**EXHIBIT A**

NATIONAL ARCHIVES AND RECORDS ADMINISTRATION

**To all to whom these presents shall come. Greeting:**

By virtue of the authority vested in me by the Archivist of the United States, I certify on his behalf, that the seal of the National Archives and Records Administration, that the attached reproduction(s) is a true and correct copy of documents in his custody.

SIGNATURE

NAME PAMELA A. WEGNER

DATE 10-17-05

TITLE DIRECTOR, RECORDS CENTER OPERATIONS

NAME AND ADDRESS OF DEPOSITORY

NARA-GREAT LAKES REGION (CHICAGO)
7358 SOUTH PULASKI ROAD
CHICAGO, ILLINOIS 60629

NA FORM 13040 (10-86)

declare:

1. I reside at 1115 Glenview Road, Glenview, Illinois 60025.

2. I am employed by IMC as Manager of Market Planning - Industrial Chemical Division.

3. In January, 1982 I decided to invest with Heritage Capital Advisory Services, Ltd., hereinafter "Heritage", which I believed to be a "sales arm" for Financial Partners Brokerage, Ltd., hereinafter "FPB". A presentation was to be made by Mr. Ward Weaver, formerly affiliated with the Schaumburg State Bank and then affiliated with Heritage.

4. I met with Ward Weaver in early January, 1982. His son, Jeff Weaver, who also worked for Heritage, was also present at the meeting. Mr. Ward Weaver explained to me that FPB was a corporation headed by Bob Serhant. The extent of information

17

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

FILED

SEP 28 1982

H. Stuart Cunningham, Clerk
United States District Court

COMMODITY FUTURES TRADING COMMISSION,

Plaintiff,

TYRONE C. FAHNER, Attorney General of the State of Illinois,

~~Intervenor,~~

vs.

FINANCIAL PARTNERS BROKERAGE, LTD. et al.,

Defendants.

No. 82 C 5955

DECLARATION OF EDWARD C. LUKE
UNDER PENALTY OF PERJURY
PURSUANT TO 28 U.S.C. § 1746

I, EDWARD C. LUKE, under penalty of perjury do hereby declare:

1. I reside at 1115 Glenview Road, Glenview, Illinois 60025.

2. I am employed by IMC as Manager of Market Planning - Industrial Chemical Division.

3. In January, 1982 I decided to invest with Heritage Capital Advisory Services, Ltd., hereinafter "Heritage", which I believed to be a "sales arm" for Financial Partners Brokerage, Ltd., hereinafter "FPB". A presentation was to be made by Mr. Ward Weaver, formerly affiliated with the Schaumburg State Bank and then affiliated with Heritage.

4. I met with Ward Weaver in early January, 1982. His son, Jeff Weaver, who also worked for Heritage, was also present at the meeting. Mr. Ward Weaver explained to me that FPB was a corporation headed by Bob Serhant. The extent of information

17

provided to me concerning Bob Serhant was that Serhant formerly worked for E.F. Hutton, was a registered commodities broker and had been involved in FPB for at least a year.

5. Mr. Weaver explained that Serhant bought $100,000.00 T-Bills at the current discount rate and would use the discount to speculate on the futures T-Bill market. Mr. Weaver further indicated that only the discount was at risk; that the Principal was entirely safe. Mr. Weaver further indicated that the minimum investment amount was $10,000.00. Thus, my $10,000.00 would be combined with others to buy one $100,000.00 T-Bill.

6. Concerning interest payments, Mr. Weaver explained that I could take one of two options: 1) to "roll-over" or re-invest the interest earned; or 2) to withdraw the interest and thereby receive a monthly interest check. He further explained that Heritage would take one percent (1%) of all profits earned as it's commission, and that the commission amounts would be deducted before I received my monthly statement or interest check from Heritage.

7. On January 21, 1982 I decided to invest with Heritage. Pursuant to agreement with Mr. Weaver, I gave him four (4) staggered checks each for $2,500.00 [1/] and totalling $10,000.00. I futher opted to withdraw the interest and did so until each portion of my investment reached ninety (90) day maturity. I then withdrew my original investment of $10,000.00 in four succeeding weeks.

---

[1/] January 21, 1982; January 28, 1982; February 4, 1982; and February 11, 1982.

8. Copies of the only disclosure materials provided to me are attached hereto and made a part hereof as follows: Exhibit A - entitled "Account History"; Exhibit B - September 1, 1982 Chicago Tribune article; Exhibit C - two page statement from FPB signed by Robert B. Serhant; Exhibit D - November 21, 1979 Wall Street Journal article; Exhibit E -article entitled "Pension Plan not afraid of rate futures"; Exhibit F - article entitled "Hedging with interest rate futures"; Exhibit G - article by Jerome Idaszuk; Exhibit H - Prime vs. T-Bill Futures Chart.

I declare under penalty of perjury that the foregoing is true and correct.

Executed September 26, 1982.

Edward C. Luke

Edward C. Luke

For [redacted] mation ( J. Weaver

| Week of | Monthly Return on Investment. Gross | Net | Annualized Return On Investment Gross | Net |
|---|---|---|---|---|
| 1/6 | 4.55% | 3.55% | 54.60% | 42.60% |
| 1/13 | 4.35% | 3.35% | 52.20% | 40.20% |
| 1/20 | 4.78% | 3.78% | 57.36% | 45.36% |
| 1/27 | 4.87% | 3.87% | 58.44% | 46.44% |
| 2/3 | 4.90% | 3.90% | 58.80% | 46.80% |
| 2/10 | 4.71% | 3.71% | 56.62% | 44.62% |
| 2/17 | 5.08% | 4.08% | 60.96% | 48.96% |
| 2/24 | 5.17% | 4.17% | 62.04% | 50.04% |
| 3/3 | 4.52% | 3.52% | 54.24% | 42.24% |
| 3/10 | 4.45% | 3.45% | 53.40% | 41.40% |
| 3/17 | 4.23% | 3.23% | 50.76% | 38.76% |
| 3/24 | 4.75% | 3.75% | 57.00% | 45.00% |
| 3/31 | 4.32% | 3.23% | 51.84% | 39.84% |
| 4/7 | 4.35% | 3.35% | 52.60% | 40.20% |
| 4/14 | 4.50% | 3.50% | 54.00% | 42.00% |
| 4/21 | 4.15% | 3.15% | 49.80% | 37.80% |
| 4/28 | 4.91% | 3.91% | 59.00% | 47.00% |
| 5/5 | 4.25% | 3.25% | 51.00% | 39.00% |
| 5/12 | 3.95% | 2.95% | 47.00% | 35.00% |
| 5/19 | 4.09% | 3.09% | 49.00% | 37.00% |
| 5/26 | 4.15% | 3.15% | 50.00% | 38.00% |
| 6/2 | 4.23% | 3.23% | 50.76% | 38.76% |
| 6/9 | 4.09% | 3.09% | 49.00% | 37.00% |
| 6/16 | 4.25% | 3.25% | 51.00% | 39.00% |
| Switch to 90 Day T-Bills | | | | |
| 6/23 | 4.58% | 3.58% | 55.00% | 43.00% |
| 6/30 | 5.10% | 4.10% | 61.20% | 49.20% |
| 7/7 | 4.50% | 3.50% | 54.00% | 42.00% |
| 7/14 | 5.50% | 4.50% | 66.00% | 54.00% |
| 7/21 | 5.50% | 4.50% | 66.00% | 54.00% |
| 7/28 | 4.71% | 3.71% | 57.00% | 45.00% |
| 8/4 | 5.25% | 4.25% | 63.00% | 51.00% |
| 8/11 | 5.05% | 4.05% | 60.60% | 48.60% |
| 8/18 | 5.01% | 4.01% | 60.12% | 48.12% |
| 8/25 | 5.15% | 4.15% | 61.80% | 49.80% |
| 9/1 | 5.20% | 4.20% | 62.40% | 50.40% |
| 9/8 | 5.25% | 4.25% | 63.00% | 51.00% |
| 9/15 | 5.10% | 4.10% | 61.20% | 49.20% |
| 9/22 | 5.05% | 4.05% | 60.60% | 48.60% |
| 9/29 | 4.85% | 3.85% | 58.20% | 46.20% |
| 10/6 | 5.05% | 4.05% | 60.60% | 48.60% |

Exhibit A

## Money manager

Tribune photo by Earl Gustie

Robert B. Serhant: "We can tell much more about the way interest rates are going by looking at the spread relationships."

# He finds hedge to help investor

said investors in this program are reaping a 30 per cent annual return.

The hedge-spread program is based on the premise that the volatility of the price spread between long (buy) and short (sell) futures contracts with two different delivery dates will be less than the volatility of the prices of the individual contracts, Serhant said.

"BY ENTERING INTO a spread position, you're not taking as risky a position as if you were going into an outright long or short position," Serhant said.

The second major feature of the program is that each investor's potential loss is limited by the outright purchase of a Treasury bill whose return is virtually riskless based on the government's promise to redeem at full par value.

As an example, the program may work like this: The investor gives Serhant $100,000. Serhant buys a 90-day Treasury bill, which sells at a discount for, say, $97,000. The remaining $3,000 is used to buy spread contracts in 90-day T-bill futures. Depending on market conditions, Serhant may, for example, buy the December contract and sell the September contract short. Or he may sell short the December contract and buy a September contract.

"WHAT WE'RE HOPING for is that the price differential on the two contracts will widen or narrow down, depending on our position," he said.

If the strategy were to buy the September contract and sell short the December contract, for example, the investor hopes the price spread between the two will narrow.

If the spread moves in the desired direction, the investor profits. If the spread moves adversely, the maximum loss would be the $3,000 at risk.

"The investor knows from the beginning that if he's wrong it's only going to cost him no more than $3,000," Serhant said.

That's because Serhant will close out the position at that point by a buy-stop or sell-stop mechanism. Also, Serhant will close out the position if the profit objective is achieved before the underlying T-bill matures.

"WE'VE TRIED TO structure it whereby the in-

Exhibit B

# Financial Partners Brokerage, Ltd.

In reference to your questions regarding the Customer Application of our clearing firm, this is to advise that we adhere to the following guidelines:

(1) The purchase of a 90-day United States Treasury Bill in an amount of 75% - 95% of the funds invested. These United States Treasury Bills are purchased in your name and credited to your account. As you know, they are purchased on a discount basis and are redeemed at maturity for a full 100 cents on a dollar. The United States Treasury Bills are backed by the full faith and credit of the United States Government directly and are considered to be the prime Government Security available..

The purchase of the United States Treasury Bills are executed by and through a major Chicago bank. Should you desire to redeem these securities prior to maturity, the procedure would be to contact us and an immediate execution of the same would be accomplished.

(2) The United States Treasury Bills and your cash excess will be recorded on a computerized statement on the next business day following your investment of funds. The transactional statement will show all of the transactions in your account, both in the cash and futures market.

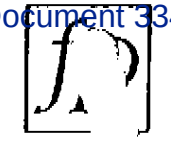
(3) The difference between the discount cost of the Treasury Bills and the full redemption value on the maturity will be your dollar risk. For example:

| | |
|---|---|
| $100,000.00 United States Treasury Bills @ 12% | |
| Cost of 90-day Treasury Bills on Day 1 at approximately | $97,000.00 |
| Value of 90-day Treasury Bills on Day 90 | $100,000.00 |

1900 Spring Road Oakbrook, Illinois 60521 312-789-2000

Member—International Monetary Market

Exhibit C



Financial Partners Brokerage, Ltd.

Therefore, if you purchased a $100,000.00 United States Treasury Bill, 90-day maturity on January 1, 1981 at a cost of $97,000.00, by April 1, 1981 your account will show a $3,000.00 gain. It is precisely this amount, namely the $3,000.00 that you have at risk in this United States Treasury Bill cash/future spread.

(4) Our customary involvement in the United States Treasury Bill futures market is done on a spread basis, whereby one particular maturity is purchased and another maturity is sold simultaneously. You could lose money in the United States Treasury Bills futures commitment, but that loss is limited in its amount by a specific price liquidation point. This liquidations point is there for your protection, so that if our projections and forecasts are not correct or timed appropriately you will be liquidated at a point wherein the loss will not exceed your accrued gain at maturity on the cash Treasury Bill.

(5) Furthermore, the only financial future to be utilized will be United States Treasury Bills and no other future contract whatsoever will be traded in your account unless specific written authorization by you is given to us.

ROBERT B. SERHANT, PRESIDENT
FINANCIAL PARTNERS BROKERAGE, LTD.

REPRINTED FROM THE WALL STREET JOURNAL.
ISSUE OF NOVEMBER 21, 1979

*Exposed Position*

# Bond Market's Plunge Caught Most Investors With Hedges Down

## They Couldn't or Didn't Use Futures in Interest Rates; But One Saved $150,000

## 'I Wish I Had Done More'

By Lawrence Rout
*Staff Reporter of The Wall Street Journal*

Most people in the bond market probably want to kick themselves.

During the recent plunge in bond prices, they could have saved a lot of money by using a four-year-old hedging mechanism that was available for the first time in a sharply declining market. But all except a relative handful weren't able or simply failed to do so.

What most bond-portfolio managers—to cite one group—didn't do was to hedge their bondholdings in the interest-rate futures market. To hedge bondholdings, a portfolio manager could have sold futures in Treasury securities. The reasoning: The futures, which are agreements to deliver government securities at a specified price and future time, would respond much like bonds to an increase in interest rates—that is, their prices would fall.

And after Oct. 6, when the Federal Reserve moved to curb inflation by driving up interest rates, prices of both bonds and interest-rate futures did decline steeply. A well-hedged portfolio manager could have offset much of the loss in the value of his bonds by buying back his futures for less than his earlier selling price. Because the hedging transaction began with the sale of futures, the manager's repurchase of identical futures liquidates his position in the futures market. For the first time, bondholders had an opportunity to do something besides passively riding out a plunge in prices—just selling bonds at a big loss.

### Most Steered Clear

Yet, says Robert Zellner, president of Advant Financial Inc., a Chicago-based interest-rate-futures brokerage firm for financial institutions, "there were certainly more people who didn't use futures than who did."

The relatively small amount of hedging is particularly striking because of the huge amounts of money at stake in the bond market. The totals for just three major types of bonds: Publicly offered corporates outstanding amount to about $260 billion, municipal bonds (issued by both states and local governments) about $315 billion, and marketable Treasury debt about $395 billion.

And in the bond market last month, the loss of principal was staggering. According to Salomon Brothers, a big New York bond house, prices of high-quality corporates fell nearly 10%. This estimate indicates that a $1 billion portfolio of corporates—not unusually large these days—may have sustained a paper loss of almost $100 million; the exact amount would have depended on the particular issues and maturities involved.

So, because of the record declines in bond prices, institutional investors and bond dealers alike are holding seriously depreciated portfolios and are taking substantial losses on securities that they do sell. In addition, corporations planning to issue new bonds are being stuck with sharply higher interest rates.

### Big Opportunity

These troubles could present the interest-rate futures market with the biggest opportunity ever before it, proponents of such futures say. "If ever you wanted an advertisement for the interest-rate futures market, this is it," says Morton Lane, president of Discount Corp. of New York Futures. "It's a classic example."

Here's how hedging with futures works. Let's say a bank held a $1 billion portfolio of bonds at the beginning of October. By the end of the month, those bonds were worth about $900 million, representing a portfolio loss of about $100 million.

To protect itself, the bank could have sold $1 billion of Treasury-bond futures, thus taking a short position in the futures market. During the month, prices of these futures dropped about 8%; so on Oct. 31 the same futures were worth about $920 million.

The bank could have bought bond futures that day, canceling its short position and resulting in an $80 million profit, less commissions, to apply against its $100 million portfolio loss. Profits from hedging usually don't work out to equal losses exactly, because of differences between futures and portfolio holdings.

Consider the experience of Craig Wardlaw, a bond-portfolio manager at North Carolina National Bank in Charlotte. Expecting trouble, Mr. Wardlaw had sold a lot of bonds as well as hedged in the futures market by the time the Fed acted. "When you've got a $650 million portfolio, you can get creamed," he explains. "But with interest-rate futures, at least we weren't standing there defenseless." His futures-market profit—about $150,000—partially offset the decline in his bond portfolio, although his bondholdings, like almost everyone else's, still took a beating. He says he wishes he had used the futures market more extensively.

Even before Oct. 6, a growing number of people had become aware of the potentialities of the futures game. Since its inception at the Chicago Board of Trade nearly four years ago, interest-rate futures have been a phenomenal success, even though until August 1977 only two types of interest-rate futures contracts—in certificates of the Government National Mortgage Association and in 90-day Treasury bills—were traded. (One GNMA contract, for example, covers $100,000 of securities.)

Now, about a dozen types of contracts are traded on the Board of Trade, Chicago Mercantile Exchange, Amex Commodities Exchange and Commodity Exchange Inc. Trading volume in interest-rate futures rose 198% to 2.3 million contracts last year, and it climbed 206% in 1979's first 10 months.

Moreover, the Fed's moves may give the market a big push. "We're going to have increased volatility in rates," says Laurence Mollner, a vice president at Dean Witter Reynolds Inc. "That points out the need for an awareness of the futures market and how it can be used."

And there's plenty of room for growth. "I would say that less than 1% of the potential users are actually using it," says George Hall, vice president and director of financial futures marketing at Merrill Lynch, Pierce, Fenner & Smith Inc. "Even though it has grown faster than the other commodities, it's still in the embryonic stages."

Its growth has been held down significantly because many people aren't authorized to use it. Many state-chartered banks haven't obtained permission from state banking authorities, and only about 40 national banks have received a go-ahead from the Comptroller of the Currency. The Comptroller's office in Washington says no applications to use interest-rate futures have been rejected, but some bankers contend that the federal authorities have raised numerous objections and, in effect, barred them from the market.

Similarly, many pension-fund managers need to get approval from their boards of directors or state legislatures before using the market. Robert Barman, senior portfolio manager for Minnesota state pension funds, says he "definitely would have used the futures market" if he had had authority to do so. He has asked the legislature for a change in the statute governing his operations.

### Low Commission Costs

Also holding down the market's growth is widespread doubt about its effectiveness. Some doubters say that the market isn't liquid enough and that sharp swings in prices make it a dangerous game. They worry that newcomers don't understand it and are getting in over their heads. And they note that because no hedge against interest-rate changes is perfect, it's possible, though unlikely, to get burned both in the underlying securities holdings and in the futures market simultaneously.

Moreover, the small amount of money that investors have to put up can work



Exhibit D

against them as well as for them. Investors in Treasury-bill futures, for instance, need only about $1,000 to control about $1 million of securities. But the leverage works both ways, and if the market moves against them, additional margin money is required immediately. Big losses are possible.

The commission costs of hedging are so low, however, that they aren't likely to retard the market's expansion. To get into and out of a $1 million hedge in Treasury securities, for example, costs about $50, and these hedges can be good for as long as two years. Of course, "just how expensive it is depends on whether or not the hedge works," notes Mr. Lane of Discount Corp. of New York Futures.

Despite the risks, most bond-market participants undoubtedly regret not using futures last month. In fact, even the Monday after the Fed's weekend announcement wouldn't have been too late to have saved money.

That's because, while the bond markets were observing the Columbus Day holiday, the futures markets were hopping. If people had come in to work, says Stanley Jonas, manager of the financial-futures division of ACLI Commodities Service Inc. in White Plains, N.Y., "they could have at least mitigated their losses."

One who did was Erwin Williams, a vice president at First Union National Bank in Charlotte. Figuring that bond prices would fall on Tuesday when trading resumed, Mrs. Williams sold futures on Monday. Since futures prices didn't drop sharply until Monday afternoon, she had time in the morning to make up about $12,000, or about 10% of the decline in her portfolio's value.

## Corporate Users

Similarly, some Wall Street bond houses say futures helped them cut their losses during the recent bond-market debacle. Observers say more houses are likely to use futures hedging in the wake of the battering that they took in the $1 billion debt offering of International Business Machines Corp. The underwriting loss, estimated at $10 million, "is going to become a textbook example for the necessity to hedge" bond inventories, says Frank Mickel, an E. F. Hutton & Co. vice president.

Industrial corporations also are beginning to use the futures market. Six months ago, Esmark Inc. anticipated rising borrowing costs and, to protect itself, sold about $15 million of Treasury-bill futures. "The strategy obviously worked," says Jay Proops, treasurer of the diversified company, although he saved less than $100,000. "I just wish I had done more."

So does Lawrence Geraghty, a senior vice president at First Pennsylvania Bank in Philadelphia. In the past, Mr. Geraghty has sold futures to hedge against rising costs of the bank's certificates of deposit, at an annual saving of about $1 million. But recently, he wasn't in the futures market, and he estimates that the bank lost an opportunity to recoup $250,000 in interest costs. "In retrospect," he concedes, "we should have been more aggressive."

Aggressiveness certainly is the hallmark of people who use the futures market not to hedge but to seek quick profits. These people take advantage of perceived discrepancies in the relationship between the futures market and the underlying debt markets. "When it moves, the futures market reacts with a knee jerk and the cash market is more stable," says Earl Johnson, a securities-trading officer at Seattle-First National Bank. "Both may be going up, but the futures will be more exuberant." So he buys the cash market, sells the futures and tries to profit as the relationship between the markets returns to "normal."

## Too Many Speculators?

But most observers question just how easy that really is. One trader who shuns futures complains of too many volatile speculators—traders trying to guess what the market will do without having any stake in the corresponding securities. "You're playing with John Q. Public out there," he says, "and you can never predict what the general public will feel about interest rates."

And even hedging has risks, partly because rates vary with the security and the maturity. Because there isn't any futures contract in corporate bonds, for instance, a hedger must use Treasury-bond futures. But if the relationship between Treasury bonds and corporates changes, his protection is diminished.

First Pennsylvania's Mr. Geraghty observes that hedging can even work against you. In 1978, for example, he sold Treasury-bill futures to hedge the bank's future costs from certificates of deposit. But because of technical market factors, he says, the CD rates rose and the Treasury-bill rates fell. As a result, he was hurt in both markets.

Although that hasn't happened often to Mr. Geraghty, he says it isn't unusual for novices. He blames the notion "that the futures market is a panacea rather than a normal marketplace. A lot of participants enter the market mindlessly and don't take the same precautions they would in the cash market."

# Pension Plan Not afraid of rate futures

By Michael Edgerton

IT IS SAID THAT fools rush in where angels fear to tread, and nowhere has that been truer than in using interest rate futures as part of a pension plan's investment strategy.

Nevertheless, Seymou Lotsoff, vice president for fixed income securities at Sears Investment Management Co., doesn't consider himself a fool for making his company the first investment adviser to use interest rate futures. The customer that has benefited is SIMCO's chief client, the pension plan of Sears, Roebuck & Co.

Other managers have been chary of futures because of perceived risks or their novelty: The first interest rate futures, contracts on securities of the Government National Mortgage Association (Ginnie Mae), were traded on the Chicago Board of Trade just five years ago.

An interest rate futures contract is an agreement to buy or sell a fixed income security at a specified price on a specified future date.

BUT LOTSOFF'S phenomenal success may soon make believers of other portfolio managers. July 1 marked the end of SIMCO's first year of interest rate futures trading, and in that period its bond portfolio was up 12.5 per cent. The portion of the portfolio devoted to futures was up 15 per cent, compared with a decline in the Salomon Brothers high-grade bond index of 2.37 per cent in the same period.

SIMCO handles Sears' profit-sharing plan, amounting to about $1.8 billion of Sears stock and other equities. It also manages about $2 billion for the Sears pension plan and for other clients. A third of that is in fixed income securities and the remainder in equities.

Lotsoff is an enthusiastic advocate of futures, but he draws several distinctions between the strategy and motives for what he does and for what the individual trader or speculator might do.

"When we make a commitment to buy or sell a futures contract, it's the same thing as committing to buy or sell the underlying security," Lotsoff says. "If I buy a contract for a $100,000 bond, I have the $100,000. From a portfolio standpoint we're done nothing different than in normal trading.

"We differ from own-account traders who might leverage their dealings. We don't leverage any of the portfolios we manage, and the ability to control large amounts of securities with relatively small amounts of money isn't that interesting to us. Futures are incidental to the main point, which is maximizing the return on the bond portfolio."

USING FUTURES solves a problem for SIMCO. "It may be cheaper to buy bonds due for delivery in a year than to buy them now and hold them," Lotsoff says.

Futures contacts can be used as a hedge, which reduces risk by using a futures market position to offset a cash market position. "For example, if I were to assume that the underlying security would go down in value, I'd sell some futures contracts to avoid having to sell it," Lotsoff explains.

Selling Treasury bond contracts, to take just one instance, might be used to avoid selling a corporate bond with attractive income generating characteris-

Continued on page 4

Exhibit E

# Pension adviser not afraid of interest futures

Continued from page 3

tion. "This would effectively protect the corporate bond's principal," Lotsoff says.

Lotsoff likes the interest rate futures contracts because of their size and liquidity in relation to dealer markets in the underlying securities. He points out that the average daily volume in long government bonds among dealers is about $300 million to $500 million; the daily volume of the Chicago Board of Trade T-bond contract is about $2.5 billion. Similar relationships exist between dealer and futures markets in T-bills and Ginnie Maes, which SIMCO also trades.

BECAUSE OF THE liquidity of these markets, and the relatively smaller amounts of money involved in transactions in dealer markets, Lotsoff has found that executing government security trades in futures markets can often save commission money. The total cost of changing a position is often less in the futures markets.

"As an example, the commission on a T-bond contract might be 2-32 or 3-32 of a point, but through a dealer the cost of exection could be as much as ½ of a point," Lotsoff says. "The reason is simply that volume is much greater on the futures markets."

The liquidity characteristic of the futures markets lends itself to several investent ploys. There are some securities, such as deep-discount Ginnie Maes or low-rated bonds, that may be attractive for their yields but difficult to trade.

Purchases or sales of these kinds of securities can be hedged, rather than distorting dealer markets with large buy and sell orders. The same thing goes for relatively small-issue bonds which might be hard to sell, but harder to replace if sold: An agile futures trader could protect his bond investment by shrewdly putting on futures trades at given points in the interest rate cycle.

IN THESE DAYS of volatile interest rates, the old "buy-and-hold" bond management strategy just doesn't work. Or, as Lotsoff puts it, "The time when an investment manager could think of long-term bonds as a basically stable part of the portfolios he or she is responsible for existed long ago and may exist again in the future, but surely doesn't exist now."

Lotsoff and his team are constantly looking for situations where the prices in futures markets show wide discrepancies from those available in dealer markets. "In much of 1979, for example, you could buy T-bond contracts for delivery a year from now and make as much as 2.5 points from the current rate in cash markets."

How would Lotsoff approach that situation, which is one he faced during his first year of interest rate futures dealing?

"Let's say I want to buy bonds in the futures market because they're more attractively priced than the ones in the cash market," he suggests. "Let's say that six months later the situation is reversed and the cash market looks more attractive.

"I can close out the futures contract and trade in the cash market, taking the relative profit I've earned. Futures prices would have moved up more rapidly relative to the cash market, which is what originally made the cash market cheaper."

ANOTHER STRATAGEM Lotsoff has used involves two different instruments at the same time: Long bonds are yielding about 12 per cent now, and Treasury bill yields are around 14 per cent. Assuming that the T-bond and the T-bond contract are priced the same, the smart thing to do is to buy the T-bond contract (it costs about $3,000 for a $100,000 bond contract) and use a cash reserve, which might have been used to buy the bond itself, to buy a $100,000 T-bill.

"I'd do this because I expect interest rates will decline in a year, and that in fact short-term rates will decline more than long-term rates," Lotsoff explains. "In a year, I can earn 14 per cent on the T-bill, a two-point advantage over the long bond.

"When the bill matures I'll also take deliv the bond contract, paying for it with the proceeds. And I've locked in the 12 per cent r the bond. If rates go up instead of dow decision to buy either security would have wrong, but at least I got the two-point advanta

LOTSOFF BELIEVES other money manage have to educate themselves to the possibilit are open for interest rate futures. "The trad uncertainty in investing is buying at today's and not knowing what tomorrow's price will b says. "In futures there are other uncert Although you know what the price will be wh contract expires, you don't know exactly wh curity will be delivered, for example."

Margin buying of contracts has gotten reputation (because margin buying of secur cash markets involves loans), and that has some conservative institutions. Nonetheless, suggests it is a conceptual problem that overcome by thinking of margin buying borrowing, but as posting a performance b guarantee the execution of a contract.

Some state insurance commissions have fo pension plans from engaging in futures tradi accountants and lawyers still are wrangli just how futures contracts should be treated connection to the periodic reporting requirem pension plans. But the importance of better returns will ultimately bring all institutions i fold of users, Lotsoff believes.

CORPORATE FINANCE

# Hedging with interest-rate futures

The bank prime rate is now 17% and probably headed higher, and long-term rates are churning as they, too, threaten to climb. Would-be corporate borrowers are wringing their hands over what they might have to pay when they come to market. So more corporate treasurers are now frantically looking for ways to keep their borrowing costs from running totally out of control.

Currently, a dozen or so companies, including Burlington Northern, Esmark, and Stauffer Chemical, are ensuring lower borrowing costs by hedging in interest-rate futures, which are traded primarily on the Chicago Board of Trade and Chicago Mercantile Exchange. Financial officers can hedge their interest-rate bets, since the profit on successful trades in Treasury bill or bond futures will offset the higher interest costs they will have to pay when they eventually sell their debt. And experts predict still more corporate financial officers will be drawn to futures if rates continue their stomach-churning gyrations.

**Short-term profits.** Of course, financial futures can be used in both rising and falling markets, but they are commonly being used today by prospective borrowers who anticipate a continuing rise in rates. The strategy is to sell futures short (table). If interest rates rise and bond prices consequently fall, the company can simply buy back the contracts at a lower price. The corporation, of course, makes a trading profit that can mount into the millions over a matter of days.

Last July, for instance, Burlington Northern Inc. decided that it would sell $125 million of debt in mid-August to pay for railroad property improvements and equipment. And while rates on corporate bonds were 12.5% to 12.65% then, Burlington Treasurer R. C. Burton Jr. worried that they would be higher by the time he got the issue to market. So Burton decided to trade futures. On Aug. 4, he sold short 650 Treasury bond futures contracts. Because each contract had a face value of $100,000, the contracts represented $65 million.

By the following week, interest rates had indeed risen higher, and Burlington was forced to pay 12.9% for its $125 million. However, as rates rose, bond prices slid, and so did the price of the futures contracts. On Aug. 12, when Burlington bought back the futures contracts in order to close out its position, it did so at a lower price than it had originally sold them. The result was a $750,000 profit. By spreading that investment gain over the 25-year life of the bond issue, Burton says that his company's effective borrowing cost drops to 12.84%.

"It's incredibly difficult to predict the capital markets as far as interest rates are concerned," explains Burton. "For a corporation which has raised more than $1 billion of capital in the past three years, we thought this was a weapon we ought to have in our arsenal."

**Trading futures.** To trade futures, a corporate treasurer need only call one of the brokerage firms, such as Bache Halsey Stuart Shields Inc. or ContiCommodity Services Inc., that do a brisk business in financial futures. The broker takes a commission of $50, at most, per contract and executes the transaction. Standard futures contracts involving Treasury bonds have a $100,000 face value and an 8% coupon. Three-month Treasury bill contracts are traded in denominations of $1 million face value.

The investor in futures actually puts up only $1,500 in cash per contract. Burlington Northern, for instance, put up just $975,000 for its $65 million position. Of course, if the market had gone against Burlington—that is, if interest rates had fallen and bond prices risen—the company would have had to put up more money on its margined position.

Many corporations still resist using the futures market. For one thing, participation always requires board approval, and a company has to be pretty sure that a hedge position will pay off. An outright loss on the investment in a hedge position is a lot tougher to explain to irate board members than a higher interest rate inescapably dictated by the market. "Today, if a company is borrowing in a rising interest-rate environment, often the easy way out is to just sit back and say, 'The market is going against us,'" says Kenneth A. Drucker, assistant treasurer at Stauffer Chemical Co., which has been hedging its commercial paper borrowing since 1978.

The chief executive of another company scoffs at the whole notion of hedging interest rates—particularly on long-term debt. "If you're so sure interest rates are going up," he says "then why not take the money now at the lower rate?" The answer, say users, is that it sometimes takes weeks to mull a debt offering together, during which time the market could have swung dramatically. Further, hedging helps companies forecast their borrowing costs and therefore aids planning. Finally, it helps treasurers, unsure about their interest-rate forecasts, hedge their guesses.

**Prudent borrowing.** "If we really don't know where interest rates are headed, we will hedge a portion of our borrowing needs to be prudent and be able to plan our borrowing costs," explains one treasurer. "On the other hand, if we have a high degree of confidence that rates will decline, we probably won't hedge. And if

## How a company can hedge against rising costs of borrowing

| Date | Action in the debt market | Action in the futures market |
|---|---|---|
| | Current interest rate: 10.9% | |
| June 2 | Corporation decides to sell $100 million of 20-year bonds within three months | Corporation sells 1,000 Treasury bond futures contracts, with 8% coupon, for September delivery. Each contract brings $78,531.25. The below-par price indicates a yield on the contracts of 10.61% |
| | Current interest rate: 11.8% | |
| Aug. 25 | Corporation sells its $100 million debt issue at 11.8% | Corporation buys back 1,000 Treasury bond futures contracts, with 8% coupon, thus closing out its position. Each contract costs $73,343.75. The contracts are priced to yield 11.41% |

**Result: The effective borrowing cost is reduced to 11.15%, thanks to the $5,187,500 total profit on the trade in the futures market**



Exhibit F

we are fairly certain that rates will increase, we'll probably do a larger hedge."

Probably the most common use of hedging in the futures market involves the short sale of Treasury bill futures in anticipation of commercial paper borrowing. Esmark Inc. has been hedging its commercial paper borrowing since the inception of the Treasury bill futures market in 1976. After hedging its commodity business with grain and livestock futures for years, "It seemed natural to use financial futures to control our interest costs," declares Jay D. Proops, vice-president and treasurer. "Money is a commodity too, and futures are an insurance contract."

Having started with just a couple of futures contracts in 1976, Esmark has recently hedged as much as $50 million of its short-term debt. So far this year, the company has netted $500,000 from its futures positions, which, in turn, has offset its higher interest costs.

On Aug. 28, for example, the rate on Esmark's 90-day commercial paper was 11.05%. That paper was due to be rolled over on Oct. 30. Sensing that rates would be higher at the end of October, Proops sold 23 Treasury bill futures contracts, which represented a face value of $23 million. The discount price of each contract on Aug. 28 was $972,900. Sure enough, by Oct. 30, the commercial paper rate had moved up to 14.2%, and the prices of those Treasury bill futures contracts had fallen to $968,200 apiece. Esmark bought them back at the lower price to close out its position and made a profit of $108,100. The profit, of course, lowered Esmark's borrowing cost.

**'Cross hedging.'** In fact, Esmark's hedge failed for two reasons to offset the higher interest expense completely. First, it was only a partial hedge. Second, there is an imperfect relationship between commercial paper and Treasury bill rates. This is called a "cross hedge"—hedging one instrument with a different one, such as commercial paper with Treasury bill futures or corporate bonds with Treasury bond futures.

For many corporations, the risks and complexities of trading futures cause them to shy away from the market. "Corporations still tend to view not hedging as an opportunity loss, not a real loss," says Richard L. Sandor, director of ContiFinancial, a subsidiary of ContiCommodity. "Consequently, it tends to take a lower priority." ■

## Investment figures of the week

Ballooning money-s... figures convinced analy... that the Federal Reserv... not run its course on tig... oney policies, sending interest rates higher. A two-dc... ling session eroded gains ...e stock market.

| | Latest week | Previous week | Previous month | Year ago |
|---|---|---|---|---|
| **Money market rates** | | | | |
| Federal funds* | 17.11% | 17.19% | 13.02% | 12.53% |
| New three-month Treasury bills* | 14.38% | 14.31% | 12.33% | 11.32% |
| New six-month Treasury bills* | 14.03% | 13.92% | 12.28% | 11.42% |
| Three-month commercial paper* | 16.00% | 14.25% | 12.25% | 13.63% |
| **Stocks** | | | | |
| Price/earnings ratio* (avg. 1,500 stocks) | 10.00 | 9.96 | 9.69 | 8.15 |
| Dividend yield* (avg. 1,500 stocks) | 4.90% | 4.86% | 4.87% | 5.30% |
| Dow Jones Industrial average | 978.75 | 997.95 | 932.59 | 825.85 |
| Standard & Poor's 500 stock index | 138.31 | 139.70 | 128.05 | 106.38 |
| Value Line composite index | 147.55 | 149.23 | 143.45 | 116.63 |
| Upper growth mutual fund index* | 166.72 | 167.89 | 152.64 | 114.69 |
| Average daily NYSE volume (millions) | 59.1 | 64.0 | 41.6 | 37.7 |
| Average daily NYSE blocks (10,000 shares and over) | 798 | 874 | 526 | 501 |
| **Bonds** | | | | |
| New Aaa utilities* | 13.75% | 13.63% | 13.13% | 11.13% |
| New Baa utilities* | 15.75% | 15.50% | 15.13% | 13.00% |
| New Aa industrials* | 13.38% | 13.25% | 12.63% | 11.00% |
| U.S. governments (8½% issue of 1994-99)** | 12.36% | 12.07% | 12.27% | 9.97% |
| Bond Buyer municipals (20-bond index) | 9.50% | 9.50% | 9.60% | 7.31% |

All figures are as of Monday, Nov. 24—except those marked*, which are from Friday, Nov. 21, and the Bond Buyer index from Thursday, Nov. 20.

Data: Salomon Bros., Standard & Poor's Compustat Services Inc., Lipper Analytical Services Inc.

MARKETS & INVESTMENTS

# Institutions are going for gold

As the Dow Jones industrial average hovered near 1000 in mid-November, Alaska state Treasurer Peter A. Bushre was in daily contact with New York, seeking to complete the latest phase of a massive investment program. He was more than pleased with the results. The state's $750 million pension fund bought into a frenzied market quickly, and at prices low by recent standards.

But while most pension managers were busy buying equities, Bushre was snapping up 45,000 oz. of gold—a commodity never before seen in the holdings of a public retirement fund. The move is an audacious one at a time when the stock market is bullish, since the metal's prices usually run contrary to equities. But more important, Alaska's move is one of the first signs of the institutionalization of gold investment—considered only a few years ago to be the realm of wide-eyed doomsayers.

Gold has long been the investment of refuge for those worried about political and economic instability. Thus, its recent acceptance by cautious fiduciaries is also a sign that, stock market ebullience notwithstanding, professional investors are not unanimous in their confidence that President-elect Reagan can bring order back to the economy and restore the capital markets.

Intergold's Sherman: Persuading pension fund managers to buy gold as a prudent strategy.

**Cutting losses.** Gold has already caught the attention of ultraconservative Morgan Guaranty Trust Co., which recently launched a precious-metals trading division. Sources say the bank has put several trust clients into gold at their own request recently and is seriously considering more active marketing.

Alabama's Birmingham Trust National Bank has

# ...re for financial futures

...of Wall Street's ... partner in ... investment ...ms said simply, "You'll see a lot more people using financial futures in 1981."

While futures contracts on grains are more than 100 years old, financial futures have been around less than a decade. The growth of the financial futures has been explosive, and market observers say many big potential users are still on the sidelines.

Among the new users about to enter the trading arena: Harris Bank, with assets of more than $7 billion, and Colonial Bank & Trust, which has assets of $170 million.

AT HARRIS, assistant vice president Willard R. Phillips Jr. said management approval is expected in January that would allow the bank to use futures in Treasury bonds and bills for pension fund accounts.

"The competitive pressures will be such that a number of individuals and institutions will be forced to examine the [financial futures] markets," Phillips said.

The lure is a better rate of return.

"Compared to what we're using, we're hoping to attain an incremental return of ¼ to ¾ of 1 percent, compounded annually, over a three-to-five-year time horizon," Phillips said.

William R. Duquaine, president of Colonial Bank on Chicago's northwest side, said his bank is attracted to using futures because of rising expenses paid to customers.

"During the first quarter, we'll be making recommendations to our investment committee," Duquaine said, about using T-bill futures as a hedge to offset expenses that Colonial Bank faces on six-month certificates of deposit.

FINANCIAL FUTURES trading was launched by the Chicago Mercantile Exchange and its International Monetary Market in 1972, with trading in currency futures. Treasury bill futures followed at the Merc, and other exchanges launched futures on Treasury bonds, Treasury notes and other financial vehicles.

It didn't take long for financial futures to boom, helped by volatility in the

## Along La Salle Street

Jerome Idaszak

cost of cash. During the 1960s, the prime rate—which is a barometer of interest rates—changed twice a year. During the 1970s, change increased to four times a year. In 1980 alone, the prime changed about 40 times.

In addition to banks, several firms are preparing for financial futures growth.

For example, Heinold Commodities, one of the nation's biggest commodities firms, plans a "vigorous expansion into the financial futures markets." Heinold late in 1980 created a new position—director of financial futures—filled by Howard P. Blechmann, former executive vice president at Chicago's Central National Bank.

GETTING INTO THE business isn't easy.

Phillips said financial futures trading requires "homework" and the involvement of top officers.

"Futures trading requires a tremendous commitment of time to understand the market. It requires potential additions to staff and changes in accounting," Phillips said.

Accounting requirements have been a barrier. Banks must calculate futures positions daily as the market rises or falls while the cash holdings of Treasury bonds or bills are calculated at the time of purchase or sale.

So using futures to hedge holdings of bonds or bills might show a loss [or gain] during a quarter on paper though the loss is neutralized by the cash holdings.

When a bank goes beyond using futures for its own accounts into using the market for clients such as pension funds that "involves a substantial amount of communication with the client prior to using futures," Phillips said.

The most popular futures have been T-bonds at the Chicago Board of T... and T-bills at the Chicago Mercan... Exchange.

In a year marked by unprecedented changes in interest rates, trading volume in those contracts soared in 1980.

T-bond volume at the CBOT totaled almost 6.5 million contracts compared with 1.8 million in 1979. At the Merc, volume in 90-day T-bill futures surged to 3.3 million from 1.7 million in 1979.

The concept is so popular that the Toronto and Montreal Stock Exchanges last September began trading in Canadian T-bond and bill futures. And financial people in London are studying formation of an exchange there for precious metals and financial futures trading.

Richard Sandor, an architect of financial futures contracts developed at the CBOT in the '70s and now a vice president at ContiCommodity Services, said the growth of bond futures in the '80s should make that the CBOT's "single biggest contract." At present, corn and soybean futures each are about 12 million contracts, or double the bond volume.

BUT SANDOR said that "long-term debt is a much larger market."

Sandor said the market is at the point now where "we're getting the coporate user, and we're getting to insurance companies."

The insurance companies, however, face barriers by state regulators who fear that misuse of futures could cripple a company.

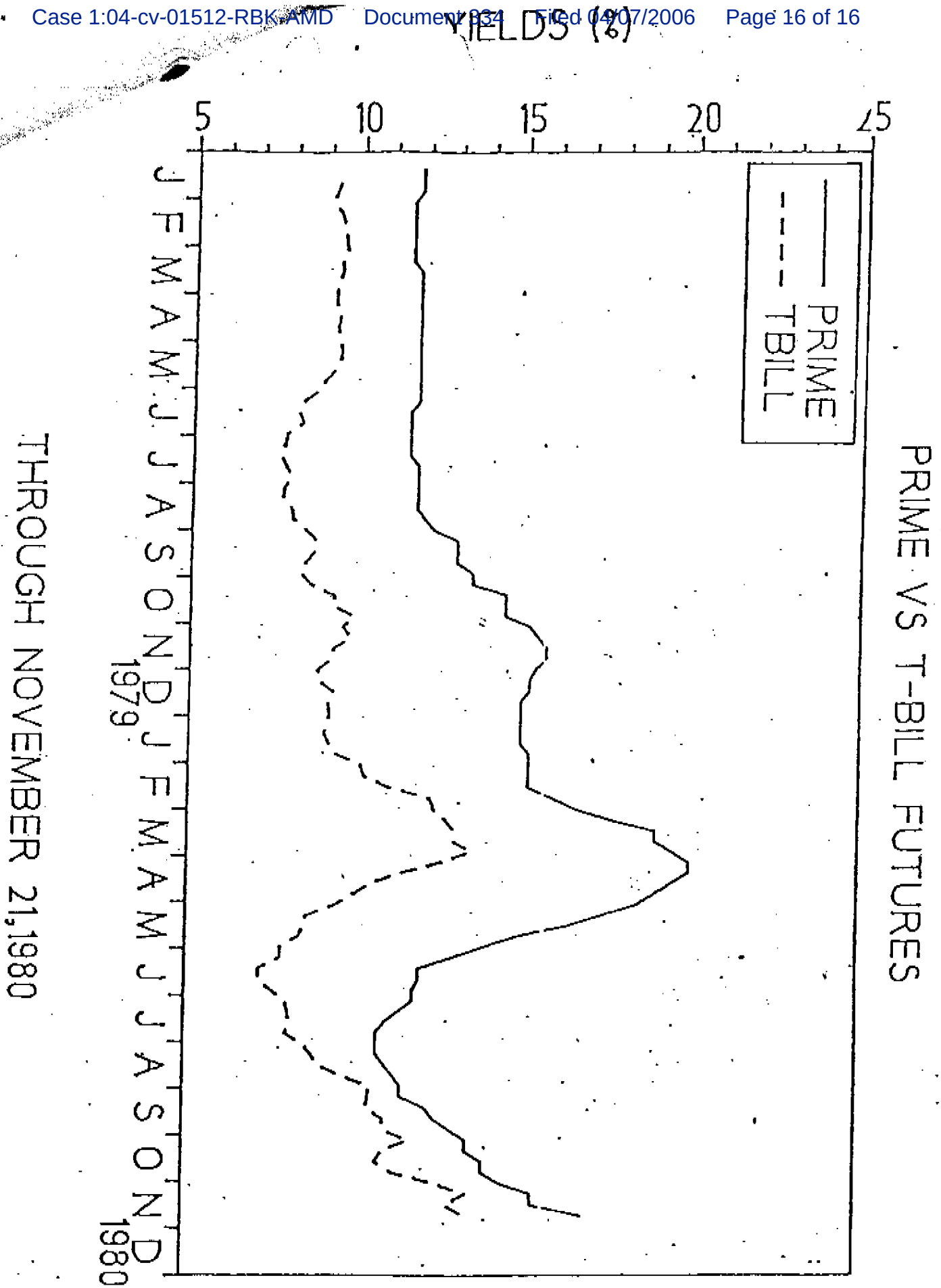
Experiences have varied. Salomon Brothers is widely cited for hedging an IBM bond offering in 1979 and saving itself millions.

But Wisconsin's banking commissioner last year threatened to sue a bank that was using financial futures. And Oregon's commissioner warned local banks against speculating in Government National Mortgage Association (Ginnie Mae) futures.

Sandor said he believes the barriers will fall "as education expands."

And Duquaine said Colonial will avoid speculation, adding that futures trading offers the potential to increase gross income through careful hedging.

Exhibit 6




PRIME VS T-BILL FUTURES

THROUGH NOVEMBER 21, 1980

Exhibit H