Commitments of Traders .com **Special Report:**

Who are the "Smart Money?"

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All aspects of any trade recommendations contained in this report are subject to modification at any time.

FUTURES TRADING INVOLVES SIGNIFICANT RISK OF LOSS AND IS NOT SUITABLE FOR EVERYONE AND THE RISK OF LOSS SHOULD BE CONSIDERED CAREFULLY BEFORE MAKING ANY TRADES. A STOP LOSS MAY NOT LIMIT YOUR LOSS TO THE AMOUNT INTENDED. YOU SHOULD BE FOREWARNED THAT SYSTEMS WHICH TRIGGER FREQUENT TRADING SIGNALS AS PART OF A DAY TRADING STRATEGY CAN RESULT IN SUBSTANTIAL COMMISSIONS AND FEES. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. ANY STATEMENT OF FACTS HEREIN CONTAINED ARE DERIVED FROM SOURCES BELIEVED TO BE RELIABLE, BUT ARE NOT GUARANTEED AS TO ACCURACY, NOR DO THEY PURPORT TO BE COMPLETE.

ANY REFERENCE TO PERFORMANCE IS INTENDED TO BE UNDERSTOOD AS STRICTLY THEORETICAL.

REGULATORY DISCLOSURES REGARDING HYPOTHETICAL RESULTS

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.

ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. THE RISK OF LOSS EXISTS IN FUTURES TRADING.

NF 9-21-2002

Who are the "Smart Money?"

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The Net Commercial Position in the S&P Futures has been heralded as one of the top "Smart Money" indicators in calling the Stock Market top in early 2000. What is it? Who is it? Are they the *"Smart Money?"*

Monitoring the "Net Commercial Position" in the Commitments of Traders (COT) Report is often called "following the Smart Money" and has proven to be a useful tool in calling turning points in many different markets.

The net commercial position in the S&P rose to it's largest net short position in May of 2000 and then grew even shorter. The placing of large hedges against portfolios of stocks during mid 2000 proved to be a great move. This article provides background to help the reader understand the COT Report and understand who is the "smart money."

Let's review some terms before we begin using the information as a stock market indicator.

The "Commitments of Traders Report" (COT) is published each week by the Commodity Futures Trading Commission (CFTC). The CFTC is an agency of the US Government that was created in 1974 and is charged with the responsibility to regulate commodity futures and option markets in the United States. The agency protects market participants against manipulation, abusive trade practices and fraud. Their oversight and regulation of the markets serves the nation's economy by providing a mechanism for price discovery and a means of offsetting price risk.

Commitments of Traders Report

The CFTC receives daily reporting from the clearing firms on the large traders. The CFTC compiles and analyzes the data and separates the large trader accounts between commercial hedgers and speculators. The CFTC does not release each day's information. On Friday each week, the CFTC makes public the accumulated and analyzed information received on the large traders as of the previous Tuesday's close in a report titled "The Commitments of Traders Report." The report covers every commodity futures market and is published each Friday evening at http://www.cftc.gov . In the report, it tells the size of the large trader positions in the categories of the large traders that have hedge accounts (called the commercials, or hedgers) and those that do not have hedge accounts (called the large speculators). The balance of the open interest are the positions in accounts that are under the reporting levels (called the small speculators.)

Following is the "short form of Commitments data from the CFTC web site for S&P futures at the CME for 12/23/02:

(http://www.cftc.gov/dea/futures/deacmesf.htm)

S&P 500 STOCK INDEX - CHICAGO MERCANTILE EXCHANGE

REPORTABLE POSITIONS AS OF 12/23/02

NON-COMMERCIAL			COMMERCIAL		TOTAL		NONREPORTABLE POSITIONS	
LONG	SHORT	SPREADING	LONG	SHORT	LONG	SHORT	LONG	SHORT
(S&P 500 INDEX X $250.00)						OPEN INTEREST:		578,658
COMMITMENTS								
29,578	51,431	1,732	408,592	467,259	439,902	520,422	138,756	58,236
CHANGES FROM 12/17/02 (CHANGE IN OPEN INTEREST: -133708)								
-3,124	-21,673	-17,831	-56,769	-61,637	-77,724	-101141	-55,984	-32,567
PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS								
5.1	8.9	0.3	70.6	80.7	76.0	89.9	24.0	10.1
NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS: 150)								
23	16	11	86	63	117	82		

Reporting Levels

In performing their oversight of the markets, the CFTC requires the brokerage firms that hold regulated commodity contracts for their customers to file daily reports with the Commission. Those reports show the futures and option positions of traders that hold positions above specific reporting levels set by CFTC regulations. The reporting levels are set so that the holders of 70% to 90% of the outstanding futures contracts in each market are reported to the agency for monitoring.

When an account is reported to the CFTC as holding positions above the specified reporting level number of contracts, the CFTC determines if the account is a commercial hedger or a large speculator.

Commercial Hedgers

The CFTC classifies a futures account that meets the reporting level as a "commercial" when that account holder files a statement with the Commission that states it is commercially engaged in business activities hedged by the use of the futures or option markets.

The "commercial hedger" in the "physical commodity" markets can be both a producer of the physical commodity (gold mine, farm) and/or a user (jewelry manufacturer, food processor) of the physical commodity. A commercial hedger uses the futures markets to lock in revenue or costs by transferring market risk to speculators.

When a commercial user of the futures market buys futures to hedge market risk he is generally buying because he feels he can hedge future production cost at an advantage. For example, a cattle feed lot might hedge future grain cost by buying futures when they feel the futures price is attractive to their cost of production. A farmer might sell futures to lock in the price (hedge) of a future crop harvest. An airline might buy energy futures when crude oil is considered low per barrel to lock in the energy costs of the airline out a year or more in time.

The "commercial hedger" in the financial futures markets can be both a producer and an investor in the underlying financial market. A Real Estate Mortgage lender might accumulate loans to package them for sale in the Collateralized Mortgage Market. While he is accumulating the group of loans for sale he might use financial futures to hedge the risk of interest rates moving prior to his sale of the package. A manager of a portfolio of stocks (ie a pension plan, endowment, mutual fund, insurance company) can use the stock index futures to hedge from a possible decline in value of stock market prices.

Large Speculators

The commercial hedger is a commercial enterprise that uses the futures markets to transfer market risk to the speculators. The speculator buys or sells in the futures market with a expectation of profiting on a price movement. The speculator assumes the risk the hedgers are trying to avoid. The CFTC classifies the large reported futures accounts that are not "large commercial hedgers" as "large speculative accounts."

An example of a large speculative account might be a large commodity pool (a fund) that trades futures for speculative profit. Managed Futures Accounts have grown into the billions of dollars under management and those accounts, if they meet the reporting levels, would be reported to the CTFC for monitoring.

The reporting levels vary by market. In smaller markets, a large individual account might be reported to the CFTC. In coffee the reporting level is 50 contracts. A speculative account that has 50 coffee contracts would be reported to the CFTC each day by the brokerage firm holding the account.

In the S&P futures the reporting level is 1,000 contracts. 1,000 S&P futures would have a margin requirement of more than $25 million and an underlying value of about $350 million. (The reporting level in E-Mini S&P futures is 300 contracts.) Current reporting levels for all commodities is published at http://www.cftc.gov/foia/fedreg00/000317a.htm

Small Speculators

All traders, speculative and commercial, that have less than the reporting level are considered the "small speculators."

Open Interest, Reportable positions

The open interest in a futures contract is the number of open positions. Each long position in a traders account is offset by a short position in some other traders account. If we add up all the short positions, that will equal the open interest. If we add up all the long positions, that will also equal the open interest.

The arbs

Arbitrage is defined as the simultaneous purchase and sale of similar commodities in different markets to take advantage of price discrepancy. Arbitrage opportunities arise in the financial markets when demands on liquidity drive prices to a premium over or a discount under the "fair value."

Many of the speakers and writers about the "smart money" net commercial positions in the stock index futures confuse and co mingle the arbitrage activities with the hedging activities.

A CFTC economist (David Kass) that deals with classifying accounts as commercial or speculative, explains that stock index futures held by firms that deal in arbitrage as a business activity are classified as speculative accounts. He said there are also accounts that primarily use stock index futures for hedging portfolio risk, but also participate in arbitrage as a form of portfolio enhancement. He said when the arbitrage activity is secondary to the primary hedging activity the account would be fully classified as a commercial hedger.

See the separate insert below for a more detailed explanation of stock index arbitrage.

So now we can understand the classifications of the data in the CFTC Commitments of Traders Accounts.

The large accounts are reported to the CFTC. The CFTC separates the large reported accounts between "Large Commercial Hedgers" and "Large Speculators". The balance of the open interest that did not meet the reporting level are classified as "Small Speculative Accounts."

Why do we call the Large Commercial Hedgers the "smart money?"

Why do we call the Large Commercial Hedgers the "smart money?" They built their largest net short positions in the S&P into May of 2000, and the S&P fell dramatically until September of 2001 before they substantially reduced their portfolio hedges. It is their track record of being short at the tops and reducing those shorts at the bottoms that leads us to call them the smart money.

But not all commercials hedgers are on the same side of the market at the same time. We need to look at the details of the weekly report to see that it is the **net** combined balance of long commercials and short commercials that leads us in the right direction.

The weekly COT Report.

The weekly COT Report tells us the total of the long speculative accounts and short speculative accounts, and the total of the long commercial hedge accounts and short commercial hedge accounts. By knowing the total open interest, the balance tells us the total long small speculative accounts and short speculative accounts.

The Report issued on February 2 for the reporting day of January 30, 2001, detailing the information on the S&P 500 Stock Index Futures at the Chicago Mercantile Exchange is shown in the following box:

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-------------------------------------------------------------------------------------------------------
      :  TOTAL  :                      REPORTABLE POSITIONS                       :
  F   :---------------------------------------------------------------------------: NONREPORTABLE
  U   :         :        NON-COMMERCIAL         :               :                 : POSITIONS
  T   :         :-------------------------------:               :                 :
  U   :   OPEN  :   LONG OR SHORT: LONG AND SHORT: COMMERCIAL     :      TOTAL      :
  R   : INTEREST:       ONLY     :  (SPREADING)  :               :                 :
  E   :         :--------------------------------------------------------------------------------------
  S   :         :    LONG : SHORT:   LONG : SHORT:   LONG : SHORT:   LONG : SHORT:    LONG : SHORT
-------------------------------------------------------------------------------------------------------
      :         :(S&P 500 INDEX X $250.00)                                        :
      :         :                                                                 :
ALL   :  482,277:  26,490   6,709   1,510   1,510 325,440 418,655 353,440 426,874: 128,837  55,403
OLD   :  482,277:  26,490   6,709   1,510   1,510 325,440 418,655 353,440 426,874: 128,837  55,403
OTHER :        0:       0       0       0       0       0       0       0       0:       0       0
      :         :                                                                 :
      :         :          CHANGES IN COMMITMENTS FROM January 23, 2001           :
ALL   :   -4,134:     108   1,428      11      11  -4,948  -2,786  -4,829  -1,347:     695  -2,787
      :         :                                                                 :
      :         :PERCENT OF OPEN INTEREST REPRESENTED BY EACH CATEGORY OF TRADERS:
ALL   :  100.0% :     5.5     1.4     0.3     0.3    67.5    86.8    73.3    88.5:    26.7    11.5
OLD   :  100.0% :     5.5     1.4     0.3     0.3    67.5    86.8    73.3    88.5:    26.7    11.5
OTHER :  100.0% :     0.0     0.0     0.0     0.0     0.0     0.0     0.0     0.0:     0.0     0.0
      :---------:                                                                 :
      :NUMBER OF:                                                                 :
      :TRADERS  :               NUMBER OF TRADERS IN EACH CATEGORY                :
      :---------:                                                                 :
ALL   :    137  :      16       9      10      10      89      64     109      79:
OLD   :    137  :      16       9      10      10      89      64     109      79:
OTHER :      0  :       0       0       0       0       0       0       0       0:
      :------------------------------------------------------------------------------------------------
      :                                 CONCENTRATION RATIOS
      :         PERCENT OF OPEN INTEREST HELD BY THE INDICATED NUMBER OF LARGEST TRADERS
      :------------------------------------------------------------------------------------------------
      :             BY GROSS POSITION              :              BY NET POSITION
      :------------------------------------------------------------------------------------------------
      :   4 OR LESS TRADERS   :  8 OR LESS TRADERS   :  4 OR LESS TRADERS  :  8 OR LESS TRADERS
      :------------------------------------------------------------------------------------------------
      :    LONG   :   SHORT   :   LONG   :  SHORT    :  LONG   :    SHORT   :  LONG   :    SHORT
      :------------------------------------------------------------------------------------------------
ALL   :    22.9        32.8          31       50.8       22.8         32.7      30.1         49.7
OLD   :    22.9        32.8        31.2       50.8       22.8         32.7      30.1         49.7
OTHER :     0.0         0.0         0.0        0.0        0.0          0.0       0.0          0.0
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We can see in the first columns that the non-commercial longs of 26,490 contracts versus the non-commercial shorts of 6,709 say the large speculators have a clear vote for the long side of the market.

The commercial columns tell us an incredible story. There are long hedges of 325,440 contracts and short hedges of 418,655 contracts. This is clearly a "Clash of Titans." The 325,440 contracts long represent an underlying index value, (at 1400.00 on the S&P 500 index at $250 per point equals $350,000 per contract) of $113 billion. The short position of 418,655 contracts is $147 billion dollars of underlying stock index value. So the hedgers are net short 93,215 contracts or $34 billion of underlying stock index value, which was an all time record net short.

At that time, the all time record net long position of the net commercials was 40,728 contracts. Now that we see the details, for the current record net short position to swing to a record net long position does not seem like such an incredible task when it could be accomplished by simply a 20% decrease in the short positions and a 20% increase in the long positions.

When the net plurality of the large commercial portfolio hedgers get bullish and lift their hedges, the COT Report will be able to ring a clear signal that the "Smart Money" has changed their mind about the market.

But the Large Specs are "smart money" too, or they wouldn't have accumulated so much money to be able to hold such large positions. The large spec commodity trading advisor over the large commodity pools (funds) generally build their large positions following the trend. In my Commitments of Traders Web site, (www.commitmentsoftraders.com) I suggest traders should follow the large specs to tell them what the large specs think of the overall trend. It is ONLY when the net commercial position is near the five-year net record that I suggest the trader consider following a market movement in the direction of the net commercial position. The hedgers are generally in early before the trend change and build a position over time.

George Slezak,
Commitments of Traders .com
December, 2002

George Slezak is a commodity broker and has a web site titled www.commitmentsoftraders.com. Each week he publishes summaries of the COT Report and free commentary, and shows a 12 week summary of the net data for each category of commercial, large spec and small spec. The tables include the 1, 3, and 5 year range of the net positions to help decide if the current positions may be significant indicators of a price judgment. The web site also has long term charts (1 year, 3 year, and 10 year) with the COT data plotted over the price history of selected futures markets.

George has another web site titled *www.* ***Stock Index Timing*** *.com* where he makes stock Index market timing recommendations based on the Commitments of Traders information for the Stock Indexes.

For more information, call George at 1-888-311-3400

Stock Index Futures Arbitrage

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The following explanation of the stock index futures arbitrage is intended to help the reader make an informed judgment about the Commitments of Traders Report open interest summaries in the stock index futures.

In the stock index futures, arbitrage is accomplished by the simultaneous buying or selling of a basket of stocks that equals the stock index. In the S&P 500 futures arbitrage the entire 500 stocks in the S&P are bought or sold in the proportions of the stocks in the index as defined by Standard and Poors. The 500 stocks are "programmed" into computers to execute the transaction in the appropriate number of shares to match the weighting in the index on the stock exchange at the same time that the futures are bought or sold.

Buy Program

In a "buy program" the 500 stocks are bought and the futures are sold at a premium over the cash price of the stocks to compensate the arbs for transaction costs, cost of carry (interest rate cost less dividends) and some speculative premium as compensation for the activity.

The futures held in accounts as the result of arbitrage might be classified as speculative, or, as commercial.

Stock index futures arbitrage can be done by individual firms that are in the business of arbitrage and actively trade in and out of the position. Many of the major wall street firms do stock index arbitrage futures for the house account. The CFTC does not consider an arbitrage business activity a business that uses futures to hedge commercial risk. They consider arbitrage activity to be a speculative activity of buying and selling. If an arbitrage account holding these futures was reportable (over 1,000 contracts) the account would be considered a large speculative account.

Some of the accounts that use futures to hedge portfolio risk also participate in stock index arbitrage and refer to the profit incentive of the arbitrage activity as portfolio enhancement. Let's say there is a major endowment fund that indexes a portion of it's investment portfolio to the S&P, and that fund uses the stock index futures to hedge risk when in the portfolio manager's judgment there is a possible market decline. The futures activity is primarily a hedging activity. They might also place orders with the trading firms to swap their individual stock baskets for futures if it can be done in a way that "locks" in a benefit to the portfolio. Since the primary use of the futures is to hedge, the entire account, including the arbitrage positions, would be classified by the CFTC as a "commercial account".

Fair Value, Baskets, Program Trading

When the arb buys the basket of stocks he is buying a portion in each of 500 different markets. In some markets he may be buying 1,000 shares, in others less than 100. It all depends on the weighting of the stocks in the index. Standard and Poors publishes the precise weighting that their computer use to calculate the index. Some of the markets may have a bid ask difference of an eight of a point, and some may have a bid ask difference of a half point or more. When they buy on the offer of each of the 500 stocks the price they pay is usually points higher than where the index was a moment ago. The computer screens show the added up bid and ask of the 500 stocks and the spread is often many points in total.

Since the basket trade will move the 500 stocks to all trade at the offer price at the same time, an arbitrage program trade will not be triggered until the futures price is pushed to certain value over fair value before the arb attempts a program trade offset by a future. If fair value were say, 8 points over the cash index, the arb might not attempt a buy program trade until the futures were 10 points over the cash index. He would need this extra spread over fair value to compensate for the effect of the bid ask spread on the individual 500 stocks. Same for a sell program. If fair value were 8 points over, the arb might not sell the basket unless the futures were only 6 points above the index. So the spread around fair value for program trading could be from 6 points over for sell programs to 10 points over for buy programs.

Trading at a Discount to the Index

Merely the fact that the futures are trading under the value of the index does not mean that sell programs will hit, nor that the futures are under value or over value. It depends.

Fair value is calculated considering the interest cost of carrying the 500 stocks offset by the dividends received between a given day and the expiration of the future. There are times, as you get to within a few weeks or days to expiration of the future where the fair value difference over the index could be near zero, or even under the cash index price. If fair value were zero, the buy program might be done when the futures are 2 points over the index and sell programs when the futures are 2 points discount to the index.

But how does the market move to a premium over fair value?

The S&P trading pit on any given day has about 300 to 500 "locals" trading in the pit. Locals are generally individuals that trade for their own account. They generally trade by trying to get an edge by buying on the bid and selling on the offer for a "scalp." Sometimes they might hold a trade for a day trade that is going their way for more than just a tick. Very few locals carry risk positions overnight.

If the market is somewhat in balance between buyers and sellers, the locals are busy buying on the bid with the momentary trend and selling higher on the offer. Or, selling first when there is a downswing and trying to buy lower. (In futures trading there are no "up tick" rules like there are in stocks. You can initiate a trade buy either buying first, then selling. Or, short selling first, then buying.)

If the market starts to show some extra strength, the locals that sold first now have to bid higher to other locals to get their position back. If the market is only buyers coming in, then those locals have to bid higher to get their position back. As this is happening, the stocks in the index are also showing strength, so the local has to bid the market up faster than some other local and also faster than the index going up. This is how the premium value of the futures over the index moves up to an amount over the fair value of the index at the moment, to induce the arbs to do a buy program to provide liquidity to the pit.

At this point, the arb broker who is in the pit might signal to his desk to hit the button to buy the 500 stocks. When he knows the stock trade is done, he will sell an offsetting number of futures. Programs are usually done as 100 futures and have a stock value with the index 1400 of $35 million each (1400 X $250 per point times 100 futures.) When he successfully completes one transaction he does it again and again, until the futures price falls back in line with the index price.

His trade is not without peril. He can push the button just as the market tops and turns down. Then he is caught and has to sell the futures locking in a loss. There are also times when after pushing the button the market continues higher and he sells futures to lock in a better gain than expected.

So the program trading begins when the pit no longer wants to provide the temporary liquidity to the market. There are many things that drive the futures value to above or to below fair value. Usually the events that drive the futures higher are also driving the stocks higher and the stock option markets higher. Many stock option and stock index option traders provide liquidity to their markets by arbing against the stock index futures. When they push to complete their arb, it can snowball in the pit to push for the program trade arb. They are all interrelated, they are all what make the market work.

We almost have enough information on what makes up the total open interest in the stock index futures to evaluate the information in the COT Report, but let me explain one more very important thing.

Expiration and the Roll

The reason the stock index futures can be used to hedge stock portfolios that track the underlying index (ie the S&P) is because at expiration, the futures will equal the value of the index, to the penny. The expiration of the futures is the exact price of the index at the stated expiration moment. In the case of the S&P future, the index "settles" at the added up first print of the open of each of the 500 stocks on the expiration. Therefore, if I want to liquidate my arbitrage or liquidate the hedge of futures against an indexed basket of stocks, I could sell all 500 stocks on the expiration day open and the sales price of the stocks would exactly equal the amount I would have to pay on the expiring short future. So the hedge placed weeks or months before the expiration will in effect be a complete sale of the indexed portfolio that was hedged. In this case the number of futures open interest the day after expiration would decrease by the number of futures that were cashed in.

Or, let's say the investment portfolio uses stock index futures to adjust the stock market portion of a portfolio balanced between the stock market and bond market. The portfolio can buy or sell futures to quickly and efficiently rebalance the stock market side of his asset allocation. (And possibly use Bond or Note futures on the interest rate side of the portfolio.) At the expiration of the futures contract, the portfolio manager might not want to sell out his stocks and cash in his futures. He might want to keep the hedge in place in the existing proportions. To continue his futures position past the expiration he could roll his futures position to the next futures contract month. Let's say he was short 2,000 December futures ($700 million underlying value) and to roll the position he would sell 2,000 March futures and buy 2,000 December futures. After the roll transaction, he would still have his $700 million hedge of his stock portfolio in place. He would accomplish the transaction by selling the spread. At one net spread price he would buy the December contract an sell the March contract. The spread price would be a carefully calculated price representing costs interest and dividends of the portfolio for the precise period of time. The spread price would be a price near the appropriate value (fair value) that would take into consideration costs interest and dividends. If the spread price were not near the fair price, the portfolio manager would simply sell stocks on the expiration and pay out the index price on the futures settlement.

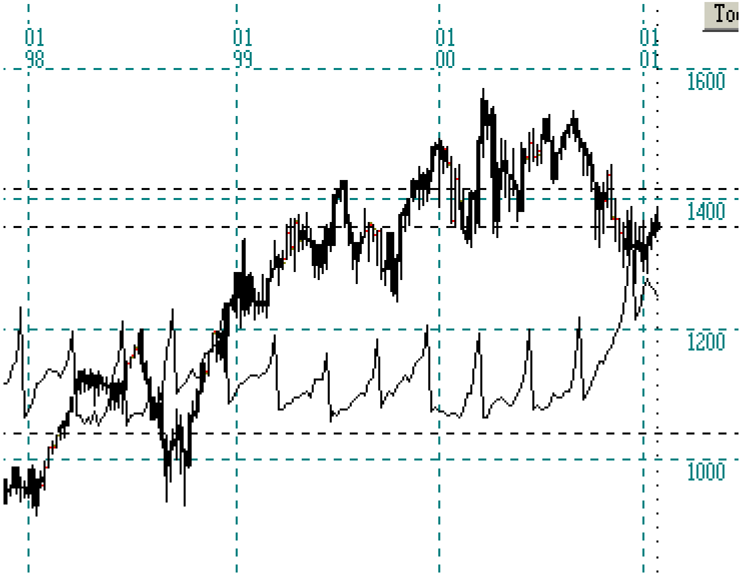
Just as in the above case where a portfolio manager might want to keep his hedge in place past the expiration, a speculative investment pool might want to keep their long position in stock index futures past the expiration. The pool would then be a buyer of the March contract and seller of the December contract in a spread.

Locals in the trading pit buy and sell the spreads with a bid/ask differential to facilitate to roll of the contracts. The spread price is a function of interest rates and dividends and therefore the spread price can move higher or lower during the weeks where the roll is active.

At expiration, a speculative holder of the futures contract can decide to cash out the futures contract or roll the futures contract to the following contract month. A commercial hedger that is holding futures contracts against his portfolio can also decide to cash out the contract or roll the contract. But it does not make a lot of sense that either party, the speculative long or the hedged short, would reduce his position just because it is the third Friday of the Month. They tend to be the buyers and sellers of the spread meeting in the open market place to roll their positions into the next contract month.

It is the Arbs that have an economic reason to close their position at expiration. If you see a chart of the open interst of the stock index futures you will see the line rise steadily, then fall in a blip at the quarterly expiration. This is the arbitrage traders unwinding their positions at the precise opening price of the stock index that is used for the expiration. During the quarter they entered into each individual basket arb with the understanding that if they held it to expiration they would realize their locked in arbitrage profit. If the market offers them opportunity to do as many buy baskets as sell baskets then they would not have positions to liquidate at expiration. But this just isn't usually the case, and the drop on open interest on the expiration is simply the arbs cashing in their position.

If you study the open interest line on a graph you will see an underlying trend in the line outside of the blip that represents the underlying growth on the commercials in using the stock index futures for portfolio adjustment.



Weekly S&P with total open interest plotted.

George Slezak

Feb. 2001

Is the net commercial position a reflection of the opinion of the "smart money?"

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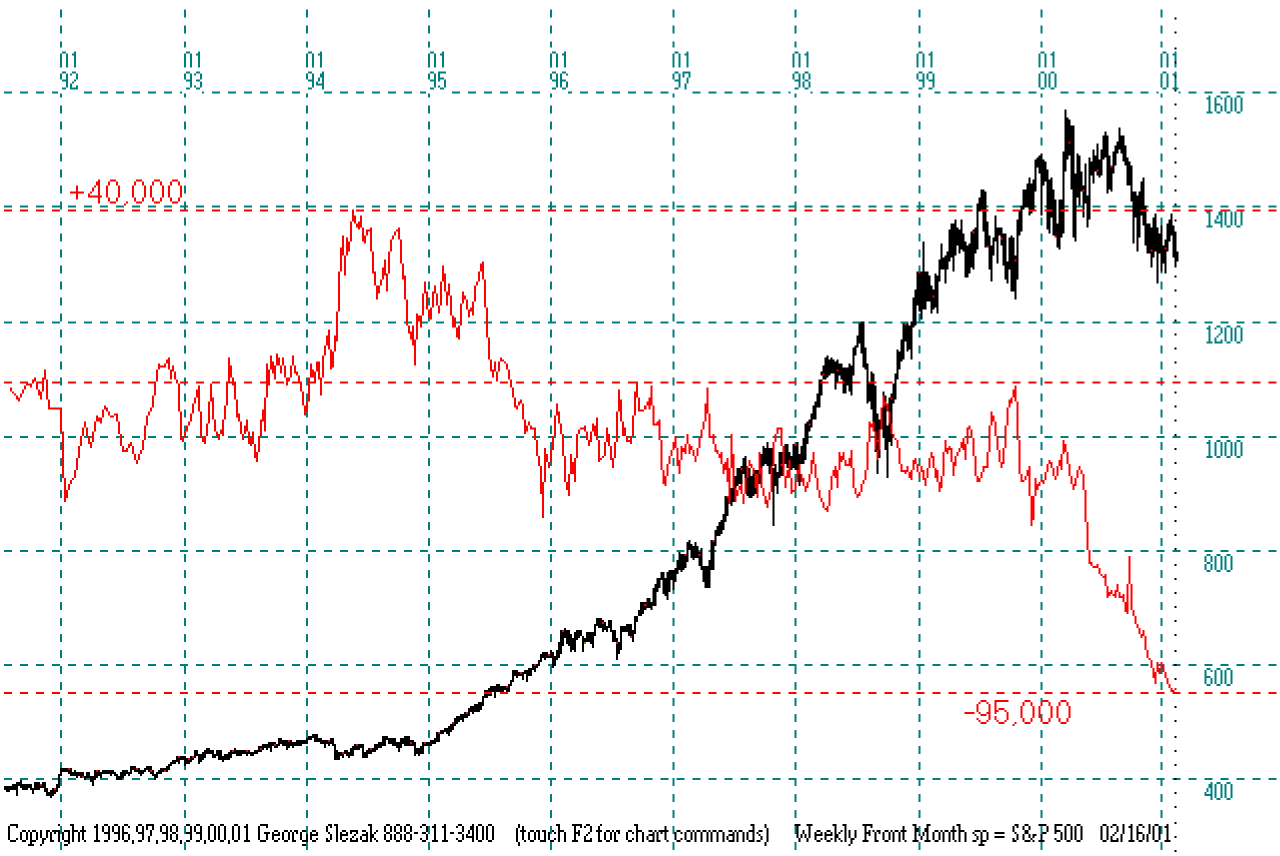
At George Slezak's www. Commitments of Traders .com web site, each week he updates the following long tern chart of the S&P futures with the net commercial position plotted over the futures prices. The comparison shows the net commercial position at an all time high near the market bottoms of 1994, correctly calling the following five year bull market. This indicates the portfolio managers that use the futures to hedge market risk had their hedges at minimal levels and in fact were net buyers of futures anticipating the market rise.

The net commercial position in the S&P futures have been at record net short levels since March of 2000, and have dramatically expanded that net short position continuing to establish new record net short positions each month since March 2000.

You can see why many traders and investors check the net commercial position in the S&P each week to see if the "smart money" portfolio managers see enough value in the stock market prices to begin lifting the portfolio hedges.



George Slezak, Feb. 2001