

# Why Trade?

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The “morning after” for energy merchants is stretching into its third year. Amidst the malaise, it is difficult to look beyond the immediate need of shoring up balance sheets and maintaining cash flow. It is worth trying. This is a time to retool strategies for a stronger market that will, some day, emerge. With investors, credit rating agencies and even the Committee of Chief Risk Officers (CCRO) clamoring for greater disclosure, let’s start with disclosure. Why? Because disclosure drives business strategy. Of the lessons to be learned from the many corporate scandals of the past three years, this one is undeniable. Disclosure shapes how managers conduct business. Modify the forms of disclosure, and you will change how those managers think.

In a recent white paper, **Risk Management Disclosures**, the CCRO outlines several forms of risk-related disclosures that energy merchants might use to supplement existing accounting disclosures. In proposed disclosures, risk and performance metrics would be reported for three categories of activities:

- proprietary trading
- structured contracts
- owned assets

This raises the question: what exactly is proprietary trading? Industry participants rarely distinguish between different types of trading. Neither does the CCRO. The quantitative disclosures—mark-to-market valuation, net margins, etc.—the CCRO proposes are excellent. Even more valuable would be qualitative information about the exact nature of the trading going on—not the instruments, but the business model underlying the trading.

In the current business environment, energy merchants have come under pressure from investors to curtail trading activities or even shut down trading operations. This backlash might be tempered if it were possible to draw meaningful distinctions between different types of trading.

Here is a list of common reasons firms trade.

- **market making:** This is the offering, on a continuous basis, of firm bid and ask prices for certain commodities or instruments. The goal is to run a hedged book (as much as possible) and profit from the bid-ask spread.
- **speculative trading:** This is an attempt to exploit a perceived competitive advantage that allows a trader to anticipate market moves. Unlike market making, the trader maintains an unhedged book in order to benefit from anticipated market moves.
- **hedging:** This is trading for the purpose of offsetting pre-existing risks in a firm’s balance sheet.

- **cost minimization:** This is a form of trading widely used by institutional investors. When an investor decides to buy or sell a large block of stocks, bonds or other instruments, it is the trader's job is to execute the transaction in such a manner as to minimize transaction and impact costs.
- **price discovery:** Performed in illiquid markets, this is about constantly polling other market participants for prices, and transacting at those prices just often enough to keep the counterparties honest. Discovered price information may be used to support other forms of trading, management planning, financial reporting, or other purposes.

All of these are, to some extent, legitimate undertakings for certain energy merchants. However, the vast majority of firms lack the market presence or resources to be market makers. Few have a meaningful competitive advantage that will allow them to make consistent profits from speculative trading. Among energy merchants that do trade, most should limit their activities to hedging, minimizing costs, and price discovery.

In 1900, Louis Bachelier published a groundbreaking paper on the French bond markets in which he concluded that the expected return of speculation is zero. Today we might modify this by saying that the expected return is zero before expenses and impact costs—and assuming the speculator has no competitive advantage.

I can think of two competitive advantages that would justify speculative trading by energy merchants:

- If an energy merchant is an active market maker, it may have privileged knowledge about market imbalances or about which market participants have concentrated exposures.
- If an energy merchant has significant assets—wells, generation, etc.—its knowledge of how it intends to use those assets (or their likelihood of being available for use) represents privileged knowledge.

Both of these competitive advantages entail possible conflicts of interest. Energy merchants in a position to exploit them may decide that damage to their client relationships is not worth the incremental profits.

The majority of energy merchants that recently engaged in speculative trading possessed neither of these competitive advantages. Perhaps they felt that their competitive advantage was being smarter than other energy merchants—or maybe one of their traders recently read a get-rich-quick book on technical analysis. Even if such competitive advantages were real (they aren't), they do not justify energy merchants engaging in speculative trading. The reason for this is the tax treatment of energy merchants. Because they are set up as corporations, any profits they might earn from speculative trading are taxed twice: once at the corporate level and again at the stockholder level. For this reason, the exploitation of purported competitive advantages that are not intrinsic to being an energy merchant should be left to tax-advantaged entities such as investment companies or hedge funds.

For most energy merchants who jumped on the speculative bandwagon in the late 1990s or early 2000s, their story is precisely what financial theory predicts. They experienced swings in earnings. Sooner or later, they had a particularly bad month. Maybe 5 million dollars walked out the door ... maybe it was 20 million or 50 million. If the firm was lucky, their board of directors shut the entire operation down. If they were unlucky, the saga continued until Enron collapsed and investors stepped in to pressure for a halt.

Eventually, the current backlash against trading will subside. A precursor for this will be industry professionals distinguishing between speculative trading and other forms of trading. However, a formal distinction will not solve the problem on its own. It is one thing to distinguish between forms of trading in theory. It is another to do so in the practical context of an active trading operation. The problem is semantics. In my experience, traders routinely use the term “hedge” to refer to any position that conforms to their market view—so speculation becomes “hedging.” Far more traders describe themselves as market makers than actually are—so speculation becomes “market making.” There are firms speculating today who tell themselves they are engaged in price discovery—so speculation becomes “price discovery.” You get the idea.

If steps are not taken to draw practical qualitative distinctions between different types of trading, any pick-up in energy trading will be accompanied by a misguided—and no doubt mislabeled—resumption in speculative trading.

To get the process started, here are some practical recommendations the CCRO and energy merchants might consider.

1. Different types of trading should be conducted in segregated portfolios.
2. VaR limits should be assigned to portfolios consistent with their intended use: high limits for speculation, moderate limits for market making, low limits for hedging, etc.
3. Quantitative disclosures such as P&Ls and volatility should be broken down by (purported) type of trading, so stakeholders can assess if portfolios are being used in the manner that is claimed.
4. Trader compensation should be based upon the goals of their portfolios. If a trader makes 5 million dollars in a hedge portfolio, that is not a good thing. Rather than give him a large bonus, he should be sanctioned.

With regard to hedging, hedge portfolios should contain that which is being hedged. A structured product linked to liquid underliers can reasonably be marked to model, so it may be placed in a hedge portfolio. Very likely, the structuring group will manage that portfolio. A power plant with a 30 year life cannot be reasonably marked to model. However, the department managing such an asset could, through an internal transaction, sell forward output from that plant to a hedge portfolio managed by traders. In this way, those aspects of assets that can reasonably be marked to market or marked to model can be placed in hedge portfolios.

If you present an idea in a certain way, people start to think about the idea in that way. As energy merchants move towards managing and disclosing risk according to different types of trading, thinking will change. Executives will start to focus on the different purposes for trading. They may start asking themselves: exactly why do we trade, anyway? Whatever answers they find for that question, the process of finding those answer can only be beneficial. If modifying disclosures—or even *talking about* modifying disclosures—will bring on such self-assessments, then let's talk about modifying disclosures.

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