Trade Stocks and Commodities with the Insiders

Secrets of the COT Report

LARRY WILLIAMS

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Introduction

> *Warning: Futures trading, stock trading, currency trading, options trading, etc., involve high risk and you can lose a lot of money.*

What a way to start an introduction to a book!

Those scary words are just one of the current disclaimers the **F**ederal Trade Commission (FTC) has proposed be prominently displayed by anyone offering an investment course to the public. Who can argue with that statement? Certainly not I.

However, two points are missing here. The first is obvious: if someone is losing money in the market, by the very definition, someone else is making money. Every dollar lost is a dollar won by someone else, hopefully you or me. There is another side of the coin the FTC does not want you to see: the potential for gargantuan profits. Where else have millions been made, in less time, with less work and less dollars up front?

What your mom or dad told you is correct. Without risk there is not much to be gained; risk and reward go hand in hand with each other. If there were no risk involved we could not have the potential for gain. To get rewards, we need risks. Duh!

When the markets first intrigued you, did you think it was possible to lose money? I sure thought it was, so the gummint men are just restating what we already know. Or are they just suppressive people at heart?

The second point I have is even more egregious. How come I have to state the obvious in an ad I choose to run, while in today's *Investor's Business Daily* (*IBD*) the exchanges-backed "Options University" is not required to scare away would-be options players? Or why doesn't a subscription to the *Wall Street Journal*, *Forbes*, *BusinessWeek*, or *IBD* come with the same warning? Why aren't brokerage firms required to use these same words?

The only reason I know of is that this is a rigged business.

The exchanges, the brokerage firms, and the large funds have set the table for themselves, created rules for themselves that are different from the rules for the smaller players in the game. There is one set of rules for what they can do and another for the average trader or adviser.

Frankly, I have no problem with that. It's their game, and they have the marbles. But we need to know of those differences to not get sucked into their game. To win at this game you need to not only know the rules but not be trapped into the fallacies. To that end let me expose a few of them.

FIRST FALLACY—"THESE GUYS KNOW SOMETHING"

In 2000 the *Wall Street Journal* survey of economists revealed that 96 percent of them were bullish.

In 2001 the same surveys of economists showed an amazing 99 percent were bullish on the economy.

In 2002, the same survey was conducted again, and by now 100 percent of the economists surveyed were bullish.

The *Wall Street Journal* has been doing this survey thing since 1982, and the track record shows the experts have been correct in predicting the future less than 22 percent of the time. This is a worse probability than random guessing!

Yet they continue doing the survey and not telling you how horrible these guys' predictions have been.

The *London Financial Times* (*LFT*) did a study in 1995 that stated, "Consensus economic forecasts failed to predict any of the most important developments in the economy over the last seven years."

SECOND FALLACY—"IF THEY KNEW SOMETHING, THEY'D TELL YOU"

Forty-three years ago, when I began following stocks, I was sure a brokerage firm could and would help me a lot. After all, wasn't that what they were in business for? Finally I got it; they are in business to make money (generate commissions) and despite what they say or do, brokers that generate huge commissions get huge rewards. The incentive is all about commissions, not customers.

Doubt that? Then explain away that Citicorp, Merrill Lynch, and a few of the other big boys were fined $1.4 billion for issuing biased ratings on stocks to lure investors.

Hmm ... why didn't the FTC have them place all those warning labels on their ads and their golf and tennis tournament promotions?

MY WAKE-UP CALL

Many years ago it was also Merrill Lynch that was fined a few hundred million for telling customers to buy when they were selling. If you and I do that, we end up in jail; they do it and they get to sponsor a conference on the new economy and give more money to politicians.

What I learned is that we are very much in this game on our own. It’s really the little guys and gals, like you and me, against the establishment. At every turn it is set up for them, not us. Me? I kinda like that—us against them—but until you come to that realization you will play the game like they are on your side. The evidence, the facts, and the fines indicate otherwise.

There ... that’s what the FTC should be telling everyone!

There is one thing you have been told, though, that is true; there are people who know more about the markets than you. Lots more. You’ve searched high and low for these people, and thought brokers or the media would dredge up their advice. Wake up, Charley, that’s not the way the game works.

THE SUPERPOWERS

What you are about to learn is that there are true superpowers of the marketplace, so critical to market structure they are required, by federal law, to report their massive buying and selling once every week.

If they don’t report they will be hit with massive fines and/or go to jail. Imagine how influential these guys are! Imagine what might happen if one whispered in your ear what he was buying. Is that information you could use?

I suspect only one investor or trader out of 10,000 is aware of this vital information, posted, for free, on the Internet every week. Most investors are looking at charts instead of the buying and selling of the people who move the charts.

Let me be clear here. I am not talking about employees in a company or officers and directors. While it’s true they might time some of their buys and sells rather well (Bill Gates and Paul Allen sure did), an employee or officer may sell to take profits, not because he foresees lower prices. Indeed, what he foresees is braces or college tuition for the kids, or a divorce.

Nor will I bore you with what the mutual funds are buying, for one simple reason: 85 percent of mutual funds don’t do as well for you as if you had just bought the laggard Dow Jones Industrial Average stocks. Amazing but true, only 15 percent of all funds outperform the simple strategy of buying and holding the Dow Industrials! What makes this even more remarkable is that it is not always the same 15 percent of funds that outperform the market. Funds come into and out of this list of success faster than rap songs hit and fall off the charts.

No, I’m going to be talking about what the largest, most powerful corporations are doing with their money, money they have to invest in their business every week of the year, year in and year out to maximize their profits.

I have been following this smart money crowd since 1970. More than 30 years of tracking these astute financial powers have taught me things I can teach you. In these years I have learned that while this camp of investors/traders is not always right, they consistently make the best bets in the game.

It was my lucky day in 1969 when a fellow named Bill Meehan was introduced to me by a couple of traders in the San Jose, California, area. Those two, Chet Conrad and Keith Campbell, went on to amazing success. The last I heard of Keith he was managing well over $1 billion, and Chet has parlayed his market winnings into an even more sure bet: he bought a casino in Reno. I have not seen Chet or the Campbells since the early 1970s. We have all gone our own way to do our own thing. All three of us owe a debt of gratitude to Bill for teaching us what he knew.

Bill, a former member of the Chicago Board of Trade, was kind enough, for a fee, to teach me how he followed these superpowers. Bill looked at this group with several sets of data, but the most powerful was something called the “Commitment of Traders” (COT) report. Back then, this report was released one month after the superpowers had bought or sold, so it was a bit delayed. Still, though, it had great merit. Today the report is released every week with a delay of just a few days.

When most people think of investing, they think of stocks and bonds. That’s traditional thinking. What they are not aware of is that each day about five times more dollars change hands in the commodity markets. Traditional real estate or stock investors are missing the boat. They are quite literally on a small boat in a small pond compared to the physical commodity markets.

Did someone say a dirty word? “Aren’t commodities full of risk?” you ask. To which I candidly admit yes, for sure, but no more risk than stocks, as you will soon see. Commodities, in the past, were to be joked about. They were an investment arena for only the bravest or most foolish, depending on your view. That has changed greatly since I first traded pork bellies in 1968. As the world has changed so have the markets. A new breed of commodities appeared consisting of financial instruments, such as bonds, Treasury bills, currencies, and stock market indexes like the Dow Jones Industrials and the S&P 500. We were no longer trading eggs and orange juice (the breakfast spread) or cattle and wheat (the dinner spread).

Overnight banks, governments, and worldwide corporations began using the commodity markets to protect their business interests. If General Motors was selling cars to

Japan, they needed to make certain the value of their payment in the future in yen did not collapse between now and when they were to be paid. The superpowers entered the commodity markets, and the trading pits in Chicago have never been the same since. Long gone are the days of one or two large traders “running” a market. No one individual has the money and backing of any one of the commercials.

The commercials, the superpowers, have research staffs, people in the field learning all they can about a physical commodity such as wheat, gold, corn, and the like as well as the abstract commodities (the man-made ones) like the British pound, the yen, Treasury bonds, the S&P 500 stock index, or other market indexes from around the world.

Whenever the commercials trade they leave tracks—the record of their buying and selling. Those are tracks we can easily follow. They are the tracks of what real informed players in the game are doing with their own real money!

This is the great advantage a commodity speculator has; he or she can rely on inside information legally, something a stock guy or gal can never do.

I say that because the weekly COT report reveals to us all the buying and selling these powerhouse players have been doing. It then becomes our job to understand what their actions mean and align ourselves with them. That’s what this book is about ... getting in step, investing and trading side by side with the largest commercial interests in the world.

HISTORICAL PERSPECTIVE ON COMMODITY AND FUTURES TRADING

What we know as the commodity markets of today came from some humble beginnings. Trading in futures originated in Japan during the eighteenth century and was primarily used for the trading of rice and silk. It wasn't until the 1850s that the United States started using futures markets to buy and sell commodities such as cotton, corn, and wheat.

A futures contract is a type of derivative instrument, or financial contract, in which two parties agree to transact a set of financial instruments or physical commodities for future delivery at a particular price. If you buy a futures contract, you are basically agreeing to buy something, for a set price, that a seller has not yet produced. But participating in the futures market does not necessarily mean that you will be responsible for receiving or delivering large inventories of physical commodities—remember, buyers and sellers in the futures market primarily enter into futures contracts to hedge risk or speculate rather than exchange physical goods (which is the primary activity of the cash/spot market). That is why futures are used as financial instruments not only by producers and consumers but also by speculators.

Before the North American futures market originated some 150 years ago, farmers would grow their crops and then bring them to market in the hope of selling their inventory. But without any indication of demand, supply often exceeded what was needed, and crops that were not bought were left to rot in the streets! Conversely, when a given commodity—for instance, wheat—was out of season, the goods made from it became very expensive because the crop was no longer available. Bread was cheap in the fall and dear in the springtime.

In the mid-nineteenth century, central grain markets were established and a central marketplace was created for farmers so they might bring their commodities and sell them either for immediate delivery (spot trading) or for forward delivery. The latter contracts—forward contracts, contracts dealing with the future—were the forerunners to today's futures contracts. This innovative concept saved many a farmer the loss of crops and profits and helped stabilize supply and prices in the off-season.

While futures are not for the risk-averse, they are useful for a wide range of people trying to break out of the humdrum 9 to 5 job syndrome, people like me who believe we should remain independent of any source of income that will deprive us of our personal liberties.

ACKNOWLEDGMENTS

There have been many people who have kept me in step with life and the markets, like Bill Meehan, who first lectured me on the commercials in 1969. I'd like to thank my long-term buddies and dear friends—Tom DeMark, Harvey Levine, Richard Joseph, and the best partner I have ever had, Louise Stapleton, without whose love and attention to details this book would never have seen the light of day. A special thanks to Chris LeDoux, whom I never met but whose music has been inspirational to my trading and living. Also a note of appreciation to Brian Schaad for all the help with my newsletter, my personal assistant Jennifer Wells, Carla for always caring when she no longer has to, and above all my five children, who each in their own way have shown me how to walk ... and dance to the joys of more than stocks and shares.

L. W.

St. Croix, U.S. Virgin Islands
2005

CHAPTER 1

Meet Your New Investment Partner and Adviser

Commercials are for more than television.

The sole purpose of this book is to get you in investment alignment with the billion-dollar successful traders and pools that move in and out of the marketplace. They will become more than your mentor; they will become your investment partner, whispering in their own way to you each week where they have been placing their money. I will be teaching you who these people are, and several ways to follow them to add to your understanding of how markets work.

While most market followers look at charts, you will be looking at the actual condition that affects price change: large buying and selling, true supply/demand pressure that we will be able to see each week as the billion-dollar successful traders and pools enter the marketplace.

Since these guys are our partners, let's meet them. Let's find out all we can about this group of traders so respected—and feared—they must register with the U.S. government and reveal all their market actions. A karate fighter having to register his powerful fists at the local police station is a good analogy.

The government in this case means the Commodity Futures Trading Commission (CFTC). Here's a little more about who they are and what they are supposed to do. The mission of the CFTC is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.

Futures contracts for agricultural commodities have been traded in the United States for more than 150 years and have been under federal regulation since the 1920s. In recent years, trading in futures contracts has expanded rapidly beyond traditional physical and agricultural commodities into a vast array of financial instruments, including foreign currencies, U.S. and foreign government securities, and U.S. and foreign stock indexes.

EVOLVING MISSION AND RESPONSIBILITIES

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The agency's mandate has been renewed and expanded several times since then, most recently by the Commodity Futures Modernization Act of 2000 (CFMA). Today, the CFTC ensures the economic utility of the futures markets by encouraging their competitiveness and efficiency; ensuring their integrity; protecting market participants against manipulation, abusive trading practices, and fraud; and ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk.

HOW THE CFTC IS ORGANIZED

The CFTC consists of five commissioners appointed by the U.S. President to serve staggered five-year terms. The

President, with the consent of the Senate, designates one of the commissioners to serve as chairman. No more than three commissioners at any one time may be from the same political party.

The chairman’s staff has direct responsibility for providing information about the Commission to the public and interacting with other governmental agencies and the Congress, and for the preparation and dissemination of Commission documents. The chairman’s staff also ensures that the CFTC is responsive to requests filed under the Freedom of Information Act. The chairman’s staff includes the Office of the Inspector General, which conducts audits of CFTC programs and operations, and the Office of International Affairs, which is the focal point for the CFTC’s global regulatory coordination efforts.

The Chairman’s staff is also responsible for liaison with the public, the Congress, and the media. The Office of External Affairs (OEA) is the CFTC’s liaison with the domestic and foreign news media, producer and market user groups, educational and academic groups and institutions, and the general public. The OEA provides timely and relevant information about the Commission’s regulatory mandate, the economic role of the futures markets, new market instruments, market regulation, enforcement actions, and customer protection initiatives, actions, and issues. The OEA also provides assistance to members of the media and the general public accessing the CFTC’s Internet web site (www.cftc.gov).

The CFTC monitors markets and market participants closely by maintaining, in addition to its headquarters office in Washington, offices in cities that have futures exchanges —New York, Chicago, Kansas City, and Minneapolis.

By law, traders must register and report their activities, and by law, the CFTC issues reports where you will learn to read what your soon-tobe partners as hedgers are doing. We will further identify them as taking positions in the market for commercial purposes as opposed to those who use the markets for speculation. These are truly the large players in the market. In fact, while you or I or a group of traders known as “large traders” can own only so much of a commodity, the hedgers or commercials (our partners in all this) have no limit to how much of a commodity they can buy or sell.

That means when the commercials see an opportunity in the markets they can step up to the plate and buy millions of pounds, bushels, or contracts of a commodity. They are the best-capitalized players in the game. They have the deepest pockets and one core reason to be in the markets: they actually use or produce the product. It is their professional business to buy and sell; they know the markets better than the outsiders, you and I. Here’s an analogy. I’m not too keen on cars and never learned much about mechanical things. So if I’m going to buy a new car I can read up on cars, then talk to a salesperson, and perhaps even take a test-drive (sorry, no test-drives in the marketplace) to arrive at a somewhat informed decision.

Or, if I happen to personally know Roy Stanley, the owner of the local Chevy dealership, I can cut to the quick and ask him what’s best for me. He’s in the business of knowing cars, the business of buying and selling them. He’s an insider in his world, so I treasure his advice.

The commercials seemingly have unlimited resources. Bill Meehan (see Introduction) told me they usually account for 60 percent of the volume in a market, so it pays to respect their judgment, to covet their wisdom, and to pay attention to what they do. To them the markets are a business, not a speculation.

The very bottom line for the commercials is that they attempt to minimize their losses as opposed to us speculators, who attempt to make profits. Let me explain. A commercial has an inventory of the product or needs the product. His or her trading will be around the product—the need to buy it or sell it. If a commercial in, say sugar, knows his company will need a million pounds of sugar in the next month and he believes sugar prices are going higher, he is literally forced to step in and buy now, today. By the same token if he thinks sugar is due for a decline—lower prices—he will still buy some sugar because he needs it to make cotton candy or whatever. But he will not be as aggressive in his buying, and we can pick up on that in the weekly CFTC report.

Here's the unusual thing that has perplexed many followers of the commercials. In an extended decline they will buy all the way down. Hence, it looks like they are dumb as they bought at high prices. "Dumb as foxes," I say. The cheaper our friend can buy sugar, the more profit he has in his cotton candy as his base cost of the product is reduced by the lower sugar cost.

My point is the commercials are not like you and me. They buy to use the product or to protect against a sudden change in prices, to lock in a profit as a producer of the item. You and I, dear reader, have a different function. Our task is to buy low and sell high, to make money from market swings while our commercial mentors are using the markets to make money in their businesses.

We can sure as heck use these guys in our game plan, as when they get unusually bullish or bearish the markets are most likely to have major moves, often with the potential for making millions of dollars. I know—I have done just that in sync with the commercials, just as Bill Meehan showed us.

You and I have one large advantage over the commercials. They must transact in the marketplace every day. It is a permanent business for them. Day in, day out, they have to be doing their best to protect their positions. That’s not true of us! We can come in and out of the markets at our fancy. We have the luxury of waiting, with great patience, for the perfect time, a time when the commercials have become uniformly biased and have become massive buyers or sellers in anticipation of a major market move.

Let me also add this: we live in an imperfect world. At times the commercials may be wrong or at least on a short-term basis appear to be on the wrong side of a market. I’m sure they don’t want to be wrong. The future, however, is fragile and oh so hard to forecast correctly. If they were always right we’d all become instant millionaires, and what fun would that be?

Because they can be wrong, at least for a while, we need tools and tactics to protect our hard-earned speculative dollars from being taken from us. In later chapters I get into some of the techniques I use to make certain that my entry and exit points, as well as my money management, are effectively used to protect against the risk of ruin.

Nothing is for sure in the world of speculation; the commercials sometimes buy a little early, and with their deeper pockets it does not matter to them. But most of us with shallower pockets, or none at all, will need more precise entry levels and absolute control of our losses.

There are three primary classes of trading action we can see each week: the hedgers or commercials, large traders (large speculators), and small traders (small speculators). These groups all look at the same market yet act differently, as the market serves different missions for each of them.

Some traders are speculators and some are hedgers. Speculators expect the price to go up when they buy a contract and expect the price to go down when they sell a contract. The idea for speculators is to buy low, sell high, and make a profit on the difference. Large hedgers that are users want to buy at low prices, whereas large hedgers that are producers want to sell at high prices. The idea for hedgers is to guarantee some price they will get or give for the commodity, currency, or financial security they're trading.

Consider for a moment that you are a wheat farmer. You estimate you will produce about 50,000 bushels of wheat and that it will cost you close to $3.25 a bushel to grow the wheat and get it to a grain terminal to sell. One fine day you open up your local paper and see that wheat, for delivery in December, is selling for $4.10 a bushel. It's May and your crop is in the ground. The current price of wheat means you can make 85 cents per bushel if you sell in the market now against what you know you can deliver by December. Your profit would be $42,500 ($.85 times the 50,000 bushels), but there are problems.

First, what if your crop fails? Maybe there will be a drought, "hoppers" will eat it alive, or you will get hailed on just before harvest. Then you won't be able to deliver all 50,000 bushels and might have a problem if wheat is selling for more than $4.10 a bushel when it is time to deliver the contract. If you can't deliver the wheat, you will have to fork over the difference between what you sold it for and the current price.

By the same token, if wheat goes down in price and by the time delivery rolls around it is selling for less than $4.10 a bushel, you have made yourself a profit (the current price minus what you sold it for). Of course, the fact you don't have wheat to deliver usually means a lot of other ranches don’t have wheat to deliver. A shortage of a crop such as that usually means higher prices.

Also, what if wheat prices rally to $8.10 a bushel and you could have sold at that price, making $4.85 a bushel for a net gain of $242,500? Ahh ... you city slickers can see there is more to farming than running a tractor. For all these reasons, and a few more, a producer, be it wheat or gold, beans or bacon, will want to use the futures markets, but with care.

And now you can appreciate that if wheat starts to rally you will sell some of your crop at different price levels. At $4.10 a bushel you may sell one-tenth of your crop, at $5.00 a bushel you may sell another one-third, and by then you may know how abundant your harvest will be so you may decide to sell more at $6.00 and the rest of it at $7.00 a bushel.

You’re happy as a hog in slop. You sold your entire crop at prices higher than your cost. You do not care if wheat goes to $20 a bushel, though you will curse yourself for selling too soon. The weekly CFTC report will reflect your selling. If lots of farmers sold wheat at say $5 a bushel and it rallies to $10 it will look like dumb selling. But was it? The farmers were happy to sell at that price. They took a profit.

One of the important features of futures markets is the interaction between speculators and hedgers. Since speculators have different opinions about how prices will move, speculators may buy and sell contracts to each other. Also, hedgers who are producers want to guarantee the price they will get for what they’re trading, and hedgers who are processors want to guarantee the price they will have to pay.

Since producers and processors both want to guarantee what return they will get or price they will pay or be paid,