PART I

COT Theory

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CHAPTER 1

The COT—Assorted History

"Look," began the spokesman when the door closed, "the Grain Futures Administration has made a complaint that you are carrying too much open stuff." It would be hard for me to make anyone other than a La Salle Street trader understand how I felt then, unless it might be some Russian farmer who has tasted the bitter flavor of government interference in matters which should not concern it.

—Arthur W. Cutten and Boyden Sparkes, "The Story of a Speculator," *The Saturday Evening Post* (November 17, 1932)

My great-grandfather A. E. Briese went bust four times in his life; the first was in 1918, in commodities. He had been growing potatoes to feed the troops during World War I, and loaded his crop on railcars at Plainview, Minnesota. Then the war ended, and the Army canceled his contract. He wasn't alone. Farmers across the country ramped up to meet demand for wheat, corn, and oats, brought on by the Great War and the Russian Revolution and famine of 1917. And nobody was hedged (only partly due to the closure of the Chicago Board of Trade during the war). Wheat prices, which reached almost $3.00 per bushel during the war, began eroding, along with land values, immediately following the Armistice. When the Chicago Board of Trade reopened in 1921, there wasn't an empty grain bin or railcar in the country, and pit prices reflected the overwhelming supply. At least farmers now had somebody to blame besides the government: the Chicago grain speculators.

THE GRAIN FUTURES ADMINISTRATION

Congress, which was dominated by farm-state members, was quick to respond to the crisis, passing the Grain Futures Act, signed by President Warren G. Harding in 1922.

The act, for the first time, required Chicago Board of Trade (CBOT) members to report their aggregate trades to the newly formed Grain Futures Administration, which posted these figures in its first annual report to Congress in 1924. From the beginning, a key feature of the report was to differentiate speculators from the "trade" (commercial hedgers who used futures markets to protect their ongoing cash business from price volatility).

In response, the Chicago grain traders first sued (unsuccessfully) to maintain their trading privacy, and then formed the Board of Trade Clearing Corporation in 1925 (now the Clearing Corporation) to provide trader anonymity in aggregating and reporting trades. Even though position sizes were only informally controlled (by the CBOT's Business Conduct Committee), large traders like Arthur Cutten—who by 1926 took delivery of 5 million bushels of wheat—were contemptuous of government oversight, an attitude that continues among certain large traders to this day.

THE COMMODITY EXCHANGE AUTHORITY

Monthly reporting continued under the Commodity Exchange Authority (CEA), created by the Commodity Exchange Act of 1936. This act empowered the CEA to establish speculative position size limits as well as prosecute market manipulators, and banned option trading on commodities—a restriction that was not lifted until 1982. This act, and subsequent amendments, added markets to the CEA's portfolio (Table 1.1).

In 1942, the "Commodity Futures Statistics" report was published separately from the U.S. Department of Agriculture's USDA annual report. The new publication included monthly trader statistics (though still published annually). The CEA published the first monthly *Commitments of Traders* (COT) report on July 13, 1962. This listed large trader positions for 13 agricultural commodity markets as of June 30.

TABLE 1.1 Contract Markets Designated for Large Trader Reporting

Year	Exchange	Markets
1924	Chicago Board of Trade	Wheat and corn
1936	Chicago Mercantile Exchange	Butter, eggs, and potatoes
1936	New York Cotton Exchange	Cotton
1940	Chicago Board of Trade	Soybeans
1950	Chicago Board of Trade	Soybean oil
1951	Chicago Board of Trade	Soybean meal
1968	New York Cotton Exchange	Orange juice
1968	Chicago Mercantile Exchange	Feeder cattle, live cattle, live hogs, and pork bellies

THE COMMODITY FUTURES TRADING COMMISSION

Congress created the Commodity Futures Trading Commission (CFTC) to succeed the CEA in 1974. By this time, several additions were made to the COT (*Commitments)* report, including adding data on the numbers of traders in each category; a new-crop, old-crop breakout; and concentration ratios that show the percentage of open interest held by the four and eight largest traders. Under the CFTC, the COT report release interval has been incrementally shortened beginning in 1990 with mid-month and month-end reports, to every two weeks beginning in 1992, and to the current weekly schedule in 2000. The delay between tabulation and release has been shortened, as well, and you can now collect the data at the CFTC's website at 3:30 P.M. eastern time each Friday (from tabulations made on Tuesday's close).

By appearances, the *Commitments* report is little changed during its first 45 years, but looks, as they say, can be deceiving. Although the format available at the CFTC's website is very similar to the pre-1982 report (Figure 1.1), numerous subtle changes have affected both the nature of the large *trader* reported and the analysis of the report. You will not find a quiz at the end of this chapter, but I will highlight the evolving nature of the COT report so that you can appreciate how earlier authors may have offered a different take on analyzing the report's contents.

I first became aware of the COT report soon after beginning my trading career. My choice to trade commodities was really a matter of timing. In 1973, when I became interested in investing, stocks were locked in their worst bear market since the Great Depression. After studying all of the various investment possibilities covered by Morton Schulman's *Anyone Can Still Make a $Million* (Schulman 1973), I settled on commodities. I went long three silver contracts at $3.97 and made $1,500 my first week. I guess I will never forget my father's response, "That's a pretty good living if you can do it every week."

There were not a lot of commodity books in print in those days, so I dove into Larry Williams's *How I Made One Million Dollars Last Year Trading Commodities*, when it was published (Williams 1974). One of his key resources was something called the *Commitments of Traders* report, so I immediately subscribed. It was a free subscription in those days, with separate reports mailed from Chicago and New York on about the 11th of each month, covering the previous month's trading.

You undoubtedly have heard the old market saying that the easiest way to make a small fortune trading commodities is to start with a large fortune. Larry's contention was that traders became large by anticipating market moves. I'm oversimplifying Larry's techniques when I tell you that he recommended using the COT report "to alert you to the 'deals' you should be scouting out" (p. 96) by comparing the size of large speculator long positions to their short holdings. If large noncommercials are overwhelmingly long, look for a long trade; look to go short if large speculators are net short. He specifically warned against using the *Commitments* report for trade timing—understandable, since it was a monthly report that reached you halfway through the following month.

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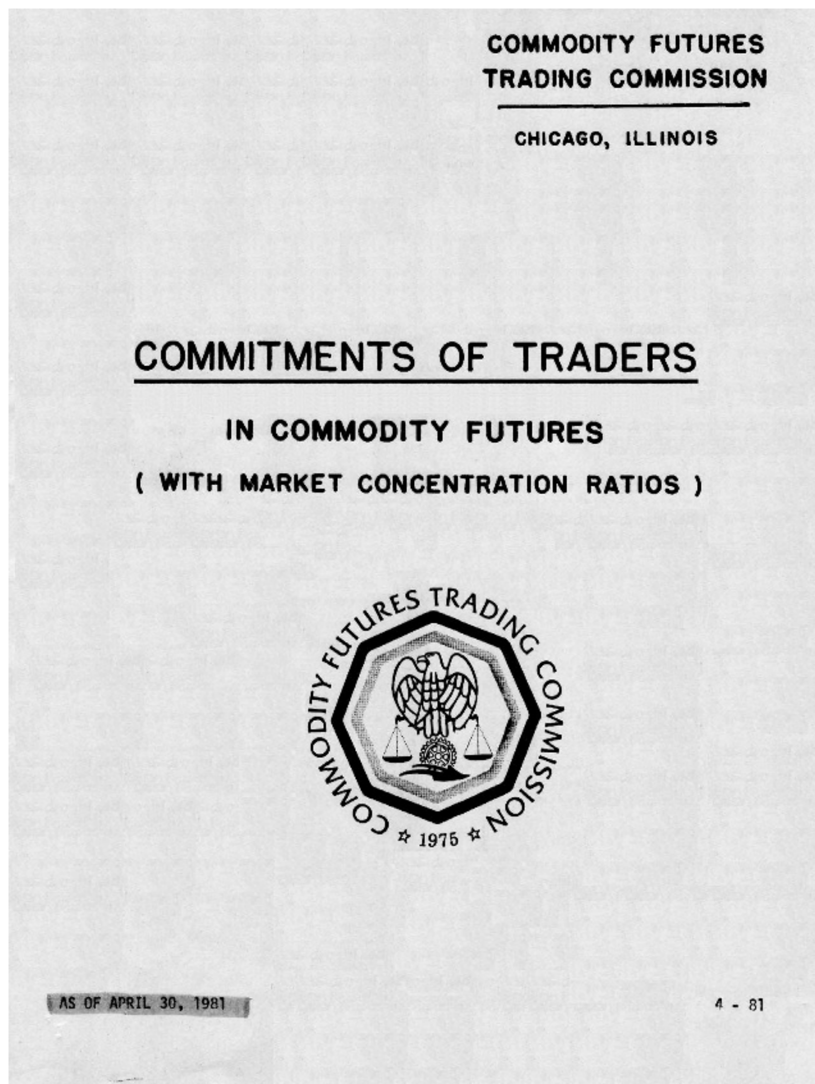
THE MODERN COT DATA

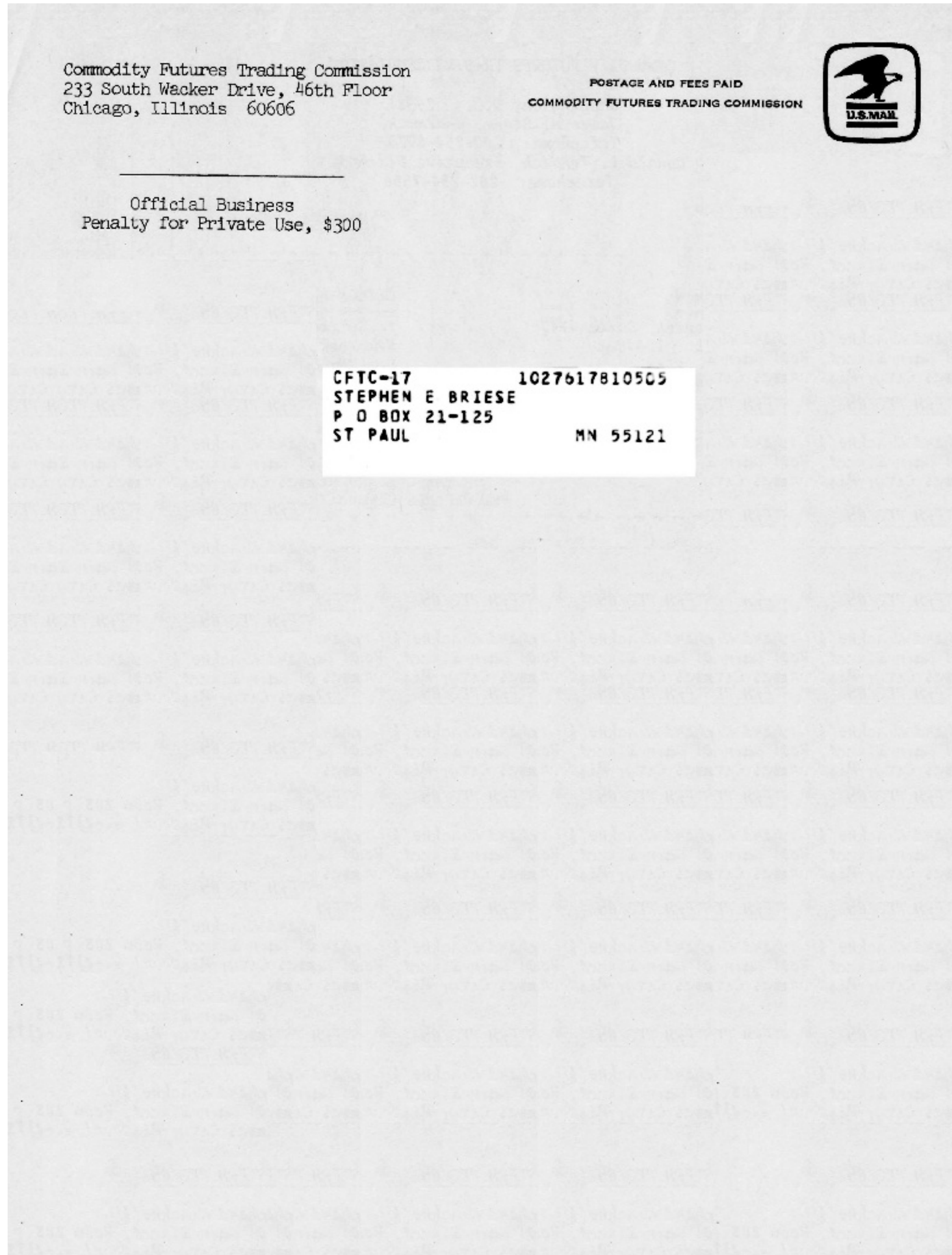
During the 1970s, the large noncommercial category was most likely dominated by large individuals à la Richard Dennis of Turtles fame. In the 1980s, this began to change as commodity funds gained popularity (including several that were run by former Turtles). So, too, did the interpretation of large speculator positions. In 1982, the CFTC stopped requiring large traders to report their own positions (on Series '03 forms). Their stated intent was to improve efficiency and the timeliness of the COT report by eliminating


COMMODITY FUTURES
TRADING COMMISSION
CHICAGO, ILLINOIS

COMMITMENTS OF TRADERS
IN COMMODITY FUTURES
(WITH MARKET CONCENTRATION RATIOS)

AS OF APRIL 30, 1981
4 - 81

FIGURE 1.1 *Commitments of Traders* Report, April 30, 1981
Courtesy of the Commodity Futures Trading Commission.


Commodity Futures Trading Commission
233 South Wacker Drive, 46th Floor
Chicago, Illinois 60606

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ST PAUL MN 55121

FIGURE 1.1 *(Continued)*

reliance on a form that was typically sent by mail. The new routine relied primarily on Series '01 reports of large traders' positions filed on a next-morning basis by Futures Commission Merchants (FCM or broker) together with Form 102, which identified large traders who held accounts with multiple FCMs. Notably, large traders were required to file Form 40, and Schedule 1, identifying any positions used for hedging purposes. The daily reports by the brokers provided the critical information on actual trading positions.

There is a bit of a dispute over why the CFTC ceased publishing the report in 1982. The Commission maintains today that it *suspended* publication "in order to implement computer changes." *Commodities* (now *Futures*) magazine reported in 1983 that "the CFTC stopped handing out the free, photocopied booklets when production costs soared" (*Commodities* December 1983). Nobody seems to dispute the magazine's account that the report was reintroduced in December 1982, "after a deluge of requests for the publication" (1983). Adding to *Commodities'* credibility, the COT reports were reintroduced as paid subscriptions, priced at $0.10 per page (about $5.80 for the Chicago report, and $2.30 for New York's).

The combination of the publishing gap, the changes in the reporting regimen, and the revised reporting thresholds instituted in 1983 made the earlier data useless for historical comparison. Because a single *Commitments* report provides no context, it is not particularly enlightening in itself. Trader position levels must be compared to their historical range to judge whether current positions might be out of the ordinary and perhaps useful for forecasting price trends. It was not until 1985 that enough new history was available to make much sense of the *Commitments* report. Thus, the total gap in usable *Commitments* reports was close to five years. I refer to post-1982 as "modern data" and all of the current methodologies and conclusions included in this book are based exclusively on post-1982 *Commitments* reports.

The CFTC made another change in 1982, one that received no attention until 23 years later when the Commission pointed to it as effectively serving notice of a change in the fundamental tenets that had governed large trader categorization since the beginning. In 1983, the COT reports began listing the trade as "commercials" instead of the previous heading of "hedgers." If this seems like nothing more than semantics, you are right. The regulations clearly defining who was a legitimate hedger were never changed, but in 2006 the CFTC pointed to the revised heading in justifying the dumping of swap funds ("commodity index traders" or "nontraditional commercials") into the commercial category.

COT *OPTIONS AND FUTURES COMBINED* REPORT

In 1995, the CFTC, which was publishing a COT report for New York futures, and a Chicago report that covered the Kansas City Board of Trade along with the Minneapolis Grain Exchange, added two new COT reports that combined the options open interest with the underlying futures positions. This COT *Options and Futures Combined* report

began with zero historical data provided, so it took a couple of years to accumulate enough data to interpret it intelligently.

When sufficient *Options and Futures Combined* data was available to compare to the *Futures Only*, there were noticeable differences in scale, but the proportions were very similar to the *Futures Only* trader positions. On a percentage basis, the long and short open interest held by each of the trader groups was very similar on the two reports. Technical studies such as the COT Index yielded nearly identical numbers, so there was little incentive to use the combined report, especially since a substantially longer historical record existed for the *Futures Only* report. This preference changed in 2007, when the Commission introduced a new supplemental report that was a subset of the data contained in the *Options and Futures Combined* report. All of the examples and charts in this book are based on the combined report.

COT-SUPPLEMENTAL COMMODITY INDEX TRADER REPORT

In June 2006 the CFTC undertook what it called a "Comprehensive Review of the *Commitments of Traders* Reporting Program." In describing the backdrop for the "Review," an astonishing admission was made: "The Commission believes that the public perception was, and is, that the "commercial vs. non-commercial" classification in current COT reports is analogous (if not identical) to the "hedging vs. speculation" distinction in the pre-1982 COT reports" (CFTC 2006).

The commodity bull market that began in 2002 had, as others before it, attracted a great deal of public notice. Paying $2.50 to $3.00 for a gallon of gasoline at the pump will catch the public's attention. This time around, however, the public was provided an alternative to opening a futures account. A number of commodity index funds were offered through mutual fund companies (and others) that were sold to the public primarily as passive investments intended to mimic a popular commodity index such as the S&P GSCI (formerly the Goldman Sachs Commodity Index).

An enormous amount of money was raised, but most mutual funds didn't have the expertise to manage actual commodity purchases or even commodity futures transactions. Along came swap dealers (derivative dealers who work outside the arena of regulated exchanges) to the rescue. They agreed—for a price—to provide cash flows equal to any increase in the particular commodity index of choice. To offset this risk, swap dealers bought commodity futures and options. (I need to interrupt this story to acknowledge an IRS ruling that stopped most mutual funds from dealing in swaps. This was quickly worked around, and the money still flows to the futures markets through the swap dealers.)

When swap dealers bought futures in large enough quantities to require large trader reporting, they soon found themselves up against speculative trading limits imposed by the CFTC (which is required by law "to protect futures markets from excessive

speculation that can cause unreasonable or unwarranted price fluctuations" (CFTC Backgrounder, 2007). But the swap dealers successfully circumvented these restrictions by petitioning the Commission for "hedge" exemptions.

What is a hedge exemption? It is an exemption from position limits imposed on speculators, which is granted on a case-by-case basis for "bona fide" hedges. It is not a back door granting "hedger" status to swap funds who have no function in the market for the actual commodity. You are supposed to be a bona fide hedger to apply for the exemption. A bona fide hedge is intricately defined, and reads (in part):

> *A short hedge, for example, includes sales for future delivery (short futures positions) that do not exceed the amount of the commodity that the seller owns, has agreed to purchase (for a fixed price), or anticipates producing during the next 12 months. A long hedge includes long futures positions that do not exceed the hedger's fixed-price sales or 12 months' unfilled anticipated requirements for processing or manufacturing . . . no transactions or position will be classified as bona fide hedging . . . unless their purpose is to offset price risks incidental to commercial cash or spot operations (CFTC Backgrounder November 2006).*

To hedge wheat (in excess of speculative trading limits), for instance, you must be a wheat grower, a flour mill, or a bread baker. In other words you have to get your hands in the wheat to hedge it. The only exception applies to a merchandiser such as a marketing cooperative. Nonetheless, the CFTC has issued "hedger" exemptions to swap dealers, who have since become the largest traders on the long side of commodity futures—at least in the contracts that are reported. This practice began under CFTC Chair Wendy Graham, wife of the former Texas senator, who left the CFTC to join Enron (McLean and Elkind 2003, 96).

Why should these exemptions concern us—other than \$2.50 gasoline, \$2.70 heating oil, \$4.50 corn, \$6.50 wheat, \$12 soybeans, \$2 OJ, \$15 natural gas, \$0.95 pork, \$1 beef, \$4 copper, \$2400 cocoa (wholesale prices)? From a trading standpoint, the large commercial hedger category is the best available indicator of the price outlook of the *trade*, who are intimately involved with the underlying cash business. The swap dealers may be bright people too, but they don't know beans about soybeans. Intermixing their market positions with the trade's positions fogs our view of the true insiders.

In their own defense, the CFTC Office of the Chief Economist released a study in 2005 that found "no evidence of a link between energy price changes and MMT [managed money traders] in natural gas futures and, in fact a negative relationship between MMT position changes and price changes in crude oil" (Haigh, Hranaiova and Overdahl, 2005). If this seems implausible on its face, Chapter 8 of this book finds the CFTC report at odds with 50 years of economic studies. In 2006, a U.S. Senate investigative report found a significant link between speculation and oil prices, noting a *Wall Street Journal (WSJ)* report that oil settled above \$70 a barrel, despite inventories at an eight-year high (Coleman and Levin 2006).

A FABLE

Goose:	I want to buy some grain, a lot of grain.
Commissar:	But you are a goose, and I am only allowed to sell to ducks.
Goose:	I'm not really into labels.
Commissar:	But you don't quack like a duck.
Goose:	Yeah, I'm nontraditional that way. Did I mention that I wanted to buy a *lot* of grain?
Commissar:	Since I am only permitted to sell to ducks, if I sell you grain, I will have to count you as a duck.
Goose:	Quack. Quack.
Commissar:	If I say you are a duck, who is to question it? But there will be a lot of squawking if it ever gets out who bought all the grain.
Goose:	Let 'em eat potatoes.

When grain prices went through the roof, the public began to call "fowl," so the commissar relented and agreed to separate counts of geese and ducks. But when he got the ducks all in a row, he found that they were outnumbered by geese! The geese squawked when told they would be ratted out, so the commissar agreed to count only the white geese. "I will just say that separating the gray geese from the gray ducks would be difficult and fraught with errors. After all, it is only a two-year pilot program, and all of this squawking about geese and ducks could be old news by then. What is good for the goose is good for the Commissar."

To reassure you how little this fable varies from the actual facts, here is circular logic used by the Commission, verbatim from its June 2006 "Request for Public Comment":

> *Because both the hedge exemption rules and the standards whereby positions are classified for purposes of the COT reports refer to "commercial" positions, the Commission has considered the classification of a position as "commercial" under the hedge exemption rule as being an appropriate indicator for how the position, and the trader holding it, should be classified for COT purposes. In other words, if an entity holding a particular futures or option position has received a hedge exemption with respect to that position, the position is, by definition, held by a "commercial enterprise" (*CFTC, *Federal Register*, June 21, 2006*).*

In any case, the brouhaha[1] resulted in a partial victory for more transparency. In January 2007, the CFTC began publishing the *COT-Supplemental Commodity Index Trader* report, separating out a new category called "commodity index traders." The report included just 12 agricultural markets. Although this is nearly half of the markets listed on

[1]For a more in-depth look at the merits of this dispute, see my article, "CFTC Expands *Commitments of Traders* Reporting," http://CommitmentsOfTraders.ORG/?p=4, 2006.

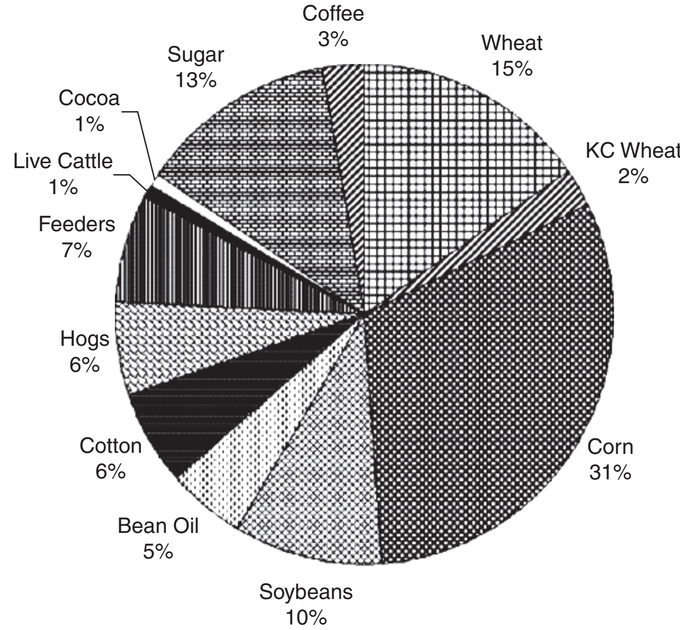

FIGURE 1.2 Open Interest Breakdown by Market from Jan. 3, 2000, *COT-Supplemental* Report

one of the most popular commodity benchmarks, the S&P GSCI, they amounted to only 17 percent of the index's weighting. Figure 1.2 breaks down the Commodity Index Trader open interest for the 12 agricultural markets included in the first *COT-Supplemental* report. Figure 1.3 illustrates how much information this new report omits. (I cannot tell whether those are duck or goose tracks across the missing section—a symbol of the shortcomings of the new report.)

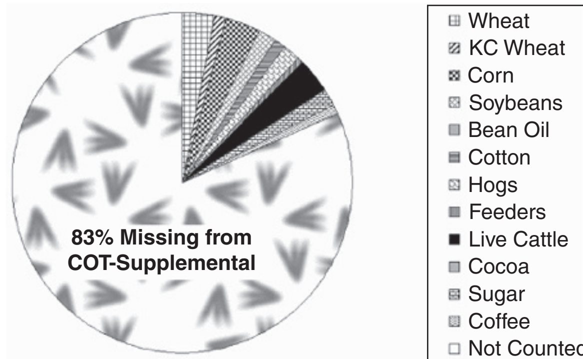

FIGURE 1.3 Relative Weighting in the S&P GSCI of Markets Included in the Jan. 3, 2000, *COT-Supplemental* Report

The initial *COT-Supplemental* report was accompanied by weekly historical data for 2006, which did not give market analysts or traders much for comparison. For now, the *COT-Supplemental* will be of secondary interest, both because of the few markets it covers, and due to the short historical record available for analysis.

To recap, there are currently three versions of the COT report issued: one covering futures positions, one combining futures with options, and a subset of the latter that includes the new category of commodity index trader. So far you should be able to keep count on your fingers, but you might want to kick off your shoes before wading into Chapter 2.