

The Passive Investments In Commodities Market Has Limited Use Of The Futures Market For Price Risk Management

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The concept of futures trading was developed early to facilitate price discovery between a user (buyer) and a producer (seller) of a commodity which would be harvested and used in the future. This practice traces roots back to seventeenth-century Japan where merchants bought and sold rice for future delivery. A formal futures exchange originated in the U.S. with the formation of the Chicago Board of Trade (CBT) in the middle of the Nineteenth Century. Price discovery is the process of buyers and sellers arriving at a transaction price for a given quality and quantity of a product at a given time and place. For agricultural commodities, we often look to fundamental supply/demand principals to drive the price discovery process. More recently, however, and especially after the energy driven commodity price run-up which began in 2005, passive investors or speculators such as Index funds, have made huge investments in the commodities market, causing what many believe is a distortion to the supply/demand driven price discovery process.

A **futures contract** is a standardized contract to buy or sell a specified commodity of standardized quality and quantity at a certain date in the future and at a to be market-determined price, the futures price. A futures contract is similar to a forward contract except prices are normally fixed in a forward contract. Prices in the futures market change frequently as futures markets continually search for a balance between the factors of supply and demand. A futures contract price represents today's opinion of a commodity's value at the time the futures contract will expire. In the

last few years, hundreds of billions of dollars of new investments have been made in the commodities market as Index funds have gained in popularity. Funds like the Goldman Sachs Commodity Index buy nearby futures contracts in the anticipation that over time commodity prices will go up. As these contracts near expiration, they are sold and new nearby contracts are purchased. The price exaggeration generated by these investments funds is so pervasive that traders have coined a phrase to explain price activity at these critical junctures: the Goldman Roll.

This surge of new money into commodity markets may offer a partial explanation of not only the price levels seen in many commodities in recent years but also the volatility. This increased volatility has increased the risk and cost of hedging in futures markets and disrupted many traditional hedging activities. Many grain elevators have curtailed forward contracting opportunities due to the expense and risk of maintaining margin accounts as trading limits have expanded and price swings become more pronounced.

The markets may be offering farmers a higher price plateau for many commodities, but producers need to be better informed than ever of the tools and risks associated with marketing in this volatile environment.

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