sharp increase in interest rates and correspondingly lower financial instrument prices which occurred during 1979 and 1980. From August 1979 to February 1980, speculators were net long in
Ginnie Mae mortgages, anticipating lower rather than higher interest rates. In contrast, during that period of time, hedgers who sought protection against steadily rising interest rates were continuously net short.

Next question: does this contradict the bandwagon theory about speculators and speculation? That theory—which maintains that relatively low margin requirements invite large numbers of speculators to rush into the marketplace during periods of sharply rising or falling prices—is contradicted by both logic and available evidence. Statistics show that speculators leave rather than enter the marketplace during such periods. The bandwagon argument also ignores the obvious and important fact that margins at whatever level they happen to be (high, low, medium) are at all times exactly the same for buyers as they are for sellers.

I have frequently said that speculation is necessary for market liquidity—that if we didn’t have liquidity, we would have to close shop and go home. That’s very true. But the other question that always comes back is: that’s grand, Mr. Wilmuth, but other than liquidity which you say speculation provides the marketplace, what additional benefits accrue from this “notorious, infamous speculator”? That’s not the easiest question to answer, but there are at least three answers which deserve mention.

First, and most obvious, participation by speculators facilitates this process of risk transfer which, after all, is what we are all about. In the absence of speculation or in the absence of enough speculation, individuals and firms in the cash market would have nobody to whom they could transfer that price risk. Such risk would thus somehow have to be incorporated into the price structure of a commodity and would, consequently, have an adverse price impact.

Secondly, hedging costs tend to be lowest in those markets having a large volume of trading. Speculative participation increases volume, which contributes to market efficiency. Many economic studies done here and elsewhere prove that very conclusively.

The last point—perhaps not quite as cogent as the first two—is that speculators serve as important messengers of market information and analysis, contributing to one of the most important functions of this marketplace—competitive price discovery. We talk often of our being an insurance exchange; that is, that customers who do business here use us for the same purposes for which they use their liability insurance, their property insurance, and the like. But sometimes we fail to recognize that one of the most important contributions this marketplace makes is competitive price discovery.

Speculators in the futures markets profit only to the extent that they are right about the direction and timing of price changes. They have a very strong and continuing incentive to evaluate and act on the latest information with respect to supply and demand. If they are right, they make money; if they are wrong, they lose money. It’s as simple as that. The fact that they have their own money at risk tends to make them very knowledgeable about what’s going on in a particular industry. I like to say there are two times when you can get crushed at the Chicago Board of Trade. One is if you come to work early in the morning about 6 o’clock and the other is if you go home about 1:15 p.m. At 1:15 p.m. many traders are leaving at the end of the trading day. At six in the morning,
many of them are arriving so they can make calls all over the world to find out what's going on, and discuss strategies or look at weather maps or follow USDA reports or whatever it happens to be. They are very knowledgeable, and that's important to remember.

There's a thesis, particularly from farmers and from some of their congressmen, saying that if speculators make money, this inevitably has to add to the final price of the commodity or to the products made from the commodity. The rebuttal is relatively simple. Some speculators make money, and some don't. But even if it were assumed that overall they realize a profit, we maintain that speculation contributes to lower rather than higher retail prices. It contributes to the existence of a narrower margin between a raw commodity and the finished product. The reason for this is that any net profits which could be earned by the speculator are considerably less than the amounts the various merchants and middlemen in the marketing chain would have to add to their marketing costs to protect themselves against uncertain and more volatile prices which would exist without speculation.

What about the fact that speculators somehow or other have a Las Vegas image? Unfortunately, some speculators do give that impression, in Washington and elsewhere. For example, four days after my arrival at the Board in 1977, farmers came with their tractors, congregated in front of the building, and said that we were nothing but a bunch of gamblers. That analogy has to be dispelled. It is very inaccurate and very unfortunate. A gambler is someone who, in the hope of making a profit, creates a risk. A speculator, although he too wants to make a profit, accepts a risk that presently exists; he evaluates it and then makes his decision. Take, for example, the risk that a given bushel of corn in storage may over a particular period of time decline in value. When speculators don't bear that risk, then somebody else must do so. A speculative investor, unlike a gambler, has the opportunity to arrive at his own profitability factor, and buy or sell or do neither on the basis of his own personal judgment. He can base his decision to buy or sell soybeans, for example, on his own analysis of whether and when he anticipates a change in price. He can invest according to whether he expects a price increase or decrease and that's a lot different from gambling. Summed up, a speculator in the commodity futures markets invests selectively. His investment decisions are not unlike those of someone attempting to decide whether and when he should purchase stocks or bonds. And just as the stock or bond investor serves a very necessary economic purpose by helping to provide capital for established businesses, so does the commodity investor serve a very necessary economic purpose by enabling businesses to better manage their price risks.

Another question frequently brought up regarding speculation and margins is: does active participation by speculators increase the danger of market manipulation? The answer is that speculative participation has exactly the opposite effect. Attempts to manipulate prices have historically occurred in those markets where there are a small number of participants, but not in markets where there are a large number of small participants. Actively traded markets in which no individual can unduly influence price are the best possible protection against manipulation being either attempted or successful.

One final question: would higher margin requirements provide additional protection against risk of contract defaults by speculators? There's always
concern about the possibility of defaults, and margin levels are continuously monitored and frequently adjusted in light of such a possibility. During the recent period when silver prices were rising to extremely high levels and then falling back down again, our margin committee met frequently and adjusted silver margins eight times. The point is: that committee can meet at 11 o'clock in the morning and make its decision by 11:30; we can poll the directors on the committee's decision by 1:30 p.m., announce the Board's decision, and then put the new margin level into effect the next morning. Not only do we monitor market volatility through our margin committee and through our Office of Investigations and Audits, but the clearing organizations of the individual brokerage firms also monitor it. At one time, we had $30,000 margins on silver, and some of the major brokerage houses had margins as high or higher than that during that period. Therefore, I think the issue is not whether margins should be increased from time to time as market circumstances change. In fact, they can be changed and they are changed. We have plenty of positive proof on this point, including a thorough study of margin changes over a five-year period. Rather, the issue is whether, at the risk of interfering with the very smooth, efficient, and effective functioning of the market, margins should ever be set higher than necessary to insure contract integrity. The answer to that question is: absolutely no.

Later today, Walter Brinkman will discuss the long-established system of daily marking-to-market and daily cash settlements, so I won't delve into those areas. However, in response to the last question regarding defaults, I believe the most convincing argument for continuing to permit this present system of margins to work is the fact that it does work. It always has, and it always will. No customer, hedger or speculator, has ever lost a cent due to a contract default on any regulated commodity futures exchange.

In sum, the participation of speculators in commodities futures markets can be compared to the use of engine oil in an automobile. Automobiles do not run on lubricating oil, but neither do they run very long nor very well without it; and neither do commodity markets run very long nor very well without speculators. Essentially, that is the best argument for their presence.

In closing, let me say that these questions I've mentioned are ones I face every day. And let me repeat that I'm hopeful that seminars such as this will help us get more definitive information on this topic of speculation.