August 23, 2017 – A Good Idea Gone Bad

Over the past couple of days, Iâ??ve had the pleasure of an impromptu visit from a friend I met 40 years ago. Bill and I first met in 1977 at a Drexel Burnham conference in La Jolla, California and struck up a friendship as we were among the few commodity brokers in what was mostly a gathering of stock and bond brokers. But while we had commodities in common, Billâ??s business was starkly different from mine and in time, I began to adjust my approach to be more like his.

Billâ??s approach was to market selective trading advisors to his clients, in which instead of him or his clients making the trading decisions on which commodities were bought and sold, all trading decisions were made by an independent advisor who held limited power of attorney over the trading decisions. The brokerage firm held the clientâ??s funds and executed the trading advisorâ??s instructions on behalf of the client and this arrangement removed many of the inherent conflicts that can result in a more traditional broker/client relationship.

For instance, since the trading advisorâ??s fees were primarily based on how well the account performed, there was never a question of a trade being executed for the purpose of generating excessive commissions. After all, excessive commissions would not only hurt the client, they would also hurt the advisor as they would detract from the clientâ??s bottom line. In fact, that was one of the keys that attracted me to this approach, namely, it basically removed the omnipresent potential conflict of trading for the purpose of generating commissions. It was a â??cleanâ?• business arrangement and, quite frankly, a good idea.

Not surprisingly, most of the early Commodity Trading Advisors (CTAâ??s) used a technical approach to the markets, as opposed to a fundamental study of the actual physical supply/demand in different commodities. There were a number of reasons for this. For one, most of the early commodity trading advisors had mathematical or computer backgrounds, or at least, so did the advisors in Billâ??s neck of the woods, which was the Silicon Valley (he was in the Palo Alto office). A mathematician is bound to take a mathematical approach and one of the hallmarks of the pioneer trading advisors was the use of computers to calculate the formulae for when to buy and sell. Invariably, these were price-centric formulae that relied on the principle of buying as prices moved higher and selling as prices moved lower, same as is practiced today.

Other attributes to the trading advisor approach was a strong reliance on diversification and stringent money management controls (never betting too much on any one trade). If there was one common theme among all the trading advisors, it was an approach that allowed for profits to run and for losses to be taken quickly. Just to be sure, I am writing about the attributes of the technical fund approach; despite my more recent claims that these funds are â??brain deadâ?• and suckers and the ultimate dupes in the managed money technical fund/commercial positioning tango. That was then, this in now.

Forty years ago, a large Commodity Trading Advisor (CTA) rarely had more than $10 million of total client assets under management and the very largest was said to have $25 million under management. The grand total of all client assets in the managed money technical funds was much less than one billion dollars. Today, the total amount of client money held in managed money technical fund accounts is north of $300 billion. Remarkably, despite very subpar recent investment performance, the assets in these types of accounts continues to grow or have yet to shrink meaningfully.

For a specific example of the massive dollar amounts now devoted to this space, one of the largest managed money technical funds is run by AQR Funds. Total assets under management (AUM) in this one fund dedicated to commodity futures trading are $12 billion. Since this is a publicly-traded fund, great detail is available. (Be sure to click on the fact sheet).

https://funds.aqr.com/our-funds/alternative-investment-funds/managed-futures-strategy-fund

Some things that can be gleaned from the current fact sheet on this particular fund is that actual performance has been subpar. These figures are as of June 30, 2017, so there may be some change through today, but as of the date of the calculation, one-year performance was negative 15.37% and since inception in 2010, annual performance was just under 1%, hardly setting the investment world on fire. I mention this because it confirms my claims that the technical funds are being hoodwinked by the commercials. Any trades in COMEX silver, according to my observance of COT data faired much worse.

Another thing that the fact sheet answers is the question of why do these funds persist in dealing in a market that is fundamentally structured against them. Canâ??t they see that they are being taken for a ride? The answer lies in the fundâ??s annual management fee of 1.22%, which at current total assets under management ($12 billion), brings in more than $140 million annually to fundâ??s managers. If you were running a business that generated $140 million in revenue annually, would you go looking for reasons to radically alter or shut down that revenue stream? I would submit that any and all such revenue streams would be maintained at any cost. Therefore, even though there is growing and compelling evidence that the managed money technical funds are getting the short end of the stick in modern commodity dealings, there is little evidence they are about to change their ways.

Forty years ago, I donâ??t think total assets in managed money technical funds were much higher than $140 million; today, thatâ??s the annual amount in fees paid to this one fund run by AQR. If the widely quoted total assets in these funds are around $300 billion today (as I believe is accurate), that means at a 1% annual management fee, total fees alone for the industry run $3 billion yearly. As far as I can tell, these funds are not generating big profits, but with $3 billion rolling in yearly, performance, in my opinion, has become secondary.

Not only are the current dollar amounts (and fees paid) astronomically large in these highly specialized technical funds, the excessively large dollar amounts are directly responsible for the funds getting hoodwinked and their resultant poor overall performance. In a nutshell, it is the huge size of assets in the funds that has caused a good idea to turn bad.

I could see it developing decades ago â?? too often, buy and sell fills in the managed money accounts I ran as a broker were at the worst price of the day, as floor traders learned to anticipate when a trading advisor would place orders for all their clients to buy and sell (mostly on market or stop orders). Investment performance began to be affected by consistently poor trading fills. Today, the problem is many times worse â?? the managed money technical funds have become the largest trading component in too many markets. As I consistently report, itâ??s the managed money traders against everyone else in COMEX gold and silver.

For sure, the technical funds never intended to become so large so as to distort the markets, but this is not about intentions; itâ??s about cold reality. The technical funds, by size alone, have become the 800 pound gorilla in the room, making them both the target of all other traders and the key enabler of the silver (and gold) manipulation. If the technical fundsâ?? trading positions hadnâ??t become so excessively large and if their trading patterns werenâ??t so well-anticipated by other futures traders, price behavior, particularly in silver, would be so different as to being almost unrecognizable from current price behavior.

Without the massive long and short positions established and liquidated by the technical funds in the same buy on the way up and sell on the way down predictable manner, the commercials wouldnâ??t be able to continuously snooker the technical funds. Additionally, in silver, JPMorgan would have never been able to contain silver prices for six and a half years in order to purchase in excess of 600 million oz of physical silver at bargain basement prices. When it comes to enabling most of the things wrong in modern commodities trading, nothing would be possible were it not for the excessive size of the technical funds.

As for why the managed money technical funds have grown so large, I think it is related to record low interest rates, which forces investors to seek out any reasonably-sounding investment alternative. But the why takes a distant second place to the fact that investor money has flooded into these funds.

Where is the federal commodities regulator, the CFTC, and the self-regulator, the CME Group while all this is going on? As far as I can tell, the CFTC is doing its best to avoid even mentioning what I just reported â?? they are way too busy looking the other way in order to avoid a reasonable discussion. As far as the CME, they are way too busy looking for ways to expand technical fund positioning because it increases trading fees to the exchange and benefits their true constituents, the commercials.

Left in the dust are those harmed by what is a grotesquely distorted price discovery mechanism; meaning everyone in the world apart from maybe 50 large traders on either side of COMEX gold and silver. Among those excluded from the price discovery process are real world producers and consumers and investors. Simply put, the victimized technical funds and those feeding off them have grown so large as to have pushed everyone else from the process. But since the few direct trading participants are prospering so mightily, including the technical funds via exorbitant management fees, there is little incentive to rectify things. I hope you know that it shouldnâ??t be up to me, an independent silver analyst, to be pointing these things out, when there is a federal agency in place, fully-funded and charged with just this responsibility.

How and when does this all end? Frankly, I donâ??t know. What I do know is that in silver, JPMorgan has come to acquire more physical silver than anyone in history and it is metal they didnâ??t need to acquire to continue the silver manipulation (since they could have continued the manipulation without the physical accumulation). The only reason anyone acquires a massive investment holding in any asset is to eventually sell and profit at as high a price as possible. Coincidently, this is JPMorganâ??s reason for existence. I havenâ??t detected a similar accumulation in any other asset by JPMorgan or anyone else, so that continues to put silver in a very special circumstance. In fact, it is the single biggest reason to be bullish on silver; as JPMorgan didnâ??t abuse the technical funds and the price discovery process for years to accumulate 600 million oz of actual silver on a lark.

On to developments since Saturdayâ??s review. In that review, I mentioned the record large gross and net long position of the managed money technical funds in COMEX copper futures and how this was the main reason copper prices rose to recent highs. The Wall Street Journal featured an article on Monday on copper prices hitting two year highs and mentioned the large managed money long position, among other reasons for why copper was so high. But I would still contend that managed money positioning has become the sole price driver based strictly on the size of this positioning.

A quick glance at the disaggregated COT report on copper reveals that the long position of the managed money traders in that market is greater than the combined long positions of all other traders, commercials, non-commercials and non-reporting traders alike. This makes the managed money long position in copper not just the largest long position, but the largest by measures thought to be impossible. As a reminder, managed money traders are as purely speculative as it gets; meaning speculators are setting the price (which is contrary to commodity law, as speculation doesnâ??t get more excessive than this).

Another standout feature in the COMEX copper market structure is that the other large non-commercial reporting traders hold an extraordinarily large and record short position, the likes of which have never been seen. Since these traders are also pure speculators (as opposed to legitimate hedgers), in COMEX copper futures we now have a both a record large speculative long position by managed money traders and a record large speculative short position by other (non-managed money) traders. According to commodity law, speculators are supposed to provide liquidity to legitimate hedgers, taking the price risk wishing to be offloaded by real producers and consumers. But there is little room for hedging by real producers and consumers if the game is becoming an exclusively all-speculator affair (thanks to the massive amounts of money under management by the technical funds).

Even though Iâ??m not handicapping copper prices, I understand the motivation of the large speculators in going heavily short to the managed money longs, based upon how things usually turn out. Someday, many or most of the managed money technical funds who have bought copper futures on ever-increasing prices, will undoubtedly sell when prices turn (or are rigged) lower; the only questions are when from what price levels. Iâ??ve pointed out this phenomenon also exists in COMEX gold and silver, where the other large reporting traders also happen to hold record large short positions against the managed money traders.

These record large short positions by non-managed money reporting speculators point to a number of conclusions. One is that there is growing pressure from these other large reporting traders to join in with the commercials in seeking a piece of the technical fundsâ?? hides and not to let the commercials have exclusive feeding rights. I can only assume this has come about because the technical funds have become so large and predictable in their trading. This goes along very much with my observations about the growing awareness of the COT market structure on price. Not only are more writing about the COT report, others are putting their money behind betting on the predictable behavior of the technical funds.

However, this raises a new concern. These other large reporting traders which have established record large short positions in COMEX copper, gold and silver futures are also as purely speculative as are the managed money traders they are positioned against; meaning neither side has much ability to make or take physical delivery. All are purely paper traders and as such, under certain conditions, either side could find themselves in trouble and be subject to panic on wrong way bets. Thatâ??s a big potential problem with an all-speculative trade and something one would think the CFTC and the CME should be interested in.

My point is that no legitimate economic interest is served when trading becomes purely speculative and little legitimate hedging is occurring. While it has always turned out that the managed money technical funds will get hosed in the end, the fact that other large speculators have amassed record large short positions creates the possibility the short speculators could seriously miscalculate and end up buying back their short positions at much higher prices. Iâ??m not saying that will happen, just that the possibility now exists.

As far as what to expect in this Fridayâ??s COT report, both gold and silver prices made new price highs and finished the reporting week (ended yesterday) higher, gold by $12 or so and silver by a bit over 25 cents. As such, it must be expected that there was further managed money buying and commercial selling. In gold, prices stayed above both the key moving averages (50 and 200 day), as they have for the past month or so. In silver, there were several attempts to decisively penetrate the remaining key 200 day moving average, but prices continued to be capped around that moving average. These are not high-conviction predictions, but I would suppose there was further net managed money buying in gold of around 20,000 contracts and 5000 to 10,000 contracts in silver.

A standout feature is still the relative price â??heavinessâ?• in silver. Someone seems determined to prevent silver from getting uncorked to the upside and the most likely candidate is the crooks at JPMorgan. Iâ??d love to know what deal these crooks made with or have over the CFTC to allow this crooked bank to continue to manipulate silver prices. I donâ??t mean to be wishy-washy, but clearly we are not at the formerly extremely bullish market structure readings of a month or so ago; although we are also not at anything approaching bearish readings in silver.

While I have to classify the market structure in gold as no better than neutral to bearish, considering the potential remaining buying power of the technical funds, should the commercials allow this buying power to be fully expended, gold prices could rise $100 or so. On the other hand, thereâ??s now enough potential selling pressure in place from these same technical funds that gold prices could also fall by that much. While silverâ??s market structure is relatively much more bullish than goldâ??s, should the commercials rig a gold selloff, silver prices would likely follow. Again, I dislike being wishy washy, but strictly based upon current COMEX market structure considerations, I have little choice. Considering other things, like JPMorganâ??s epic accumulation of physical silver, should prices go down, Iâ??ll be along for the ride, as I intend to be on the inevitable big ride up.

Ted Butler

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Silver – $17.05Â Â (200 day ma – $17.07, 50 day ma – $16.50)

Gold – $1294Â Â Â Â Â Â (200 day ma – $1233, 50 day ma – $1256)

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