



PROTECTING AND ENHANCING PROFITS WHILE MAINTAINING LONG COMMODITY POSITIONS

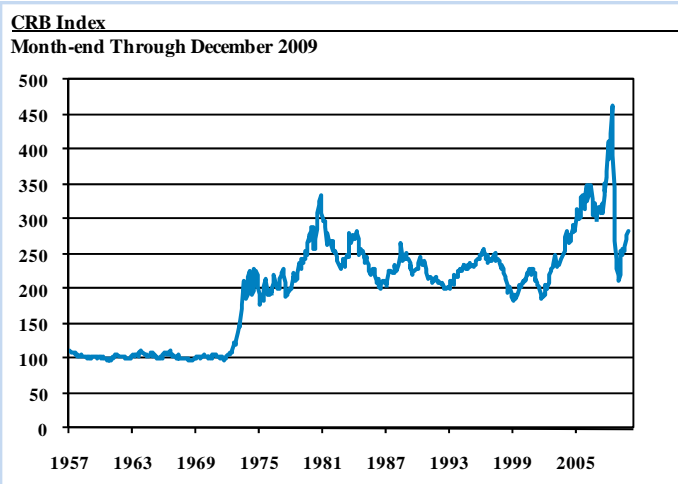
Commodities have gained enormous interest from a wide range of investors. Investors have very large long positions in many commodities markets. While many investors want to maintain their long positions, expecting still higher commodities prices in the months and years ahead, the fact that commodities prices already are up sharply over the past 12 months, and demonstrated their ability to plunge sharply in late 2008 and early 2009, is causing investor concern over maintaining long positions at already high prices.

One solution to this quandary is to maintain one's long position in futures while purchasing out of the money puts. This strategy allows an investor to remain long the underlying commodity, but protect against some of the losses that might otherwise occur if prices decline.

The strategy is simple to execute. When prices rise sharply, an investor purchases a put option, giving it the right to sell the commodity, at a price significantly below current prices. The placement of the put — the price at which the investor buys it — varies depending on the market and the individual investors' risk profiles. If prices fall back, the value of the put often will rise sharply compared to the change in the underlying commodity's price. The investor may sell the put back to the market, even if the price remains above the put's strike price, collecting a profit.

This strategy can be executed in a mechanical fashion, using percentages of price changes as indicators of when to buy and sell puts. Or, it can be executed based on a combination of such market momentum indicators and fundamental or macro-economic views that would flavor the investor's opinions of likely short and long term price moves. For example, should an investor have a given view of copper demand trends in the near term, or seasonal patterns in natural gas demand and prices, these sorts of fundamental variables could help the investor determine when to buy and sell such puts, and what price levels the investor might want to use.

This strategy has two attractions for investors. First, it allows the investor to remain long commodities while hedging or protecting itself from down drafts in prices. Second, it allows the investor to profit from these down-



ward price interruptions, enhancing the investor's overall return on its position in the commodity. If an investor buys and sells options over a long period of time, it is possible for the investor to significantly reduce the effective net acquisition price it paid for the original long investment. CPM Group had a client that bought and sold silver several times over in the 1990s, when silver was trading in a narrow, clearly defined trading range. The investor is estimated to have reduced its net effective acquisition price from around \$5.00 initially to something below \$2.00 per ounce. More recently, several investors appear to have been using this strategy to hedge long gold positions, taking advantages of sharp declines in prices during 2008 and early 2009 to profit from their hedges and reduce their net acquisition prices.

This actually raises something of a theoretical quandary. One of the basic tenets of hedging is that the hedger should not seek to profit from the hedges, but only use the hedge positions to protect the underlying position from adverse price moves. The initial objective of buying the out of the money puts against an underlying long futures position is to protect or lock in some of the profitability of the long position. However, by selling the put hedges back, the investor generates profits. This is extremely attractive. However, it does violate the premise that one should not seek to profit from hedges.

The use of puts to protect long positions in futures is only one strategy available to investors. Some investors actually will reverse the strategy, owing calls to give them the

long exposure they seek and selling futures to hedge against price pull-backs when prices spike to higher levels. Other investors will use different strategies. Another strategy is to liquidate the long futures positions when there are profits imbedded in it and buy calls with a portion, perhaps 5% - 10% of the profits. This capitalizes the profits of the investment, but gives the investor a residual exposure to rising prices in case prices continue to climb.

High and Heading Higher

Commodities prices have risen for several reasons over the past decade. First and foremost, there has been a sharp increase in demand for many basic raw materials, from oil and gas to metals and food, as the world has undergone a historical transformation. Economic liberalization, deregulation, technological innovations, increased international trade and commerce, and the decline of centrally planned economies controlled by governments have unleashed billions of people to become their own economic agents and seek their own good fortunes. As these trends have developed, the world has seen a long-term increase in the demand for natural resources.

Additionally, investors have been seeking better returns than were being offered by equities and bond markets, which led them to move into commodities. Investors also tend to follow prices: As commodities prices have risen, investors became more interested in them.

These trends were interrupted by the recession and financial panic of 2008 and 2009, but they are stronger and longer lasting, and are re-emerging as the world moves away from recession toward economic recovery.

Longer term, fundamental demand for many commodities and tight supplies are expected to continue to exert upward pressures on prices. The continued — indeed, the increased — presence of investors in commodities markets suggest that the rise in commodities prices over the coming decade actually may exceed the increase experienced from 2001 into 2008.

*CPM Group has produced a report, **Enhanced Returns Investing in Commodities**. This 13-page report discusses the advantages to investors of maintaining long positions in commodities, but hedging them by purchasing out of the money puts. The report discusses a few simple strategies that investors may use and provides a hypothetical example of how such a strategy could have enhanced returns in a long silver investment position over the past two years. Available in downloadable Acrobat PDF format. \$30. <http://store.cpmgroup.com/op2009.html>*