THE VALUE VIEW *GOLD* REPORT

Disciplined Analysis of GOLD

"Purchase Timing For Profits"

Futures are markets on which mush misunderstanding exists.
Following are extracts, from issues in 2011, on how futures work.

FUTURES: BACKWARDATION

From April 2011 issue.

PRICES FOR DELIVERY IN FUTURE: A high level of discussion has been noted on shape of price curves in various markets for future delivery. In large part, most of this discussion demonstrates a lack of understanding of the mathematics of finance.

To understand a price curve in a market for future delivery it is necessary to look at the basic, or normal, structure as the present value of a common, one year, discount loan. Term "normal" is used to describe a market without any unusual factors existing. We will also ignore margin, as that is simply a matter of how the lender, the buyer, finances the loan.

For the above graph, we chose the market for broom handles. That choice eliminates any discussion of unusual factors. Broom handle demand is stable and well known. Demand does not respond to changes in income or economic activity. Suppliers are constant in number, and have ample capacity. Price of broom handles is $1 in today's dollars, and expected to remain at that level.

Suppose for some reason a broom handle manufacturer had some need to raise money. She would like to sell the broom handles she will have available a year from now, T+1, today. The lender, or the buyer of the contract, is going to deliver money today to the broom handle maker in exchange for repayment in one year. She will repay that loan by delivering broom handles which the lender, buyer of the contract, will then sell, satisfying the loan.

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Value of that contract for future delivery is present value of a single payment, discounted loan.

$$\text{PV of loan} = \frac{\$\ 1}{(1 + r)^n}$$

where: r = appropriate discount rate(10% in this example)
n = period of time in years

So, today's value of the delivery of a broom handle one year from now is $0.91. The lender, the buyer of the contract, is willing to pay the broom handle maker, contract seller, $0.91 today for something worth $1 one year from now. By the same math, a lender, buyer of the contract, would be willing to lend, or pay, ~$0.83 today for the repayment of $1, in the form of broom handles, two years in the future. n is 2 in this case.

This math yields the price curve for broom handles to be delivered in the future shown in the graph at the top of the previous page. It has a negative slope naturally, due to the math. That shape is referred to as backwardation.

What does that curve say about supply and demand in the market for broom handles? It says it is in balance. It does not necessarily say that broom handles are in short supply today or will be in over abundance tomorrow. We defined the situation as being in balance. Deviations of the price curve from this theoretical model may say something about the market for broom handles, but that is for another day.

That price curve, and the associated math, explains why rolling contracts for future delivery can be profitable under backwardation. Note that r was positive, in this case 10%. With backwardation, the r is positive.

We can now use this understanding to appreciate why rolling contracts for future delivery under contango works against the investor. The only way to get a positively sloped price curve, contango, for the future delivery of broom handles is for the denominator in the fraction above to be less than one. That can only happen if r is negative.

More on this at some later date.

HOW TO LOSE MONEY IN THE FUTURES MARKET

From the April 2011 issue.

We at the present time have so little to worry about that is really important, we decided to talk about how to lose money in the futures market. While that would seem easy to do, we seriously want our readers to understand that analysts are not allowed to make up views or concepts for the markets.

Some of this stuff has been understood for a long time, and is not open to creative interpretation. Wheat futures traded in Egypt in the time of the Pharaohs. Mechanics of the futures market were well established in Amsterdam by end of the 17th/early 18th century. This is not new science that allows for any interpretation. Neither is it Ned's theory, but rather what the math is.

First to understand is that futures contracts are contracts for future delivery, not investments. They have a stated maturity for performance, and that maturity is an important matter.

Suppose the spot price for broom handles was $1, and the 3-month contract for future delivery was selling at $0.50. Such would be an example of backwardation. No change in spot price of broom handles will occur.

An investor buys the three-month contract for $0.50 and holds to maturity. Three months later the contract matures, ceases to exist, and is paid off by the delivery of broom handles. Investor sells the brook handles in the market for $1.00, pocketing a

$0.50 profit. Investor still has the original $0.50 with which to buy another three-month contract. In this example where the level of prices does not change, backwardation creates an "automatic" profit. That is the "r" in the formula.

Assume now that the market for broom handles is in contango for some reason. The three-month contract now sells for $1.50. Investor buys the contract, and holds to maturity. In three months the contract matures, and the broom handles are delivered to the investor.

Investor sells the broom handles in the spot market for $1.00, the prevailing price. Having paid $1.50 for the broom handles, the investor now has a LOSS of $0.50 per broom handle. Further, the investor lacks sufficient funds to buy another contract.

Contango has been a serious problem for some ETFs that use futures. Many booked repetitive losses on their positions in futures. For that reason, we would avoid ETFs that use futures when contango exists in the futures market.

More on this next month. In particular, why prices in the futures markets are not the future prices for a commodity, but rather today's price for future delivery. Two totally different things.

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