TRANSPORT TRACKERS
INDEPENDENT TRANSPORT RESEARCH

Shipping Roadmap Guidelines **Charles de Trenck** **May 2009**

The following is an extract from a report in two parts with most of part two (ex stock views and related). The purpose is to lay down some of the major driving assumptions behind assessing where we are in the cycle, and tracking and interpreting data.

In general we have been looking for entry points into some well run companies and some companies which have long-term valuation levels which can be accumulated during panic selling. We saw some values appear in 4Q08 and 1Q09, and are monitoring how this could occur again.

One big negative med-term is the level of subsidies (TALF/TARP for ships) being thrown at shipyards and shipping finance in China and Korea, which, while helping to soften the current blow, could in fact keep more ships in the market and thus lengthen the downturn or cap upside.

Underlying Assumptions/Definitions for Shipping Research

My sector is shipping and transport. Shipping/transport teaches me not only something about the approx direct 5% of the stocks out there. It leads me to study the relationships between long term growth and reversions versus deviations from mean, consumption and manufacturing, commodities and production, developed and developing countries, and so much more. I wouldn't do it otherwise.

One. Equities are fickle. And thus deep cyclical equities are even more fickle and volatile. They are worse than a popularity contest in High School. Often a company can improve its following, its disclosure, add a PR team, work on data smoothing, etc. And this will attract more investors, which will then attract more investors. We have all seen that larger, more liquid shares often become more investible.

…

In looking at company performance, we also now know more about the Enron and Madoff fabricated performances, and we know full well what US Capitalism à la Wall Street has taught us. We'll tell stories like our parents told us about the Great Depression in decades to come. We don't know the ending yet, but we know it will be a long story ("Once upon a time, a lawyer running a large US bank said he was still dancing when the market was about to tank…").

The X-Files said it well in one of their slogans: Trust No One. I don't mean this literally. But be alert as to the story you are being sold. And I think most investors now are more alert. In Buddhism it is about learning detachment. And for investing we often get told to practice this detachment as well, that we "can't fall in love with a stock or investment." My approach is to remain cautious, commit in increments, and remain diversified.

Two. Data deceive. People used to market equities on the basis they outperform bonds over the long run. After the 4Q08 and 1Q09 declines they then said that bonds and equities had turned in similar performances long term, and equities over the last several decades have gone nowhere when adjusted for inflation. No doubt, in good contrarian fashion, this also set the base to form a signal to look at equities in 2009-10. … And we also know that recent wisdom has been that longer maturities of US Treasuries don't provide attractive risk-reward profiles now.

Data is in the eyes of the beholder. Better to break down data into narrow series, and seek to understand their context at different points in time. The pretty chart tells a story. But it relies on interpretation to add the context. I love charts, even as I warn against the dangers of using them without proper preparation or without proper deference to where the data has come from and how it has been collected or changed over time.

Another issue is the longer a series the more likely discontinuities in frames of reference develop when comparing a series against another. Comparison of patterns remains very useful and instructive, but working off of indices like the CRB or the Dow Jones Industrial Average, where the components are changed, sometimes because of "survivor bias," distorts the results.

In container shipping if we look at TEU (twenty-foot equivalent container box) volumes over the decades, for instance, we are at the mercy of consultants to determine the extent of TEU performance, since compiling certain trades can be as much subjective as objective. Shifting levels of trans-shipment and other variants of double-counting mean the volume series comparisons offer their own traps. In bulk shipping the ton-mile analysis can be just as tricky.

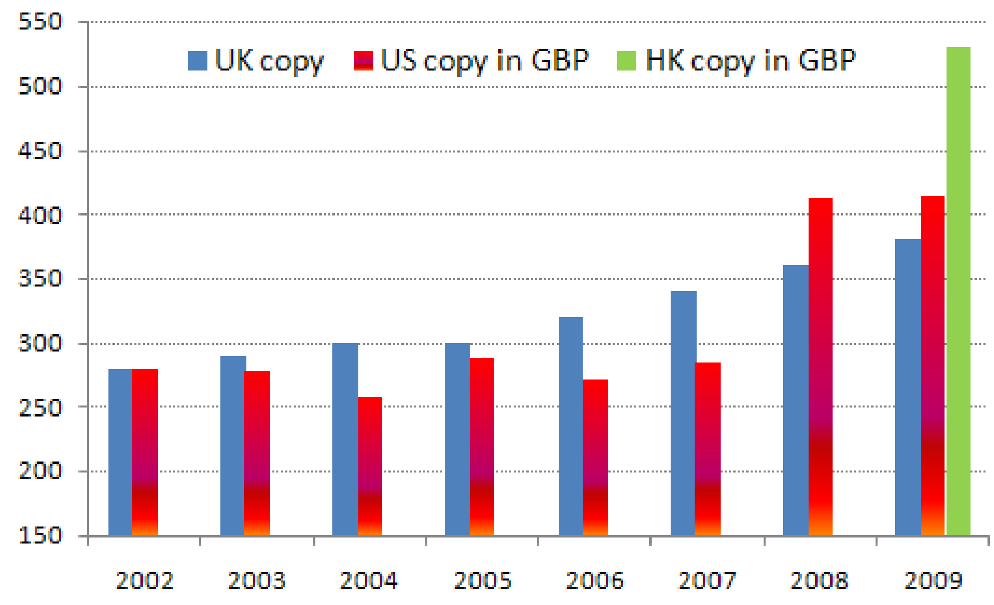
And we've all heard variants on why GDP, CPI and employment data should be discounted heavily.

Inflation tracking can be very subjective… and vary widely from series to series and FX to FX rate

<u>Does the price of a copy of the Economist over time look anything like the Economist Big Mac Index?</u>

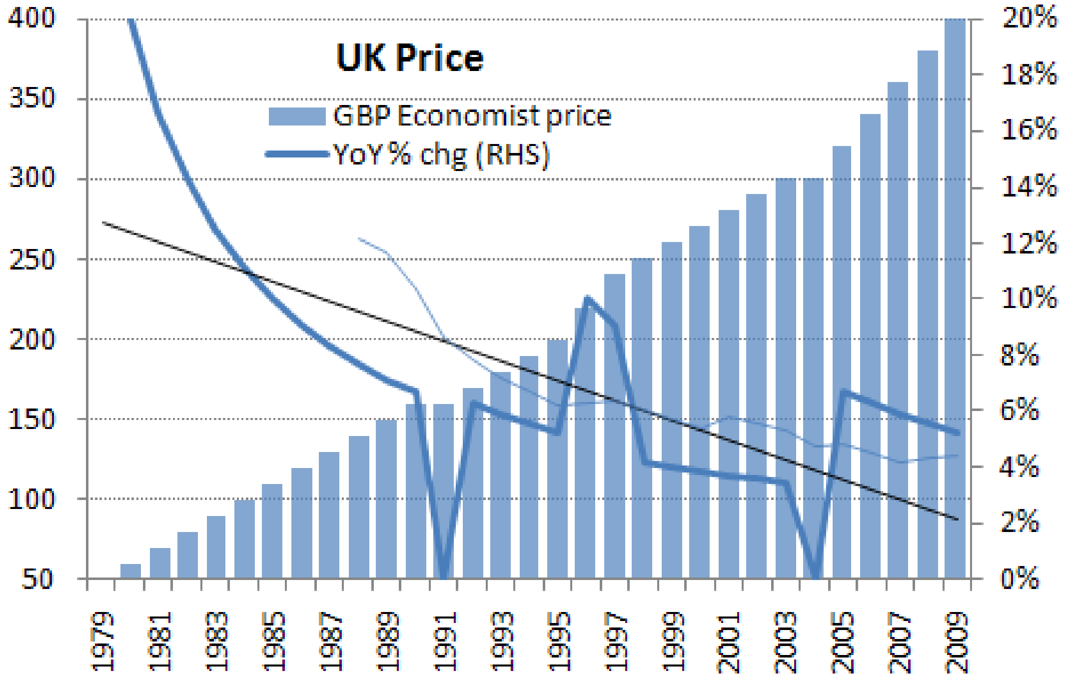
I got tired of looking at the Big Mac Index and seeing the price of the Economist rise even more at times, with no apparent grounding (especially the HK price of a copy) in other price series. The price in Hong Kong in the last few years has moved from HK$40 to HK$60, leading me at the time of the first big increases to suspect the Economist was pricing locally to get higher margins where they could. On a recent weekend I went through UK and US Economists on line to track price changes. With my colleague, Sten, we then looked at the variances in performances between the Big Mac Index and Economist pricing strategies and changes. One of the first things we found was that the Economist Big Mac Index data is interesting and useful, but the PPP outputs (the purpose of the Big Mac Index) were less useful than the inputs. So we went back to looking at the data behind the PPP series, with a focus on the UK vs the US.

The Economist: UK Cover Price in Pence versus US Cover Price Using Yr-end* FX (HK 2009 for reference)



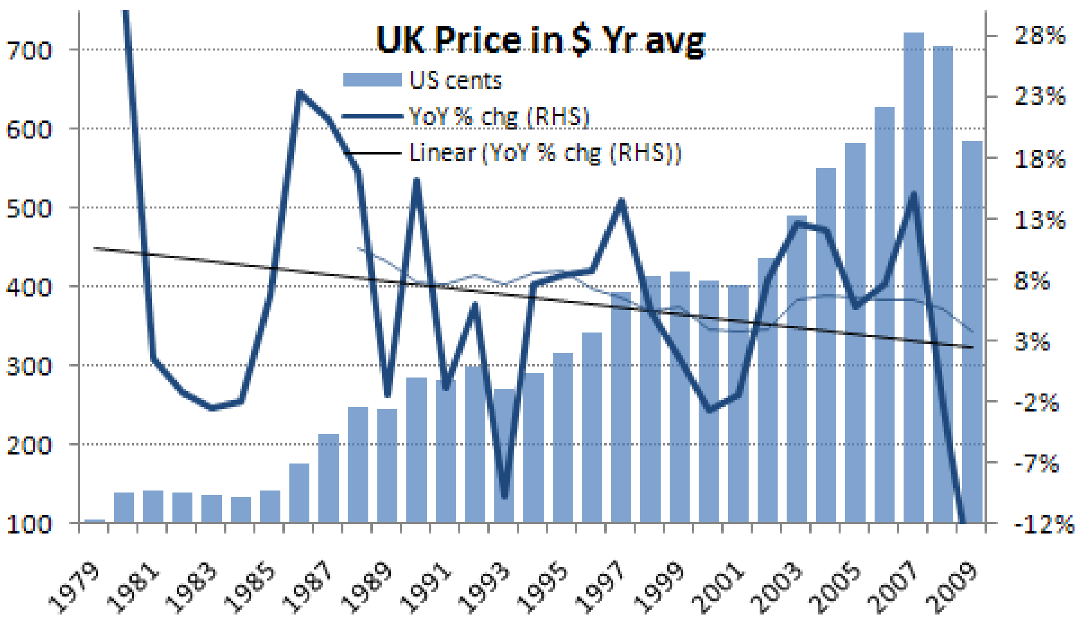
Sources: Economist; Transport Trackers *Over the years The Economist often raised prices around Sept

The Economist Price Increases in Home Market, 1979 - 2009



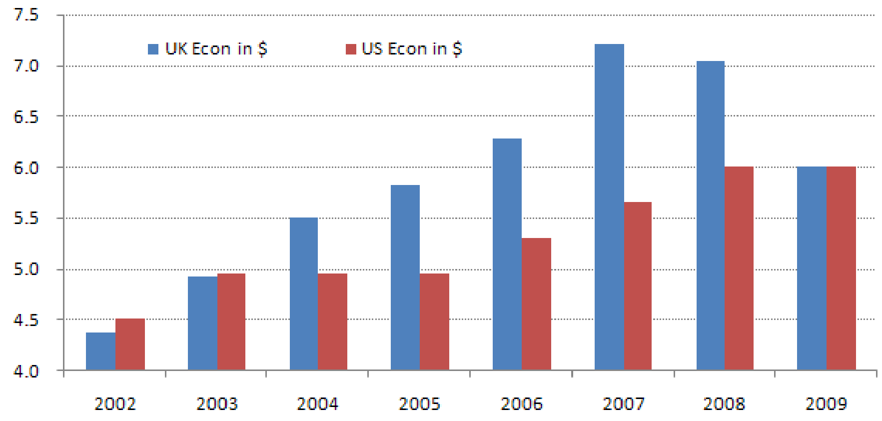
Source: Economist covers; Transport Trackers

The Economist Price (UK) Increases in US Yr-avg Terms (ie, dollar rebound '08), 1979 - 2009



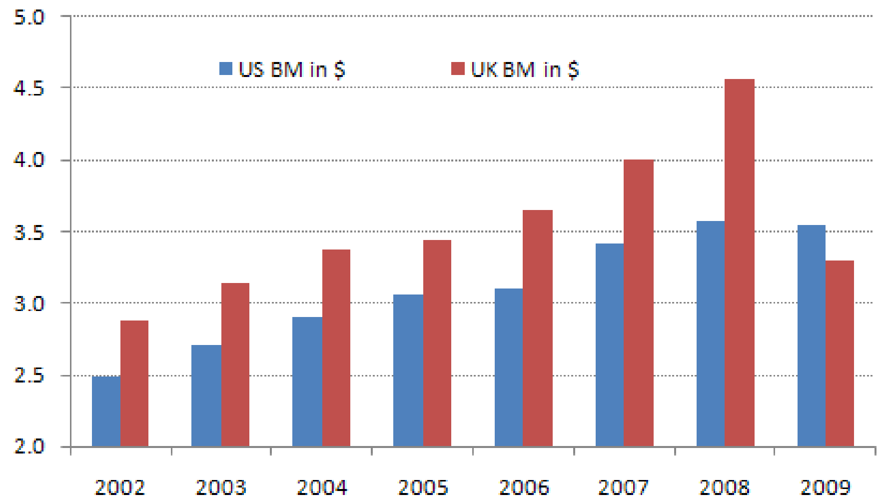
Source: Economist covers; Transport Trackers

Economist Parity: UK edition in US$ Terms vs US Edition in US$, 2002 – 2009 (using Economist Big Mac Index FX rates)



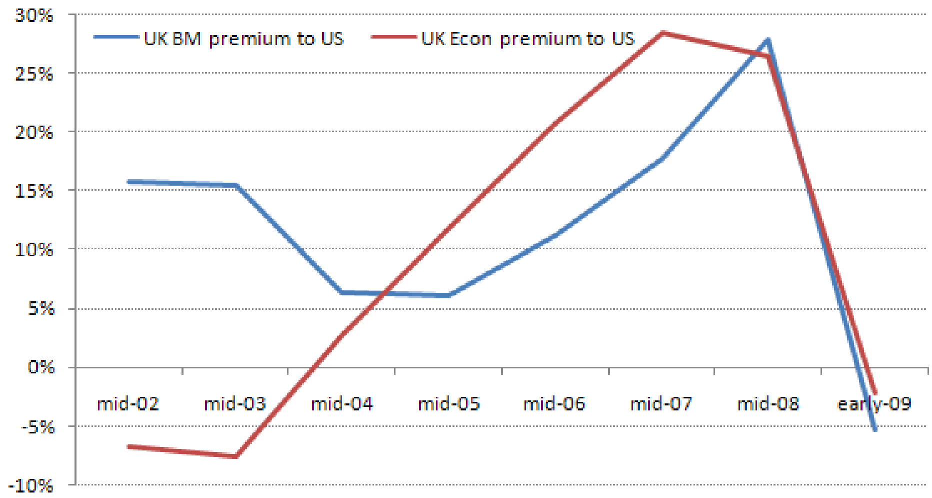
Source: Economist; Transport Trackers

The UK Big Mac in US$ Terms vs US Big Mac in US$, 2002 – 2009 (using Economist Big Mac Index FX rates)



Source: Economist; Transport Trackers

Conclusion: Big Mac UK to US Performance Similar to Economist's Own Performance 2002-09
(after initial Big Mac bigger premium to Economist in USD terms)



Source: Economist; Transport Trackers

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Over the longer term, beyond cycle to cycle comparisons, time series and indices get blurred. Individual inputs into basket prices and mechanisms experience tremendous changes and divergences. And over time, say 50 or 100 years, the drift between series and individual inputs gets more and more difficult to gauge. That is why looking at the price of gold or an Economist copy can be an interesting backtest over very long periods. And to make it more interesting look at the Economist copy in local market versus US dollar terms.

<u>Three. Ethics are not clear cut.</u> People do what they have to, not always what they should, morally or ethically. Sometimes it's the small things that give moral hazard behavior away. We all have memories of doing something we know we should not have done, and worse, when it affected those around us. Is it worse to tell someone to be careful and walk away from a proposed potential 50% IRR project or investment (with a list of cons as long as pros), and then see them initially make some money, only to lose the investment when it appears everyone else had a similar idea and over-supply kicked in…Or is it worse to have told someone to keep the money in short-term instruments, trade/invest selectively and invest at key market lows and see them make sometimes lower but safer returns…I am referring here to the ethics attached to the trust placed in a person or a team on recommendations or executions.

….

Brokers/banks should put greater effort into committees to investigate analyst logic and valuations supporting recommendations – or simply dispense with the pretense that comes with specific targets and touting most forecasts (ie, except perhaps utilities) beyond 6-12 months as anything more than guesses or educated guesses[1]. I've seen enough of investment/stock selection committees from working at small and large brokers to know that most (I won't say all) of these committees do not work a significant amount of the time for *analysts who want to bypass* the system. I won't bore the reader with war stories. But ethics is a key issue in my experience[2].

One of the major traps in the valuation process is when an analyst starts with a stock price and view, and uses a current price to mark the valuation levels, as opposed to an independent valuation to set the view as to the level of over- or under-valuation relative to stock price. Is it the case that some of the numbers generated when done independently can be so far away from the stock price that few will sign off on the figure generated if the discrepancy is large and/or the time factor to get to that price is so long as it will be embarrassing for the broker putting out the opinion?

I only spend time on this point because there are still quite a few people in the brokerage community who believe in some of the trappings of the broker report.

Ultimately – it's not the analysts, it's the system. But sometimes some analysts play along too willingly. There is a role for analysts, but as consigliere on focused topics more than for too many stocks with too many bells and whistles.

This is even more true given statements such as "…We have a hiring freeze. Now I have 20+ stocks under coverage and still no RA support…" which a friend at a major global broker recently wrote to me.

Four. China as be-all, end-all. In stages, but with the last stage being in 2008 and early 2009, arguments constantly circle back to China as a savior of many things global. In a sense it is. China has certain characteristics shared with other rising economies and its export industries in 2008-09 have been hit by the global deceleration in global trade, to be sure. But since it is a closed economy as well, it is able to protect some of its domestic markets and employ government policy to do things most others could only dream of doing. It has the best of both worlds at the moment. Others have also pointed out that its domestic consumers are not leveraged significantly compared to the US, for instance.

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[1] In container shipping and shipping – just take the volatility of the BDI for instance – I don't think we can forecast earnings much beyond 6 months, though in some periods visibility can shrink to even shorter time spans.

[2] Even the buy and sell price points are distorted in tracking analyst performance. First, the buy/sell date is effectively priced one day after the call. The analyst can downgrade to sell on a stock blow up. The investor can't get that price, let alone the volume at that price for many stocks.

Ultimately, everyone has to be responsible at a micro-level. This implies ethics and correct decisions start with oneself. The decision to buy or sell, to invest or not, comes down to the person or people pulling the trigger, not the analyst with the recommendation. Most investors, though not all, often told me they wanted insights and information from the analyst, not the recommendation (though it was sometimes salespersons who needed buy/sell to initiate the process with the client).

By definition outside analyst buy/sell calls should not be deciding factors in most investment decisions. In my view, analysts can help, provide information and analysis, supply data, etc. But the buy/sell decision at specific price points is most often with the buyer or seller.

It is a dangerous game believing that China can save the commodities world through increasing demand partly through artifice and partly through stimulating demand for infrastructure, just as it is that central banks can save OECD economies from deep recession and banks from balance sheet paralysis (if they do succeed, great. But let's not start with that assumption). But certainly there is some truth that China has important financial and other roles in today's global economy[3].

One should start as a non-believer and maintain a good dose of skepticism. This is using one's long term, analyst hat. But, equally from a short-term perspective one has had to 1) play the game and buy (ready to ask questions later), and 2) be ready to consider this could be a med-term rather than only short-term rebound on the view that China can will itself into a mild recovery, while 3) being ready to reverse positions and run. Clear as mud, as a friend often reminds me. But it's the truth.

In a sense this is why one could argue on being more positive on bulk demand drivers (ex-capacity concerns) than on container drivers, which are driven by OECD demand.

Five. Shipping is cyclical and approach to valuations/momentum. What we learn in shipping can be at least partly applied to steel, energy, chemicals and other cyclicals. Capacity and time to build-out and eventual capacity growth in excess of demand share similar behavior patterns. The longer the capacity ramps up, the longer the period of the cycle. The higher the ball rises, the more it will bounce.

To paraphrase Sir Isaac Newton, objects when set in motion remain in motion unless acted upon by an outside force…The shipping cycle can be turned down through either a reversal of demand from up to down, or an excess of capacity in excess of demand.

Momentum versus valuation is a tricky relationship. Just as when to choose when demand is more important than capacity concerns versus over-capacity as the main headwind period. Ultimately, I will always start with a view of market price of assets and compare this to cashflow and earnings, and to a long term ability to pay dividends or dispose assets.

Six (6a). Dreams and mean reversions. A journey starts with the first step. The question I have asked many times over, and to which I never truly know whether there is a correct or simply one answer to is: <u>Do we operate in a zero sum world?</u> If we consider the laws of karma, then we would have to say yes, generally speaking. You can't have your cake and eat it too.

A few years ago, I talked to a hedge fund manager who worked at a steel trader and who had been a specialist on Russian steel, and who had concluded Russian steel production converted to a higher level from which it would be difficult to backslide back into. I stayed with this example, as I believe this stands out, and perhaps some industries in China too, where one can say, these are not zero sum

[3] In early 2009 the following observation made the rounds, originally sourced from the German press: "1949: Only Socialism can Save China…1979: Only Capitalism can Save China….1989: Only China can Save Socialism….2009: Only China can Save Capitalism…

cases. There were real, long lasting improvements in the process of production, and the clock will not likely get reversed at this level. China, has moved up to higher quality production and activities, and appears to be on course for a continued ascendancy to the global stage.

… But when we expand the angle of the lens, we then find who is on the receiving end of increased competition. If someone is winning, then someone is losing too. The issue of the US being in a structural decline has been raised many times, despite its historical knack for re-inventing itself (we need to ask as well if Big Government will hurt this process and do any permanent damage or if the US will pick itself back up…Maybe Ford yes, GM no?).

It is about the supply chain and why "the world is only flat where the roads are built" … only to find someone forgot to add the connecting highway. The whole global village concept is flawed, in my view. Of course, many practices, markets and companies have been made more uniform. But the variances that remain are large enough to render the exercise very dangerous to apply in practice.

Seven (6b). How do we add value in a process based system of trade? And where is the process of reversion to mean observed? The supply chain is key in understanding the process of adding value in trade. China fabricates a good, often using equipment and labor that is in abundant supply and which commands no premium. For decades (until just a few years ago) it was argued that China did not even make money making many of the goods it was sending overseas. But when goods got to Pier1, to Wal-Mart, etc the price at the other end captured the cost of the ship transfer (and often just barely), and the cost of the transfer and storage on its way to its final destination, the corner store or mega store, usually via a distribution center and based on skillful management of the transfer process.

The supply chain is the process by which a multiplier effect on top of the manufactured good generates jobs, commissions, fees, rentals, etc. "Value" is added in the process, until the price at the retail level no longer resembles the price at point of manufacturing. The west thrives on adding value through marketing on top of underlying qualities/technologies.

The game was everyone in the supply chain made more money when the good was sourced from a cheaper point of origin (but with upward sloping price…) than if its initial cost was going to be higher offering less opportunities to hike pricing…etc. The concept is simple. But the point is difficult to drive home.

Is this the game that is over? In the strict sense this game of price/value arbitrage will never be over as long as there is free trade, but the degree is the question. And is the process, the unwinding of spreads and margins, what constitutes the zero sum effect? I can't formulate the question better without taking more time. And I certainly don't think we can answer this question now, but if I can ask it another way: Why should some developing countries including China allow the US to reap the benefits of more control over the process of inflating values within its borders when it is doing so at the partial expense of China[4], and arguably, with more of China's money given the US as more debtor than creditor? I don't mean this question in the sense of erecting trade barriers, etc, but simply to identify that value multipliers are controlled on the import side not the export side – or to whoever controls the supply chain. This is pretty evident, and yet it is still ignored. <u>China will/should likely seek to grow into the supply chain rather than be as much of a price taker in future as it has been in past</u> (even if the product itself remains in oversupply).

China's rise and the global supply chain. But the short term answer is/has been the US, Europe and other importing regions control the rules of the game – where the value is added.

The game of value adding going forward should change and set the tone for the relative decline of the US and perhaps Europe and others relative to China. This should be even more the case if we don't see a change in how the US deploys its human capital relative to its consumption patterns.

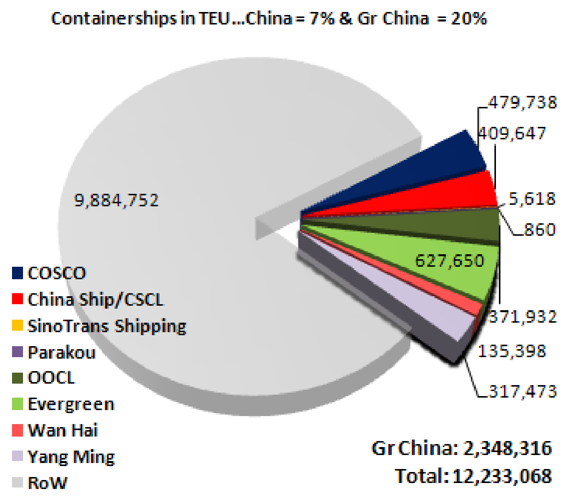
As Chinese firms go overseas and use their cash to invest for the long term they should work their way into more control of the supply chain. As they do they should take control of the price multipliers from factory to consumer. Why should they leave western firms in control?

The first move will be to take over more control for moving the cargo. In the short to medium term, say the next 2-3 years, the move may be painful. In shipping it won't be about buying assets that are expensive, but about assets that generate relatively little cash flow.

According to one shipowner, European owner control about 60% of ships and Japan 20% of ships, and China in past years control perhaps only 15% of its container cargo. COSCO and CSCL have been the major owners. Yet most large international container lines derive about 45-50% of their revenues from transporting China outbound cargo. The total global figure falls when one includes regional shipping companies, but the 50% figure covers longer haul trades which generate larger revenue tickets, although clearly not always higher profits.

[4] And this even if there is an implicit contract between China the maker of cheaper goods and the US the buyer of cheaper goods fed through the supply chain it controls more than China?

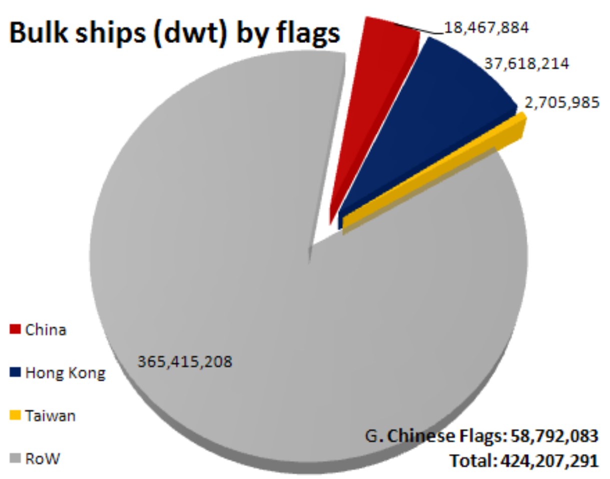
Snapshot of Global Container Fleet March 2009



Sources: CI; Transport Trackers

China will move to control more ships to control its own cargo, despite false starts. When China transferred its Shougang fleet of dry bulk vessels in the late 90s into a JV (ABC Bulkcarriers) with P&O, and later let control slip in 2000 and 2003 to the Ofer family and Samama/Eurotower Holdings, one could argue it went backwards. But with the current wave of over-building, vessel price declines of 50+% in 2008-09, and China subsidies for shipyards[5] it makes sense for China to buy the ships and transfer them to domestic companies. The big question will be what will be the price and where will cashflow levels become attractive. It is too early to tell. In other industries, I would urge China to move into warehouse ownership, logistics providers and other supply chain companies.

Snapshot of Global Bulk Fleet March 2009



Sources: Clarksons; Transport Trackers

[5] Mindful of course that Korea has initiated its own Korean shipyard/creditor bailout program. Transport Trackers has written about both approaches while noting some of the differences in the two shipyard rescue approaches.

Eight. Reversion to mean and/or zero sum from a trading perspective

Reversion to mean and momentum trades are sometimes listed as the two main trading strategies underlying decisions. A fund manager and friend points out that European type investors tend to be mean reversion types, while Asian tends to be momentum traders. I might add that another way to look at it is whether in Asia, US or Europe, trader and speculator types tend to be of the momentum investor kind, whereas value investors may gravitate to mean reversions. But no doubt many will have issue with such classifications. Perhaps we can all agree this is generally the case. Could we argue that some of the world's best known investors failed on key investments like GE in 2008 because they assumed reversion to mean would kick in based on past experience, but that perhaps momentum traders would have simply picked up no key reversals and continued to stay out of the market or to invest in its downside?

My own bias is to observe the process to mean reversion, with my special interest being to seek to understand how the mean shifts from period to period. I also believe that if we widen the lens as far as we can, then mean reversions are more clear. But I continue to be unable to answer the question as to whether everything boils down to zero sum or not. I don't want to answer the question fully because then I might stop asking it.

A side question for another time: How far does the volatility of greed and fear extend?

Source: Bloomberg

Nine. Phenomenology versus ontology in investing

This sounds really far out as a topic. What could Husserl, Heidegger, Zen Buddhism, Daoism or Plato, Christianity, Pure Land Buddhism, Hinduism, Islam, etc have to do with investing, besides perhaps determine if one is a good or bad person, or if one conducts oneself properly (refer to dharma and dharmic actions)[6] while one invests, though not necessarily influence the outcome of investments themselves? Isn't this where socially conscious investing is taking us as well?

I would argue that if one is referring to value investing, of mean reverting strategies, then one is talking more in terms of ontology, of the science of being. Momentum trading one could argue is more speculative, in the sense of less value based and more directionality based. Momentum may be simply buying when stocks go up and selling when stocks go down. Values are attractive or not. Trading is how you get there.

But I would argue that the phenomenological process is the observation or the participation of the movements – the trading – of a stock. To me it is a dynamic process.

I will buy if the momentum and technical indicators break out, or sell if they breakdown. I am not experienced enough to rule in favor or one system or another outright or recommend a strategy of combining the two.

What I do know is that most sell-side research is underpinned by an ontological approach. Technical research is tolerated and used to support, aid or as a stand-alone product, but not in the same dosage as fundamental research.[7]

Though one can find traces of each influence in fundamental and technical research, I suspect most would agree with the "traditional" approach to research being the deployment of a research team on stocks and their earnings and balance sheets, etc. I support such work. I would just like to see a more ecumenical approach between methods used, and more off the wall/non-traditional studies/approaches as well. Perhaps it is because I enjoyed literary criticism and comparative literature classes in my grad school programs, but I think there is a lot to learn by applying philosophy/psychology/anthropology to stock investment behavior.

Ten. Forecasts are shite. My forecasts at a minimum are as wrong as right. I know that most of the time. In 2001 I was positive into buying into shipping names, but by 2003-04 I was neutral and by 2005-06 I was negative on valuations against long term opportunities. That was wrong in 2005. By not changing this view for 2006, this turned out to be correct as the sector corrected. Then in 2007 it appeared to many analysts as if the 2007 run up/rebound was just one long continuation of a bull run

[6] Dharma is an interesting term. My understanding (more from Buddhist thought but from Hindu thought) is as a noun it refers more to a concept such as "truth" (and therefore something like alethea in Greek…). But it can also be used as verb as in "rightful action."

[7] Even the concept of "trading restrictions" approaches the issue from a perspective of speculation is bad rather than trading as part of truth discovery process…

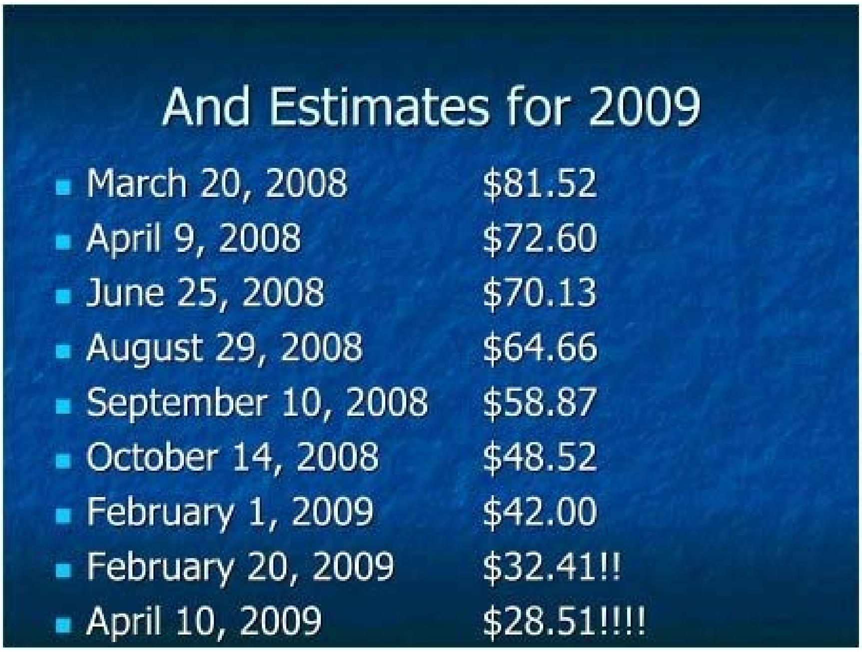
for shipping as a commodity in all vessel types. This of course made them very wrong in 2008 based on their unchanged arguments of 2007 and prior.

The bulls blew themselves up in 2008 just as the bears had in 2007. Some analysts and investors think like this. Given so many people use this perspective to express themselves, I will use these terms at times, though I do not agree with this perspective much of the time. I don't believe, deep down, in bulls, bears or perma-bulls or perma-bears, with all deference to usefulness of using the characterization.

More and more I want to develop two lines of thinking, a long term "fundamental" hat, and a short-term "trading" or momentum hat. I want to get away from bull-bear thinking. I know my forecasts will be wrong as much as they are right. I just want to understand how I went wrong and what parts were right…

I know how so many analysts draw up their forecasts, targets and projected earnings. I saw many US analysts in the NY office at Citigroup Investment Research generate their forecasts. And I saw Asia analysts generate theirs. The two different approaches can vary significantly.

I know the discussions I held with colleagues and heads of research. Some analysts share my view. Others play the game and pretend like there is none. I can't understand why forecasts can't just be taken for what they are – sometimes educated and at other times uneducated guesses. A table of forecasts at different points in time for the S&P 500 2009 earnings is below, for fun.


And Estimates for 2009

March 20, 2008	$81.52
April 9, 2008	$72.60
June 25, 2008	$70.13
August 29, 2008	$64.66
September 10, 2008	$58.87
October 14, 2008	$48.52
February 1, 2009	$42.00
February 20, 2009	$32.41!!
April 10, 2009	$28.51!!!!

Source: John Mauldin, April 2009