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Gambling or hedging?

Freight futures have been with us for some time now but not everyone understands them. Fairplay's markets team has compiled this simple guide to futures – or what can be described as a charterer's cap and an owner's safety net

In the early days of personal computers, there were some who turned their back on the whole beastly process. Educated before calculators were invented, PCs were anathema to them. They were frightened off by the bits and bytes, by RAM and by the whole of this silicon valley gobbledegook.

In a similar fashion, jargon within the futures market also brought out a marked distaste in some people. So *Fairplay* went to see Jeremy Penn, chief executive of the Baltic Exchange to provide an idiot's guide to futures.

So let's get a concept of a futures contract. A purchaser wants to buy a quantity of pork bellies on the

Chicago Mercantile Exchange. The spot price is $1 per lb. So the buyer would pay his $1/lb to the seller and he then will own the pork bellies and the seller will not.

But it transpires that the buyer doesn't want to take delivery now. He doesn't have anywhere to store it for the next three months so he enters into a futures contract with the seller. In three months time he will come back to the Mercantile Exchange and take delivery of the pork bellies. He will pay $1.20/lb to compensate the seller for the cost of storage and of funding.

The buyer has price certainty for those three months and no risk. The seller also has price certainty and recovers the interim costs of funding and storage. And the graph for a three month future, a six month, a nine month and a 12 month future will extend in a straight line. That is the market in 'contango'.

Say for the sake of argument there is an outbreak of foot and mouth disease among pig farms. As a result, the spot price of pork bellies moves up sharply. The market knows that within a few months the outbreak will be over and that the 12-month forward contract will not have moved much. Therefore, the spot price is higher than the forward price. This is called 'backwardation'.

Another commodity where contango can quickly move into backwardation is the Brazilian coffee market. A single hint of a frost in Brazil and the spot price moves up sharply, quickly overtaking the futures price.

That is a thumbnail sketch of a futures contract – and the first part of the bits and the bytes and the gobbledegook is out of the way.

In the shipping market, there are too many types of ship, too many types of cargo and too many trading ports to have a futures market such as exists on the commodities exchanges. So you can't have a contract where price arbitration relies on the physical delivery of a ship or cargo.

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The most satisfactory futures formula therefore evolved and it uses the Baltic Exchange's daily indices. Currently in the dry bulk Capesize sector there are 10 routes that are assessed by industry panellists. In the Panamax sector there are four timecharter routes, in the Supramax nine and in Handymax six routes. These figures contribute to what is, in fact, a forward contract.

Taking an example. A shipowner has a Panamax bulker that is currently earning $75,000 daily. The owner is not rapturous about this rate but if that hire could be locked in for the 12 calendar months of 2009, he would be happy. So he sells a 'Cal-09' for $75,000 per day – essentially 12 monthly units.

On the other side, you have a charterer that feels it cannot afford to pay more than $75,000 per day over 2009 to transport its cargoes. If the market goes up to say $100,000 per day, it is stuffed. So the charterer buys a 'Cal-09' for $75,000 per day.

On 31 January 2009, at the end of the first month of the contract, it is the first payback time. If over that month, the timecharter trips making up the Baltic Panamax Index had averaged $80,000 per day, the shipowner, which had been happy at receiving $75,000 per day, pays the clearing house $5,000 x 31 (days in January), or $155,000.

The charterer, happy to lock in the hire at $75,000 per day, receives a similar amount. There are commissions and expenses here, but we will ignore those for the sake of clarity.

But if the market falls to average $60,000 per day, the owner will have his coffers topped up by $15,000 per day while the charterer forks out a similar amount.

Such amounts are settled within the first five days of the next month. In actual fact, the clearing house will look at its clients' exposure and from time to time request some margin-taking, one or two initial margins during the course of the month and a variation margin at the end.

So that is essentially how it works.

Futures are typically bought and sold through specialist companies dealing in freight futures. A few have an association with shipbrokers such as ACM, SSY and Clarkson's. The size of the market is difficult to quantify, but an educated guess would put it at about $150Bn per year.

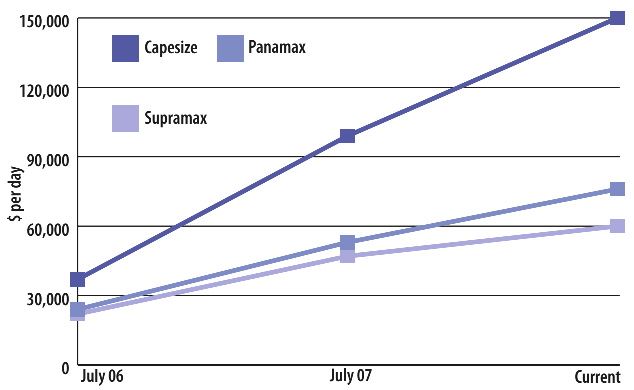
What is even less clear is how large the physical freight market is. The picture is clouded by long-term timecharters and the reletting of ships by charterers and operators for voyages, trips or shorter periods.

Of course, there are some principals that would not touch the forward contracts market. They are quite confident in taking the high-highs and the low-lows of a cyclical market in their corporate stride.

A few have no ships and no cargoes but use futures as a form of gambling. But *Fairplay* must add a health warning as a *caveat*.

This is just a rough guide. If you wish to get involved in the freight futures market, get expert advice and do not rely on this idiot's manual. F

Guaranteed income



Banks which traditionally finance ships usually look for a long-term guaranteed income flow. The ship may be put away on longer-term timecharters, consecutive voyages or contracts of affreightment and this will tick some of the boxes.

For a ship that will trade in the spot market, a guaranteed cash-flow amount is impossible to forecast, given the cyclical nature of the business.

For example, over the last three years the rates above were applicable.

If an owner had gone to a bank two years ago and said that in his opinion the average of the Baltic Capesize timecharter trips would reach $230,000 per day, this forecast might have been met with some merriment.

If the average income for the next four years could have been smoothed out with a forward contract, the shipowner might have missed out on the big bucks. But without one, might not have been able to finance the ship in the first place.