The Inconvenience Cost: A Portfolio Approach to Non-Convergence Between Cash and Futures Prices

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Poster prepared for presentation at the Agricultural & Applied Economics Association 2010

AAEA, CAES & WAEA Joint Annual Meeting, Denver, Colorado, July 25-27, 2010.

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Why haven't prices converged?

Cash and futures prices for storable commodities should reach equality, or converge, upon contract maturity. Traders can impose convergence during the delivery month through arbitrage behavior: either making or taking delivery on futures contracts. If convergence is not predictable, a futures market fails to provide a clear storage signal to potential inventory holders and reduces the attractiveness of hedging [1], which can threaten its own viability [2]. Recent convergence problems in domestic commodity markets [3] demonstrate the existence of persistent, significant arbitrage opportunities over the second-half of the last decade. Yet, terminal elevator operators—perhaps the only participants with the capacity to do so [4]—have not arbitraged away these riskless returns by making enough deliveries.

This model demonstrates conditions under which a profit-maximizing warehouseman foregoes available arbitrage. We find that making delivery involves substantial opportunity costs [4], which stem from the loss of managerial control over warehouse space. We refer to the inconvenience of losing such control as the **inconvenience cost.**

Figure 1: Arbitrage Opportunities for CBOT Wheat? Basis on the First Delivery Day in Chicago

The elevator operator's portfolio

A terminal elevator operator allocates his available warehouse space (I=1) between making delivery (I_f) and other business (I_a).

Making delivery earns a riskless return (r_f), but the operator loses control of the space he allocates to this behavior [4], since the taker of the delivery instrument is a passive trader, and earns only a storage fee over the period. The risk-free return is a combination of the arbitrage from the delivery-month basis (b) and storage fees (F).

Warehouse space can also be allocated to alternative business, such as providing throughput to regular turnover customers, storing this or some other commodity [5], whether hedged or unhedged, or a combination of these, to earn a risk return (r_a) with some variance (σ_a).

The total expected utility for the portfolio return (r_p) is a linear combination of the expected return of delivery and the alternative, weighted by the relative allocation of available warehouse space, plus an adjustment for any risk aversion (A):

$$U(r_p) = I_f r_f + I_a r_a - \frac{1}{2} A (I_a \sigma_a)^2$$

Optimal allocation of space

The warehouse maximizes expected utility, subject to

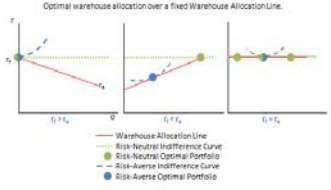
$$I_j \geq 0, \text{ for } j = f, a$$

$$I_f + I_a = I$$

If b is exogenous, a risk-neutral, price-taking elevator will simply choose to allocate all space to the asset with the highest return. Risk-aversion will bias the choice towards arbitrage, even if its return is dominated by the alternative, so that making delivery becomes more likely.

Figure 2: Exogenous Basis

Optimal warehouse allocation over a fixed Warehouse Allocation Line.



Making delivery prevents the operator from taking advantage of potentially more profitable opportunities.

An endogenous basis

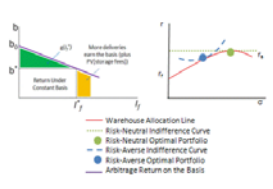
Re-specify the return on the delivery-month basis as an linear function of the arbitrage behavior by the warehouse:

$$b = b_0 - D I_f$$

If the elevator operator delivers enough, he will force the basis to zero and impose convergence, assuming b_0<D.

Figure 3: Endogenous Basis

Arbitrage surplus and optimal portfolio over a non-linear Warehouse Allocation Line.



When does an elevator force convergence?

Portfolio utility now includes the arbitrage surplus, $g(I_f)$, from a strengthening basis:

$$U(r_p) = I_f r_f + I_a r_a - \frac{1}{2} A (I_a \sigma_a)^2 + g(I_f)$$

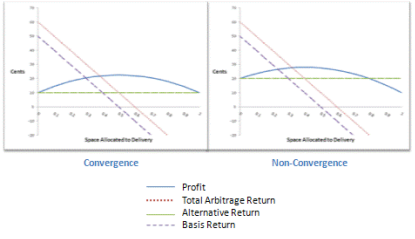
A **risk-neutral** elevator operator will choose to deliver until the arbitrage return is just equal to the alternative return, or where

$$I_f^* = \frac{b_0 + F - r_a}{D}$$

Futures and cash prices will :

- Converge if F=r_a
- Not converge otherwise

Figure 4: Convergence Conditions



A **risk-averse** operator will choose to deliver until the arbitrage return is equal to the risk-adjusted alternative return. Risk-aversion makes delivery more attractive. The optimal delivery allocation is now:

$$I_f^* = \frac{b_0 + F + A\sigma_a^2 - r_a}{D + A\sigma_a^2}$$

Under **risk-aversion**, futures and cash prices will :

- Converge if $r_a = \frac{DF - A\sigma_a^2 (b_0 - D)}{D}$
- Not achieve convergence if r_a is higher

Conclusion

- The possibility of arbitrage does not necessarily lead to convergence, even without accounting for grade and location differences in the commodity.
- The opportunity cost of making delivery, or the **inconvenience cost**, entails a loss of control of warehouse space, and may be too high for the elevator operator to arbitrage away non-convergence.
- Although risk aversion may lead to more deliveries, convergence is still dependent upon opportunity costs.

Limitations

- We do not explain the source of non-convergence, but instead only attempt to show why arbitrage does not necessarily result in convergence.
- In future work, we intend to explore the motivations of other actors in these markets, particularly those that agree to stand for delivery and pay storage fees.

References

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Acknowledgments

We thank several futures market traders, including commercial warehouse operators, for explaining their trading philosophies and business strategies in detailed interviews.

For further information

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