

Commodities Speculation as an Investment Class

Beneficial, Risk Reducing, and Profitable

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Before we talk commodities,
Let's talk investing.

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Before we talk economics,
Let's talk humanity / society.

What distinguishes humankind from most animals?

- Deductive reasoning – delaying present satisfaction for (greater) future satisfaction.
- Development and use of tools / capital goods.
- Cooperative and specialized production.
- Respect for private property rights.
- Trade, investment and money.

Capital Goods

- Without Capital Goods & Specialization:
 - Kill animal or find edible plant: eat,
 - Fail to do so: go hungry,
 - Each day, repeat.
- WITH Capital Goods & Specialization:
 - Develop skills, invest and trade with others,
 - Dining / fashion / entertainment / leisure / sport / travel / literature / health / hobbies / recreation / education / contemplation.....an enlightened life.

Property Rights.

- Respect for property rights is the necessary condition for trade and investment.
- Alternative to cooperation is isolation, war, theft and slavery.
- Stealing yields possessions, but encourages revenge, eliminates labor and quells entrepreneurial spirit.
- Slavery is intuitively lower value-creating system compared to free-market cooperation.

Life Alone or In Conflict

"Whatsoever therefore is consequent to a time of Warre, where every man is Enemy to every man; the same is consequent to the time, wherein men live without other security, than what their own strength, and their own invention shall furnish them withall. In such condition, there is no place for Industry; because the fruit thereof is uncertain; and consequently no Culture of the Earth; no Navigation, nor use of the commodities that may be imported by Sea; no commodious Building; no Instruments of moving, and removing such things as require much force; no Knowledge of the face of the Earth; no account of Time; no Arts; no Letters; no Society; and which is worst of all, continuall feare, and danger of violent death; And the life of man, solitary, poore, nasty, brutish, and short."

Thomas Hobbes (1588 – 1679)

Money: Indirect Exchange

- First exchange was barter, but money evolved when someone recognized the value of indirect exchange using a commodity of generally recognizable value.
- Money became the numerator by which all other goods and services were denominated.
- Money allows people to calculate profit or loss on transactions and enterprises.

Requirements for “Good” Money

- Universally valued and accepted in trade / exchange.
- Easily divisible.
- High value to weight/volume (transportable).
- Does not degrade over time.
- Easy to store.
- Uniform quality.
- Easy to authenticate.
- Difficult to counterfeit.
- Ratio of new production / total supply relatively low.

What is Economics?

- The study of “fairness”, “inflation”, “growth”, “redistribution”, “control”, “organization” (Keynesian School / Chicago School).

- OR -

- The study of scarcity and removal thereof. A subset of the study of human action or “praxeology” (Austrian School)

Economics and Government

- Keynesian / Chicago School: Governments can fine tune market performance to optimize wealth distribution. Governments must control markets and “animal spirits” of people.
- Austrian School: Government intervention is suboptimal and destroys wealth; good intentions do not create good results; intervention always sends false price signals to the market.

Investment Classes

- Government (Redistribution)
- Capital Investment (Wealth Creation)
- Commodities Speculation (Anticipating Consumption / Driving Production)

Where does Investment Come From?

- Private Savings (earned money)
- Banks (fractional reserve money)
- Central Banks (newly printed money)

Government “Sources and Uses”

- Sources:
 - Taxation
 - Borrowing from Savers (Deferred Taxation)
 - Borrowing from the Fed (Inflation)
- Uses:
 - Bureaucracy / Government Infrastructure
 - Entitlements
 - Defense
 - Social Programs / Welfare

Private Capital Investment

Balance Sheet	
Owns	Owes
Use of Cash	Source of Cash
Assets which are the most like cash	Obligations which must be paid to keep creditors happy
Assets which will turn into cash within one year	Obligations which will be due and payable within one year
Assets which may never mature into cash	Obligations which are the least nervous and never due
Total Assets	Liabilities & Net Worth

Commodities Speculation

Category	Instruments
Agricultural Futures	
Softs	Sugar / Cotton / Coffee / Cocoa / Orange Juice / Lumber
Grains	Soybeans / Soybean Oil / Soybean Meal / Corn / Wheat / Cotton
Meats	Live Cattle / Feeder Cattle / Lean Hogs / Pork Bellies
Metals Futures	
Precious	Gold / Silver / Platinum / Palladium
Base	Copper / Aluminum / Zinc / Nickel
Energy Futures	Crude Oil / Natural Gas / Unleaded Gas / Heating Oil

How does a farmer know what seed to buy and how many acres to plant?

How does a miner know what metal to mine and how deep to dig?

How does a driller know how many barrels to pump or whether to find new ways to extract?

Without a futures market, the farmers / miners / drillers plan production in the dark.

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How does a consumer-goods company know the cost of raw materials for product planning?

How does a capital-goods company know how much metals and minerals will cost?

How does everyone, from individuals to businesses to governments, plan for energy cost changes in the future?

Without a futures market,
consumers, entrepreneurs and
capitalists plan inputs in the dark.



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Commodity Speculators –
shedding light on commodity
price expectations for the future -
allowing producers and
consumers the time to make
adjustments and prepare.

The Essence of Speculation

“In the specific understanding of future events there are as a rule two orders of likelihood to be ascertained: The first refers to the enumeration of the factors that could possibly take or have taken effect in producing an outcome in question. The second refers to the influence of each of these factors to the production of the outcome. The precariousness of forecasting is mainly due to the second problem. In order to anticipate outcomes correctly the speculator must also anticipate correctly the quantity as it were of each factor's contribution and the instant at which its contribution will become effective. “

Ludwig von Mises (1881 – 1973)

Commodity Speculators – How do they do it?

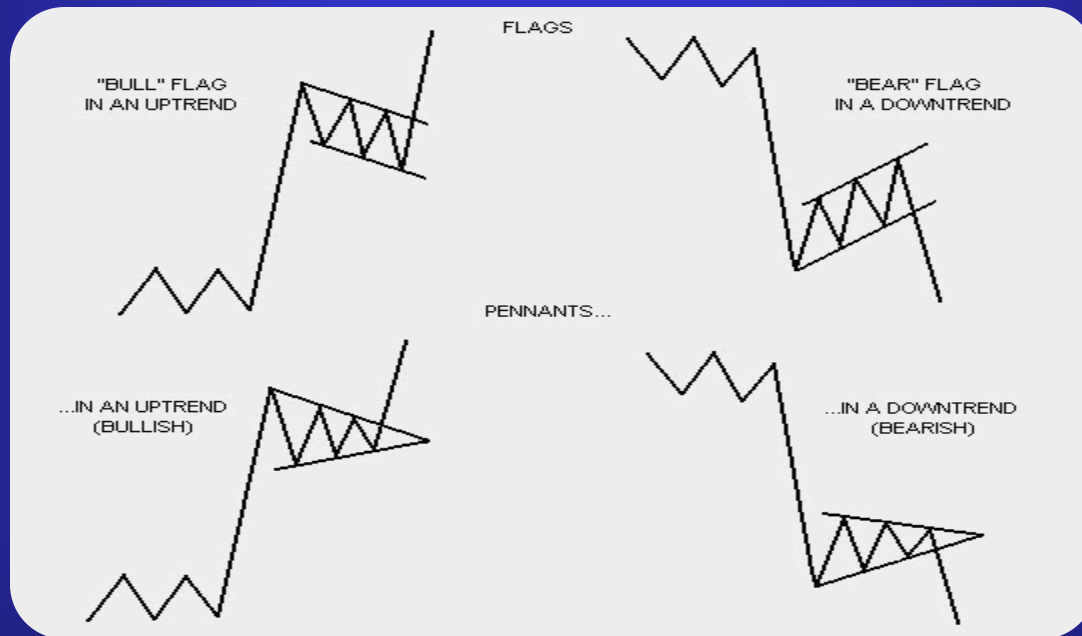
- Understanding fundamental drivers – supply and demand over time,
- Understanding technical signals – what factors are most relevant to change prices?
- Tacit knowledge and trading skill.
- A little bit of luck and a lot of discipline!

Supply and Demand Factors

- Supply:
 - Climate and weather,
 - Technology, investment,
 - Alternative uses for scarce land and resources.
- Demand:
 - Economic conditions globally and regionally,
 - Cultural changes and changes in taste,
 - Technology, new applications for input goods.

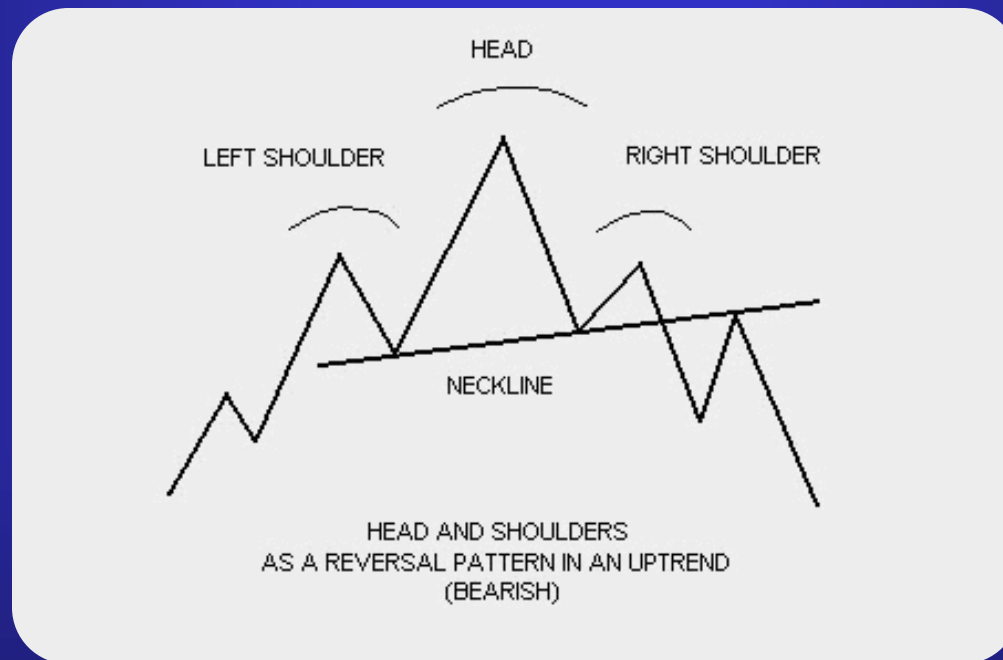
Technical Analysis - weighting
the coefficients of change.

Basic “continuation” Pattern



Flags and pennants can be categorized as continuation patterns. They usually represent only brief pauses in a dynamic market. They are typically seen right after a big, quick move. The market then usually takes off again in the same direction. Research has shown that these patterns are some of the most reliable continuation patterns.

Basic “reversal” Pattern



The head and shoulders pattern is generally regarded as a reversal pattern and it is most often seen in uptrends. It is also most reliable when found in an uptrend as well. Eventually, the market begins to slow down and the forces of supply and demand are generally considered in balance. Sellers come in at the highs (left shoulder) and the downside is probed (beginning neckline.)

Layers of Complexity - Fractals



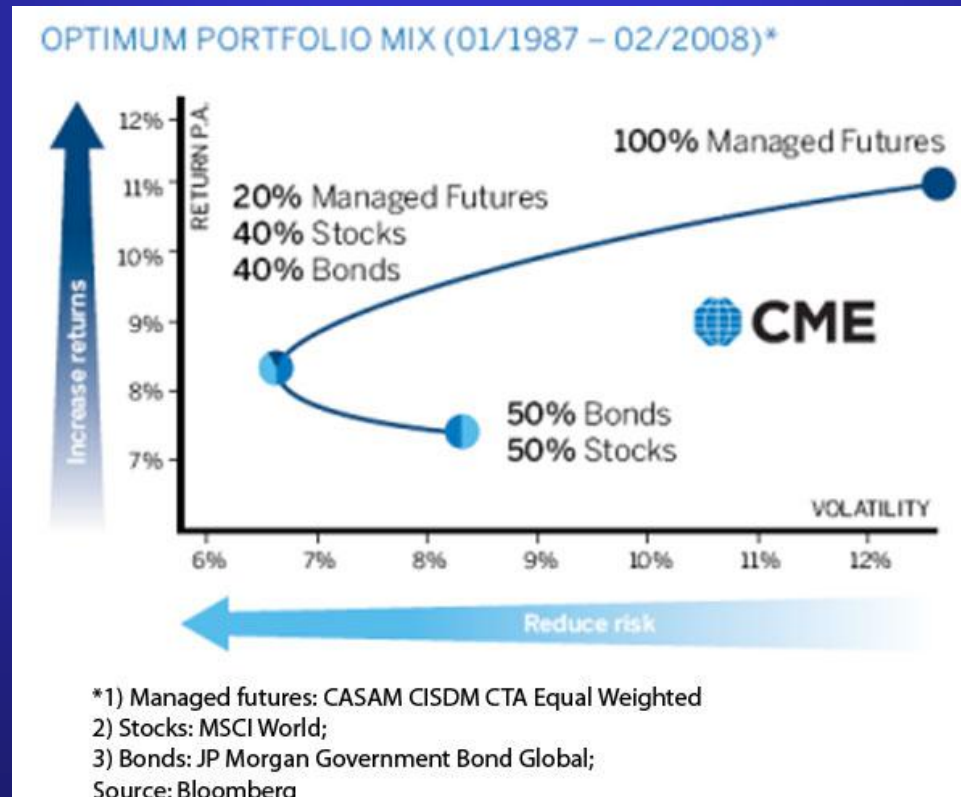
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How does commodities speculation fit in traditional investment portfolio?

- Helping to bridge the time gap in pricing of consumption goods.
- Not a capital creation endeavor per se, but rather an information transference process.
- Invest in managers – not commodities. Passive options (“ETFs”, “Indices”) miss the point.

Optimizing the Efficient Frontier



Resource List

Humanity / Society

- The Wealth of Nations (Adam Smith)
- Human Action (Ludwig von Mises)
- The Protestant Ethic and the Spirit of Capitalism (Max Weber)
- The Communist Manifesto (Karl Marx)
- The US Constitution / Bill of Rights / Amendments
- Democracy – The God that Failed (Hans-Hermann Hoppe)

Resource List

Economics

- The General Theory of Employment, Interest and Money (John Maynard Keynes).
- Where Keynes Went Wrong (Hunter Lewis)
- Man, Economy and State (Murray Rothbard)
- The Principles of Political Economy and Taxation (David Ricardo)
- Capitalism (George Reisman)

Resource List

Investing

- The Intelligent Investor (Graham & Dodd)
- Security Analysis (Graham & Dodd)
- Tomorrow's Gold (Marc Faber)
- Conquer the Crash (Robert Prechter)
- Margin of Safety (Seth Klarman)

Resource List

Commodities Speculation

- The Complete TurtleTrader (Michael Covel)
- The (Mis)behavior of Markets (Benoit Mandelbrot).
- Hot Commodities (Jim Rogers)
- Inside the House of Money (Steven Drobny)
- The Market Wizards / The New Market Wizards (Jack Schwager).