Thomas A. Hieronymus

ECONOMICS OF FUTURES TRADING

For Commercial and Personal Profit
The fascinating world of commodity futures trading has long deserved an authoritative book to tell us "what it's all about" and how to trade effectively in the pursuit of profits. In this definitive work, Professor Hieronymus has fulfilled the needs of scholars, commercial interests, speculators and the investing public. It is written in a clear and readable style and assumes no prior knowledge or experience on the part of the reader as it guides him through the full complexity of market operation and evaluation.

ECONOMICS OF FUTURES TRADING is a college level textbook for a course in commodity futures markets and trading. Secondly, it is a "how it is done" and a "how to do it" book, to guide commercial people in the commodity trades and those who want to speculate in futures markets where the rewards can be spectacular. The combination of what markets are about and how to use them is necessary because one cannot really know what markets are about unless he knows how they are used. Neither can one succeed in the use of futures markets if he does not understand the economics behind the trading. And finally, it is an appraisal of the adequacy and effectiveness of the system in the performance of its economic functions. Professor Hieronymus, an acknowledged expert by both academic and commodity trade interests, has developed some notions about how markets ought to be run and regulated that differ from standard doctrine and procedure.

The salient points that, in a measure, describe the book and also reveal the biases of the author are:

1. Futures trading is an exciting game, the score of which is kept with money. There are important amounts of money involved so that the game is taken seriously. But, a game it is. The people who participate, including the commercials—the hedgers—appear to be first interested in the game itself and second, in the money.

CONTINUED ON BACK FLAP
ECONOMICS OF FUTURES TRADING

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By THOMAS A. HIERONYMUS

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DEDICATION

To My Teacher

The late L. J. Norton
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Preface

This book is designed to serve several purposes—probably more than can be reasonably expected. It is, in the first instance, a college level textbook for a course in commodity futures markets and trading. The subject matter is in an area almost totally neglected in college curricula, particularly in business and finance schools. There is a great deal of student interest but limited satisfactory literature and teaching expertise. Hopefully, a textbook will serve as the catalyst that will get greater inclusion and generate enough teacher confidence that more courses are offered. The manuscript has been tried on students and seems to have at least one thing going: they read it with minimum coercion. It begins at the beginning, includes the economic results of trading, and does not shy away from the complexities that are a part of the subject matter.

It is a "how it is done" and a "how to do it" book designed to be used by commercial people in the commodity trades and by investors in futures contracts. The combination of what markets are about and how to use them is compatible because one cannot really know what markets are about unless he knows how they are used, nor can one succeed in the use of futures markets if he does not understand the economics behind the trading. So, I have put them together and, hopefully, made them interdependent.

It is an appraisal of the adequacy and effectiveness of the system in the performance of its economic functions. Having put together the economics and the use of futures trading, it was but a short step to looking for things the matter with the system as it exists. Over the years, I have developed some notions about how markets ought to be run and regulated that differ from standard doctrine and procedure. Either much that is known about futures trading is not true or much that I think I know is in error. So, the book is a forum, and conflict is to be expected.
At the start I thought that the preparation of a manuscript would be fairly simple. Having knocked about the field of futures trading for twenty years and written fairly extensively, I thought that I could link together much that I had written with only a moderate amount of new work. Such was not the case. I found that much that I had done was in too much depth and detail or too applied and, more importantly, I found that many standard concepts—including some of my own—were difficult to reconcile and could not be fitted together into a coherent whole. I hope that enough concepts were modified that the material is internally consistent.

In looking back on the experience, some central points stand out. A statement of these before the beginning is useful in setting the reader straight about the biases of the author and, in a measure, describing what the book is about.

First, futures trading is a zero sum game. For every buyer there is a seller; for every long there is a short; the clearing house breaks even so that for every dollar made there is a dollar lost; the market is a balance of judgments so that for every good judgment there is a poor judgment. The markets are remarkably symmetrical. The symmetry turns up repeatedly as different aspects of trading are examined. The net hedged positions are a mirror image of the net speculative positions. Class interval tabulations of winners and losers among speculators form a nearly perfect normal curve. The amounts of money made and lost form the convex of the curve. Price variations are random so that the next price change is as apt to be up as down. There is a balance of competitive power in the market so that the game is remarkably fair to all of the players.

Futures trading is an exciting game, the score of which is kept with money. There are important amounts of money involved so that the game is taken seriously. But a game it is. The people who participate, including the commercials—the hedgers—appear to be first interested in the game itself and second in the money.

Second, futures trading is a remarkably close approximation to the classical economic concept of pure competition. The established, high volume markets, nearly meet the tests for perfect markets. They are not planned with the economic concept of pure competition in the fore but evolved into this form out of the crucible of market forces. They can serve as models for the further development of less sophisticated sister markets.

Third, the markets are mainly about the pricing of commodities, which is speculative. And so the markets are about speculation. Hedging, in its standard context, is a nonsense term. Equal and opposite is still speculative. In addition, a high proportion of "hedged" positions are taken with a "view of the market." If this book makes only one contribution, it is the thorough lousing up of a standard doctrine of hedging.

Fourth, futures markets are investment media. They are financial markets and futures contracts are financial instruments. The markets generate equity capital
from the speculators and, as furnishers of capital, the speculators play a significant role in the direction of the economic processes. Speculators form judgments, back them with capital, and, in part, order the system. Thus, commodity speculation is, indeed, investment.

Fifth, much of the regulation of markets is misdirected: a) much of the alleged manipulation and price distortion hasn’t really happened, b) when prices have been distorted, the guilt has usually been misplaced, c) market dominance is more apt to be accomplished by hedgers than by speculators, and d) regulation has generally restricted speculation and decreased competition. The markets are relatively free of monopolistic influences but a preoccupation with price distortion has hampered market growth and development.

Sixth, the futures markets that work, work well indeed. These are the visible ones. But rather more markets do not work than do. The rate of failure among newly established futures markets is high. When compared to the total risk shifting—financing problems, the amount of futures trading is quite small. Thus, the institution has great growth potential. There is need for much more speculation of a higher quality than now exists.

The book is a tribute to the people who trade commodities, both commercials and speculators. For twenty years I have had the somewhat unique experience of being continuously associated with the operation, regulation, and trading of futures while, at the same time, being continuously concerned with forecasting the prices of a major group of actively traded commodities (feed, grains, soybeans, and soybean products). This duality of interest has not only resulted in insights that either of the areas alone would not have produced but has also brought me into continuous association with the players. They are a fascinating group of sportsmen who try to run a good game and who play to win. This is the story of their activities as I have observed them for a long time. The activities are theirs but the generalizations and implications are mine, and I can do naught but accept responsibility for the mistakes that I have doubtless made. I am deeply grateful to the people of the markets for the long association. To start naming names is tempting, but it would be a mistake for there are so many who have contributed to my education.

In a broader sense, the book is a tribute to a competitive economic system that is not only highly productive of goods and services, but more importantly, contributes so much to liberty and the excitement of a life style. These markets are such a system at its best, open to all, and where men are bounded only by their capacity. Unfortunately, where there is capacity there is also incapacity and where there are winners there must also be losers. But the game is fair and the people who play it are free.
Preface to the Second Edition

I like the preface that I wrote in 1971 and so it remains unchanged. Events of the intervening years have reinforced rather than changed my biases. The looking forward that I did then was enough correct that I am not embarrassed.

Writing a second edition of a successful book is dangerous. It is tempting to turn a readable volume into a demonstration of scholarship and in the process limit both readability and usefulness. In contemplating revision the omissions and incompletely documented parts of the volume were readily apparent. New studies have been made and there have been changes in futures markets. I have tried to add the new without adding bulk or tediousness.

The book is accomplishing its purpose. It is a text in the increasing numbers of college level courses in commodity markets and trading. It is flattering that few copies come on the used book market when the course is completed. It is a text in training programs of companies in the commodity trades and appears to be useful to people starting work for firms in the field. It has been accepted by traders so that a sense of comradeship has developed. As every trader knows, Murphy’s Law is operative—“That which can go wrong will”—as is its companion—“Some of our greatest successes are fashioned from lucky mistakes.”

In the main, the second edition is a modernization job, changing prices to new levels in illustration and selecting more recent examples of principles. In spite of the turmoil of commodities in the 1970’s there has been relatively little fundamental change. Volume of trade and open interest have increased dramatically. The number and kinds of commodities have increased. But the underlying principles are unchanged.

Survival and growth in these troubled times is a tribute to the merit of the market form of futures trading. The markets have grown as uncertainty has increased. Understanding of markets has increased.
A new and comprehensive regulatory law—The Commodity Futures Trading Act of 1974—grew out of the commodity turmoil of 1972 and 1973. Numerous punitive bills were introduced but the Act is favorably disposed toward market growth and development. These things lead me to be even more optimistic about the future, not only the future of futures trading but about the future of an economic system directed by competitive prices.