FUTURES $ OPTIONS

Timing is Everything

by Philip J. Baratz, C.T.A.

In the five weeks leading up to the beginning of December, heating oil prices (at the rack) reached levels (in most locations) slightly above $1.60 per gallon. The timing of the peaking prices could not have been any worse for many oil dealers. Despite the fact that more and more dealers manage their margin risk (whether offering a cap or a fixed-price program) with wetbarrels, futures, or options, there were still many out there still "waiting for the collapse". As the end of October arrived, time seemed to have run out for many, and panic-buying set in. Dealers who refused to buy oil at $1.20 per gallon in August were seen locking in wetbarrels for the balance of the winter in the $1.50s and $1.60s. In many of these cases, the locked in prices had the effect of locking in either very small profits, or, in some cases, locking in losses for this winter. While the panic was understandable—***after all, heating oil inventories were near historical lows, and prices were heading through the roof***—the very idea that there was a ***need*** to panic is of real concern. Not that this is a newsflash, but as of the beginning of December, those who locked in those wetbarrels at the end of October are about 35-cents per gallon "under water".

What did they do wrong? Last month, we talked about the "what to do" part of hedging, and protecting your margins and your bottom line. The notion of finding a proper mix of hedging products, while a little more complicated than simply "doing what you do every year", is intended to keep you in the game regardless of where prices may go, or what Mother Nature may have in store for us. But, knowing "what to do" is of the utmost importance.

As creatures of habit, there is a natural tendency to not change things until they need changing (actually, usually a little AFTER they need changing—look at the Yankees pitching staff!). Change takes time and effort, and running a heating oil company does not usually allow for that "luxury". The old adage that says "if it ain't broke, don't fix it" makes sense, but does not consider how to tell if "something's broke". For a while we had been struggling with the sharp increase in hedging costs (premiums for protection against prices rising or falling), and grappling with the question of "what to do". In reviewing the numbers, the question was posed as to how much does the market really move, and if that changed over the last few years. As we were considering the "what" to do, we had to find the proper mix that would (a) keep costs under control, and (b) work each year—cold or warm, and low price or high price. The parameters that we came up with to customize to our clients' needs prove this out each year—with the data to verify it. Although statistics can often be used to prove or disprove almost anything, in researching the new program that we have for our clients for the next heating season, I came across some interesting numbers.

Logic—and history—dictate that in order to get effective results in the winter, you need to execute an effective plan during the spring and summer beforehand. But does the timing of that plan really matter? If prices don't vary all that much, then (in theory) you could hedge your winter heating oil at any time in the spring or the summer. So, do prices move that much? We looked at heating oil prices, not based upon the actual price, but upon the range of prices over a period of time. Since many oil dealers like to start hedging in the spring, we studied the high-to-low range of heating oil prices on a rolling basis for a quarter at a time. So, the August "range" would show the difference in prices between the high and low from June through August. September's would show the range from July through September, etc. From mid '91 through mid '99, the "normal" quarterly range was about a nickel (see Chart 1), with about 60% of the months having a quarterly range of less than 10-cents per gallon. In the 5+ years since mid-'99, only three months have had quarterly ranges of less than 10-cents per gallon—less than 5% of the months, as compared to 60%! More glaring is that the annu-

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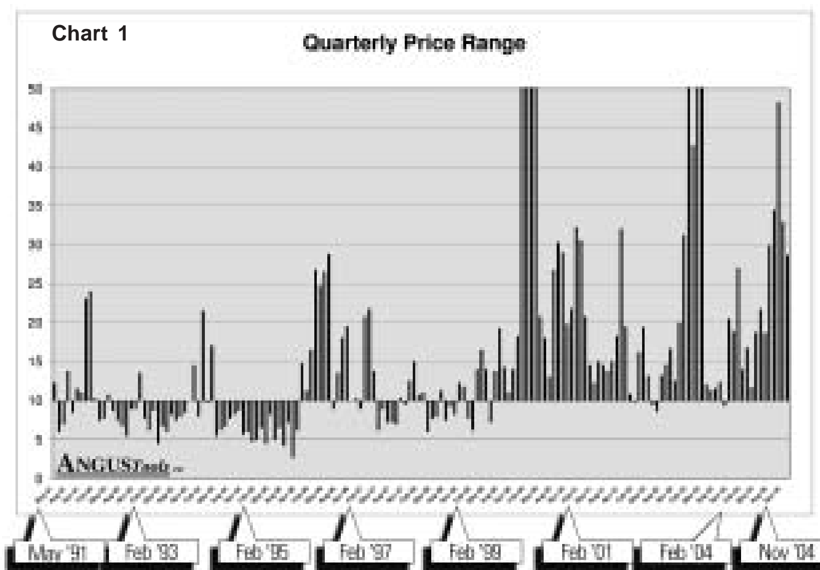

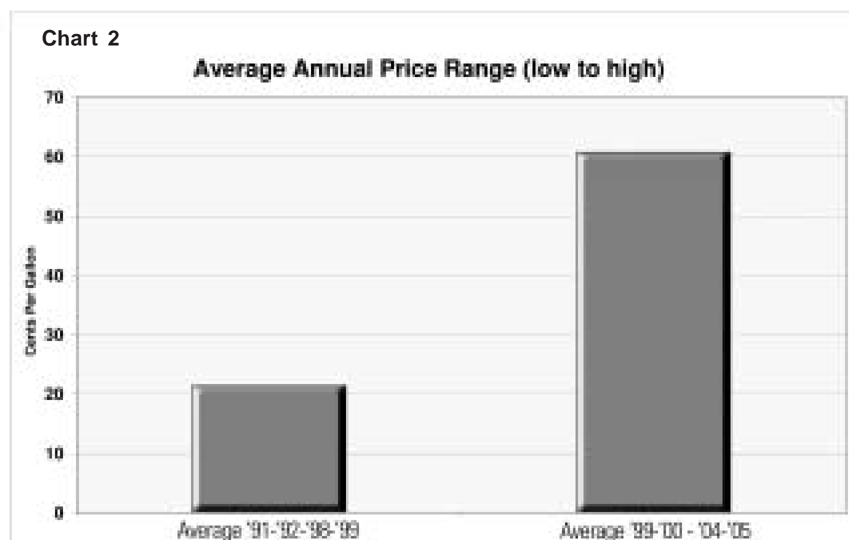

al range has moved from about 21 cents per gallon in the '90s to about 61 cents per gallon over the past five years (see Chart 2). Yes, options did cost about 5-cents per gallon in the late '90s, but if the annual range has tripled, shouldn't the cost of "insurance" increase commensurately?

So, the market swings much more than ever before, and that has become the new reality in oil pricing. Where does that leave the "creature of habit"? It leaves him (or her) in a position that is forcing him to re-think, and to change how he approaches his hedging. As fearful as he may be of taking the time to change things, we have found an approach that should not only take away that fear of having to spend more time on something that is quite difficult, but actually will cut way down on the time and effort expended. That is the "when?" part of the hedging plan.

In addressing the "**when**" part of a hedge program, we needed to first look at our choices. The first choice was to simply buy ratably—a little every month, or in our case, a little every day. The second choice was to see what oil dealers currently do—known as the "Dartboard approach". Before we tell someone that all the hours that they spend during the summer trying to guess what oil prices will do is a waste of their precious time, we needed to see if the "Dartboard Approach" was better than steady ratable buying. We gathered data from several reliable sources (brokers, traders and wetbarrel suppliers), and tracked actual buying patterns for the past three years. Our theory was that if you were indeed hedging (as opposed to the always entertaining group of oil dealers who gamble—speculate—each and every year without even once stepping into a casino), you had to make a buying decision ***at some point*** during the spring or summer. Once all that data was gathered, we did the comparisons, and found out—not to anyone's surprise—that panic-buying is more of the norm than logic-buying is. Purchasing volumes (by the "Dartboarders") were generally lower when prices were their weakest. In fact, over the three-year period, simple, ratable buying beat out "real-time", i.e. Dartboard, buying all three times: in '02 by 2 cents per gallon, in '03 by 2 cents per gallon, and in '04 by 13 cents per gallon. All that work not only didn't save any money, it actually cost the "Dartboarders" money. It seems that when prices are in a "down-trend" there is a tendency to say, "See, they're falling. When they get a little lower, maybe I'll buy." That buying generally takes place when the "lows" are firmly in place, and prices are rallying. If, however, prices are in an "up-trend", the ego gets in the way—"As soon as I buy prices will fall, so I'm just going to hold off for a while." That "while" usually ends when prices are higher. Human nature wants to try to pick the bottom, even though the low price for the year occurs only once—the other 250 trading days are not at the low! The program that we now offer to our clients forces their hands as to the ratable buying. If prices are up one day, some of the hedge is bought. If prices are down the next day, some of the hedge is bought. ***By staying away from trying to pick and choose the "right" days, you end up avoiding buying too much on the "wrong" days.***

So, planning makes sense—hard to argue with that. Not trying to pick the bottoms, but buying ratably makes sense as well—history (and logic) bears that out. Not spending hours during the "off-season" worrying about what oil prices will do makes sense, as well. With all that logic, why isn't there an easy way to hedge for your programs, and to not have to work as hard, or worry as much? In fact, there is.

If we assume that following is true:

1) You need a plan, because "Good plans shape good decisions".

2) A mixture of products is needed, and that the mixture needs to make sense, and be proven that it will work year-in and year-out.

3) Trying to pick the perfect time to buy usually doesn't work any better than steady, ratable buying.

4) The summer is there for you to enjoy, not to be chained to your desk.

5) You want someone to not only "plan the plan" with you, but execute the plan for you.

Then, you need to sit down, and spend some time—probably not more than an hour or two—to see if this approach matches your business (and temperament) needs. If you want to "play the markets", and try to guess what prices will do—be our guest. Many people like to do that. If you'd rather work on your handicap, and achieve more predictable results, it is a conversation worth having.

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