CUBIC ASSET MANAGEMENT, LLC

2008 3rd Quarter Stock Market Commentary

A FREE TICKET TO THE GRANDSTAND

"There are two times in a man's life when he should not speculate:
when he can't afford it, and when he can."
- Mark Twain

In 1763, the British government issued a Proclamation to the Thirteen Colonies establishing a frontier beyond which the land was to be preserved in perpetuity so that the Indian nations could continue their traditional way of life. The edict was aimed at speculators who had been seizing Indian lands. George Washington, the wealthiest man in the American colonies (and the only President never to blame his troubles on the previous administration) made plans to "hunt out and mark" Indian land in the frontier areas to be seized whenever the Royal Proclamation could be safely ignored. Washington, not wanting his role in the scheme to be made public, wrote to his criminal co-conspirator Captain William Crawford, that their "scheme must be snugly carried out by you under the pretence of hunting other game."

Washington was far from the only member of the Founding Fathers" engaged in illegal land speculation. Benjamin Franklin was the major force behind the Vandalia Company, a group of Philadelphia land dealers who plotted to seize ten million acres of Indian land that was protected by the Proclamation. Speculators, it seems, have been with us even before the founding of the Republic.

If Congress and the newspapers are to be believed (and who could ever doubt the accuracy of such reliable sources) energy speculators are responsible for this year's dramatic increase in oil prices. The rise in energy prices, in turn, is straining the budgets of consumers, businesses and municipalities, and contributing to a broad slowdown in economic activity. In July, Senate Majority Leader Harry Reid and other Democrats, under pressure to do something about record energy prices, proposed legislation which would have limited speculation in energy markets. The measure, which would have criminalized trading "that is not legitimate hedge trading", was defeated without ever getting to the floor for a full vote. While speculators from the era of forefathers were lionized by having their faces plastered on our currency, today's financial risk-takers are more likely to be demonized, with their pictures being hung in Post Offices.

Despite the sweeping oratory of grandstanding politicians, the root cause of the oil price spike is basically Economics 101. Global demand is rising, driven by an emerging middle class in countries like China, India and Brazil. This demand is barely being met by a static supply, much of which comes from politically unstable countries such as Nigeria, Venezuela or Iraq. New fields to replace depleting ones are only to be found in extremely harsh environments, such as the Arctic or deep water. It is much easier to

simply rile against the Gordon Gekkos of the world, who are portrayed as cruelly manipulating oil prices from Wall Street towers, than to institute the types of change required to adjust to the reality that energy resources are scarcer than they used to be.

Typical of the rhetoric surrounding this issue are comments made three months ago during meetings of the House Energy and Commerce Oversight and Investigations Subcommittee. This subcommittee is chaired by Congressman Bart Stupak, in his 16th year representing a district in the Upper Peninsula of Michigan. Stupak, a centrist Democrat, has focused on speculation in energy markets as his primary issue for the past three years. The keynote witness was Michael W. Masters, an offshore hedge fund manager. Mr. Masters asserted that federal regulation would result in a $70/barrel drop in oil prices in one month. This is simply ridiculous. Under oath, Mr. Masters swore that his firm does not have any position in oil futures, implying that his testimony was objective. It turns out, though, that he has a heavy weighting of airline and automotive stocks, giving him a powerful self-interest in lower oil prices.

The Chairman of the full House Energy and Commerce Committee is John Dingell, currently in his 54th year as representative from Detroit. During Dingell's cross-examination of acting chairman Walter Lukken of the Commodity Futures Trading Commission, Dingell accused Lukken of "twiddling your thumbs in not regulating those good-hearted folks up there in New York who are running this wonderful, speculative enterprise." He went on: "Now we find that these good-hearted folks in the futures market have figured how to screw the farmers and the consumers in the city … on a whole new product: oil."

This same song is being sung by people who are not running for office. In an open letter to all airline customers published in July, the CEOs of every domestic airline company wrote the following:

> Twenty years ago, 21 per cent of oil contracts were purchased by speculators who trade oil on paper with no intention of ever taking delivery. Today, oil speculators purchase 66 per cent of all oil futures contracts, and that reflects just the transactions that are known. Speculators buy up large amounts of oil and then sell it to each other again and again. A barrel of oil may trade 20-plus times before it is delivered and used; the price goes up with each trade and consumers pick up the final tab. Some market experts estimate that current prices reflect as much as $30 to $60 per barrel in unnecessary speculative costs.
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> Over seventy years ago, Congress established regulations to control excessive, largely unchecked market speculation and manipulation. However, over the past two decades, these regulatory limits have been weakened or removed. We believe that restoring and enforcing these limits, along with several other modest measures, will provide more disclosure, transparency and sound market oversight. Together, these reforms will help cool the over-heated oil market and permit the economy to prosper.

Can I get an "Amen"!

In order to judge the validity of these accusations, let's examine how the futures markets work, and who uses them. Consider the dilemma faced by Southwest Airlines, which consumed roughly 1.5 billion gallons of jet fuel in 2007. As a result of the recent drop in the price of crude oil, the price of jet fuel has dropped 13% from a month ago. Management could hope that prices will continue to fall, but then it would run the risk that prices will instead surge 30% higher, just as they have done over the past twelve months. The company decides to lock in some portion of next year's cost of fuel at today's prices to avoid a potential catastrophe. One way to do that would be to buy crude oil futures. (In actuality, the company uses a combination of futures on crude oil, gasoline and derivative contracts tied to the spread of refined products over crude.) A typical contract might be the December, 2009 contract for light, sweet

crude. Each contract obligates the buyer to accept, and the seller to deliver, 1,000 barrels of oil. (Each barrel, in turn, produces 28 gallons of gasoline.) The value of the contract is currently $100.16 per barrel, or $100,160, although the buyer typically needs to put up only 8% of the actual purchase price. If Southwest were to buy 5,000 contracts, it would basically lock in the cost of jet fuel for 10% of its anticipated need for 2009. Last year, Southwest's fuel costs averaged only $1.70/gallon, well below the year-end market price of $2.87, precisely because it successfully implemented a hedging program like that described above.

Two points are worth noting. First, there is no guarantee that oil will rise next year. As the past two months have shown, prices can drop. In that case, Southwest would have committed to purchase oil at higher prices than it could have paid if it had not purchased any futures contracts. Essentially, by hedging its oil purchase expenses, Southwest is speculating that the price of oil will be higher next year than it is currently.

Second, note that in the open letter to airline passengers, speculators are criticized because "they have no intention of taking delivery." But neither does Southwest. After all, its planes cannot burn crude oil, and it does not have refineries able to convert crude oil to gasoline, heating oil and jet fuel. Rather, if energy prices rise, Southwest will sell its contracts for a gain, which it will then use to subsidize jet fuel purchases.

When Southwest, or any other consumer of oil, purchases futures contracts, who takes the other side of the transaction?

Consider, for example, a typical mid-sized independent oil and gas company, such as Range Resources, that explores for fossil fuels in Appalachia, the Gulf Coast and the Southwest. The company typically drills about 1,000 wells per year. It contracts for the drilling rigs in advance, so that its cost of production can be defined in advance. Unfortunately, though, the prices it realizes at the wellhead are subject to market fluctuation, and a large decline could result in a loss. Management can guarantee a profit, though, by selling its future production at today's prices. In fact, Range Resources, whose management is financially conservative despite being engaged in an inherently risky business, sells 72% of its production in advance through the use of oil and gas futures.

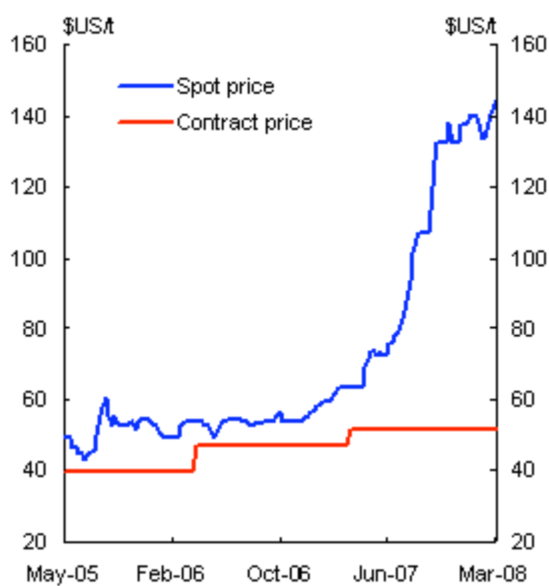
In the world that politicians and airline CEOs envision, buyers of oil wanting to lock in their cost, such as airlines, trucking companies or petrochemical producers, would buy futures contracts from producers willing to lock in their future sales prices, like Range Resources, Devon Energy, Anadarko Petroleum, or hundreds of other companies. The problem is, though, that a world without speculators presupposes that the number of willing buyers exactly matches up with the number of willing sellers. Even further, the time horizons need to coincide. A driller wishing to lock in the selling price over the next year is a poor match for an airline wishing to guarantee its fuel costs for the next two.

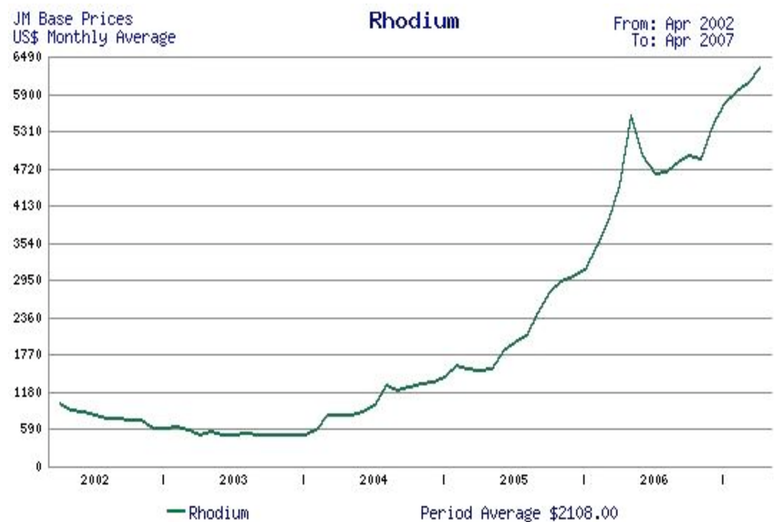
Even worse, suppose that the airline wishing to hedge its fuel costs is financially weak Northwest Airlines, rather than Southwest. Does an oil producer want to enter into a transaction with a weak counterparty, who may not be able to pay on settlement day? Without financially strong speculators willing to serve as the counterparties to the hedging transactions desired by corporations, the entire mechanism for dispersing risk can grind to a halt.

On the face of it, the notion that futures speculators are responsible for the sharp rise in oil prices is ridiculous. When oil prices crossed the $100 per barrel mark for the first time in March, there were over 113,000 net long crude oil contracts on the New York Mercantile Exchange. By mid-June, as oil prices neared their peak, there were only 25,000 net long contracts, implying that bullish speculation had fallen by nearly 80% at the same time that oil prices were soaring. For every futures buyer, there must be a

futures seller, otherwise no transaction would take place. And there is nothing about futures contracts that makes it more attractive to bet that commodity prices will rise rather than fall. In fact, some speculators, like Tulsa, Oklahoma based SemGroup have gone bankrupt by speculating incorrectly on the direction of oil prices. The only way to affect the price of the commodity meaningfully is to hoard it physically, as the Hunt brothers tried to do in the silver markets in the early 1980s. There is no evidence at all of oil hoarding.

It is worth noting, too, that numerous other commodities for which no futures contracts are available have also risen dramatically over the past year. Below we have shown the price charts for iron ore the most widely traded commodity for which no futures are available (a billion tons a year are mined), and rhodium, a scarce metal used in catalytic converters. The graphs would have been similar for cobalt, palm oil, potash, molybdenum or vanadium, to name just a few other commodities with soaring prices.





During the Great Depression, Herbert Hoover was described by author Ron Chernow in *The House of Morgan*, as being "moody and isolated" and convinced that Democrats were conspiring to drive down stocks through short selling. He even began to compile a list of people involved in the conspiracy, who he claimed met every Sunday afternoon to plan the nation's economic destruction. Throughout history, it has always been easier to villainize someone whenever markets are chaotic.

The nation would be better served if Congress abandoned hearings on the evils of speculation and returned to the work it seems to relish: passing resolutions declaring July to be National Watermelon Month, August to be Heat Stroke Awareness Month, and May 5-9 as National Substitute Teacher Recognition Week. (These are actually part of the accomplishments of the 110th Congress whose term ends in January.) It is way too much to ask that our elected representatives focus instead on finding more oil and gas, developing renewable energy sources and creating incentives for conservation. Perhaps they think that there's a technological breakthrough lurking just around the corner that will allow us to run cars and power plants on hot air.