By Diana Klemme

When **Gorillas** Migrate

One important aspect of 'spec limits' is that all speculative entities must reduce their holdings to a minimal position by the start of the spot month.

Managing future spread risk is an important duty for grain merchandisers. Managing that risk successfully is the challenge. A merchandiser wants to capture wide futures carries when the elevator owns inventory, for example. The larger the futures carry the more the elevator can "collect" to offset costs of carrying owned-inventory. Selecting when to roll an elevator's short futures hedges forward is an important harvest trading decision. This is when facilities often hold their peak grain ownership, and these spreads have a significant impact on an elevators' bottom line.

Futures spreads reflect the market compensation to hold a physical commodity over time in the delivery market; from December 1 to March 1 on corn, for example. But futures carries can lessen or even disappear, so merchandisers should be able to recognize what factors affect spreads. Changes in basis or level of readily available supplies can impact spreads, but other factors include:

- Transportation cost
- Interest rates
- Cost of the underlying commodity (it costs more to hold soybeans than corn)
- Fund trading

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But one factor isn't related to the fundamentals of the underlying commodity: fund trading. Managed speculative funds can be long or short futures, and can trade in any futures month. These funds are "managed" actively, with trading decisions based on computer or chart signals. (Let's refer to these simply as "managed funds.") The maximum speculative position size any individual or any single fund can hold is defined under CBOT regulations or other designated markets (KCBT, MGE, etc). (Figure 1) These in turn are governed by federal Commodity Futures Trading Commission regulations.

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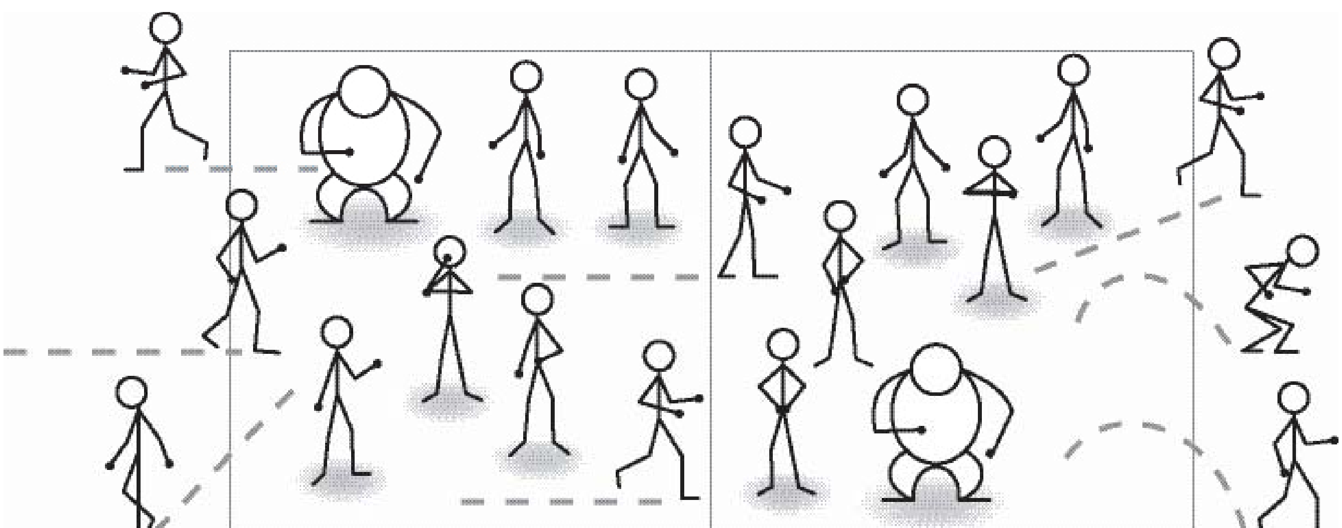
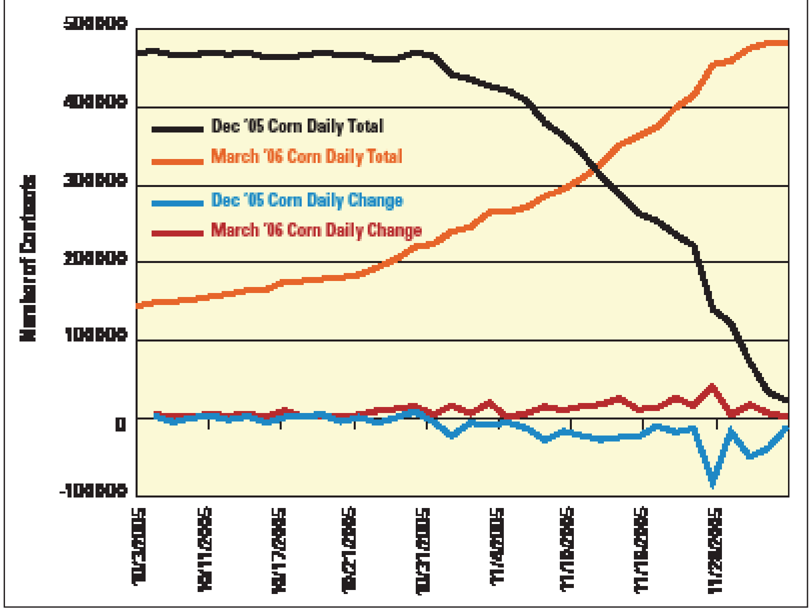


December 2005 March 2006

Whether it's by choice, by formula or by mandate, at any given point trading decisions are being made in fund trading. Traders may leave a position completely or move to a new position — and watch out when the 900-lb. gorillas make a move. There are a lot of gorillas trading large commodity positions that all must exit at the same time.

Figure 1

Open interest CBOT corn futures (Dec 05 and March 06) during October and November 2005.



to a minimal position by the start of the spot month; by the end of November 2005 in the case of December 2005 corn futures, for example. This is because of CFTC's mandate under the Commodity Exchange Act to ensure orderly liquidation of futures and prevent price manipulation. This forced reduction or relocation in positions creates a predictable exit of the speculative positions held in front-month futures as that month approaches and becomes the spot month. The following chart illustrates this "migration." Note the "crossover" pattern beginning in early November.

CFTC's report as of 11/8/05 showed large speculators about 150,000 contracts net long in corn vs. 174,000 contracts net short — different funds held different positions. Managed speculative funds were about evenly split between longs and shorts. A large percentage was in December futures, but as these funds began to exit December 05 corn futures, the impact wasn't necessarily large in this case because both longs and shorts were rolling their positions.

Open interest dropped steadily out of December 2005 futures, transferring to March 2006 as fund traders rolled their positions forward. During this time other traders may have just liquidated their positions, or new trades may have gone directly into March futures. But the "migration" pattern was clear. During this time the Dec 5/ March 6 corn spread was relatively quiet, however, trading around 13 to 14 cents carry. If the funds had been predominantly long or short, their rollovers could have affected the spread more. (Figure 2).

Outright buying or selling by funds in a single futures month can also affect futures spreads short term, or when funds are rolling sizable volumes of front-month holdings in a short time frame. Open interest (outstanding contracts) tends to concentrate in nearby futures and drops sharply past the second futures month. Fund rollovers before deliveries begin (along with rolling of positions held by small traders) can create short-term opportunities or create problems for grain merchandisers. (Figure 3).

If funds are heavily short, rolling forward will involve buying the nearby month and selling a deferred month. All else equal this may narrow the futures spread — even if briefly. When funds roll long futures, the spread(s) may widen temporarily. In every trade there's a buyer and a seller, which should negate the impact on spreads. But large orders can "stretch" the market; rollovers are no exception.

Even bigger positions

The CBOT has been phasing in higher speculative position limits in recent years to accommodate growth in demand. Just as stock mutual funds have exploded in size and number over the years, managed commodity spec funds have also grown. There are a lot of 900-pound 'gorillas' trading large commodity positions that all must exit the front month by the same date(s).

The CBOT's latest and highest speculative position limits went into effect December 10. These new limits are for futures and options combined (in contracts). Spot month limits remain at maximum 600 contracts, which means speculative funds may be moving even larger positions just before deliveries begin — which may increase the short-term impact on front-month spreads. And the higher limits will give funds more clout to affect price on any given day. A 900-pound gorilla doesn't intend to level things in its path, but that may be the result simply due to its sheer size. Over time the jungle will restore itself, just as market fundamentals will ultimately govern price

Fig. 2 CBOT Speculative Limits

Futures + Options	Single Month		All Months Total	
	Phase 1	Dec 10	Phase 1	Dec 10
Corn	9500	13500	15500	22000
Soybeans	5000	6500	7750	10000
Wheat	4000	5000	5250	6500
Oats	1200	1400	1750	2000

Spot month limits remain at 600 contracts

and spreads. But that may be of little consolation to others in the path when the gorillas come through!

Index funds

Commodity index funds are a separate type of trading entity, not automatically classed as speculators for purposes of position limits. They can presently be classified by CFTC as commercial hedgers if it's shown they own futures to reflect the "ownership" set by the index. This means an index fund will only be long futures — never short — and may need to hold positions far in excess of the spec position limits. And in this case, an index-fund hedger would not be subject to the 600 contract spot month speculative limit, but would remain subject to CFTC's anti-fraud regulations.

Fig. 3 Open Interest: CBOT corn futures 10/11/05 a.m.

Dec 05 corn	470064	61.7%
March 06	156483	20.3%
May 06	32627	4.3%
July 06	52099	6.8%
Other	51028	6.7%
Total	**762301**	**100%**

In contracts; each contract =5,000 bu.

Overall there are billions of dollars invested in commodity index funds; a large percentage of their assets are in energy futures, but even a small percentage invested in corn, soybeans or wheat is one huge gorilla.

An index fund can have a fixed formula for exiting their front-month futures positions before deliveries begin; exiting December 2005 corn prior to December 1, for example. Goldman Sachs Commodity Index, one of the dominant index funds, always "rolls'" front-month long positions over a five-day period starting on the fifth business day of the month prior to delivery (November 7 to 11, 2005 for rolling December 2005 corn futures). This schedule is widely known, and it means GSCI will be selling the nearby month and buying the second-month forward. The impact of these rollovers on price or spreads can vary based on what other traders are doing and in what volume.

Implications traders

Commercial grain traders should be interested in how funds exit their nearby futures. The process of exiting or spreading and moving their futures positions forward is fairly predictable. The effect on futures spreads is not because markets don't trade in a vacuum. Commercial trading by processors or exporters, or outright buying or selling, may dwarf even the big gorillas on any given day. But be aware of the clout of funds due to their sheer size and their mandates under CFTC and exchange regulations.

Investors and advisers are increasingly focusing on including commodities for diversification in portfolios. Even pension funds are venturing deeper into commodity index funds. A 2004 research study from the Yale International Center for Finance compares long-term returns of stocks, bonds and commodities, and the results triggered substantial interest. Commodities generated the same return as equities (overall), in a negative correlation, but position correlation with inflation. The full study is available on the Internet at: http://mayet.som.yale.edu/~geert/wp.html

As index and managed commodity funds grow in size, the short-term impact on spreads can grow as well. Grain merchandisers and managers who are aware of the size of fund positions and whether the managed funds are net long or net short will have clues to what may be coming. ■

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