




Hilary Till
Principal,
Premia Risk Consultancy, Inc.

- Audio via Internet, select "Mic & Speakers" under Audio pane.
- Audio via telephone, use number on receipt or reminder e-mail.
- For technical assistance contact Citrix 1-888-259-8414.
- Submit question via pane on right or on twitter  @PRMIA, # ???

Why Do Some Futures Contracts Succeed & Others Fail?

This material is the intellectual property of the presenter and shall not be reproduced or used without expressed written permission

Why Do Some Futures Contracts Succeed & Others Fail?

PRMIA Webinar
<http://www.prmia.org>

February 18, 2015

**Ms. Hilary Till, Principal,
Premia Risk Consultancy, Inc.,
<http://www.premiarisk.com>;
Research Associate, EDHEC-Risk Institute,
<http://www.edhec-risk.com>; and
Co-Editor, Intelligent Commodity Investing,
<http://www.riskbooks.com/intelligent-commodity-investing>**

Disclaimer

This presentation is provided for educational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell securities or other financial instruments.

The opinions expressed during this presentation are the personal opinions of Hilary Till and do not necessarily reflect those of other organizations with which Ms. Till is affiliated.

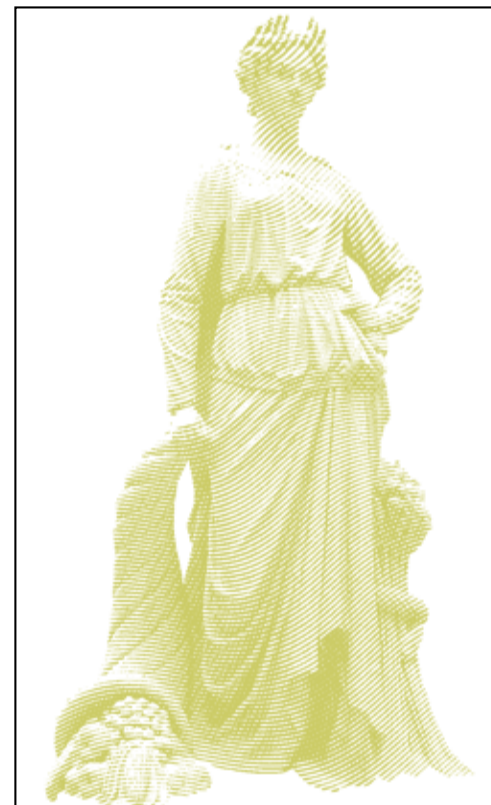
Any (inadvertent) errors and omissions are the responsibility of Ms. Till alone.

The information contained in this presentation has been assembled from sources believed to be reliable, but is not guaranteed by the presenter.

Why Do Some Futures Contracts Succeed & Others Fail?*

- I. There Must Be a Commercial Need for Hedging**
- II. A Pool of Speculators Must Be Attracted to a Market**
- III. Public Policy Should Not Be Too Adverse**
- IV. Case Studies: Pulp, Uranium, and Weather-Related Futures Contracts**

Conclusion of Webinar



Icon above is based on the statue in the Chicago Board of Trade plaza.

* This seminar is drawn from Till (2015a).

Quick Poll Question

1. Does your firm use futures contracts to hedge risk?
 - a. Yes
 - b. No

I. Commercial Need for Hedging

A. New Contracts

1. Successful Contracts

2. Failed Contracts

B. Existing Contracts

1. Failed Contracts

2. Successful Contracts



*Source of Graphic:
Chicago Board of Trade / CME Group.*

I. A. 1. Successful New Contracts

a. New Kinds of Risks

- **Chicago Became Large-Scale Grain Terminal in the Mid-1800s**
- **Collapse of Bretton Woods System Ushered in New Era of Financial Market Volatility**
- **Forced Shift to Spot Oil Market**
- **Gradual Deregulation of the U.S. Natural Gas Market**



I. A. 1. Successful New Contracts

b. New Ways to Hedge Existing Risks

- **Futures Contracts in the Soybean Complex**
- **First Futures Contract on Non-Storable Commodity: Live Cattle Futures Contracts**
- **The Chicago Board Options Exchange**



I. Commercial Need for Hedging

A. New Contracts

1. Successful Contracts

2. Failed Contracts

B. Existing Contracts

1. Failed Contracts

2. Successful Contracts



*Source of Graphic:
Chicago Board of Trade / CME Group.*

I. A. 2. Failed New Contracts

a. Risks Not Sufficiently Material

- **Currency Futures Launch Pre-Bretton Woods Breakdown**
- **CPI Futures**



*Source of Graphic:
Chicago Board of Trade / CME Group.*

I. A. 2. Failed New Contracts

b. Redundancy

- **U.S. Interest-Rate Futures Contracts
(1970s and 1980s)**
- **Pacific Northwest Wheat Futures Contract
(1950s)**
-  **Canadian Coin
Futures Contract (1973)**

I. Commercial Need for Hedging

A. New Contracts

- 1. Successful Contracts**
- 2. Failed Contracts**

B. Existing Contracts

- 1. Failed Contracts**
-
- 2. Successful Contracts**

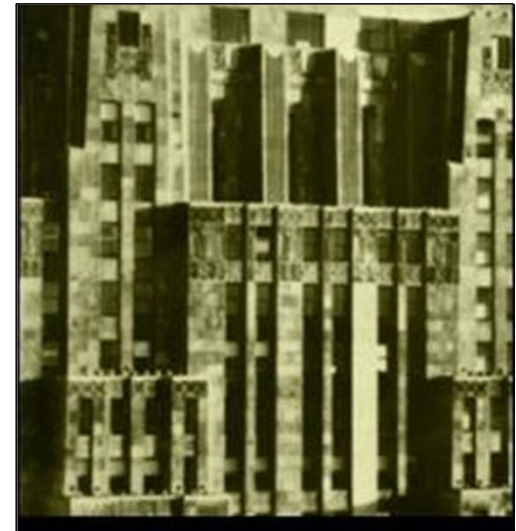


*Source of Graphic:
Chicago Board of Trade / CME Group.*

I. B. 1. Failed Existing Contracts

a. Obsolescence

- **Technological Changes: Butter and Eggs**
- **Risks Shifted to the Government: Cotton**
- **Risks Shifted to the Government: Butter**



*Source of Graphic:
Chicago Board of Trade / CME Group.*

I. B. 1. Failed Existing Contracts

b. Terms Became Disadvantageous for Hedgers

- **Kansas Wheat Futures Contract (1953)**
- **GNMA (Government National Mortgage Association) Futures Contract**
- **Maine Potato Futures Contract**

c. Perishable Nature of Commodity Market Made Physically-Delivered Futures Contract Vulnerable to Manipulation

- **Maine Potato Futures Contract**

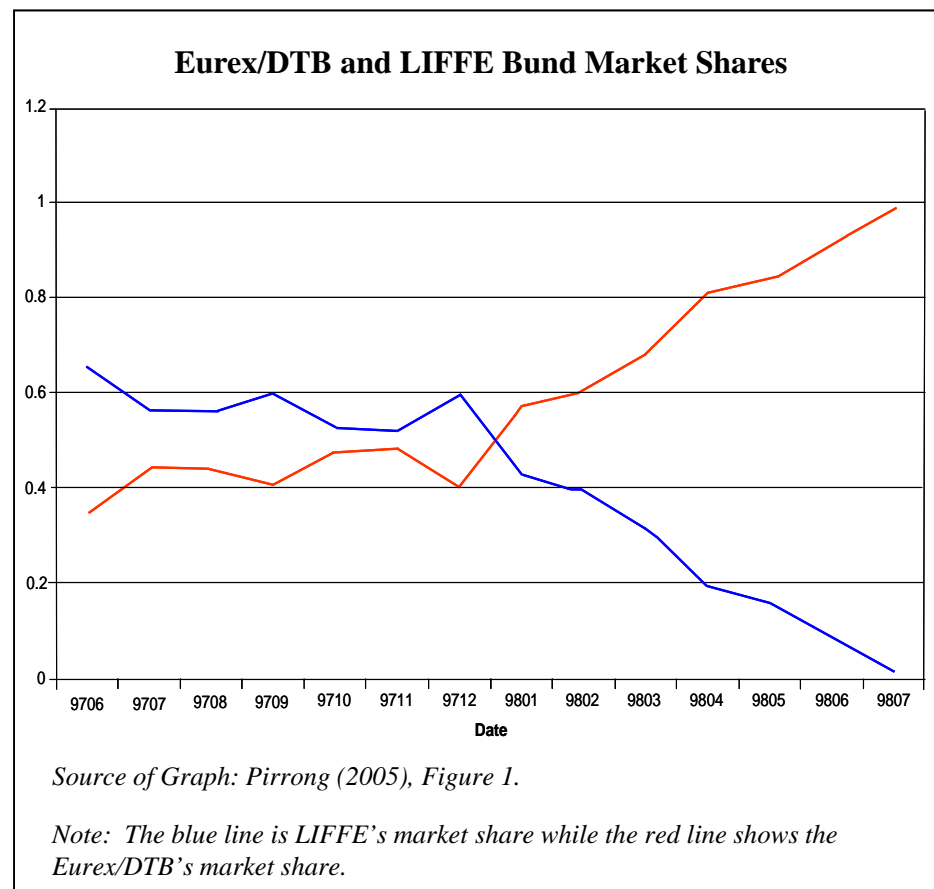


I. B. 1. Failed Existing Contracts

d. Competition

Example:

LIFFE Bund Contract



I. Commercial Need for Hedging

A. New Contracts

1. Successful Contracts

2. Failed Contracts

B. Existing Contracts

1. Failed Contracts

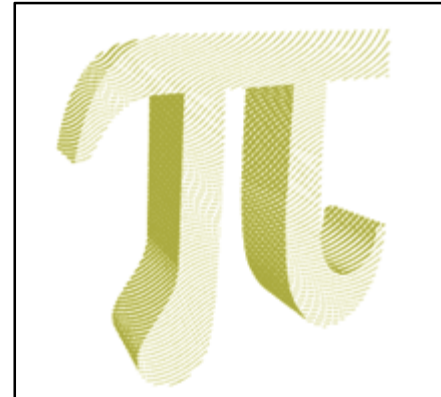
2. Successful Contracts



*Source of Graphic:
Chicago Board of Trade / CME Group.*

I. B. 2. Successful Existing Contracts

- a. NYMEX WTI vs. ICE WTI**
- b. Chicago Exchanges**



Why Do Some Futures Contracts Succeed & Others Fail?

I. There Must Be a Commercial Need for Hedging

II. A Pool of Speculators Must Be Attracted to a Market

III. Public Policy Should Not Be Too Adverse

IV. Case Studies: Pulp, Uranium, and Weather-Related Futures Contracts

Conclusion of Webinar



Icon above is based on the statue in the Chicago Board of Trade plaza.

Quick Poll Question

2. Which best describes your role?
- a. Practitioner
 - b. Academic

II. Attracting Speculators

A. Community of Risk-Takers

B. Level Playing Field for Speculators

C. Ability to Actually Manage Risk



*Source of Graphic:
Chicago Board of Trade / CME Group.*

II. A. Community of Risk-Takers

1. **Chicago as a Case Study**
2. **Other Financial Centers**
3. **Practical Approach**
4. **Willingness to Risk Failure**



*Source of Graphic: Wilmott
Magazine cover of Jan/Feb 2007.*

II. A. 1. Chicago as a Case Study*

- a. Mid-Nineteenth Century
- b. 1970s
- c. Present Day



* This section is drawn from Till (2014).

II. A. Community of Risk-Takers

1. Chicago as a Case Study

2. Other Financial Centers

3. Practical Approach

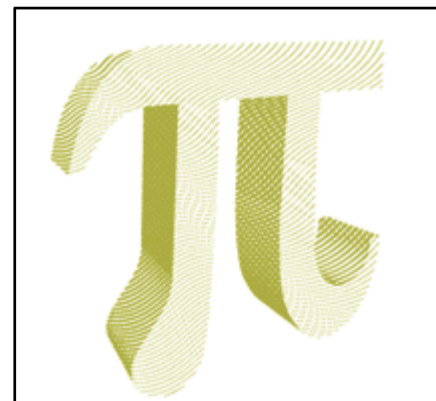
4. Willingness to Risk Failure



*Source of Graphic: Wilmott
Magazine cover of Jan/Feb 2007.*

II. A. 2. Other Financial Centers

- a. Kansas City Board of Trade**
- b. Sydney Futures Exchange**
- c. New York Mercantile Exchange**



II. A. Community of Risk-Takers

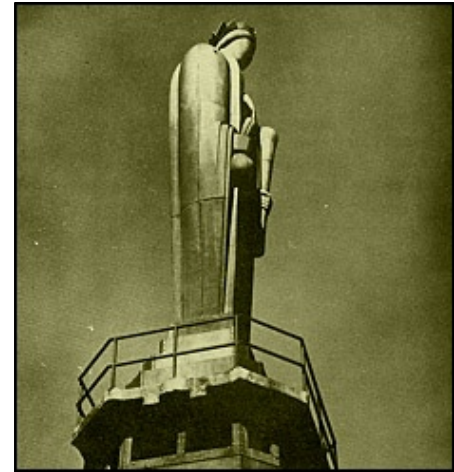
1. Chicago as a Case Study
2. Other Financial Centers
3. Practical Approach
4. Willingness to Risk Failure



*Source of Graphic: Wilmott
Magazine cover of Jan/Feb 2007.*

II. A. 3. Practical Approach

- a. **Pioneering Businessmen**
- b. **New Commodity Products in the 1960s**
- c. **Present Day**



*Source of Graphic:
Chicago Board of Trade / CME Group.*

II. A. Community of Risk-Takers

1. Chicago as a Case Study

2. Other Financial Centers

3. Practical Approach

4. Willingness to Risk Failure



*Source of Graphic: Wilmott
Magazine cover of Jan/Feb 2007.*

II. A. 4. Willingness to Risk Failure

Harris (1970) noted that an enduring philosophy of the CME has been an acceptance of the possibility of failure in its new product ventures:

“Necessity is the mother of invention. Beginning in the early fifties ... [CME] members have vigorously researched, tested, and promoted many new contracts for futures trading. ...

Some have succeeded and some have failed, but fear of failure has not impeded progress,” concluded Harris.



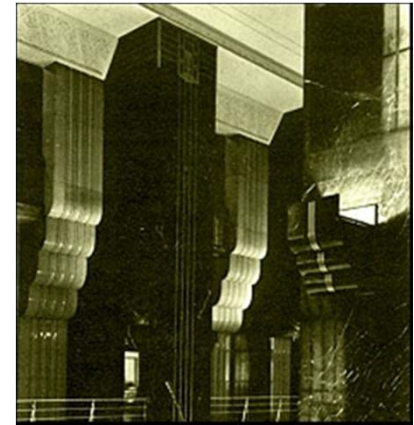
Rembrandt's Storm on the Sea of Galilee, Isabella Stewart Gardner Museum, Boston, and Cover of Against the Gods: The Remarkable Story of Risk by Peter Bernstein, John Wiley & Sons, 1996.

II. Attracting Speculators

A. Community of Risk-Takers

B. Level Playing Field for Speculators

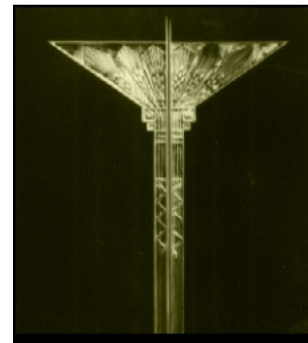
C. Ability to Actually Manage Risk



*Source of Graphic:
Chicago Board of Trade / CME Group.*

II. B. Level Playing Field for Speculators

- 1. Grains**
- 2. Equities**



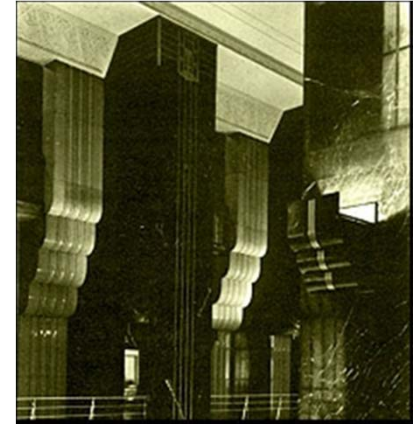
*Source of Graphic:
Chicago Board of Trade / CME Group.*

II. Attracting Speculators

A. Community of Risk-Takers

B. Level Playing Field for Speculators

C. Ability to Actually Manage Risk



*Source of Graphic:
Chicago Board of Trade / CME Group.*

II. C. Ability to Manage Risk

1. How Speculators Manage Risk*
2. Example: CPI Futures



* This section is drawn from Till (2012).

Why Do Some Futures Contracts Succeed & Others Fail?

- I. There Must Be a Commercial Need for Hedging**
- II. A Pool of Speculators Must Be Attracted to a Market**
- III. Public Policy Should Not Be Too Adverse**
- IV. Case Studies: Pulp, Uranium, and Weather-Related Futures Contracts**

Conclusion of Webinar



Icon above is based on the statue in the Chicago Board of Trade plaza.

Quick Poll Question

3. Is the regulatory environment for futures markets a concern at your firm?

- a. Yes
- b. No

III. Public Policy

A. Convincing Economic Rationale

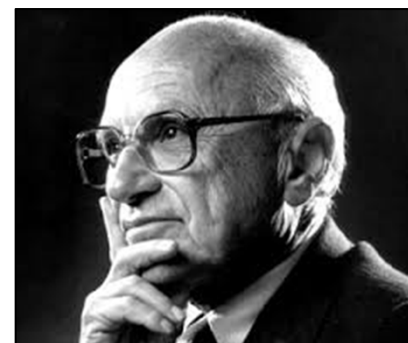
1. If Unconvincing, Contracts are at Risk to Being Banned or Heavily Curtailed
2. Role of Academics and Empirical Studies in the Debate



*Source of Graphic:
Chicago Board of Trade / CME Group.*

III. Public Policy

- B. Helpful if Contracts are Viewed as Being in the National Interest**
- C. Regulatory Parity Across Financial Centers**
- D. If Regulatory Interventions, Should Not Be Too Draconian**



*Milton Friedman, (1912-2006),
Nobel-Prize-Winning Economist*

Why Do Some Futures Contracts Succeed & Others Fail?

- I. There Must Be a Commercial Need for Hedging**
- II. A Pool of Speculators Must Be Attracted to a Market**
- III. Public Policy Should Not Be Too Adverse**
- IV. Case Studies: Pulp, Uranium, and Weather Futures Contracts**

Conclusion of Webinar



Icon above is based on the statue in the Chicago Board of Trade plaza.

Quick Poll Question

4. Which type of futures contract would your institution likely use?
- a. Financial Futures
 - b. Commodity Futures
 - c. Both
 - d. None

IV. Case Studies

A. Pulp

B. Uranium

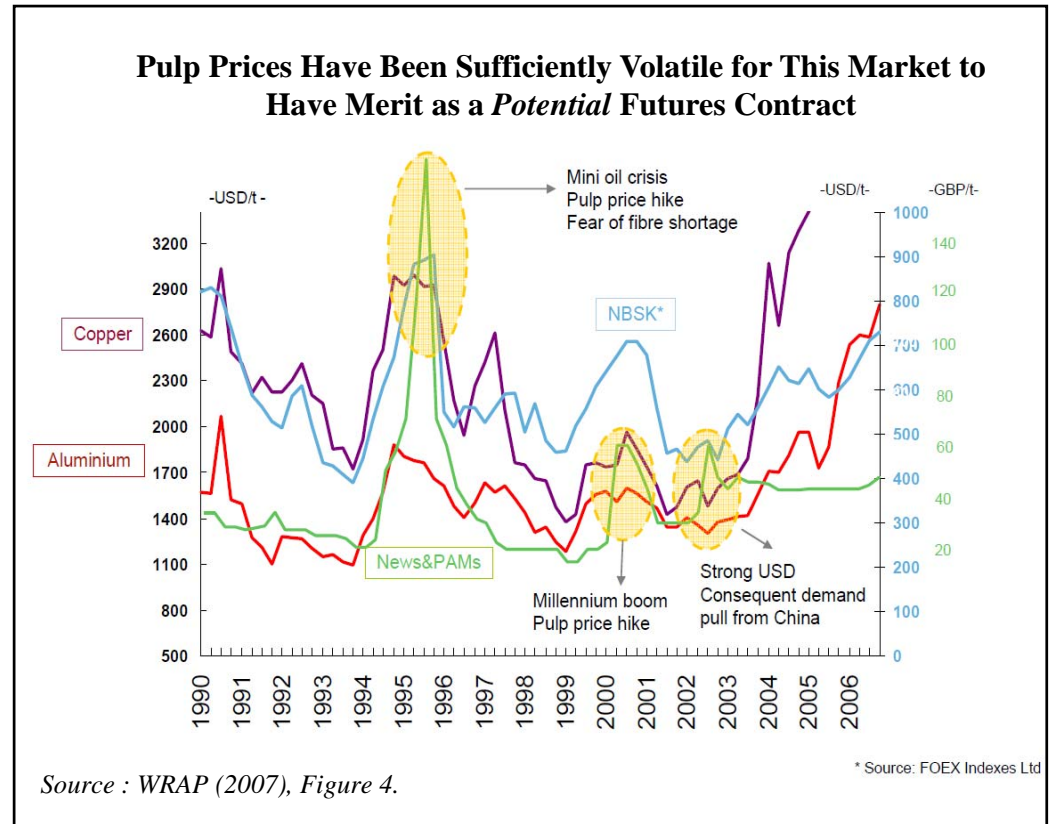
C. Weather Derivatives



*Source of Graphic:
Chicago Board of Trade / CME Group.*

IV. A. Pulp*

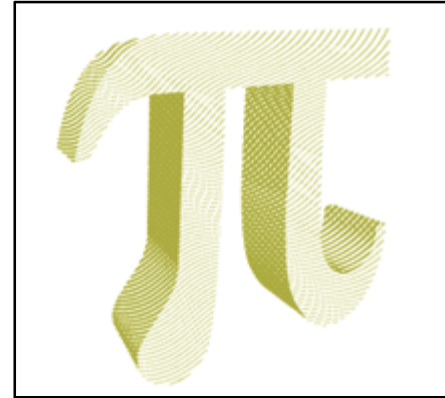
1. Individual Attempts at Launching Pulp Futures Contracts
2. How the Pulp Markets Do Not Match Up Against the Various Criteria for the Successful Launch of a Futures Contract
3. Conclusion



* This section is drawn from Till (2015b).

IV. A. 1. Failed Individual Attempts

- a. Montreal Exchange**
- b. Merrill Lynch**
- c. FOEX**
- d. PULPEX**
- e. NYBOT**
- f. CME Group**



IV. A. 2. How the Pulp Markets Fail to Match Up Against Necessary Criteria

- a. A prior pattern of forward contracting has not broken down;**
- b. There has been insufficient net hedging demand;
and**
- c. The industrial organization of the pulp industry has not been conducive to the success of a futures market.**



*Source of Graphic:
Chicago Board of Trade / CME Group.*

IV. A. 3. Conclusion (Pulp)

The common theme with each of the points on the preceding slide is that it appears that the pulp industry has not been in need of price-risk-bearing intermediaries, whom, in turn, can provide this service on futures exchanges.

IV. Case Studies

A. Pulp

B. Uranium

C. Weather Derivatives



*Source of Graphic:
Chicago Board of Trade / CME Group.*

IV. B. Uranium*

How the Uranium Market Does Not *Sufficiently* Match Up Against the Criteria for the Successful Launch of a Futures Contract

- 1. There Should be Sufficient Volatility**
[Criterion Met]
- 2. There Should be Fragmented Marketing Chains**
[Criterion Not Met]
- 3. There Should be a Level Playing Field Amongst Participants**
[Criterion Not Met]

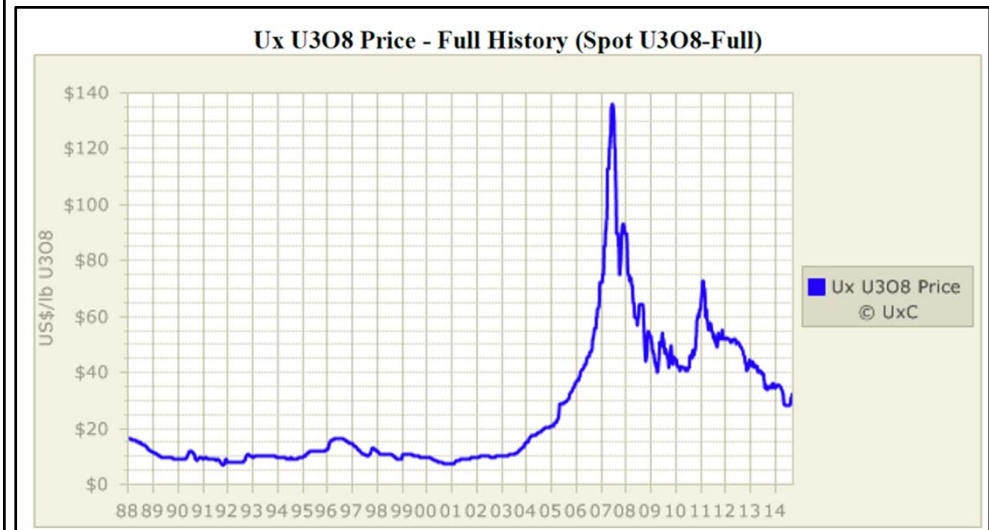
* This section is drawn from Till (2015c).

IV. B. Uranium

4. Conclusion

While uranium prices have been sufficiently volatile to merit a futures contract, it appears that the industrial organization of the uranium industry has not been conducive to the success of a futures contract.

Uranium Prices Have Been Sufficiently Volatile for This Market to Have Merit as a *Potential* Futures Contract



Source of Graph: U.S. Senate (2014), p. 122, which, in turn, accessed the graph from the Ux Consulting Company, LLC, <http://www.uxc.com>.

IV. Case Studies

A. Pulp

B. Uranium

C. Weather Derivatives



*Source of Graphic:
Chicago Board of Trade / CME Group.*

IV. C. Weather*

1. History of Weather Derivatives Contracts

a. First Contract

b. Futures Contracts

c. Over-the-Counter Contracts

2. Description of Weather Derivatives Contracts




** This section is drawn from Till (2015d).*

IV. C. Weather

3. Customized Over-the-Counter Weather Derivatives Contracts Via Reinsurers

a. The Role of Reinsurers

b. Example



Barney Schauble, Nephila Capital, investing in reinsurance and weather risk - Opalesque TV Part 1

In 2010, “Barney Schauble ... [was] a managing ... [principal] of Bermuda-based Nephila Capital, a leading investment manager specializing in the reinsurance industry[. The firm has] invest[ed] in insurance-linked securities, catastrophe bonds, insurance swaps, and weather derivatives.” The firm had slightly under \$2.5 billion in assets under management at the time of the Opalesque TV interview; and by 2014, the firm’s assets had grown to \$10 billion.

Source of Content: Opalesque TV (2010).

IV. C. Weather

4. Futures Contracts: Not as Successful a Method of Risk Transfer

a. A Small Proportion of the Overall Market

a. A Unique Pricing Problem



*Source of Graphic:
Chicago Board of Trade / CME Group.*

IV. C. Weather

- 5. How Weather Exposures Do Not Sufficiently Match Up Against the Criteria for the Successful Launch of a Futures Contract**
 - a. Level Playing Field for Speculators *[Criterion Met]***
 - b. Speculators Able to Manage the Risk of Positions from Hedgers *[Criterion Not Sufficiently Met]***
 - c. The Commodity is Relatively Homogenous *[Criterion Not Met]***

IV. C. Weather

6. Conclusion

Even though the potential size of the weather-derivatives markets is large, it is likely that the specialized institutions, which are most equipped for managing weather risk, are outside the futures markets.

Instead, it may be that reinsurance companies and funds, using customized OTC derivatives, may be the most suited for taking on and managing weather risk.

Why Do Some Futures Contracts Succeed & Others Fail?

- I. There Must Be a Commercial Need for Hedging**
- II. A Pool of Speculators Must Be Attracted to a Market**
- III. Public Policy Should Not Be Too Adverse**
- IV. Case Studies: Pulp, Uranium, and Weather-Related Futures Contracts**

Conclusion of Webinar



Icon above is based on the statue in the Chicago Board of Trade plaza.

Conclusion of Webinar

Futures trading can be seen as a game where the competing players, the hedgers and the speculators, each have sufficient economic reasons to participate.

The referee of this game, the governmental authorities, have the power to stop the game, if there is not a convincing economic rationale for a futures contract's existence.



Conclusion of Webinar

Therefore, a futures contract can succeed only if it responds to a commercial hedging need, *and* if speculators are able to manage the risk of taking on the hedger's positions.

In addition, a convincing case must be made that the contract serves an economic purpose; otherwise the contract is at risk to either being banned or heavily curtailed.



References

Harris, E., 1970, "History of the Chicago Mercantile Exchange," in H. Bakken (ed) Futures Trading in Livestock – Origins and Concepts, Madison: Mimir Publishers, pp. 49-54.

Opalesque TV, 2010, "Barney Schauble, Nephila Capital: Investing in Reinsurance and Weather Risk," Interview by Matthias Knab, Transcription, May 25. [Barney Schauble is now a managing partner at Nephila Advisors, LLC in California.] Accessed via website: http://www.opalesque.tv/youtube/Barney_Schauble/1 on November 22, 2014.

Pirrong, C., 2005, "Bund For Glory, or It's a Long Way to Tip a Market," *University of Houston Working Paper*, March 8.

Till, H., 2012, "'Who Sank the Boat?' Challenges to Popular Narratives on Commodity Futures Speculation," *Alternative Investment Analyst Review*, a publication of the Chartered Alternative Investment Association, Third Quarter, pp. 28-43.

Till, H., 2014, "Futures Industry: A Story of Crisis and Opportunity," *Futures Magazine* cover story, February, pp. 14-17, 21. Accessible at: <http://m.futuresmag.com/2014/02/01/futures-industry-a-story-of-crisis-and-opportunity>.



Degas, Edgar, "The Cotton Exchange at New Orleans," 1873, Musée Municipal, Pau, France.

For an article on the historical parallels between 1873 and now, as seen when looking into the distant mirror of Degas' painting, please see: Till, H., 2011, "Cotton Through a Distant Mirror," Commodities Now, http://www.premiacap.com/publications/CN_Degas_0311.pdf, March, pp. 28-29.

References



Till, H., 2015a, “Why Some Futures Contracts Succeed and Others Fail: A Survey of Relevant Research,” *EDHEC-Risk Publication*, <http://www.edhec-risk.com>, Forthcoming.

Till, H., 2015b, “Why Haven’t *Pulp Futures Contracts* Succeeded?”, *EDHEC-Risk Publication*, Forthcoming.

Till, H., 2015c, “Why Haven’t *Uranium Futures Contracts* Succeeded?”, *EDHEC-Risk Publication*, Forthcoming.

Till, H., 2015d, “Why Haven’t *Weather Derivatives* Been More Successful as Futures Contracts?”, *EDHEC-Risk Publication*, Forthcoming.

U.S. Senate, 2014, “Wall Street Bank Involvement with Physical Commodities: Majority and Minority Staff Report,” Permanent Subcommittee on Investigation, Committee on Homeland Security and Governmental Affairs, November 18. Accessed via website: <http://www.hsgac.senate.gov/download/report-wall-streetinvolvement-with-physical-commodities> on November 23, 2014.

[WRAP] Waste and Resources Action Programme, 2007, “Managing Risks in The Recovered Fibre Market,” Final Report, July. Accessed via website: <http://www.wrap.org.uk/content/managing-risks-recovered-fibre-market-0> on November 20, 2014.

Additional articles by the presenter can be accessed here:

<http://faculty-research.edhec.com/faculty-researchers/alphabetical-list/r-s-t/till-hilary-143898.kjsp?RH=faculty-gbl>



*Presentation Prepared By Katherine Farren, CAIA,
Premia Risk Consultancy, Inc.*

This logo is registered in the U.S. Patent and Trademark Office.

Intelligent Commodity Investing



Intelligent Commodity Investing
New Strategies and Practical Insights for Informed Decision Making
Edited by Hilary Till and Joseph Eagleeye

Bestseller

Intelligent Commodity Investing
Edited by Hilary Till and Joseph Eagleeye

Price
£99/US\$194/€149

Format
Hardback/155mm x 235mm/592pp

ISBN
978 1 904339 63 2

Link to “Intelligent Commodity Investing”:
www.riskbooks.com/intelligent-commodity-investing

Order online
riskbooks.com

Email order
books@incisivemedia.com

“Essential reading for commodity investors, or would-be investors everywhere.”

Sir Howard Davies, (Current) Chairman of the International Advisory Council of the China Securities Regulatory Commission; (Former) Director of the London School of Economics (2003-2011); and (Inaugural) Chairman of the U.K. Financial Services Authority (1997-2003).

Hilary Till

Hilary Till is a co-founder of Chicago-based Premia Capital Management, LLC, a proprietary trading firm, <http://www.premiacap.com>. She is also a principal of Premia Risk Consultancy, Inc., which advises investment firms on risk-management policy. Prior to Premia Capital, Ms. Till was the Chief of Derivatives Strategies at Putnam Investments, and a Quantitative Analyst at the Harvard Management Company. In addition, Ms. Till is the co-editor of “Intelligent Commodity Investing,” <http://www.riskbooks.com/intelligent-commodity-investing>, a bestseller for Risk Books, a London publisher.

Ms. Till has presented her analysis of the commodity futures markets to the following institutions: the U.S. Commodity Futures Trading Commission, the International Energy Agency, and to (then) U.K. Financial Services Authority.

She presently serves on the North American Advisory Board of the London School of Economics; is a member of the newly formed Research Council within the J.P. Morgan Center for Commodities at the University of Colorado-Denver Business School; and is a Research Associate at the EDHEC-Risk Institute, <http://www.edhec-risk.com>, in Nice, France.

In Chicago, Ms. Till is a member of the Federal Reserve Bank of Chicago’s Working Group on Financial Markets; is an Advisory Board Member of DePaul University’s Arditti Center for Risk Management; and has provided seminars to staff from the Shanghai Futures Exchange and the China Financial Futures Exchange. In addition, she serves on the steering committees for the Chicago chapters of both the **Professional Risk Managers’ International Association (PRMIA)** and the Chartered Alternative Investment Analyst Association (CAIA).

She has a B.A. with General Honors in Statistics from the University of Chicago and an M.Sc. degree in Statistics from the London School of Economics (LSE). Ms. Till studied at the LSE under a private fellowship administered by the Fulbright Commission.



PREMIA RISK CONSULTANCY, INC.

Questions for the Presenter?



Send them via the Question Pane in the webinar utility panel on the right hand side of your screen

A blue globe with a white grid of latitude and longitude lines, showing the Americas. It is positioned on the left side of the slide.

**PRMIA provides
international
industry thought
leadership**

A blue globe with a white grid of latitude and longitude lines, showing the Americas. It is positioned in the center of the slide.

**We help
you reach the
pinnacle of your
career with world-
class education
& credentials**

A blue globe with a white grid of latitude and longitude lines, showing the Americas. It is positioned on the right side of the slide.

**We connect
you to risk
professionals
around the globe**

Thank you for attending this PRMIA Webinar!

E-mail webinars@prmia.org to request CPE credit immediately following the **LIVE** webinar