Market Commentary: Fun With Finance

June 2024

Innovation is a theme we speak about a lot at Fountainhead. It is not merely exciting given new discoveries and capabilities but materially contributes to the increase in global wealth. Transportation is a simple example, as we went from walking and running to domesticating and riding animals, to creating a wheel and boats and bikes and eventually motors and trains and cars and planes. It allowed us to move objects around the world rather effortlessly.

Innovation, though, cannot happen without finance. In fact, we owe our everyday economy to finance.

A farmer decides they will grow wheat. This takes time (4 – 8 months depending on season and variety), material, equipment, and work. The farmer's land may have been purchased through financing from the government or a bank, essentially a mortgage, and their equipment through an "asset backed" loan where the equipment serves as collateral, lowering the risk for the issuer (or maker) of the loan.[1] The farmer takes on some significant risks such as an unforeseen event that ruins their crop or an inability to sell their wheat when it is harvested. The insurance industry is able to provide protection against a disastrous outcome. The farmer can sell wheat futures[2] that mature at roughly the point of harvest on the Chicago Mercantile Exchange[3] and lock in their sales price. That means the farmer can calculate all their expected cost inputs, inclusive of insurance and know with certainty their sales revenue (assuming no insurable event).

Finance has materially lowered the risk of the farmer. Finance also lowers the cost to the consumer. Without the finance industry providing a level of certainty, the farmer would need to price in additional profit in

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[1] We own a number of funds making asset backed loans and other funds buying mortgage securities, so our clients are essentially lenders.

[2] A future is an exchange-based contract between two parties who agree on price and date of delivery. Prior to date of delivery, either party can exit their exposure by buying back or selling their contract to anyone on the market. If the contract remains open, then there is delivery. My first job was on an exchange and there was an old wives' tale of someone who accidentally took delivery of potato futures and had the potatoes dumped on their front lawn. One can take accidental delivery but that is not how it would happen – they would get a warehouse receipt and have to cover storage fees until they figured out what to do with the commodity. A forward is a non-standard future, meaning it makes use of a private market. This makes exiting harder since you need to go back to your original counterparty.

[3] [Chicago SRW Wheat Futures Quotes - CME Group]

order to make up for the uncertainties of unforeseen events, lack of buyers, and change in value among other volatile variables.

A buyer of wheat, such as an industrial bakery, is also able to use the futures market, but in their case, they would be buying wheat futures in order to lock in future costs. There will be times where it may make sense for this purchaser to use options rather than futures, another financial vehicle. The many buyers and sellers meet up on an "exchange," resulting in relatively liquid markets that further assist in lowering the volatility of consumer prices.[4]

Deep Thought: Olympics!

The Summer Olympics will be taking place beginning in late July in Paris! The original Olympics took place in Greece for close to 12 centuries (800 BC – 400 AD). They were played naked and only by men. They were so popular that a war was delayed due to an upcoming scheduled Olympic event! And eventually the games were outlawed by the Romans due to their pagan origins.[5]


[6]

The Olympics is supposed to be about coming together as a people. The Olympic rings represent the [ideal] unity of the five inhabited continents. In an increasingly ominous global geo-political landscape, getting together over sport and food sounds like a good idea.

However, it seems problematic for countries to compete for hosting and then get destroyed economically in building the necessary sport infrastructure to support the games. It supposedly took Montreal 30 years to pay off its Olympic price tag and the list of cities that were simply clobbered in a number of ways (displaced people, cost overruns, empty stadiums)[7] goes on.

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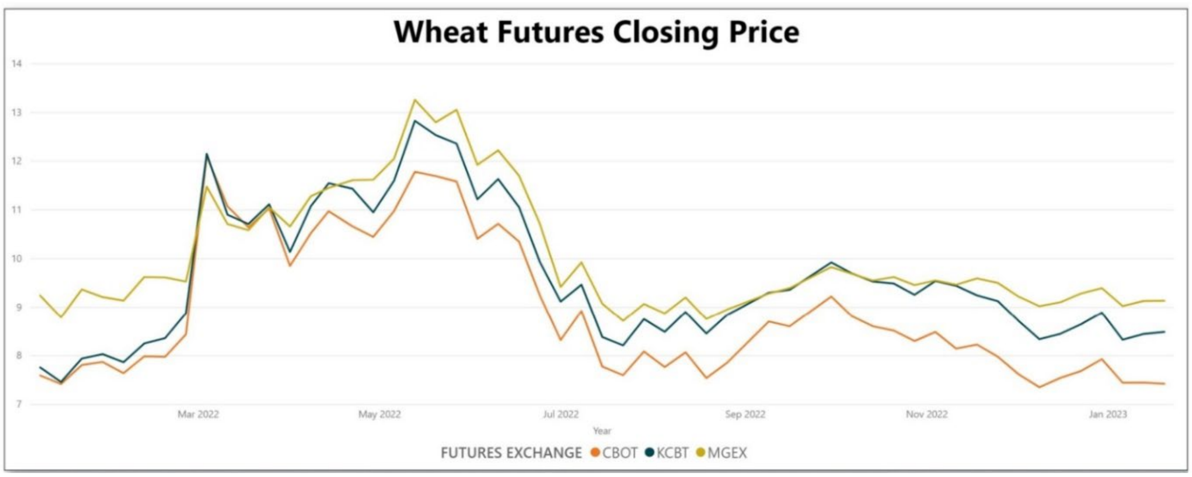
[4] Lower market spreads and costs result in more efficient pricing generally, and that typically flows through to the consumer.
[5] Summarized from [Welcome to the Ancient Olympic Games (olympics.com)]
[6] [Welcome to the Ancient Olympic Games (olympics.com)]
[7] [Why Can't We Just Host the Olympics in the Same Place Every Year? - Bloomberg]

A universal Olympic city (perhaps in or near Greece – Greek island?) can solve many of the aforementioned problems with rotating the host. This could possibly help in focusing on the true meaning and benefit of the games! We did not come upon this concept until learning more about the games, but it sounds worthy, matching the idealism of those who brought the games back into being.[8]

Outside influences and global events can have a significant impact on these decisions. As an example, when Russia attacked Ukraine, wheat prices skyrocketed because Ukraine is a major producer and exporter of wheat. The buyer in the example above would have been protected from this event, while the farmer could have done better but at least locked in on the economics of that growing season. Financial markets provided a clear indication of the demand of buyers and lack of sellers and these markets allowed new producers to enter the market while locking in future prices, increasing eventual supply (it still takes a "season" to produce wheat). It allowed better forecasting for the industry, which ultimately allowed for further efficiencies, thanks to our robust financial markets.



[9]

Our society has constantly refined our financial infrastructure and added to financial innovations to find ways to regularly squeeze more uncertainty and cost out of the system.[10] Some insurance companies are not much more than branding and distribution entities, necessary to cover that last mile and connect to the end client. These "insurance" companies will then resell their liabilities to another insurance company who may further package and sell their liabilities to reinsurance companies that may be located in weird locales like Bermuda for a variety of regulatory and tax reasons. Others may take some of the reinsurance

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8 Why Can't We Just Host the Olympics in the Same Place Every Year? - Bloomberg

9 Wheat Prices Trend Lower Even as Uncertainty Continues (uswheat.org)

10 Yes, finance seems inherently capitalist, so it is worth commenting that the path to financial innovation is not straight. It involves many fees, both reasonable and unreasonable, along the route.

exposure and package it in a fund that is sold to retail investors. Everyone takes a layer of fees but ultimately the structure provides potential opportunity for an investor to obtain a diversified investment that falls into a range of risk / reward exposures.

Many times, innovations are loon shots, meaning that at the point of concept the idea seems outlandish and will take a long time to develop. Governments frequently fund loon shots, space exploration being a good example of this. Longer term investors, such as private equity investors who focus on early-stage venture capital, are other investors in loon shots that may be seven to ten years out. These investors only expect a minority of ideas to work out. But when these ideas work out they have the potential to generate tremendous returns – one can only lose 100% of an investment but can generate returns many times that (a “ten bagger” is a 1,000% return).

In summary, finance allows for innovation, it allows for business planning, and it assists in creating material efficiencies within our economy. It also provides opportunities for investment, though often at the cost of complexity (reinsurance strategies are complicated!) in a multitude of product wrappers.