

Hedging Oil Purchases

This is the third in a series of articles explaining how various segments of the soybean industry may utilize the futures market for both risk protection and profit.

Futures markets are distinctly separate from the cash market. True, there is a relationship and there are some deliveries made of the cash items against futures contracts but one seldom takes a futures position for the express purpose of making or taking delivery of the cash article. Only occasionally does the situation develop where there is economic advantage to making or taking delivery.

Most agricultural commodities are harvested during a brief time each year while the supply must be rationed to last for an entire year. Soybeans are harvested during September to November. This supply must then last until the next fall. Price action during the ensuing months performs the rationing function. Since soybeans have no economic value until crushed, producing oil and meal, the price action in oil and meal must relate to the price of beans. So oil and meal prices, in effect ration the supply of oil and meal and thereby ration bean supply.

Futures markets deal with price ideas based on supply and demand considerations for one year in advance, thereby accommodating the ration function with greater ease than any other manner so far devised. Futures markets do not attempt to allow for specific product qualities or freight differentials with which a given firm is concerned. To facilitate these specifics, the cash price will fluctuate above or below the futures price. This we speak of as the "cash basis."

Futures markets provide a central focal point to which all available pertinent market information flows to assist the participants in assessing the supply and demand situation. This facilitates establishment of price to properly ration supply. At this focal point, there congregate the best analysts of the market situation and to this point flows the money which people are willing to expend to demonstrate their confidence in the analysis of market conditions. Any change in these conditions will cause a realignment of supply ration ideas and thereby price.

Futures markets provide an advance pricing technique which is especially designed to benefit commodity consumers. This permits them to proceed with advertising and promotional plans and other operational and corporate planning, knowing that a large segment of cost has been established. If prices go up, there will be a profit in the futures transaction. If prices go down, the futures position could be liquidated with the satisfaction that the cash item can be bought at lower prices than thought earlier. This brings us to the next important point.

Futures markets provide a flexibility in forward pricing which is not possible in cash markets. If forward purchasing arrangements are concluded in the cash market and prices go up, you are not likely to let the supplier out of the contract. If prices go down, the supplier is not likely to let you out of the contract. In the futures market, however, there is greater flexibility if you want out of a position which would work to your disadvantage.

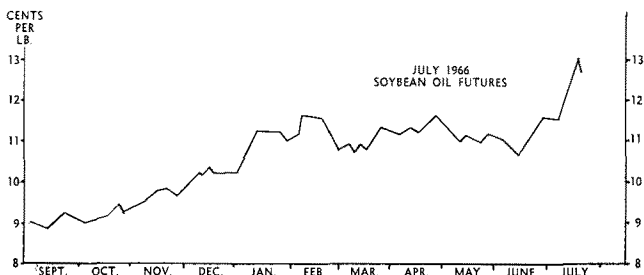


Fig. 1

This is because you don't have to ask your original seller to buy back the contracts you had purchased.

Now let's consider the present pricing technique for soybean oil, as used by many buyers. They do not take a futures position in anticipation of future needs for oil. They watch the futures and the cash basis, buying cash oil at more or less regular intervals year around and agreeing to pay the best current price which can be negotiated. This technique allows price averaging throughout the year. By use of a futures purchasing program, however, it should be possible to secure lower than average prices.

There is a distinct disadvantage to the standard cash pricing program. It happens in this manner. The oil supplier is short futures as a hedge against inventory. When selling cash oil, he buys back his short hedge and then charges the futures price at that time plus the agreed upon cash basis. When he bought futures, he most likely caused a firmness in the futures market that would not have been there otherwise. The net result is that the buyer likely paid more than necessary.

This disadvantage could be eliminated if the buyer had purchased futures earlier. Through special provision of the commodity exchanges, it is permissible for the buyer to exchange long futures with the supplier's short futures in what is called an "ex-pit" transaction. This can be done at the price agreed upon in the terms of the total cash purchase cost. This provision is made for the express purpose of allowing futures to be used as a cash price fixing mechanism without unduly influencing prices to the disadvantage of the buyer. It also permits those who are long and those who are short to liquidate both positions at the same price thereby simplifying the cash price determination.

There may be some occasions when the supplier of cash oil is quoting a basis in distant months that looks too good to pass up, but there is no clear trend in those futures months so the buyer is not ready to buy futures. Under those circumstances, it would be advisable to contract for the cash oil at a basis over the futures but wait for better trend indication before buying futures. Conversely, there are times when it is best to buy futures before contracting the cash basis.

There are some seasons when distant futures months are higher than nearby months, while in other seasons the reverse is true. There are valid economic reasons for these occurrences and they need to be properly observed for trading to maximum advantage.

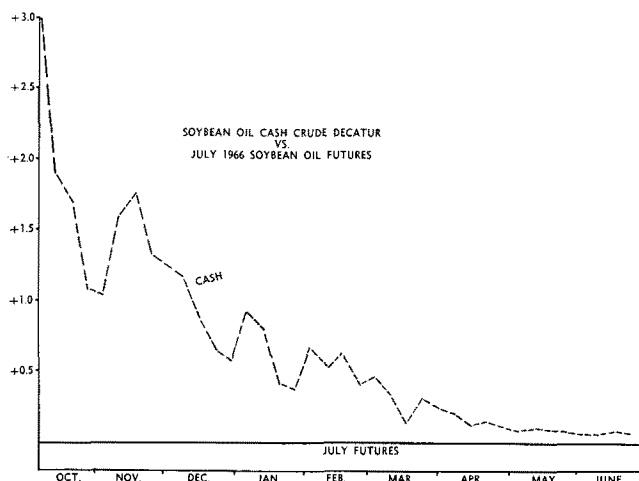


Fig. 2

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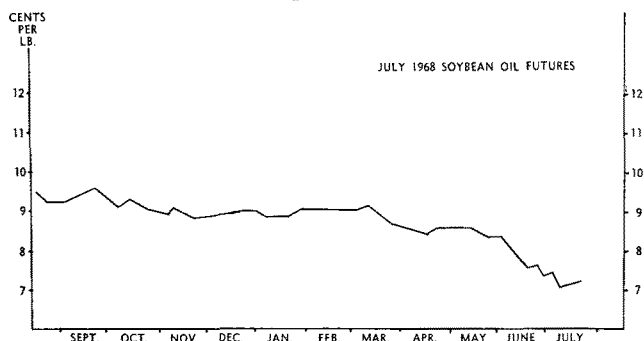


Fig. 3

For illustration of these diverse situations one can look at the 1966 and 1968 markets. In the fall of 1965, the cash market for soybean oil was very tight. Because of the restricted supply, the nearby futures were above distant months, and cash oil was at a very wide premium over futures. The July 1966 futures contract was trading at 9 cents, but worked steadily higher to 13 cents by the following summer. Figure 1 shows the futures action. Figure 2 shows how the cash vs. July futures relationship narrowed. Under these conditions, the oil user would be advised to buy futures well ahead of actual needs, and wait to contract the cash basis until near time of shipment. Then he would liquidate the long futures position with the net result that oil for July use would cost him around 9½ cents instead of 13 cents.

An entirely different situation existed two years later. In the fall of 1967, there were adequate supplies of soybean oil, the nearby futures months were under distant months, and cash oil was at a nominal premium to futures. The July 1968 futures declined from a September high of 9½ cents to a low of 7 cents. Figure 3 shows the

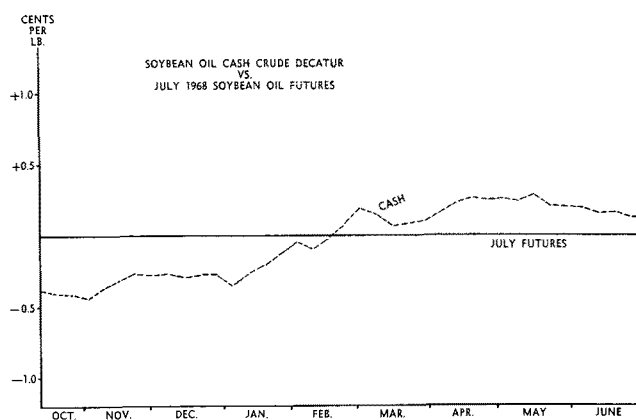


Fig. 4

futures action. Figure 4 shows how the cash vs. July futures relationship advanced from 40 points under to 15 points over. Under these conditions, the oil user would be advised to contract the cash basis as early as possible when considered to be reasonable, but refrain from buying futures until the cash oil is actually needed and then give up the futures to the supplier.

The futures market seeks to discern the price level of a commodity in accord with the broad spectrum of market influencing circumstances prevailing or anticipated. The cash market discriminates for conditions at a given location for a given quality. The two complement each other, for the total price is derived by a combination of general price level (futures) plus specific location and quality differentials (cash basis).

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Call for Nominations for Seventh AOCS \$2,500 Award in Lipid Chemistry

Sponsored by Applied Science Laboratories

In April 1964 the Governing Board of the American Oil Chemists' Society established an Award in Lipid Chemistry under the sponsorship of the Applied Science Laboratories Inc., State College, Pennsylvania. Previous awards were presented as follows: Erich Baer, August 1964; Ernest Klenk, October 1965; H. E. Carter, October 1966; Sune Bergstrom, October 1967; Daniel Swern, October 1968 and H. J. Dutton, October 1969.

The award consists of \$2,500 accompanied by an appropriate certificate. It is now planned that the seventh award will be presented at the AOCS Fall Meeting in Chicago, Illinois, Sept. 27-Oct. 1, 1970.

Canvassing Committee Appointees

Policies and procedures governing the selection of award winners have been set forth by the AOCS Governing Board. An Award Nomination Canvassing Committee has been appointed. Its membership is L. N. Noreia, Chairman; J. G. Coniglio, Morris Kates, J. C. Hamilton and F. T. Lindgren. The function of this committee is to solicit nominations for the seventh award. Selection of the award winner will be made by the Award Committee whose membership will remain anonymous.

Rules

The rules prescribe that nominees shall have been responsible for the accomplishment of original re-

search in lipid chemistry and must have presented the results thereof through publication of technical papers of high quality. Preference will be given to individuals who are actively associated with research in lipid chemistry and who have made fundamental discoveries that affect a large segment of the lipid field. For award purposes, the term "lipid chemistry" is considered to embrace all aspects of the chemistry and biochemistry of fatty acids, of naturally occurring and synthetic compounds and derivatives of fatty acids, and of compounds that are related to fatty acids metabolically, or occur naturally in close association with fatty acids or derivatives thereof. The award will be made without regard for national origin, race, color, creed or sex.

Letters of nomination together with supporting documents must be submitted in octuplicate to L. N. Noreia, Temple University, Health Science Center, School of Medicine, Philadelphia, Pennsylvania 19140, before the deadline date of April 15, 1970. The supporting documents shall consist of professional biographical data, including a summary of the nominee's research accomplishments, a list of his publications, the degrees he holds, together with the names of the granting institutions, and the positions held during his professional career. There is no requirement that either the nominator or the nominee be a member of the American Oil Chemists' Society.

Remember the DEADLINE, April 15, 1970