

# 'Another fun day at the elevator...'



*Keeping so many balls in the air already has elevator managers stretched thin. With the volatile money sector adding another ball to juggle, their jobs look tougher than ever.*

**M**ike shuts off the engine of his pick-up and gathers up his papers from the two-day outlook meeting he just attended. "Ethanol . . ." he thought to himself; "it's sure making my job tougher. And then there are those Index Funds. I'm convinced those funds are ruining our markets."

He opens the door to the elevator and looks around.

It's 10 p.m. and everything's quiet as he checks the night markets. "Doggone it, corn's almost limit-up again and soybeans are 20 cents higher. Where's the top of the market? I just

wrapped up our new credit line and we'll need to try to raise it again pretty soon. How is an elevator manager supposed to handle this kind of volatility?"

He scans over the news and stares in disbelief at the announcement of four more ethanol plants in the northern part of the state. "At this rate maybe there won't even be a place for elevators anymore."

Mike's frustration is increasingly common and understandable. But

*"... managers who feared the arrival of an ethanol plant in their area have mostly found it has been positive for their bottom line."*

he's wrong in thinking there won't be a place for him in this new era. Grain handling volumes will rise as corn acres expand to meet the explosive growth in demand, and elevator services continue to have value!

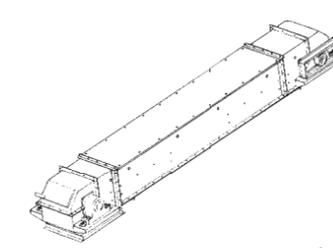
The construction of ethanol plants in production areas has not forced elevators out of business. To the contrary, managers who feared the arrival of an ethanol plant in their area have mostly found it has been positive for their bottom line. Elevators perform important functions: They receive grain at harvest, dry and condition it, and hold it for efficient distribution

throughout the crop year. Elevators are critical market-makers: They buy grain when farmers want to sell, and sell when destination markets want to buy. (They also split checks for farmers, another

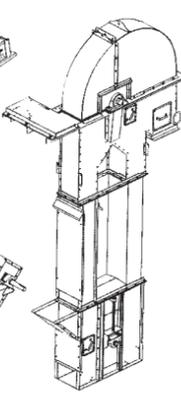
popular service.) Ethanol plants, like soybean crushers or other corn processing plants, need a steady arrival of inventory through the year; they can't accommodate an onslaught whenever farmers are



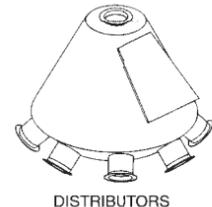
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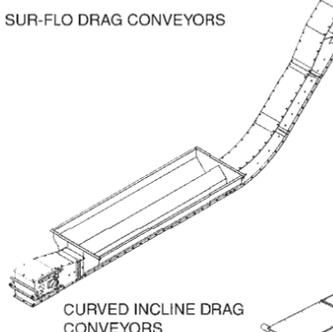
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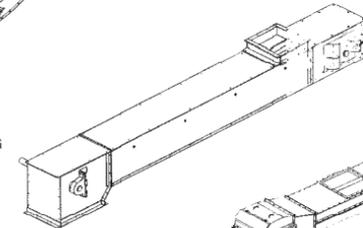
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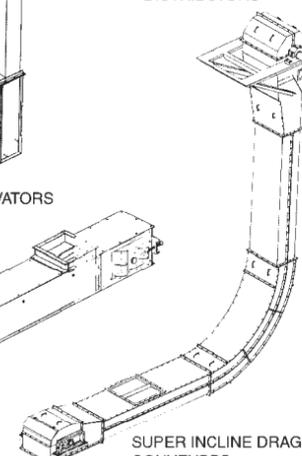
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ready to ship. But even elevators will be challenged by the logistics required to supply high-volume truck markets instead of loading large unit-trains.

Mike turns slowly in his chair and prepares to head home for a short night's sleep. Thoughts still roll through his head: "That brokerage firm analyst who spoke today said that the United States needs 7 to 10 million additional corn acres for 2007 crop, and even more in 2008 and beyond. There's 11.5 billion gallons of ethanol production capacity already open or under construction; those plants will require around 4 billion bushels of corn. And the news says there are hundreds more plants on the drawing board or in varying stages of permitting. Maybe not all those plants get built, but a lot will. Just how much corn did he say it will take for 15 billion gallons?" Mike does some quick calculations:

15 billion gallons at 2.8 gallons/bushel  
= 5.4 billion bushels of corn

"That's a far cry from the 2.1 billion bushels of corn usage for ethanol the USDA's forecasting this year," he thinks. "And \$4 corn may not be high enough to get enough acres for 2008 crop. We need to expand our elevator financing arrangements, widen our handling margins (especially on new-crop), and I'll have to explain this new environment to all our station managers. They're not going to like lowering their bids but we cannot continue to work on just a few cents per bushel."

"Everything costs more in high-priced markets," Mark says to himself. "Shrink is a bigger expense, our interest costs soar, and the risk rises of a farmer defaulting on a low-priced contract.

"And when the ethanol plants go up in my area, I'll be shipping most of our corn by truck. That adds costs. We sent 8 million bushels out last year in trains. That would take at least 8,000 truckloads, on top of our other truck shipments of soybeans and wheat. How are we going to do that? That's 32 more truckloads every single day and we can hardly find enough drivers as it is." Mike groans out loud and shuts off



the lights, "Our operations staff will rebel for sure!"

The next morning Mike gets up early and turns on his home computer. "I need to learn more about these Index Funds they talked about yesterday," he thinks. Mike checks a few websites and prints out a few pages.

"I didn't realize there's around \$100 billion invested in index-type funds. I also didn't realize these funds don't react to fundamentals or chart signals. Sounds like they're similar to how our employees invest their 401K funds. They select one or more funds, we with-

**"Commodity index funds are 'long only;' the money they receive is invested in specific commodities using a published, set allocation"**

hold and deposit part of their salary to those fund(s), and then they own shares in that fund.

Typically an employee leaves the money in whether the market goes up or down. The 401K is a long-term approach to investing, and that's what Index Funds do with commodities."

Commodity Index funds are "long-only"; the money they receive is invested in specific commodities using a published, set allocation. A fund might allocate 5% of its dollar assets to corn, for example, and will buy corn futures as dollars are received.

That's important for agricultural futures. These funds buy but rarely sell. Occasionally a fund 'rebalances' their holdings — monthly, quarterly or even just once per year. A fund that bought sufficient \$2 corn futures to equate to 5% of the fund's assets will need



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fewer bushels if corn rises to \$3/bushel. At rebalancing time, the fund manager will sell off the 'surplus' bushels if prices have risen, and invest the money in whatever commodities declined in value to raise ownership in those commodities. *Chart 1.*

Next Mike checks the Commodity Futures Trading

futures. He opens the file and looks at the numbers and is stunned. The index funds hold almost 40% of the entire long side of the wheat market (CBOT), and 18% of all longs in corn (futures and options combined.)

"These funds control the market," he mutters. "No

contracts of corn, or 2 billion bushels. Index funds can hold such large positions because the futures are a hedge against the index they are obliged to price for investors. As a result, CFTC classes this type of transaction as a "commercial" position, or hedge position, which is exempt from speculative limits.

Mike's reaction may be extreme, but index-fund buying that doesn't react to negative news does pose a challenge to cash/futures relationships. Cash markets may be weak due to heavy selling or weak demand, but futures may continue to climb as passive inves-

**"Greater basis volatility; historical patterns will be of less value as a signpost for the future."**

tors contribute dollars to a fund. The larger the index fund positions, the greater the chance for a disconnect between cash and futures at times. That means greater basis volatility and less predictability.

Mike pauses for a moment and jots down some key points before he heads to his office:

- Index funds + new ethanol demand = strong markets.
- Greater basis volatility; historical patterns will be of less value as a signpost for the future.
- Check into alternate financing sources.
- Review all new-crop contracts; see how far each one is below the market.

"Gonna be another fun day at the elevator . . ." ■



Diana Klemme is a longtime contributor to *FEED & GRAIN*. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at [diana@grainservice.com](mailto:diana@grainservice.com).

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Chart 1: Theoretical Index Fund with \$1 billion in assets					
		Allocation	\$ to own	Price	Quantity to own
Corn	1/3/06	5.5%	\$55,000,000	\$2.10	26,190,476 Bushels
	1/3/07	5.3%	\$53,000,000	\$3.75	14,133,333 Bushels
Crude	1/3/06	12.5%	\$125,000,000	\$65.00	1,923,077 Barrels
Oil	1/3/07	12.3%	\$123,000,000	\$53.00	2,320,755 Barrels

(Note: Prices on January 3 are theoretical for illustration)

Commission website ([www.cftc.gov](http://www.cftc.gov)). He had heard there's a new Supplemental Weekly Report that shows the size of the Index Fund positions in agricultural

wonder futures keep rising! How can they even be so big; don't the exchanges have speculative limits?"

Mike notes index funds control almost 400,000



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