TAG21

Value Investing: King of Trading Methods in the Commodity Markets

COVERING: FUTURES

Masover

Commodity trading involves a high degree of leverage. That leverage allows for large returns, but also large losses. Due to the high degree of risk involved in high leverage, anyone involved in commodity trading should be aware of the risks—and gain as much understanding of trading strategies as possible.

In this informative session, Hal Masover will discuss value investing in general, and the specific technique of scale trading. Value investing is an intermediate to long-term investment method that takes advantage of supply/demand imbalances occurring in most physical commodity markets. Although this time-tested method has been around since at least 1975, it is not well known among traders. As a leading expert on the topic, Hal will provide you with in-depth, up-to-date information on this important technique.

A licensed commodity broker since 1987, **Hal Masover** wrote *Invest Like the Pros: Value Investing in Commodity Futures.* He also publishes the monthly *Crown Value Investment Letter* and a daily update on agricultural market fundamentals.

In 1985, Hal left a successful real estate investing career in Philadelphia for the pastoral fields of Iowa. Using cash from real estate sales, Hal began trading his own commodity futures account. He also worked with several investment firms, gaining valuable experience in the futures trading arena. In 1991, he began using the value investing method, and with partner Stuart Valentine, formed Crown Futures Corporation, an investment firm. A recognized expert in his field, Hal has been frequently quoted on Financial World News and Bridge News Service.

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Scale Trading -- Value Investing In Commodity Futures

Scale trading is a disciplined, mechanical approach to medium to long-term investment in commodity futures. It is a methodology based on the assumption that commodity prices ultimately move on factors affecting supply and demand. Two basic principles guide the scale investment strategy.

A) Is it a bargain price?

B) Are the supply and demand dynamics about to change in a significant and favorable way?

If the answer is yes to both questions, the investor begins buying the commodity at progressively lower prices until it stops declining. Then he starts selling at progressively higher prices as it rises.

Benefits of Scale Trading

Rather than using heavy leverage to chase large market movements, scale trading provides the ability to **de-leverage**–creating a product much more compatible with traditional, conservative investment portfolios, including IRAs.

With scale trading, more of the equity in the account is committed to each trade and the volume of trading is much less–producing an additional benefit of less commission expense than with most futures accounts. The trading strategy involves taking consistent small profit, rather than riding big, flashy run-ups (followed by equally flashy run-downs).

The results, both in terms of returns and risk profile, are completely different than the type of futures trading which causes most investors to leave futures out of their portfolios.

The Law of Supply and Demand

The law of supply and demand says that as the price of a commodity such as wheat falls then the demand for wheat increases. As the wheat price approaches or even falls below its cost of production, producers will be inclined to cut back or switch to a more profitable crop, thereby reducing the available supply for the coming year. As supply shrinks, buyers competing for less and less wheat eventually push prices higher in order to ration demand. This higher price in turn motivates producers to increase production, thereby increasing supply. This results in lower prices. . .and the process starts all over again.

Supply and demand create practical low ranges for commodity prices. "Mother Nature" commodities have intrinsic value, and therefore are not likely to become valueless. Because of costs of production the investor is assured that wheat prices will not fall to $ 0 and more likely will have a much higher support price–which puts some practical limits to his risk

A scale investor enters the cycle when he feels wheat prices are about to rise from their lows. Along with such factors as decreased acreage in the United States, the investor also looks for global fundamentals that prices could rise well above contract purchase prices as the supply/demand cycle continues.

The Scale Method: Selecting and Managing a Scale

A scale investment plan is created when a commodity's price is cheap and the investor is convinced things are about to change. This plan will determine capital requirements as well as the number of contracts and at what prices to buy and sell. To develop a plan:

1) Choose a market that is trading in the lower 30% of its historical price range. Commodities that are produced and consumed are preferred for scale trading. Paper assets such as currencies and stock indexes are generally avoided.

2) Evaluate the seasonality of the commodity in question. Timing when to start a scale can make a big difference in the performance of your scale account.

3) Review fundamental factors. What are the short and long-term supply/demand expectations for the commodity? This means, with soybeans, for example, planting intentions, acreage planted, crop

conditions, previous year's crop carryover, exports, etc. This additional information not only helps in determining the probable areas of price support–i.e. will the commodity's price hold at or above its historic lows?– but more importantly helps determine when significant changes are imminent.

4) If the above criteria is supportive then a scale investment plan, based upon available capital, is constructed. The plan begins with purchases near the probable low and makes additional purchases at specified price intervals down to the lowest projected price. There should be at least 30% of capital left in reserve, after allowing for any losses on open positions as well as margin requirements (margin requirements are deposits required by the exchange and the amount required can change without notice).

5) Enter limit order GTC (Good till Canceled) to purchase the commodity (going long, never short) on an incremental scale all the way down to a level determined to be a “worst case” scenario. Keep in mind that stop-loss orders are not used since the purpose is to accumulate contracts at lower prices.

6) As each buy order fills, enter a limit sell order to close out the position at a pre-determined price that normally captures a $250-400 profit (net of fees and commissions). This profit objective will vary depending on the investor's personality and market conditions.

7) As each sell order is filled, then reinstate the original buy order. As prices fall, contracts are accumulated. As prices rise, those contracts are sold at a profit.

8) Continue this process until the commodity bottoms and rallies up to the point at which your first contract purchased is sold. You have now completed your first scale.

Pitfalls to Avoid

There are several cautionary points to keep in mind when planning a scale.

First it is usually best to avoid scaling from the short side of the market as it is virtually impossible to determine how high the price can go. Any large scale catastrophe such as war or world wide drought is capable of creating severe shortages driving a commodity price to new and unpredictable highs. For this reason it is much more difficult to anticipate capital requirements.

Also it is good to avoid financial markets such as stock indexes, bonds and currencies. Their fundamental value is more difficult to ascertain and these markets are subject to gross manipulation by government and central bank policies making it very difficult to determine how low they can go in price.

By sticking with commodities that are produced and consumed, we ensure that even the worst case scenario will eventually give way to a recovery in prices. While our worst case scenario does not represent certainty of what our ultimate exposure well be, the principles that drive the law of supply and demand are the best tools we have found for long term success in the commodity markets.

Beginning a scale at too high a price or being too aggressive at high prices can lead to difficulties when prices go lower than expected. Remember that even the best research is sometimes wrong. You can be assured that prices will sometimes go significantly lower than anticipated no matter how well you plan. Therefore it is advantageous to always plan a capital reserve and if possible diversify into several scales simultaneously rather than just one.

HAL MASOVER
CROWN FUTURES CORPORATION

VALUE INVESTING

We will start this session with a quiz to test your knowledge of commodities.

The answers to this quiz are instructional. We will review them together.

In the process of reviewing them we will use two real life markets, platinum and cattle, which represent recent or current examples of good markets for this method.

We will learn how to determine if a value opportunity exists and the details of how to use the method of scale trading to capitalize on these opportunities.

There are other ways to capitalize on these opportunities:

1) Seasonal spreads
2) Option strategies
3) Position trading

Conclusion: Whether you are long or short term oriented, understanding what constitutes value in commodities can enhance your trading.

STOP

I know you would like to review all the materials here to help you decide which session to attend, <u>HOWEVER</u> you will get more out of this session if you do not read any further until you are actually in the session.

VALUE INVESTING QUIZ

1) From 1980 to the present commodity prices have:
   a) Advanced 23%
   b) Declined 51%
   c) Declined 75%
   d) Declined more than 75%
   e) Advanced less than 10%

2) From 1965 to 1980 stock prices:

a) Advanced an average of 5% per year
b) Advanced an average of 12% per year
c) Declined 45%
d) Declined 4%

3) During the same period commodity prices:

a) Advanced 403%
b) Advanced 105%
c) Advanced 269%
d) Declined 26%

4) The change in money supply in the US as measured by M1 last year was_____%.

a) +11.2%
b) –11.2%
c) +3.4%
d) –3.4%
e) Essentially unchanged

5) During the past year GDP grew by

a) 11.2%
b) 3.4%
c) 4.2%
d) –2.1%
e) 5.4%

6) There are _______ platinum mines in the world.

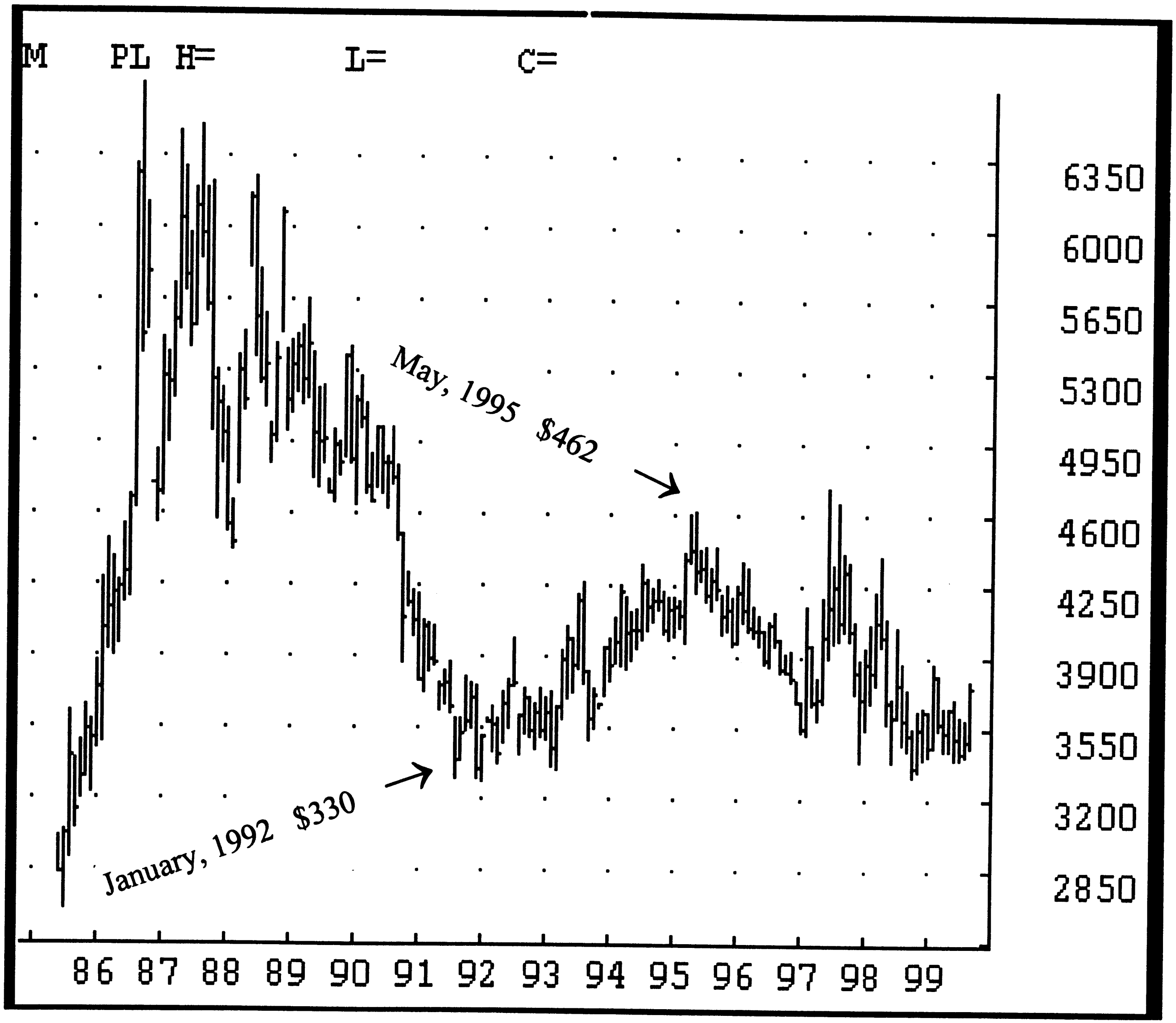
a) 47
b) 131
c) 1,200
d) 3

7) Russia's platinum mines account for ______% of the world's supply.

a) 2.7
b) 25
c) 12.1
d) none
e) 7.4

8) Platinum prices ranged from approximately $332 up to $440 per ounce in 1998. Production was approximately 50,000 ounces less than consumption. Through September 13th the range of prices for 1999 is from $341 to $388. Production estimates for 1999 are a

a) deficit of 25,000 ounces
b) balanced
c) surplus of 10,000 ounces
d) deficit of 150,000 ounces
e) surplus of 25,000 ounces


M PL H= L= C=
6350
6000
5650
5300
4950
4600
4250
3900
3550
3200
2850
86 87 88 89 90 91 92 93 94 95 96 97 98 99
May, 1995 $462
January, 1992 $330

RECOMMENDED SCALE TRADE PLAN

Commodity	**Platinum**
Month:	**January**
Start Price:	**$360.00**
Maint. Margin:	**$1,100**
P or L per $:	**$50.00**
Buy-Down Incr.:	**$10.00**
Sell-Profit Incr.:	**$10.00**
Total Buy Levels:	**5**
Cntrcts / Level:	**1**

PLEASE REMEMBER THAT COMMODITY TRADING INVOLVES A HIGH DEGREE OF LEVERAGE. THAT LEVERAGE ALLOWS FOR LARGE RETURNS BUT ALSO LARGE LOSSES. DUE TO THE HIGH DEGREE OF RISK INVOLVED IN HIGH LEVERAGE, YOU SHOULD CAREFULLY CONSIDER WHETHER COMMODITY TRADING IS APPROPRIATE FOR YOU. AS ALWAYS, MARKET CONDITIONS MAY MAKE IT DIFFICULT, IF NOT IMPOSSIBLE TO EXECUTE LIMIT ORDERS.

	1		**2**	**3**	**4**	**5**	**6**	**7**	**8**
Buy Level	Buy Price	Sell Price	# of Contracts Held	Losing Contracts	Loss Per Contract	Possible Cumulative Loss Per Contract	Possible Cumulative Loss-All Contracts	Cumulative Required Margin	Minimum Account Funds
1	$360.00	$370.00	1	0	$0.00	$0.00	$0.00	$1,100.00	$1,100.00
2	$350.00	$360.00	2	1	$500.00	$500.00	$500.00	$2,200.00	$2,700.00
3	$340.00	$350.00	3	2	$500.00	$1,000.00	$1,500.00	$3,300.00	$4,800.00
4	$330.00	$340.00	4	3	$500.00	$1,500.00	$3,000.00	$4,400.00	$7,400.00
5	$320.00	$330.00	5	4	$500.00	$2,000.00	$5,000.00	$5,500.00	$10,500.00

VALUE INVESTING

MID-SESSION RECAP

We have learned that long term opportunities may exist in commodities and specifically in the platinum and cattle markets

We will now focus on how to capitalize on these opportunities, first through scale trading. Then we will review other possible strategies to capitalize on these opportunities.

We will also focus on possible combinations of these strategies to attempt create good low risk strategies.

9) Since 1990 US beef exports have:

a) Declined by 36%
b) Remained about steady
c) Increased by approximately 27.8%
d) Increased by approximately 105%
e) Increased by approximately 215%

10) Since 1990 foreign beef imports have:

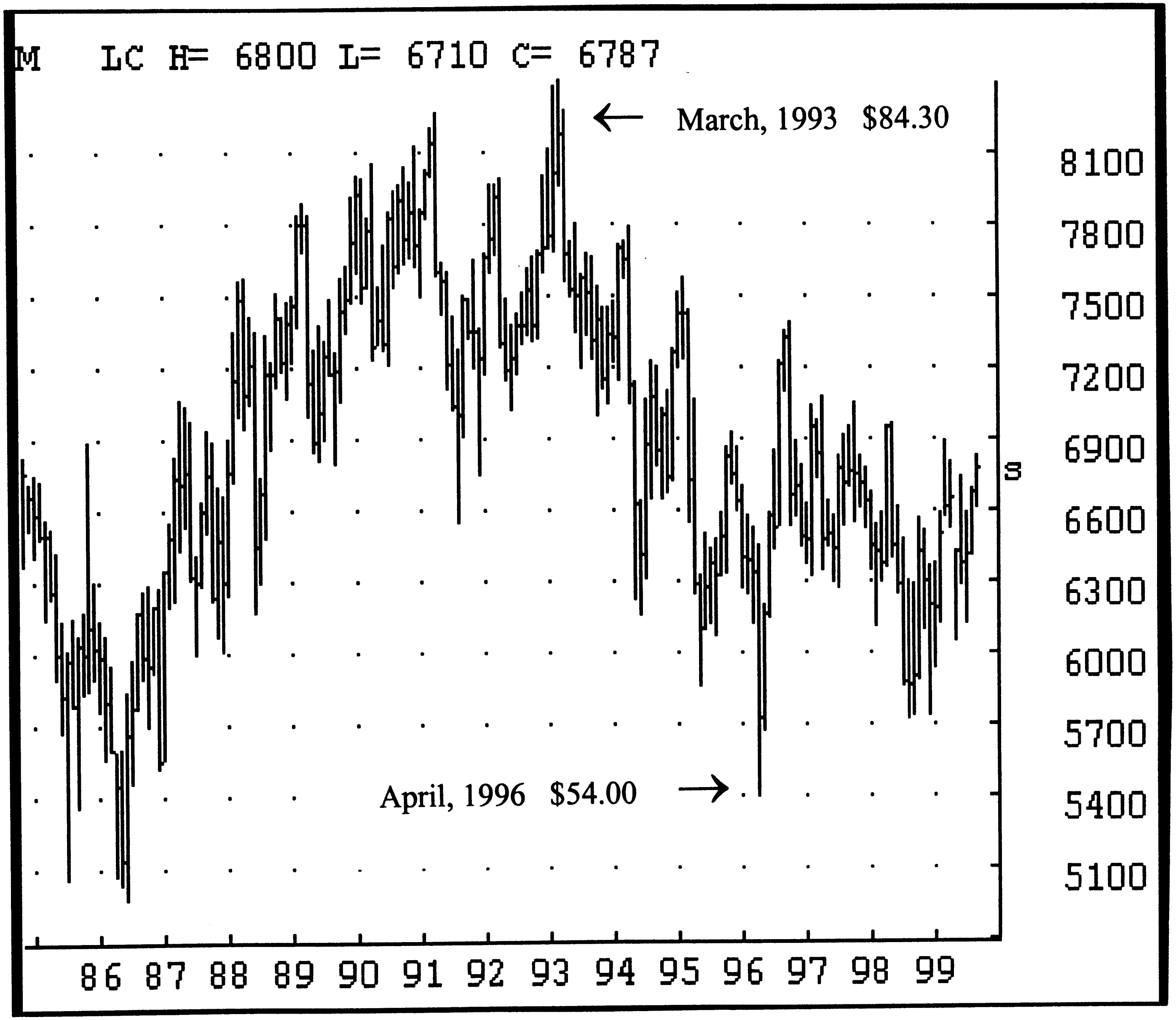
a) Declined by approximately 40%
b) Remained about steady
c) Increased by approximately 75%
d) Increased by approximately 103.5%
e) Increased by approximately 365%

11) Since 1990 the January 1st annual inventory of cattle has:

a) Declined by about 36%
b) Remained about steady
c) Increased by about 36%
d) Increased by about 43%
e) Increased by about 87%

12) Since 1990 the total US calf crop has:

a) Declined by about 10%
b) Remained about the same
c) Increased by about 16%
d) Increased by about 35%


M LC H= 6800 L= 6710 C= 6787
March, 1993 $84.30
April, 1996 $54.00
8100
7800
7500
7200
6900
6600
6300
6000
5700
5400
5100
s
86 87 88 89 90 91 92 93 94 95 96 97 98 99

RECOMMENDED SCALE TRADE PLAN

Commodity:	**Live Cattle**	
Month:	**April**	
Start Price:	**$67.50**	
Maint. Margin:	**$500**	
P or L per $:	**$400.00**	
Buy-Down Incr.:	**$2.00**	
Sell-Profit Incr.:	**$1.00**	**$400**
otal Buy Levels:	**6**	
Cntrcts / Level:	**1**	

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	1		**2**	**3**	**4**	**5**	**6**	**7**	**8**
Buy Level	Buy Price	Sell Price	# of Contracts Held	Losing Contracts	Loss Per Contract	Possible Cumulative Loss Per Contract	Possible Cumulative Loss-All Contracts	Cumulative Required Margin	Minimum Account Funds
1	$67.50	$68.50	1	0	$0.00	$0.00	$0.00	$500.00	$500.00
2	$65.50	$66.50	2	1	$800.00	$800.00	$800.00	$1,000.00	$1,800.00
3	$63.50	$64.50	3	2	$800.00	$1,600.00	$2,400.00	$1,500.00	$3,900.00
4	$61.50	$62.50	4	3	$800.00	$2,400.00	$4,800.00	$2,000.00	$6,800.00
5	$59.50	$60.50	5	4	$800.00	$3,200.00	$8,000.00	$2,500.00	$10,500.00
6	$57.50	$58.50	6	5	$800.00	$4,000.00	$12,000.00	$3,000.00	$15,000.00

14) The country with the largest number of English speaking people is__________.

15) What was the name of the plane that Buddy Holly crashed in?

16) Who won the NBA scoring title last season?

VALUE INVESTING

SESSION REVIEW

In this session we learned that commodities in general may represent a good long term investment.

We learned of two specific commodities, platinum and cattle, whose fundamentals may represent a good long term investment. Using these two markets as examples we learned how to recognize long term value opportunities.

We further learned several methods to use in attempting to profit from these long term value opportunities. We spent most of our time learning about scale trading because of it's potentially superior ability to profit from long term value opportunities.

Crown Futures, The Scale Trading Experts

Crown Futures has eight full time brokers with a wide range of experience in Scale Trading in many different markets. A substantial portion of client equity is committed to this methodology. The support staff are also trained and experienced in the handling of scale trading accounts.

Successful scale trading requires the best sources of fundamental information. Accordingly, Crown Futures not only has access to the research of the major clearing houses but also continually seeks out the best available independent research sources in each market. Crown also periodically conducts it's own research. This rich stream of information is then utilized to evaluate trading opportunities, and to plan and execute the best possible scale trading strategies.

At Crown Futures, we give each client the time and attention necessary to understand not only the rewards, but also the risks of scale trading. We provide hands-on assistance to our clients in making the most productive decisions relating to their investment capital.

For those clients who don't have the time or inclination to research and make regular scale trading decisions, the Crown Value Investors CTA offers a variety of managed scale trading programs. Many of these programs are suitable for traditional investment portfolios, including IRAs.

Trading commodity futures involves a high degree of leverage. While this may result in substantial opportunities, it can result in substantial losses as well. When evaluating any trading recommendation or system, past results are not necessarily indicative of future results. Given these two statements, you need to make an assessment as to whether trading commodities is appropriate for you.