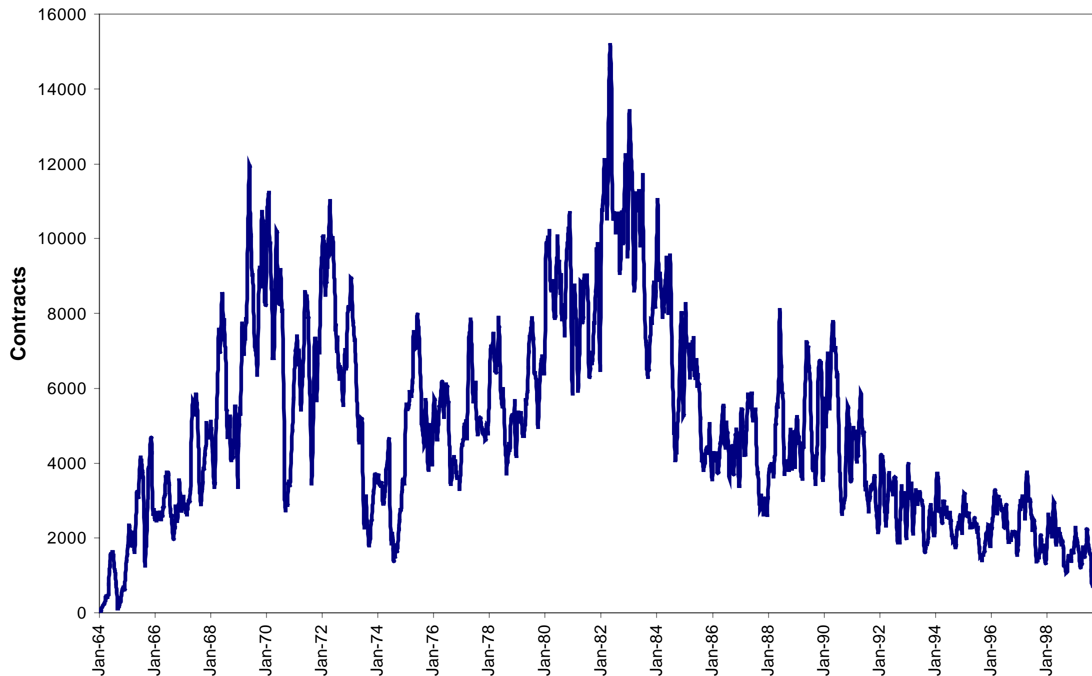
Trading Like A Commodity?

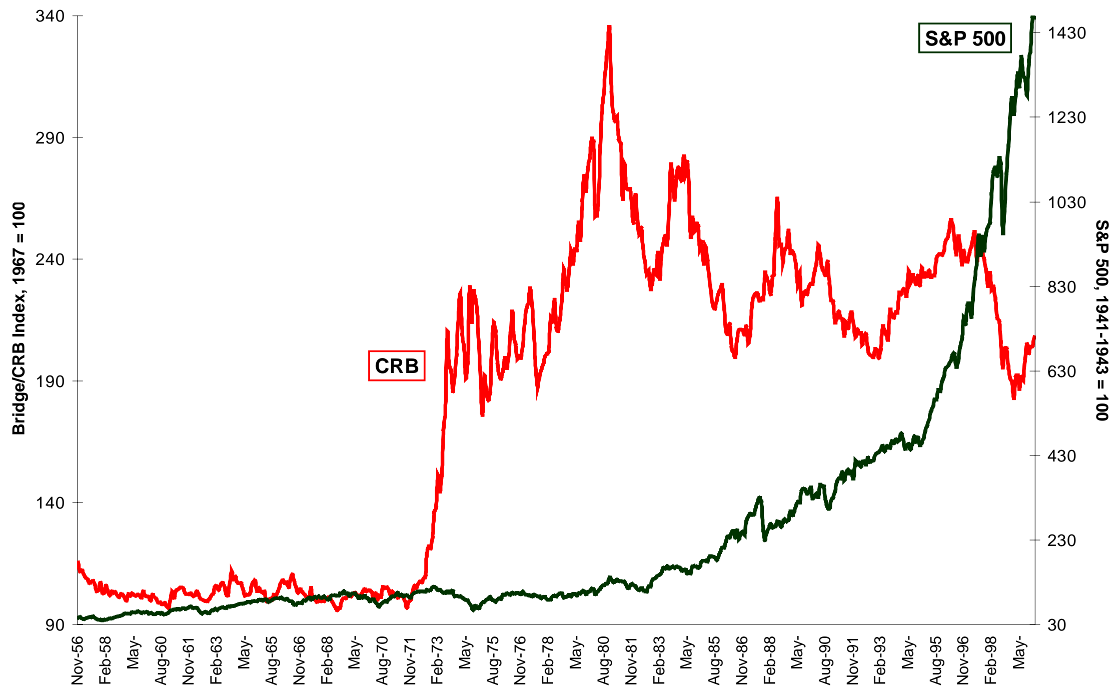
News last week of Merrill Lynch's exit from the non-energy physical futures business, which came right on the heels of Lind-Waldock's sale to Refco, was greeted with a yawn. A front-page capsule in *The Wall Street Journal* noted "small investors have turned their attention to dot-coms from pork bellies."

Pork Belly Volume: Four-Week Rolling Average



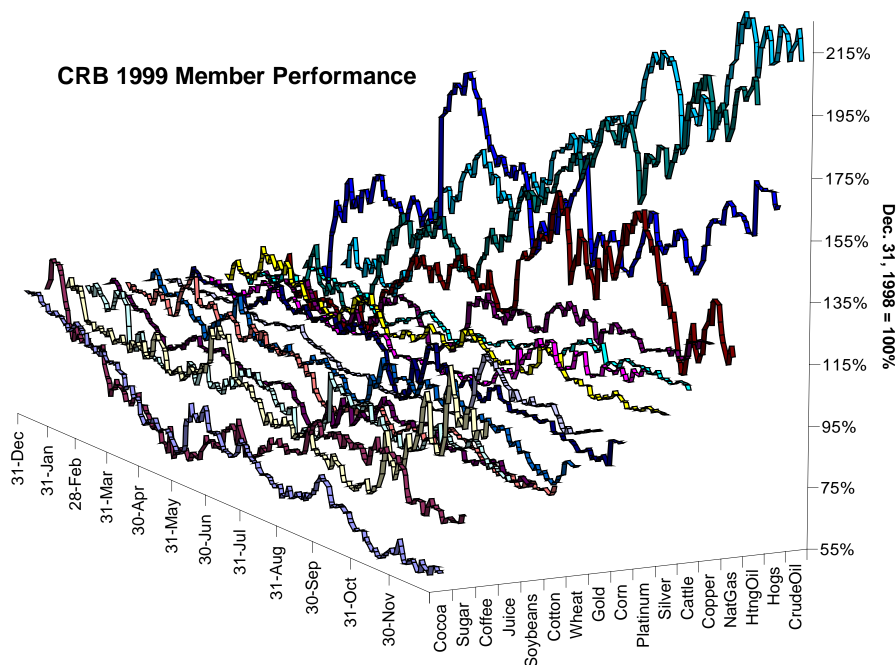
Well, start spreading the news! Volume in pork belly futures peaked in the early 1980s, and has been on a steady decline ever since. The retail investor long ago concluded there was no reason to devote time and attention to the proper market-clearing level of a frozen slab of uncured bacon. Pork bellies themselves have no natural rate of return, their price movements are both mean-reverting and quite small relative to those of technology stocks, and they are traded in conditions best described as medieval.

The mean-reverting nature of commodity prices stems from the their economic role as input factors to finished goods. Higher prices both stimulate additional production and reduce the growth rate of demand, as OPEC repeatedly has discovered. Low prices tend to both cap the growth rate of production and stimulate demand. Equity prices, on the other hand, tend to trend higher as the economy grows and as businesses increase their profitability through greater efficiencies.



Option theoreticians note mean-reverting processes are often associated with jumps, or short periods of rapid price movement. This was the case with commodity prices in the 1970s, as illustrated by the 17-member Bridge/Commodity Research Bureau index. The two jumps were associated with periods of monetary excess, one following the dissolution of the Bretton Woods system of fixed exchange rates in the early part of the decade, and one following the appointment of G. William Miller as Federal Reserve chairman during the Carter administration. With the exception of these periods, the CRB index has remained confined within ranges.

Even within the CRB index itself, prices tend to be mean-reverting. Thanks to a surprising degree of OPEC discipline, only a handful of commodities in the energy group were able to achieve significant price gains during 1999, and these were from depressed 1998 levels. Only the tropical soft commodities such as cocoa and sugar saw significant price drops, and these markets simply do not have either the depth of liquidity needed for institutional investors.



On The Endangered Species List?

Why should stock and bond investors care at all about the health of the futures industry? The answer lies in one word: Insurance. Any time you add futures and options to a market, you are adding insurance, and any time you add insurance to a market, you lower its volatility and increase its efficiency. Since the advent of organized options exchanges in the early 1970s, and especially since the introduction of stock index futures in the early 1980s, investors have benefited from central price discovery and risk management opportunities. Fund managers have been able to use these instruments to allocate resources, match the performance of underlying indices, and adjust the beta of their portfolios more efficiently than ever before. More importantly, investors have been able to use exchange-traded futures and options to protect the downside of their portfolios without having to sell securities during a market downdraft. This has reduced the risks of stock ownership, and while it is impossible to quantify the role of these derivatives in reducing the risk premium associated with equities, we are no doubt safe in saying the effect has been non-zero.

The effect has been less visible, but perhaps larger, on the fixed income side. The advent of Treasury bond futures in the late 1970s and eurodollar futures in the early 1980s coincided with the heyday of Paul Volcker, who was as peripatetic in his management of monetary policy as Alan Greenspan is cautious in his. The Treasury bond contract, in particular, became the primary mechanism of interest rate discovery in the world. A generation of bond traders cut their teeth on these instruments, and once these same traders graduated to more complex cash market derivatives, they continued to use the exchanges to lay off their residual risk. The result has been a revolution in finance allowing both borrowers and lenders to deal with products such as mortgages and asset-backed securities that would have been possible to create a quarter-century ago.

In both cases, society as a whole has benefited from the presence of exchange-traded futures and options, both by themselves and in conjunction with cash markets. It would be a tragedy for all to lose the benefits enumerated above because floor traders and brokerage firms cannot generate sufficient transaction volume to keep the markets open. Maybe we don't need pork bellies, and maybe the retail trader looking for action now can do better for himself in stocks, but the need for risk management will never go away. Futures exchanges, American ones in particular, simply have to do a better job of reducing trading costs, automating their systems, providing interesting products, and in general joining the 21st century. If they can do so, everyone wins.