

## How the trader earns his living

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The trader's remuneration comes from the exploitation of differentials, which practitioners call arbitrage in the economic sense of the term. Four types of arbitrage structure the craft.

Geographical arbitrage consists in buying a commodity where it is abundant and cheap and selling it where it is scarce and expensive, bearing the transport costs. The trader profits when the price differential between the two places exceeds the cost of transport and ancillary charges. This arbitrage requires an intimate knowledge of regional markets and efficient logistics.

Temporal arbitrage consists in buying a commodity when it is cheap, storing it and selling it later, when it is more expensive. It is profitable when the structure of forward prices — contango, in which future prices are higher than spot prices — covers the costs of storage and financing. A trader with storage capacity and financing at his disposal can thus profit from temporary imbalances between supply and demand.

Quality arbitrage consists in buying a commodity of a given quality and transforming or blending it to obtain a quality in greater demand. The blending of crudes, refined products or cereals to meet precise specifications is a routine activity, which requires technical skills and facilities.

Form arbitrage consists in transforming a commodity: refining crude oil, smelting concentrates, crushing oilseeds. The large traders have acquired refineries, smelters, silos, terminals and fleets, which brings them closer to the integrated groups and gives them access to processing margins.

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| Arbitrage    | Source of profit                                              | Conditions                                      |
|--------------|---------------------------------------------------------------|-------------------------------------------------|
| Geographical | price differential between places                             | logistics, knowledge of regional markets        |
| Temporal     | price differential between points in time                     | storage, financing, structure of forward prices |
| Quality      | price differential between grades                             | blending, facilities, technical expertise       |
| Form         | price differential between raw material and processed product | industrial assets, capital                      |

To these arbitrages are added the revenues earned from managing risks on behalf of producers and consumers, who delegate marketing, logistics and hedging to the trader in return for a margin. A producer country without marketing capacity of its own, a refinery seeking a regular supply or a food company wishing to secure its purchases call upon traders for these services.

Trading margins are thin in proportion to the volumes, as the previous chapter showed, but the volumes are enormous. Profitability therefore depends on the repetition of low-margin transactions, on the efficiency of the organisation and on the control of risks. Periods of high volatility, such as 2020 and 2022, widen the differentials and increase the profits of traders able to exploit them, whereas calm periods narrow them.

**Worked example.** A trader buys 50,000 tonnes of wheat in a Black Sea port at 220 dollars a tonne, free on board, that is 11 million dollars. Freight to a North African port costs 30 dollars a tonne, insurance and inspection 3 dollars, financing over six weeks 2 dollars. The landed cost amounts to 255 dollars a tonne. The trader sells at 262 dollars a tonne, delivered, that is 13.1 million, and realises a gross margin of 7 dollars a tonne, or 350,000 dollars, before overheads. An adverse movement of 10 dollars in the price of wheat between purchase and sale, if not hedged, would turn this margin into a loss of 150,000 dollars. The figures are fictitious.

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