

CHAPTER 1**The Basics**

Sometimes something that seems convoluted and meaningless will actually hold within it some very deep or profound meaning. Take, as an example, a personal favorite of mine—a quote from Donald Rumsfeld, former U.S. secretary of defense. At a Department of Defense news briefing on February 12, 2002, he said: “As we know, there are known knowns. There are things we know we know. We also know there are known unknowns. That is to say, we know there are some things we do not know. There are also unknown knowns, the ones we did not know we know.”

If that sounds confusing to you, go back and read it again, for it is worth taking the time to understand the grand design of what he said. We also added a final category: unknown unknowns, which are the things we did not know that we do not know. Those classifications are not just valid as the keys to military victory, they are also the keys to trading successfully! And as Satyajit Das wrote in *Traders Guns and Money* (Prentice Hall, 2006)—a highly recommended book—these are also the keys to the derivatives world. I imagine they are equally applicable in almost any complex intellectual or financial universe!

More than anything, the most important aspect of translating Rumsfeld’s categories into successful trading is to realize the truth inherent in his statements, especially that there are unknown unknowns. It is impossible to know everything, to have all the information in the universe. Doing all you can to minimize the effect of those unknown unknowns—partially by simply acknowledging that they exist—can be the difference between a winning trade and a losing one.

BREAKING IT DOWN

You drink coffee each morning, eat your cornflakes and enjoy a glass of orange juice, take a shower with water running through copper pipes, put gas in your car, and head off to work. Each one of those actions involves a specific commodity, all of which happen to be traded as commodity futures on one of the major U.S. commodity exchanges. But the reason those commodity futures exist is not because you use the physical item (not directly anyway). Perhaps the best way to understand the commodities markets is to know why they exist in the first place: *Commodity futures were created not to make you rich, nor for you to trade them, but rather to allow the producers of the commodity to hedge their risk.*

Now please understand this next important point, as for almost everyone it is an unknown unknown: *They pay you to take this risk!* That is correct: The producers and hedgers pay you! That may sound like some late-night television infomercial sales line (usually followed by “But wait, there’s more!”), but it happens to be true. The premiums and discounts of commodity futures are, in effect, payments to speculators to entice them to buy and sell the contracts, generally speaking. This is similar to the way you ask insurance companies to take on the risk of you having an accident—by paying them insurance premiums.

Really, the concept should not be all that surprising, when you consider that commodity futures are simply another major investment vehicle. Many stocks offer dividends, and bonds have their coupon. So why would commodity futures be any different?

The similarities don’t stop there. Just as a portfolio of bonds and notes will have an overall yield, a portfolio of long and short futures creates a yield, as long as you follow the trends. This is explained in detail in later chapters, but it can be proven. The primary key is to follow the trends properly and to build a balanced portfolio of commodities. I can think of no better way than using the S&P Diversified Trends Indicator (DTI) as a method for both.

The S&P DTI is deterministic, not stochastic. That is, it is fundamentally driven. It has a better 12-month win ratio than the Lehman Agg, when combined with T-bills (i.e., total return). It is not a magic formula and it was not optimized, curve-fitted, or data mined. Any system or method based on optimization will fail in the long run. This is because markets change and evolve, they do not remain constant. So if you structure a system based solely on the past, it cannot survive the future.

The second important basic to understand about commodity futures is that no cash capital is required to buy or sell futures. Only collateral

is needed. This concept is mostly misunderstood. Therefore, you can use stocks, bonds, T-bills, or many other liquid assets to own a position in futures. It is the ability to overlay your futures portfolio over the other assets that creates additional alpha and increased returns.

As the word implies, *futures* settle at a future date for cash or via delivery. However, the stories of people having a boxcar full of corn delivered to their front yard are nothing but fantasy these days. Unless you *want* to take delivery of a particular commodity, because you are an industrial or commercial purchaser or have some other legitimate need, the delivery process can be stopped far in advance (although there is a cost involved). Still, all of that can be avoided simply by rolling out of a futures contract into a later one before first notice day.

The reason for the collateral requirement is simply because your bank or broker cannot take you at your word that you will pay up if you lose. Think of placing a bet on a football game with a bookie. You only need call him up, place a bet, and it is done. If you lose, you *have* to pay. Otherwise, instead of the SEC or CFTC knocking on your door, you'll find a big man named Buster asking you for the cash. You'll soon learn he is far more of a problem than the government, bank, or broker you would owe the money to if you were trading commodity futures.

Futures contracts are created if enough volume and open interest in what is being hedged can be generated, and if a ready supply of the specific commodity in a consistent condition can be assured. A diamond contract would be problematic, for example, as diamonds are of such individual quality and value. The underlying commodity must also be *fungible*, and settled for cash.

Futures are contracts that discuss the terms of maturity, in addition to the specifics of what you are buying and selling, while forwards are futures without a standard maturity date. For the purposes of this book and the S&P DTI in general, we will be discussing futures contracts, but I think it is important to understand that forwards are a similar investment vehicle and can be used in some of the same ways.

Futures contracts are made to fix a certain value. A Comex gold futures contract in the United States is based on 100 ounces of 99.9 percent pure gold. Therefore, if gold were trading at \$650 per ounce, the total contract value is \$65,000 (although the margin or collateral one needs to put up to trade that contract is a small percentage of that). If the contract were for 1,000 ounces of gold, it would be worth \$650,000, and would be too large to attract as much public interest as a \$65,000 contract, for obvious reasons. It is for the same reasons that stocks go through stock splits—to keep values at a manageable and attractive level for investors, so the minimum investment does not grow to a size that causes people to consider other investment choices merely on that basis.

EVERYBODY WANTS SOME

Recently, there has been a tremendous resurgence in interest in commodities. This seems perfectly natural, considering the rise in prices seen in the energy, precious metals, and industrial metals sectors. Commodities as a whole are experiencing a new up cycle. An examination of the major factors contributing to these price increases suggests they are not short-lived.

The first, and most acknowledged, cause behind the commodity price increases is strengthening global demand. World populations continue to expand, in some cases at a rapid pace. The industrialization in China and India has greatly increased the need for energy and industrial products, while the supply remains limited. The formation of the European Union to a lesser extent has also caused increased demand, as a stronger economic force leads to more growth, as opposed to a number of weaker, less-efficient countries.

Growth is not limited to China and India, of course. Throughout the world, demand for physical commodities is growing. Thailand, Indonesia, Brazil, Argentina, and all around the globe, a growing number of people in increasingly modern economies outbid each other for the limited supply of materials. By definition, increasing demand, combined with supply that is either static or increasing at a slower rate, equals higher prices.

This leads us into the second reason for the new surge in commodity prices, from the supply side: the environmental movement. This is very misunderstood, and rarely talked about in this context. A theme I have suggested at times is, "Buy what you have to dig, sell what you have to grow," although lately it seems more like the answer is simply to buy everything, as long as your timing is right.

Digging has become virtually impossible during the current global fascination with environmentalism. The environmental impact of any new mining or drilling operation is more scrutinized than ever before. Even when new supplies of oil or other natural resources are located, the political and environmental hoops that industry must jump through in order to get permission to access those supplies are not only timely and complicated, but also expensive. This increases the cost of any such operation, which means those supplies cannot be profitably utilized until process have increased to higher levels. This has a tendency to become a self-fulfilling prophecy, as without those new reserves, supplies dry up and drive those prices higher.

At the same time, the land that would normally be used to grow edible crops is allocated more and more to government-sponsored bio-fuel projects of questionable scientific value, which only makes food

supplies even more scarce. Ethanol is a perfect example—any increase in the fuel supply by the use of ethanol in motor fuels is arguably offset by lowered fuel efficiency, so we wind up with higher fuel costs and higher grain costs. This, combined with changing weather patterns, leaves the global food supply in occasionally precarious situations. The markets remain jittery, as they never know what could happen next. Often, the threats to the food supply are unexpected, such as the recent problems with pollinating fruits and vegetables caused by a sudden drop in the honeybee population.

Global instability keeps all the commodities markets on edge. A sudden storm, a plague of insects, a weather-related disaster, or a large terrorist attack could have lasting ramifications on the supply side of the equation. This isn't limited to the threat of a strike on the Saudi oil fields or other energy infrastructure. The global food supplies remain attractive terrorist targets, and in many cases they are relatively unprotected. Whether in the form of a biological, chemical, or radioactive event, or simply a strike at processing or distribution systems, the fact remains that in today's global environment market nervousness in all commodities sectors means increased volatility, which also means generally higher prices. These fears also create the desire for larger government stockpiles, which draws supply away from the open market. At the same time, those larger stockpiles are often no source of comfort to the markets, because they themselves appear to be attractive targets to sabotage, and because the timing and quantity of any release from the stockpiles is an unknown—in this case a known unknown.

Another cause of rising prices is global aging of the world's population. The older the population becomes, the more money needs to be committed to health care, pensions, or programs like Social Security. The only way for younger workers to pay for the older generations is for the government to inflate the world into more revenue. This "solves" many problems, including the deficit. Did you ever wonder why the market seems not to care about budget deficits? If the United States has a real \$10 trillion debt (taking a conservative accounting of contingent liabilities), and it has a \$300 billion annual budget deficit with a 3 percent annual inflation rate, it comes out to a wash; 3 percent of \$10 trillion is \$300 billion. Too good to be true!

The situation is the same with the trade deficit. Look at the whole, not the incremental monthly increases. You also need to consider capital outflows, which is a very misunderstood concept. If the United States is investing in India and China, then money is flowing out. If foreign countries are receiving dollars, they use that money to buy U.S. assets or U.S. Treasuries. This finances our deficits.

What could potentially cause all of this to change? Lower interest rates, a weaker U.S. government, and lower energy prices (which would result in less inflation). These situations would have to remain in place for a long period of time, without additional economic growth from the stimulus of lower interest rates and lower energy prices. This seems highly unlikely. If you are investing in the stocks of emerging nations, in effect you are investing with the big users of commodities. The net result is that you need to own commodities. The question that you are left with is not *if* you should, but *how* you should!

BUY AND SELL, OR BUY AND HOLD?

With the increased volatility in the commodities markets, the surge in interest, and the generally higher prices in everything from crude oil to copper to cocoa, it seems clear that you should desire at least some exposure to commodities. But there is a major difference between owning commodities, trading commodities, or profitably investing in commodities. And they do not have to be mutually exclusive.

The first option is simply to *own commodities*. There would be various ways of accomplishing this, depending on how you wanted to go about it and how diversified you wanted the commodities exposure to be. The most direct method would be to purchase physical stores of commodities, from gold coins to bales of copper wire. This method has major drawbacks. It allows little or no leverage, requires sizable movement and storage costs if you buy in bulk, and—most importantly—there is the aging process to contend with. If you purchase freight-loads of grain or herds of livestock, those assets can only be held for so long before they either spoil or have to be slaughtered.

The next option would be to purchase futures contracts on any number of commodities, in the hope that they increase in cost. Even with large capital behind you, this seems to be a cumbersome and dangerous method. Exactly how many contracts do you purchase, and of what commodity and what delivery date? What if your timing is off, and the markets sustain a sharp correction for a month or two? With the leverage futures that contracts provide, can you afford such a price decline without allowing it to swallow all of your investment funds? What if you don't buy the market that experiences the greatest price increase, but do purchase the biggest loser?

This leaves a third option for owning commodities: the purchase of a long-only commodities index such as the S&P GSCI. Whether accomplished by purchasing the futures on the index with trade on the Chicago

Mercantile Exchange, or an ETF or fund developed to track the index, at least this option allows the investor some diversification regardless of the amount of funds invested. However, by the nature of its design the S&P GSCI is heavily weighted toward the energies, so if that sector experiences a decline in prices you could still see a negative return even if other sectors experience robust price increases. More troubling, with the increased volatility in the commodities markets at the present time, the danger of a sharp price decline in any given market in the form of a correction in a bull market still looms. Despite the diversification, the S&P GSCI and other long-only commodity indexes are meant to profit only when markets continue upward price movement.

The second commodities strategy is *trading commodities*. This is the method that most likely offers the greatest potential return, but also a good deal of risk. It also requires an investment of time, energy, study, and emotional discipline, in addition to the monetary aspect. However, there are a number of strategies that can give the commodities trader an edge over the general market, maximizing return while limiting losses. I have attempted to discuss some of those ideas in Chapters 2 through 4. Chapter 2 explains my theories on how to limit your losses in commodities. Chapter 3 discusses some of the more common indicators used on commodity trading, and potential pitfalls they may carry. Chapter 4 gives a refresher course in the 2B rule, which I first introduced in my book *Methods of a Wall Street Master*. It remains a powerful tool to identifying potential changes in trend, combining limited losses with the possibility of large profits. Direct trading and speculating in commodities is not for everyone, but if you develop the necessary skills, it can be a rewarding endeavor. In addition, please realize that regardless of how deeply you become involved with trading commodities, your overall portfolio will be just as enhanced by investing in commodities as people who do not trade the markets directly.

That is the last of the three strategies: *investing in commodities*. Without question, in my opinion the most attractive way to do so is through the use of the Standard & Poor's Diversified Trends Indicator (S&P DTI). This vehicle not only offers you a fully diversified portfolio of futures that is equally weighted between financials and commodities, but by its design as a long-short index-like strategy it allows you to profit from both sides of the market, and often obtain hedged interrelated positions. As a supplemental vehicle, the Standard & Poor's Commodity Trends Indicator (S&P CTI), offers investors the same methodology but without the exposure to the financial futures. Either way, the S&P DTI and S&P CTI can become an additional asset class within a typical investment portfolio, whether or not you speculate in commodities as an overlay. They offer the ability to lower your overall portfolio volatility without sacrificing return, whether used in combination with stocks, bonds, or both.

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TRADER VIC ON COMMODITIES

All strategies have risks large and small, and nobody should invest in any program or product without a complete understanding of the risks involved.

So let us move on to the main focus points of this book, and study them one at a time: first, *trading* commodities (especially losing properly); and then, *investing* in commodities through the S&P DTI.