

thebigpicture

guideposts for the private investor

Week Commencing 9 December 2002

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

HOW CAN HEDGING BE HARMFUL?

The term "hedging" has been used misleadingly by companies to describe outright speculative activities which add risks shareholders might never have envisaged.

Technically, hedging is what is described quite simply in the Oxford dictionary: to secure oneself against loss on (bet, speculation, or abs.) by compensating transactions on the other side.

Several companies have attributed significant losses to "hedging" and, in one conspicuous example, shareholders funds have been virtually eliminated. How can something as benign as "hedging" be so dangerous?

In fact, the term hedging is being used erroneously to describe any futures or forward contracts which have been entered into whether or not they modify financial risk.

The example in the box on page 3 is a typical hedging arrangement of the type contemplated by the Oxford dictionary. It shows how offsetting transactions eliminate a financial exposure which might otherwise threaten profitability. Planned and executed properly, hedging cannot lead to a corporate failure.

Failure occurs when directors have taken an unprotected bet about the direction of a price. Because most mining companies sell their output in US dollars, they are often tempted to take a view about how the Australian dollar might move against the US dollar. Since their US dollar receipts must be sold and Australian dollars purchased, the lower the Australian dollar, the greater the Australian dollar revenues and, therefore, profits.

The risk is best illustrated by an example. Assume that there is an Australian copper miner with production costs of A\$2600 a tonne. The current copper price is US\$1650 a tonne which means that, at an exchange rate of 55 cents, its selling price is A\$3000 and its profit is \$400 a tonne. The company could follow one of three courses.

- A. Take all prices as they arise on international markets.
- B. Because it believes that metal prices will rise and that the Australian dollar is as weak as it might get, sell its anticipated US dollar receipts for the coming year at 55¢.
- C. Because management values certainty, lock in both the copper price and the exchange rate for all anticipated production for the year.

The US dollar copper price then falls by 20 per cent to US\$1320 a tonne. However, since the Australian dollar is still often treated as a commodity currency by the international markets, significant weakness in commodity prices is often reflected in further exchange rate weakness. So, in this case, the fall in metal price is associated with a further fall of 10 per cent in the exchange rate.

In case A, profit is reduced to \$67 a tonne. In case B, there is a loss of \$200 a tonne. In case C, there is a profit of \$400 a tonne.

In other words, the financial outcome may bear little resemblance to how skilled the company might be at mining and refining metal.

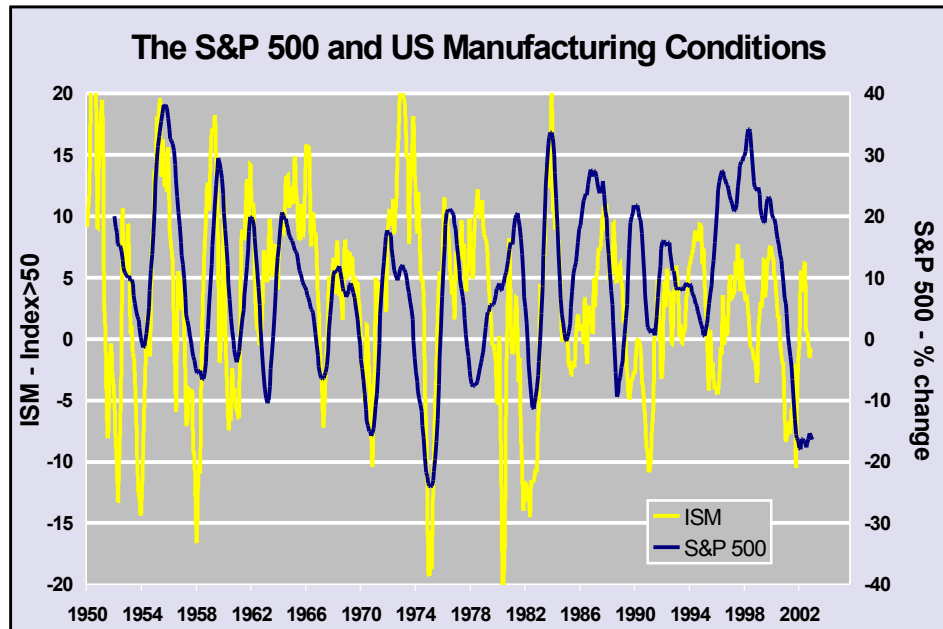
Quote from Pasmenco directors:

Lower metal prices reduced earnings by \$208 million, but even so, had it not been for the adverse impact of currency hedges (-\$130 million) the Company would have been roughly break even before significant items.

(Continued on page 2)

THE WEEKLY CHART SPOT

“US manufacturing activity, which had shown signs of recovery earlier in the year, is now falling short of the levels which would be required to facilitate more buoyant market conditions.”



Sources: Standard & Poor's and US Institute of Supply Managers.

This week's chart illustrates the relationship between the US equity market (measured as percentage changes in the S&P 500 index) and the index of manufacturing conditions compiled by the US Institute of Supply Managers (ISM).

The ISM index is a leading indicator of economic activity and an indicator of changes in equity market direction.

The index, which is reported at the beginning of each month for the prior month, shows the percentage of supply managers who have a positive view about their business. In this chart, the index is shown as a deviation from a reading of 50.

Statistically, a reading above 50 is consistent with an expanding manufacturing sector. A reading below 50 is generally associated with a contracting manufacturing industry.

The ISM index has been below 50 for three consecutive months. From an equity market viewpoint, this weakness is significant because a decline in this measure is also associated with a decline in the market.

The turn in this market cycle has been the most prolonged of any cycle over the 50 years displayed in the chart. While the duration of the turn has been caused partly by the excessive accumulation of speculative fervour which kept the market aloft for so long (the turn at the top was also the most prolonged of any shown in the 50 year chart history), the economic fundamentals have also been retarding a change in direction. US manufacturing activity, which had shown signs of recovery earlier in the year, is now falling short of the levels which would be required to facilitate more buoyant market conditions.

HOW CAN HEDGING BE HARMFUL? CONT'D

(Continued from page 1)

There are other risks, too. It might not be possible to mine the anticipated volumes. Forward positions will have to be closed out without having made physical sales and losses would be generated if the metal price has risen.

There is also a liquidity risk if the hedge transaction does not match the timing of the physical transaction. For example, a

mining company could sell the equivalent of one year's production forward for three months with the intention of rolling the position every quarter until the full year's production is delivered against it. Rolling the position would require buying back the short position and selling at the three month price. If, however, after three months the price has risen, the company must fund a cash loss in the short term.

“...investors need to be able to assure themselves of the extent to which they have leverage to commodity price or exchange rate movements to understand the nature of their investment risks.”

To avoid such risks, many alternative products have been developed by the financial markets. Options became a widely used risk management tool. With an option, the copper producer could purchase the right to sell a tonne of copper at, say, \$1650 at some future date. This would involve an initial premium payment, say, \$70 a tonne. If the price subsequently fell below \$1650, the miner could still sell at \$1650 (with the net return of \$1650 less the \$70 premium). If the price went higher, to \$1800, for example, the miner would not exercise his put option but would sell at \$1800. In doing so, he would lose his premium but achieve a net selling price of \$1730 a tonne. This was an attractive way, depending on the premium which was being asked, to protect the company from the downside risk while allowing it to participate in the price upside if any was to occur.

Of course, such a product required companies to make a cash payment before their product was sold. Even this could be eliminated. As well as buying a put option at \$1650, the company could sell a \$1800 call option at \$70 a tonne. Now, there would be no cash outlay. If the price dropped below \$1650, the company had its protection. If it went above \$1800, the buyer of the call option would exercise it and the exercise price would represent the selling price for the miner. That would leave the mining company with any price upside between \$1650 and \$1800 but nothing from a rally beyond this level.

So the mechanisms could become quite complicated requiring rising levels of financial management sophistication. That, in itself, was another risk for a company.

In entering these and similar arrangements, companies were either modifying their commodity price exposures or, if not done properly, creating other risks, sometimes not quantified, for their shareholders.

This was an added burden for investors who had to assess carefully the extent to which such transactions had occurred to understand what it was they were buying. Our mining company might have no more

exposure to the copper price than a food retailer!

Are there any circumstances in which such transactions might be in the interests of shareholders?

Where a company needs to fund a capital investment, which itself creates a financial risk for the company, it might make sense to lock in a certain price today on

The Classic Hedge

There is a company which makes copper widgets. This fabricator normally purchases refined copper from an integrated mining company like MIM Holdings based on prices set on the London Metal Exchange. It buys a tonne of copper at US\$1650 converted to Australian dollars at the current exchange rate of 55 cents to give an Australian dollar price of \$3000.

It takes the fabricator 60 days to manufacture and sell his widget. His selling price is based on the copper price prevailing at the time of sale plus a margin to cover costs of \$600 a tonne and profit (10 per cent). That is, a tonne of widgets would sell for A\$3900.

However, during the time it takes him to manufacture and sell the widget, the fabricator faces a risk that the copper price falls. If the copper price was to fall by, say, 20% to A\$2400 a tonne, the widget selling price would have to be \$3240 a tonne compared to a cost of \$3600 and the fabricator's profit would be eliminated.

To protect against such an eventuality, the fabricator enters a 60 day forward contract to sell a tonne of copper at the same time as he purchases his copper from MIM. He could do this at A\$3030 a tonne. This is the hedge.

If the copper price subsequently falls to A\$2400 a tonne, the selling price of his widget will be \$3240 a tonne. He will, however, buy back his forward contract from which he would receive a net profit of \$630 providing an overall profit of \$270 a tonne from making and selling the widget.

enough production to ensure that the additional capital can be financed.

The second, although less compelling, case is where a company is operating a marginally profitable or unprofitable mine. If the price moves above the operating costs, a company might consider selling its output at that higher price to ensure a period of profitable operation. This would provide certainty but, nonetheless, it removes the opportunity for a shareholder to use his investment to gain additional financial leverage from commodity price movements.

Whether a company should undertake such activities depends, therefore, on how it seeks to position itself with its shareholders. In any event, investors need to be able to assure themselves of the extent to which they have leverage to commodity price or exchange rate movements to understand the nature of their investment risks.

Importantly, though, it is not safe to assume that a company which says it has "hedged" is without risk. Given the way in which that term is used, it actually may mean the reverse.

"...it is not safe to assume that a company which says it has "hedged" is without risk. Given the way in which that term is used, it actually may mean the reverse."

AUSTRALIA'S ASIAN RELATIONSHIPS: BEING SECURE WITHIN THE REGION

Does the Prime Minister's recent remarks about taking pre-emptive military action to protect Australian interests represent an evolution in Australia's links with the Asian region?

Australia's relationship with Asia has gone through several phases. As long as Australia saw itself as essentially a European country, Asia was regarded as an undesirable neighbourhood but one with which we could live as long as the front gate was shut. Asia then became something of an economic threat, sapping the strength of Australia's manufacturing industry as it used its cost advantages against Australia's higher cost manufacturing industries. Subsequently, being engaged with Asia was seen as an economic benefit as it became wealthier and its growth path more sustainable.

Culturally, too, more common ground was being found with many Asian nationals studying, working and living in Australia and building bridges between Australia and the region.

It is probably true, as the Prime Minister would assert, that his statement of Australia's right to defend its interests was unexceptional in that any national leader would react similarly if confronted with the hypothetical situation outlined in the question to which he responded.

What was most intriguing was that the Prime Minister responded at all to the question as it is a long-standing mantra among Australian politicians that the hypothetical question is to be avoided. It is usually seen as a trap for the unwary with good reason.

That this hypothetical question was not turned away by Australia's most experienced and skilled politician must, therefore, be significant or a sign of deteriorating skills. Assuming the former, it must have been a point he wanted to make and, therefore, betrays a preparedness for more bellicose language than might have been the case in the past.

Every democracy is now in much the same position. It is a target for attack and a po-

tential training ground for international political criminals. Those countries with well-equipped mobile armies would dearly love to use them to eradicate the threat. Frustratingly, they are unable to do so but talking in terms of military action is still prevalent even though it seems to miss the nature of the threat. After all, if the US had wished to take pre-emptive action to prevent the destruction of the World Trade Towers on 11 September 2001, it would have bombed Florida.

As the evidence in the US is showing, prevention would have been best achieved by competent intelligence gathering, skilled analysis and co-operation amongst like minded countries and domestic law enforcement agencies.

The Asian region is undergoing a radical change. The United Nations expects that within 50 years about 60 per cent of the world's population will live in the region. The region's population will become older and more affluent. Access to its markets will be ever more important for Australian companies and national economic well-being. Maximising the longer term opportunities within the region will require Australia to be continually engaged trying to demonstrate how it identifies with the region and, politically, seeking to work within it to solve common problems.

Australia's preparedness historically to build itself as a nation through deployment of its armed forces (something with which the Prime Minister enjoys being associated) might be looked on favourably by countries such as the USA and Britain which are similarly inclined but their applause on these matters is largely irrelevant to Australia's longer term interests.

In the longer term, Australia's interests are economic and require governments, companies and individuals to participate in the region's growth and wealth generation. Those interests require that Australia be secure within the region in which its standard of living will be determined rather than buttress itself against the region which will determine much of its future welfare.

"...Australia's interests ...require that Australia be secure within the region in which its standard of living will be determined rather than buttress itself against the region which will determine much of its future welfare."