A Brokerage Firm's Approach to Risk Management
Pete Nessler, President, FCStone, LLC

MR. NESSLER: Thank you, Charles. As the wrap-up speaker here, it's kind of interesting listening to the economists that make prices in theory go up and down, the traders that we do know will be part of the solution which I believe they are not part of the problem. A quick background. When I started, I look at these kids in front of me, willing that I was in the business before most of you were born, and to give you an idea when I started 30 years ago Microsoft was a NUCO company. Dell Computer didn't exist. Apple, i-phones, i-pods, electronics. There were three TV stations. We got our news on Reuters on a piece of paper. The quote screen as Charles talked about when I started there was a person on a headset with their dry eraser-board that would write prices for us. Now we have technology.

So it's a clearing firm today when you look at it. When we started it was pretty easy in the de facto as we dealt with primarily one exchange, in Chicago, the Mercantile and the Board of Trade. It traded virtually all the commodities globally. We didn't have a lot of other exchanges. Today, now besides the Merc you got the BM&F in Brazil and I'm sure I'm going to forget somebody, but we've got London, Shanghai, Dalian and everybody else in between. So now as the clearing firm today we deal with things from a viewpoint, it's not we're just looking into Chicago anymore. But it's New York and the global basis.

So I'm going to try to discuss with you how we look at risk, how we manage risk. The first few slides are what we are as a company.

INTL-FC Stone, to give you an idea, we're just not a basic brokerage house where we just take a ticket. We have roughly 120 risk managers in the firm that deal with clients on a day to day basis, so we're a little bit more in depth than a typical brokerage house where you put your orders in and it's done. We deal with the customer. A lot of them are commercial in base, so when you look at what we do we have physical books, we have the over-the-counter brokerage derivative desk, the risk management consultant, and then the futures and brokerage clearing on a global basis.

We work with a lot of customers in the last two three years more as a consultant that does the clearing at the end of the day. We will work with them from a line item in a budget process.

This is just a footprint of where the company is. There's one change—we have 30 offices now, just opened three more offices in Brazil. So we have a global, we are across all the different time zones, so one of the other issues when you started before you didn't worry about what your offices did in other parts of the world. Today we literally have 30 offices in 10 countries dealing with customers in 100 countries. So there's a lot more to what you do today than you did 10 years ago, let alone 20 or 30 years ago.

The products we trade in literally are all the products globally that are handled, from 4X to weather derivatives, all the energy products on all the energy exchanges, the metals products from COMEX to LME and everything in between. I was in China three days ago, and spent the last week in Shanghai and Shenzhen, met with the CEO of the Shanghai Exchange. I had a great discussion. They are rolling out more products. One product they plan to work on is a crude oil product, so we'll have more opportunities to get you into arbitrage from WTI to Brent to Shanghai. The market is going to be bigger, more robust. At Shanghai the largest commodity that's traded there is rebar. Dalian as Chuck said is beans and cotton, but that's more of an industrial site in Shanghai and it's going to get larger and larger, and it's all electronic.

We met with an FCM there in China. They have a client that in a week can trade 400,000 contracts a week. So this is what we're doing by the evolution of electronics. The other products we deal with you can see is dairy food, and a lot of these products maybe go into a clear port model or an exchange, but a lot of these products that are large in volume but don't have the opportunity clearing-wise will be a derivative product.

This is just a quick snapshot, and then we'll get into the meat and potatoes of how we look at things. Our integrated risk management program is a program as RFCM. We look at a customer's balance sheet, work with him and do the transactions on a brokerage basis. We take analysis data, budgets, work with their CFOs, their treasury.

Charles made a good point, we've got a lot of customers today that are hedging, doing what is right, sitting in a marketplace where they are long at cash commodity and trading what we call a basis, difference between cash and futures. So they are long-cash, and to protect their price from going down they're short futures. If you look at what's happened in the cotton market in particular or even in crude, but in cotton you run these markets to a point where the banking needs and capital requirements are stressing some of the largest companies in the world. I don't know if there's an answer for this by anybody here. When I started the markets are the markets, and we are going to do what the markets will do at the end of the day. When I started, we walked into an embargo in 1980 and wondered why I got into this whole business. Since then if you look at the last 10 years of commodities I truly believe we're going to have ups and downs, but the commodity-driven market being ag and/or metals or industrials is the next 10 to 20 years is where it's going to be at because it grows globally.

We still run into this position when we have customers legitimately hedging; but then the banks come, as Charles said and it's happened more than once, "There's no more money." So now the onus falls on the brokerage company, and obviously that's not what we want. The customer blows out at the top, and at the end it's not a good picture for anybody.

So the options and what we deal with, try to structure products through our program, optionality will help customers a lot more than just being sometimes just a straight futures player. That's my two-cent tidbit for the day.

Now we'll talk about where the markets are at and what we've done over time. This is the Reuters/Jeff CRB returns, and if you go back in each quadrant is roughly a 10-year period. You could tell the '60s were pretty low key in the commodity markets at least. The '70s, as things went up we saw the big thing was the great grain robbery, the Russians, the wheat and everything else for those view. So we some of that in the beginning, we saw more of a growth in the United States. Globally we didn't see as much, but it really was a U.S. driven market in what we saw. The '80s believe it or not were fairly low key. We came off the Carter administration into the Reagan administration, high interest rates. I remember coming out of school, interest rate mortgage was 16 percent and at the end it was about 7 or 8 percent. So you took a farm economy also at that time that was leveraged up on higher interest costs, higher land values, and all of a sudden when inflation and everything else broke, it broke the back of the Midwest farmer.

Now, other parts of the sectors got a lot better, but when you look at the flyover country, in the middle of America, that's what probably got hit the hardest in the first six to seven years of the '80s -- and then slowly but surely got out of it. If you look at this program too, the farm programs we had back in the '80s, we had a Reserve Price Program that you had to go to a certain level, a certain amount of days, and then the government would release it. Then in their infinite wisdom in the mid '80s they decided, we have all this corn, roughly about 3.5 billion bushels if I remember right back in about 1986 or '87, that we had a pick year. We took a lot of ground out of production. And we had the CRP and took out all this. This was 1983.

So believe it or not, we take out literally almost 25 percent of the acres, and what do we have? A drought. Prices go up, we reserve it, and then we go back to the same farm program. We start this whole ball again. And you talk about volatility. In '86 and '87 we had a pick where we gave away, futures corn traded at $1.42 a bushel. It's hard to believe. That's when I believe we finally got some semblance where we decided we were going to go to more of a basic loan rate. The government's not going to own grain and pay people 26 cents a bushel a year to go store it for them. It went to more of a free market program.

I also think, when you look at that, is when volatility came in; but we also looked at it that we grew other parts of the world on a global basis. I do believe one of the earlier speakers said that in the early '80s we really subsidized and thought the United States could feed the world. That ain't going to happen.

You look at global growth today, and I've got some charts at the end to give you an idea of this, the world has to feed itself. We've got to be part, at least in my opinion, part of that solution. But we cannot have a late '70s, early '80s program where we think U.S. farmers can potentially feed the growth of the world. We had 2,000 people in here in this meeting hall, and 20 percent of that if this was the world right now, 400 of you would be Chinese, 350 of you would be from India. So when you look around from a global basis, this is a small section of what we're dealing with globally in agriculture.

I had these charts made up for you, and they are different commodities. They'll be in the book, I think, and you'll be able to see them a little bit better than even I can. But if you look at that, the purple, blue and yellow lines are 10, 5 and 2-year volatilities. When we first had it they were 10 years. I'm not big on looking at anything in particular, but I said, Give me where 5 and 2 years are. When you look at this, you can see the blue line is the 5 and the yellow is the 2. Some are way higher than they are versus their 10-year value. Those in particular are sugar, wheat, copper and corn. Very much an industrial and/or consumptive program on a global basis. I don't know if we've got cotton in there, but if we did and you looked at cotton over the last year it would be on the top end of the scale.

So this tells me, we are going to be building into a more volatile market. There are reasons, in my opinion, why we are having volatility. We talked earlier about cotton at $2.00. When you look ate the demand on cotton, there is no substitute for cotton. If you want to have cotton jeans or cotton clothing, you're going to buy cotton. You don't have other commodities that can compete with it. So that's part of the problem in certainties commodities is that they are identified by one commodity only.

This chart here – someone asked me the other day, "If you looked at this chart, what would you look at?" I said, "By the rule of law, natural gas hasn't done anything for the last two or three years and is probably the next one to explode." Why? I have no idea. But it's the same thing, you look back at the demand base and cocoa and coffee, some it's just time in the bucket. As long as we have a global demand base, everything will get used on a global basis.

I'll put all these up here for you at once. For 2008, 2009, I'll be quite honest, it was something I don't think anybody here or in the business 30 or 40 years thought could happen in such a short duration. When the world was blowing up – one thing that really helped everybody here is that the exchanges and the FCMs involved all survived. The system again was stressed, but the system worked. And that's what we need, because without the system we don't have price discovery. That's the big thing we learned out of it. It hurt a little bit, there were some aches and bruises, but when it was all said and done things worked out pretty well.

Increase in price volatility, greater risk in credit and credit performance counter-party. The Exchange is 150-plus years old. The first one was Chicago Board of Trade, and now we have exchanges all over the world. The OTC market, even that market when you look at it, the over-the-counter market performed very well also.

One of the big things is that when people looked at '08 and '09 they started looking at different ways, alternatives to potentially hedge their risk and how to look at different vehicles. Charles hit on it earlier. When you look at this program, people that used just straight futures all of a sudden realized optionality is something that needs to be looked at. There are still some large major firms today that have rules and bylaws where they will not allow them to use options. My personal opinion, I think it's crazy. You can quantify it. It's a cost of an insurance, but at least you'll be around if something happens unexpected, and that's what the commodity markets do.

This is just another chart on the indexes. The black line is the spot market in an aggregate so you can see obviously from a spot index where we're going today.

Traditional diversification. When you looked at this, in the old days 15 or 20 years ago, a farmer or General Mills or a large food company—a farmer goes out, has corn, what's he do? He raises hogs or cattle figuring he can make money. Ten years ago the farmer decided, we'll build ethanol plants so if I can't sell my corn here I'll make money on the ethanol. It worked for a couple years, and now they realize it's a margin-management business. So typical diversification of your assets or what you grow are not there because of the disconnections at times and because of the margin management going into the world today.

The natural hedgers as I talked earlier – when you looked at the processors and at natural hedging, the marks have changed and we are in a totally different environment, another opportunity for FCMs. At the end of the day the exchange is still where you'll lay off your risk. And part of our program and part of what these other gentlemen up here have done is, you come up with different products – and derivative values, and it's not a bad word in our book, over-the-counter derivative used the same way – that you'll come up with different products to help different clients. Without that, the client will have major problems from a budgetary position.

Going through the last couple of these. When you look at the different programs on corporate risk and where we're at, this probably in my 30 years—in the beginning I was a broker and only cared about that I go get a client, get money, get a commission and go home. Now I get to sit on this side and go, Wow, I got a guy like me that only wants to get a commission and go home. But when you look at where we're at today from a corporate level, we have markets now that we have customers overseas. Go back 20 or 30 years ago, and there was not a broad customer base all overseas. And exchanges, we're now clearing 20, 30, 40 different exchanges, and the risk of that exchange and where the fiduciary responsibility comes in and is probably our biggest credit risk is, What is the exchange? When somebody says, What's your biggest client risk? – it's not a client risk, but an exchange risk. If there is something wrong with the exchange, it takes the whole industry down. It's like the Federal Reserve to us, and it's really Federal Reserve to you. Without the Exchange and the validity of the Exchange we have nothing to hedge with.

Operational. Charles talked about the electronics. You've got orders coming in on Yahoo IM, coming in on your i-phone, your Droid, blah, blah. You also have the chance for a fat finger. You sit there and all of a sudden, oh, a 100 lot, a 1,000 lot, how many zeros? There was a true story of a scanner that went over an order sheet five times and each one was a 100-lot. They wanted to sell 100 once, but they sold it five times because the guy happened to move the scanner with his hand five different times. So how do you quantify that? Then, when we give the electronics to a customer—which I don't disagree with you and I've got enough older guys that don't even want to mess with it—but when you deal with that, what happens when you have someone on the other end with the tool to trade? You've got to quantify the contract limits, how much they can put in at one time. All of a sudden you give them a 50-lot as their top, so they want to sell 50 at 5. But all of a sudden the customer comes in and sells them a quantity of 60 and you've cut them off at 50; now you've got a tee'd off customer that has to make a phone call and say, "Why can't I trade more because I've got to hedge more?"

These are all the little nuances that, when you go through the clearing end, every single day you must look at and in multiple languages and multiple platforms. Or the customer at the end of the day thinks, I did all my trades, but he finds out his server is not working. Or your server is not working, but the Exchange's is, and now all of a sudden you've got to figure out how to take care of your customers because somebody cut a phone line into your building and you can't get the orders--something we never thought about 20 or 30 years ago.

Legal and corporate. We're always going to keep attorneys and jobs, so that's no big deal. The more we have the more we enjoy them.

[Laughter]

But one thing though is rule of law in foreign countries. If we have an issue in the United States, right or wrong, at least we have a judicial system. As we go into foreign entities, what is the rule of law there? And is there a point where: "You know what? It's not worth it." You write it off and say, "One more learned experience for X amount of dollars." That's the potential. So we've got customers in over 100 countries, dealing with 100 different types of legalities.

Litigation, risk to defend, risk to pursue, we're all in the United States, we enter that one.

Liquidity risk. How do you offset positions, how do you get out of positions? When you get these run-ups in these commodities, where do we get out of things? Or somebody has to blow out of a position or knows they have a bad position on – trying to liquidate that for them.

Reg issues. Obviously we need it. NFA, CFTC, the SEC, IRS maybe is debatable, but when you look at it we've got different regulatory issues not only in the United States but we have the other issues in other foreign entities. When I was in Shanghai a week ago today, met with their CEO, part of it is their limitations on trading and how many quantities of contracts they can have. They are fairly small, which is why you get a lot of trading. Some contracts, it's 10,000 contracts. The problem, their contract equivalent is about a fifth of ours, so it's only 2,000 U.S. contracts. So now you see why this happens. These are some of the things we've got to look at. They're taking it slow and a cautious approach, but I think eventually they understand that to get the major trade in the arbitrage trade they'll have to have bigger limit positions.

Governance, management, human resources. Absolutely. When INTL and FC Stone merged about 15 months ago, we had 600 people. Today, we're at 800. I would be willing to bet you, probably 60 of the 200 new employees in our firm came through HR that will be governance, IT, and that. Some of them were brokers, but a bit part of it was just running around what we're doing from a legal entity and keeping everybody in tune.

Political risk. Obviously, this is a no-brainer. You see what's going on in the Middle East today. We've got to look at things and clients and what we've got. Do you have customers out there now that have positions on there in the country that has an issue and can you get a hold of them? Can you liquidate? Do they want to liquidate? Those are some things you go global.

I'll let you read these. I want to get to the last couple lines in these last minutes. Information from a financial information for customers, obviously we need to know. That's one of our criteria, we are going to have financials either in-house or we will visit them to make sure. Same thing, we provide market-to-market positions. You need to know where your customer and your own internal bar is on a daily basis.

New electronics, as I said, is much money databased feed sources. IT, absolutely critical to us. We do talk to our brokers and get their feedback to what we're doing right, they're doing right.

Policies, management program and a company disaster plan.

This is the other legal end of it. We have to make sure everything is documented. We want to make sure that we have every I and T crossed in case there are any legal hassles. We make sure now more than any other time that only certain people can sign for certain things from a legal viewpoint. Hire good legal staff.

Company-wide ethics, code of ethics, morality. We joke about it, but it's a very serious thing when you deal in the markets we are in today.

Management practices. This will all be on here, but when you look at the bar in the stressing – before you might stress things two deviations, but after the cot* mark I don't know if 3 or 4 is even enough anymore.

Liquidity. When we have customers trading we have to make sure what market they are in and how big the market is. That is a big key for us. We don't just let anybody trade anywhere for any reason, because if they have to get out who are they getting out against?

I'll go through these in this last minute. I want to show you some slides. When we talk about things and what's going on, I brought these out because I'm a fundamental guy from that end of it. This is the World Price Index. If you look what happened in former Soviet Union, grain demand, this is what's going on in the grain markets. There are speculators, all these other things, but we had a perfect storm over the last two years, and if we don't get a good grain crop this year in the United States we're going to have a bigger storm.

This is world soybean statistics. If anybody sees soybeans potentially at $18 the next couple years, this is your reason why. From 1982 just after I started, we've had a growth, the yellow line, of world usage year in and year out except for the '08, '09 global debacle. Look at the grown on an annual basis, and it's not stopping. Look where we're at now, look at Chinese consumption, and there's one of my final slides. This is Chinese soybean imports over the last 15 years. In 1995 it was virtually zero. The Chinese soybean import is roughly the equivalent of the country of Argentina, which is the third largest soybean producer in the world. So you heard a week and a half ago that China overtook Japan as the second largest economy back of the United States, but when you take those numbers and reverse them the per capital GDP of Japan is roughly $42,000 per person; yet in China ranks 95th at $4,500 per person. Now you think what happens if they just double from $4,500 to $9,000. It's more demand, Chinese soybean usage.

The last chart, hog production in the world. I'm sure a lot of you came here just for this fact today. When you look at this, China's hog production is larger than the next 43 countries in the world. If they take their relationship of red meats and chicken, this is where the demand base is globally. Thank you.

[Applause]