Author's Note

By 1970 I had long been a defender and advocate of commodity speculation as an essential part of a smoothly and productively functioning economy. In addition, I had been exposed to the results of speculation, both anecdotal and quantitative. I was drawn, like a moth to a flame, to address the topic of how to speculate when the opportunity arose. It was another fun trip to New York, much appreciated by my wife. There is a broader lesson in the survey results presented: most of us are doomed to mediocrity, some more than others.

Commodity Speculation As an Investment Medium

Morton Shulman begins the commodity futures chapter in his book *Anyone Can Make a Million*, "Commodity futures represent the quickest possible way to get rich or go bankrupt amongst all forms of market trading. . . . Comparatively few speculators participate in this form of gambling. . . . This is a pity, because here is probably the only completely honest form of pure gambling in the market. Commodity futures are neither investments or speculations . . ., but an exciting form of gambling from which small amounts of money can turn into huge fortunes." This is a strong statement of what is fairly typical of the prevailing attitude toward commodity futures trading.

Obviously, I would not have foisted the topic of commodity speculation as an investment medium on this seminar had I intended to take a negative stance. Yet, some of what Mr. Shulman says is true. Commodity trading is exciting; it can be used as a remarkably honest gambling device with a relatively small house take; and it is a way in which unimportant amounts of money can be turned into important amounts. But commodity speculation is much more: it is a vehicle for exercising the prudent investment techniques that enable one to get a larger than common interest return on invested capital. It is a vehicle of great flexibility that can be adapted to the circumstances and objectives of all kinds of investors. At the same time, it is a demanding vehicle that offers maximum opportunity for dramatic failure. It is, thus, a singularly honest game in which victory goes to the best players and defeat to the worst.

Motivation

The many motivations for commodity speculation can be generalized into three. First, successful speculation can be used to increase a relatively unimportant amount of money into an important amount. Some important amounts of money are inherited, but few of us have an opportunity to choose our parents. Others are accumulated out of earnings by such people as excel in sports, entertainment, the professions, business entrepreneurship, and the like. But only a few reach the top. Other important amounts are accumulated out of speculation. Speculation

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takes many forms but generally involves selling property at higher prices than those at which it is purchased. Gold, uranium, and oil are sold at higher prices than mining rights are purchased; the trick is to locate and purchase the right rights. Large fortunes have been accumulated from real estate speculation. Precious jewels, art objects, and rare coins are popular speculative media. Securities are probably the most popular medium in the United States.

Second, speculation is a means of supplementing income and gaining a return on a constant capital investment. Here, the motivation is not to accumulate but to make money to spend or save. There are professional speculators, particularly in commodities, who do not intend to use markets for capital growth but as an income-producing system and who plan to accumulate wealth by saving. This is a different game than using the markets in quest of capital growth.

Third, some speculators are attracted by the stimulation of the game. People trade in the same way that others are baseball or football fans. Sports fans appear to get a vicarious thrill from associating themselves with a team and its fate. The exuberance of winning and the dejection of losing are real. The thrills from speculation would seem to be greater because profits and losses are real; the trader is a participant. But for some, the money made and lost is not of consequence; money is only the way the game is scored.

Appeal As a Speculative Medium

Commodity futures markets have much appeal as a speculative medium. First, the mechanics are simple and clear-cut. Information is abundant and readily available; price quotations are abundant; and the market is liquid. The commodity trader is not concerned with the dividends, options, splits, proxies, conversions, etc., that clutter up trading in securities. It is easy to keep score in commodity trading; one buys and sells and wins or loses.

Second, minimum capital requirements for entry into commodity trading are small. Contract units and margin requirements are small enough that only a few hundred dollars are required to finance an initial transaction. Commodity trading is one of the very few roads to big money open to the shoestring investor.

Third, commodity trading has appeal because of the realism of prices. Contracts mature and go out of existence by the end of the delivery month and are exchangeable for the cash commodity on first delivery day. Contract maturities are frequent—five to twelve times per year. The securities analog to this would be to declare XYZ Corporation bankrupt five or more times per year and auction off the plant, equipment, patents, goodwill, etc. Speculative fictions in securities can be long perpetuated, but speculative excesses in commodities, up or down, are soon pricked by the test of the first delivery day auction block.

Fourth, commodities are relatively low-risk speculative media. This notion is a contradiction of standard doctrine and widely accepted concepts—commodity trading is said to be the fastest track of them all. Commodity trading can be made a fast track, but it is not inherently fast and need not be made so.

The degree of riskiness is a function of price forecastability and price variability. Commodity prices are relatively easy to forecast because of the vast amount of information that is universally available. There just is not inside information. Further, the realism of prices forced by delivery yields a solid value base for forecasting.

A test of the relative variability of commodity and security prices made in 1968 yielded an average coefficient of relative dispersion of securities prices 1.65 times that of commodity prices.

Fifth, the great appeal of commodity speculation is leverage. This is the way that the track is made fast. Margin requirements tend to be 5 to 10 percent of the contract value. Thus, a 5 to 10 percent move in the price is either double or nothing of the investment required. Because of the great leverage, the doubling of one's capital in one year is not out of a realm of reasonable possibility. Now, $1,000 doubled in each of ten successive years expands to something over $1 million. A successful speculator can turn an unimportant amount of money into an important amount.

The Game Speculators Are in

A first step in playing a game is to understand it. Speculators need to understand what markets are, how they work, their economic basis, and how they are used by commercial interests. Here, we can only underscore a few features of the markets.

First, the clearinghouse breaks even; it pays out the amount that it takes in. Futures trading is a zero-sum game minus the cost of doing business. In the aggregate, the participants break even gross and lose net by the amount paid in commissions, brokerage, and clearing fees. Thus, when the speculator enters the market, he is attempting to take money away from someone else who, in general, is most reluctant to lose.

Second, price variations in the major, highly developed futures markets, are random. Successive price changes are independent; that the most recent price change has been up does not increase the likelihood that the next price change will be up, etc.

Third, the speculating public must compete with a large group of professionals. These include the professional speculators—people who have gotten good enough at the game to make a living at it. They also include the facilitators at the markets whose primary purpose is to furnish liquidity. These are the scalpers, pit traders, and floor traders who trade in large volume for small price changes. And they include commercial interests whose market actions are partly based on their judgment about prices. The competition is tough.

Results of Speculation

Little is known about how well the speculating public makes out. The lore of the market suggests that 85 to 90 percent lose money. I recently took a look at the trading results of a group of 462 speculator customers of a large commission house for 1969. These were all of the customers of three offices. The information consisted of the profits, losses, and commission paid by each. On quick examination the data suggested a need for some classification. Accounts that had only profits or losses suggesting one or a series of trades were separated. Second, a group was designated as regular traders. The standard for regularity was low: (1) commission paid of at least $250 indicating at least ten contracts traded, and (2) both profits and losses, each of which was $500 or more. This left a group of "other traders." The results were as follows:

	REGULAR	ONE TIME	OTHER	TOTAL
Number Accounts	193	170	99	462
Number Profits	80	44	40	164
Number Losses	113	126	59	298
Profits	398,839	37,237	26,337	462,413
Losses	421,030	461,659	244,666	1,127,355
Net	- 22,191	- 424,422	-218,329	-664,942
Commissions	364,646	21,403	20,295	406,344
Gross	+ 342,455	- 403,019	-198,034	-258,598

There are a lot of people who come into the market, lose a lot, and go away or make a little, breathe a sigh of relief, and go away. The occasional traders are big losers.

Second, a lot of money falls through the slot in the table—commissions. Commodity commissions are small in relation to the value of the contracts and in relation to price variations, but they take a lot of money out of the game and their cost should be kept in mind by would-be speculators.

Third, even at the low criteria established, the regular traders did better than is generally thought. A frequency distribution of their results is as follows:

	RANGE	NUMBER ACCOUNTS	GROUP TOTAL
Loss	15,000 and over	7	143,063
	10,000–14,999	6	75,273
	5,000–9,999	7	51,598
	3,000–4,999	14	53,883
	1,000–2,999	39	75,753
	0–999	40	21,460
Profit	0–999	26	13,948
	1,000–2,999	21	40,035
	3,000–4,99	11	45,142
	5,000–9,999	11	81,714
	10,000–14,999	5	67,426
	15,000 and over	6	150,574

Fourth, a high proportion of regular traders neither made nor lost substantial sums; 126 of the 193 were within the plus or minus $3,000 range. This apparent lack of results obscures a lot of activity. For example, one account made $27,000, lost $23,000, and paid $5,000 in commissions. His gross trading results were a modest profit and his net a modest loss, but it was an active game.

Fifth, a few people made substantial sums, and a few people lost substantial sums. The game was quite expensive for a few of the regular players, just as it was quite lucrative for a few. The game is played and won by some people; it can be done.

How to Speculate

To trade successfully, the speculator must do three things well: manage capital, forecast prices, and avoid speculative suicide.

The purpose of commodity speculation is to make money. It is not to make cents per bushel of soybeans, cents per pound of copper, or dollars per ton of soybean meal. It is not to make X thousands of dollars. The purpose is to make a given amount of capital grow into a larger amount to obtain a return on investment.

The potential profits are a function of the risks of loss that are accepted. Every commodity investor should establish a fund of capital that he is willing to hazard. He should next establish his objectives in trading in terms of returns on capital; if his objective is 20 percent per year, he establishes one kind of program and level of risk, but if his objective is 50 to 100 percent he needs a different program and risk level. All trades and positions should be related to the capital position and their potential contribution to the objective.

Commodity prices fluctuate, and it is out of these fluctuations that profits and losses are made. Commodity prices are real, responding to market forces of supplies and requirements so that an equilibrium price is established. Thus, the essence of successful commodity speculation is price forecasting. The market as a whole forecasts prices, and the current price is the composite forecast of the market participants, weighted by the size of their positions. To take a position in a market is to challenge the aggregate judgement—to say that the market is in error. It is from the mistakes of others that speculators make money and from their own mistakes that they lose money.

There are numerous kinds of forecasts that apply to different time periods. The scalper is interested in the next tick—whether the next order will be to buy or sell. At the other extreme, an economic analyst may be interested in a twelve-month equilibrium. There are all gradations in between. Each kind of forecast requires a different style of trading and different capital management. Each speculator should know his own forecasting skills and limitations and stay within them.

The forces affecting the price of a commodity are numerous and subtle in their effects. Information about them is never absolutely complete or accurate. Many of the forces are nonrepetitive and change over time. Thus, an analyst must be completely and thoroughly familiar with the commodity or commodity group that he trades, and no one can possibly know enough about a large group of commodities to challenge the wisdom of the market in them all.

Price forecasts vary in their level of certainty; all are uncertain, but some are more uncertain than others. The level of certainty must be appraised and related to the allocation of capital to market positions. One might be worth, in size of move and certainty, one-half of the capital in the fund, while another might be worth none at all.

This interplay of forecasting and capital management requires a great deal of patience. All systems have to be A-Okay before the start button is punched, and once the start button is punched, the hand must be held over the abort button. But the prospective speculator should be consoled; speculative opportunities abound. Were a speculator to take advantage of even 20 percent of the moves in a relatively dull commodity, he would soon have most of the money in the game. The problem is not finding something to do but avoiding doing the wrong things. Needless to say, this is a game that requires talent, hard work, and discipline.

Finally, the speculator must avoid committing suicide. There are numerous ways to louse up, and the novice speculator manages to find most of them quickly. These include (1) undercapitalization of individual trades so that forecasts do not have a chance to work out, (2) trading for small moves so that the account is eaten up by commissions, (3) trading outside of the speculator's competence, either for small moves or in commodities that he does not understand, and (4) taking profits too quickly and letting losses run until capital is seriously impaired.

Behind these mistakes lie four weaknesses: the lack of strength of character to challenge the market, the lack of sufficient cowardice to run from the market, the lack of sufficient hard work to master a commodity, and greed. Commodity speculation is not a fast way to get rich; it is a hard way to make an easy living. It is a way to combine money, work, and skill to get a larger return than common interest; this is the essence of investment.