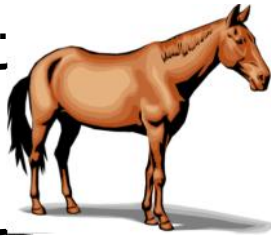


Notes from....



## Serrano Creek Ranch Equestrian Center

MAY 2011

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### Quants V. Serrano

People ask me if I ever read fiction to relax. My answer is a resounding no! That's because why read fiction when real life is more infinitely more fascinating. Take the current financial crisis we're in. The level of greed, market manipulation, and hubris among all parties from AIG insurance executives to borrowers using NINJA (that's mortgage speak for No Income, No Job, No Assets) loans. If there ever was a better real life example of the Icarus, I can't think of it.

One of the more interesting books on the subject is *Quants*. This is the story behind the traders who believe that they can write algorithms, and then program super computers to execute these in the hopes of anticipating future events. Specifically they believe that they can anticipate stock, bond, and commodity prices. These traders use the most brilliant mathematical minds, the most powerful computers, and boatloads of borrowed cash to bet on price movements. A Las Vegas analogy isn't too far off. What's interesting is that these folks don't buy and hold for long periods like we've been taught to, but they buy and sell a stock (or bond or commodity) for as short as a fraction of a second.

Commodity prices (oil, aluminum, orange juice, corn, hay, etc.) are traded by these folks. Through a myriad of financial schemes, these traders hope to buy right and then sell right to make a profit. Without getting too bogged down in details, understand that money can be made if the price goes up or price goes down. The key being whether the trader correctly anticipated the direction. Also remember that these traders never take possession of the commodity, they just control it with a contract.

If there is an equal number of traders that have opposing beliefs, then the market will remain neutral. But if their interests are aligned, then the market is artificially moved. For example if many traders' computer models are predicting that corn will be in short supply because of a possible drought, then they can buy a contract that is set at today's price, but is deliverable in some future date, say

6 months. Therefore Mr. Trader will pay \$3.00 a bushel for corn at today's price, but will "receive" it in six months. If in six months the price goes to \$4.00 a bushel, he can then sell the corn (which he never touched or stored) and make \$1 profit.

Now suppose many traders during that six month period see prices creeping up more than they had thought. Then they'll also use the same strategy, and the demand price for corn per bushel may go to \$5. In essence the true value of the corn is \$3, but speculating traders have pushed the price up to \$5. If many more traders are speculating on a future price increases, this will then push the bushel price even higher.

The faster and faster price increases attract even more traders. What results is a speculative bubble. Remember that the basic underlying demand for corn may not have changed (same number of people wanting tortillas). But the price for the corn has changed based on traders' speculations.

Bubbles are very interesting phenomena because they attract less and less sophisticated traders as the prices increase. The thinking being if I just get in I'll make big money as well. As the bubble expands some folks will borrow money so they can buy more contracts and make even more money (known as leveraging). Bubbles tend to increase at increasing rates. And this leads to price instability.

Eventually a few traders begin to think that the price is too high, and they'll sell the contract before waiting the six months. If this trader is a big name such as Goldman Sachs, other traders will pay attention. If word gets out that there's selling going on, all the traders will rush to sell their contracts before the price falls any further. Just like their mass actions drove the price up, panic selling sets in and the price plummets. In the panic, the price may fall far below the original price. Homes are a commodity, and in some neighborhoods, the price has fallen to 1999 levels, well below the bubble price..

For the customer that's buying a dozen corn tortillas, his price could double for no apparent reason. Same amount

of corn grown, same number of customers, yet the price is way up.

Now here's another twist. The tortilla maker may shop the world for the best corn price. If a country that grows corn has a weakening currency, then our tortilla buyer can buy more corn because his currency is stronger than the corn grower's. In reality, the dollar is a weakening currency, so the corn that is grown here is cheaper than say Australian corn. So world buyers come here to buy their corn. This means less corn is available for domestic consumption and the price goes up. But what happens if the traders are speculating that the dollar is going to weaken in the future. This will create an even weaker dollar and more corn is sold overseas. Again it's the consumer that pays the speculator's salary.

In the last 10 years the world has become much more interconnected. Traders now don't just speculate in one country, but instead will speculate across countries. We have seen many crises because of the almost instant ability to enter and exit (financially) a country (remember those traders may be buying and selling in a manner of a second). We've seen crises created in Russia and Thailand based just on speculators perspective. In the latest go, Iceland almost collapsed.

The demand that supported NINJA mortgages again was based on speculators demand for these financial instruments. Once they figured out that these were worth less / worthless, there was a mad dash for the exit in terms of selling. Many banks, pension funds, countries got stuck with an asset that one week was considered an excellent investment, and the next week when panic selling started, was worth nothing. So the same speculation ways go with alfalfa. The same traders speculate either directly or indirectly (through milk and grain prices) what the future will be. Trader movement is that milk prices will go up. The prices we're paying today are a result of the traders' visions of the future.

As computer power continues to become more powerful and cheaper, speculators are representing a larger percentage of the trading activity. Going forward, we can expect wider price swings. It is possible that if there is a hay bubble in the making (was there a housing bubble) prices could go higher, or they could burst.

My hope is that alfalfa and Bermuda prices will come down. Traditional market forces indicate that dairymen will produce less milk because hay has increased so much that its cost outweighs higher milk prices. Less milk means that less hay is bought. With this hope, the stable will review its feed costs quarterly, rather than annually. If prices fall, we can adjust out prices

downward, sooner, rather than wait for our usual annual review. Please see the box below for the new rates from May 1<sup>st</sup> – July 31<sup>st</sup>.

	<u>2-3 Lbs.</u>	<u>5-6 Lbs.</u>	<u>9-10 Lbs.</u>
Alflafla	\$29	\$41	\$65
Bermuda	\$25	\$35	\$55

**NEW CLASSROOM READY FOR USE!!!**

On May 9<sup>th</sup>, Ashley Martin is facilitating a seminar on Equine Dentistry. Dr. Lori Critchfield will be the honored lecturer on the benefits of good teeth. Word on the street (or in the arena) is that they'll be using the classroom's technical wizardry to give the attendees a visual tour straight from the horse's mouth. For a fee of \$15, you're guaranteed a seat. This is the first of a list of speakers who will use the classroom to make us all more informed equestrians.

Details:

Monday May 9<sup>th</sup>, 6:30-7:30

RSVP 949-636-3950 (spaces limited)

And lastly... last year our riders were quite missed in the city's 4<sup>th</sup> of July parade. If you're interested in riding, please let the office know so that we can start a list.

We need a volunteer to put in just a few hours to organize the group. The office is happy to mentor / partner with this future leader. What a great way to build a resume!!!