

Commitments of Traders as a sentiment indicator

By Stephen E. Bries

In the past, conventional market sentiment indicators have been criticized for deficiencies such as the delay involved in reading market letters, weighing their content, estimating their influence on public traders and publishing the results. Also criticized has been the lack of precision (and potential conflict) in polling short-term investors such as pit traders and in projecting public trader market positions from a poll of market gurus, especially given the growing reliance on personal computers.

I designed the Commitments of Traders (C.O.T.) Index to address some of these deficiencies. Because an accurate survey necessitates some time delay, I have concentrated on the longest timeframe trader — the large commercial hedger. These market insiders are required to report their actual market positions daily to the Commodity Futures Trading Commission (CFTC).

Using actual market positions eliminates the margin of error inherent in the polling process and accounts for traders who don't follow trading advisors. Of course there are trade-offs but, as will be shown, these are not fatal. The CFTC reports actual trader positions only once a month. While this frequency is less than optimum, the quality of the data more than compensates for this inconvenience.

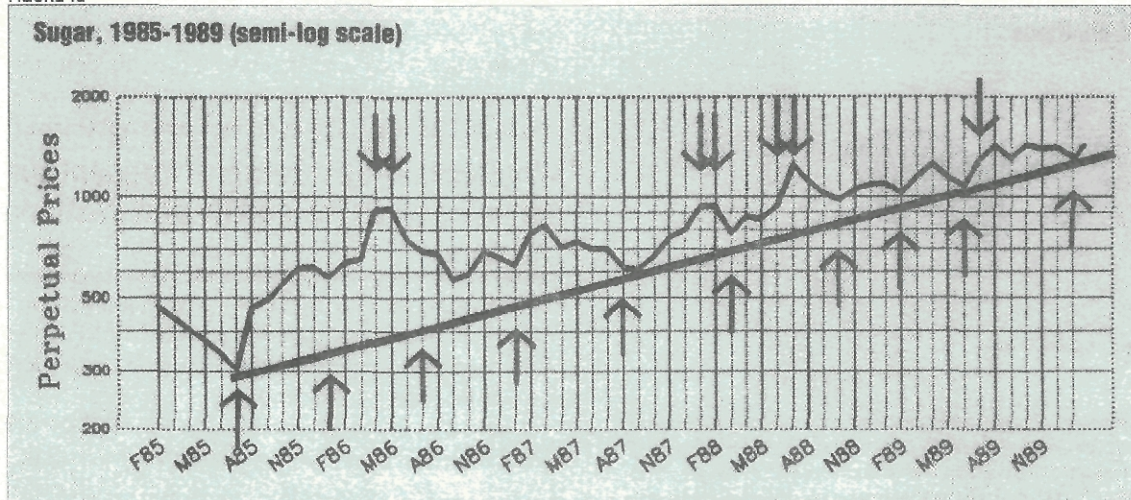
This report, *Commitments of Traders in Commodity Futures* (see related article, "The Commitments of Traders report") is the only source for factual insight into the market positions of key trader groups.

Many traders ignore this important resource because of a common misconception that the information is too old by the time the report is received. Although the CFTC does take nearly a month to print and mail the report, it actually releases the data to the press within four to six trading days of compilation. Most wire services transmit the data the following morning. Several weekly chart services display the data (in a variety of formats) on a timely basis. Traders can use these tables or charts to gauge the intensity of buying or selling of each of the three trader groups — hedgers, speculators and small traders.

Published research on *Commitments of Traders* data is meager. What has been released largely pre-dates important modifications made by the CFTC in 1982. Publication was suspended during that year. When the report was revived in January 1983, both the data collection procedure and the

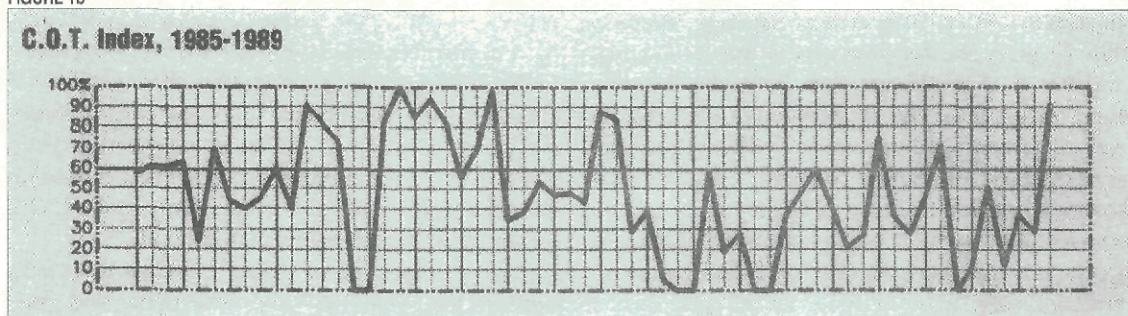


FIGURE 1a



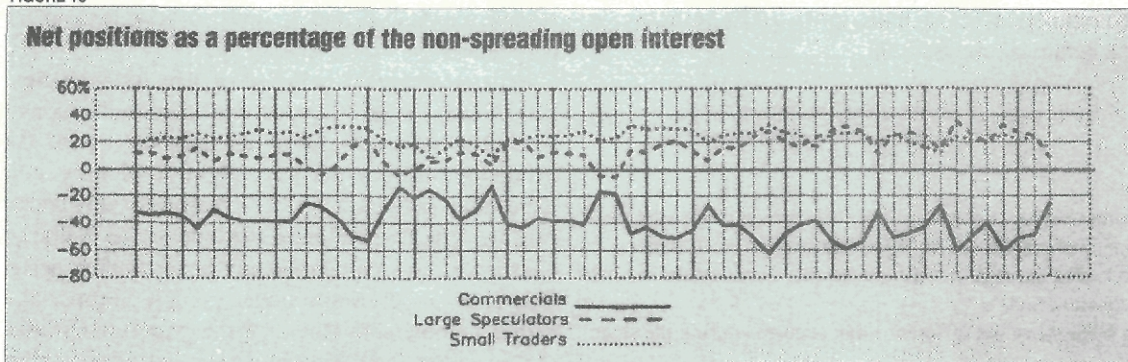
Highs and lows of monthly sugar prices correspond to the highs and lows (marked by arrows) in the C.O.T. Index depicted below in Figure 1b.

FIGURE 1b



The C.O.T. Index ranks the spread between commercial and speculative positions in a historical context. The highs and lows in C.O.T. Index confirm the highs and lows in monthly sugar prices depicted in Figure 1a above.

FIGURE 1c



The net position is calculated by subtracting a group's short positions from its long positions.

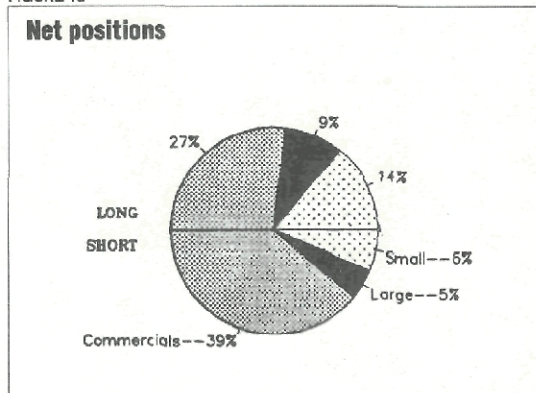
reporting levels were drastically changed. Earlier research pointed to large speculators as the group to emulate in many markets. That is no longer the case, not due to sudden ineptness, but simply the result of two major developments in the 1980s. First, commodity funds have experienced phenomenal success in raising capital. Second, the CFTC has increased the reporting levels to keep up with this new speculative giant. The large individual speculators of the 1970s have been displaced by commodity funds in current data. On average, fund managers have not shown the trading acumen of their predecessors.

Interpreting C.O.T. data

Figures 1a and 1b show the correlation between sugar no. 11 contract prices and the C.O.T. index. The net-position chart in Figure 1c is typical of those published by subscription chart services. The net position is calculated by subtracting a group's short positions from its long positions. In this chart I have plotted net positions as a percentage of the non-spreading open interest. Net short positions are plotted as negative numbers. Figure 1d clarifies the construction of net position, showing the breakdown of the non-spreading open interest in the sugar no. 11 contract as of January 1, 1990.

In this case commercial hedgers held 27% of the outstand-

FIGURE 1d



The net positions shown on the net-position chart in Figure 1c are shown here in a pie graph. Commercial hedgers held 27% of the outstanding open interest in long and 39% in short contracts, so their net position is -12% or 12% net short. The large speculator net position was +4% and small traders were at a +8% net position.

ing open interest in long and 39% in short contracts. Subtracting 39 from 27 gives the net positions of the commercial hedgers, which is -12% or 12% net short. Following the same methodology, large speculator net position in sugar no. 11 contract was +4%; small traders were at a +8% net position.

A cursory analysis of Figure 1d might conclude that because commercials are net short (-12%) they are bearish in sugar. Moreover, large speculators and small traders both hold more long contracts than short, which might indicate a bullish posture. Well, let's see.

I have refined a formula, first developed by Curtis Arnold, to make this interpretation easier. Technicians familiar with Williams' %R and Lane's %K will recognize the formula I use to convert commercial net positions to a 0 - 100% bullish scale based on a historical comparison:

$$\text{C.O.T. Index} = \frac{\text{current net} - \text{minimum net}}{\text{maximum net} - \text{minimum net}}$$

where:

Net = Commercial net position (number of contracts) minus the total combined net position of large speculators and small traders.

Maximum = The greatest net difference that occurred during the comparison period.

Minimum = The least net difference that occurred during the same period.

The C.O.T. Index (Figure 1b) effectively ranks the current spread between commercial and speculative positions within the context of the historical range. Note that on January 1, 1990, the -12% commercial net position rated a bullish 91% on the C.O.T. scale. In other words, even though commercials held more short than long contracts, their current posture was *extremely bullish* when compared to historical net positions.

The correlation between price and C.O.T. Index reveals that commercials have been consistently reliable guides to important trend changes in the sugar market. Good correlation is indicated by a mirror image relationship between the price and C.O.T. Index lines. Notice how prices in Figure 1a

bounced off the long-term price trendline each time commercial bullishness (buying) exceeded 60% on the C.O.T. scale (Figure 1b). Each intermediate high was coincident with extreme commercial bearishness reflected by zero C.O.T. readings. Commercials have done a remarkable job of manag-

What we give up in terms of frequent surveys, we make up in the quality and usefulness of the data.

ing the four-year bull market — covering a portion of their short positions when reactions approached the up trendline and letting them back out at high levels when each intermediate rally became over-extended.

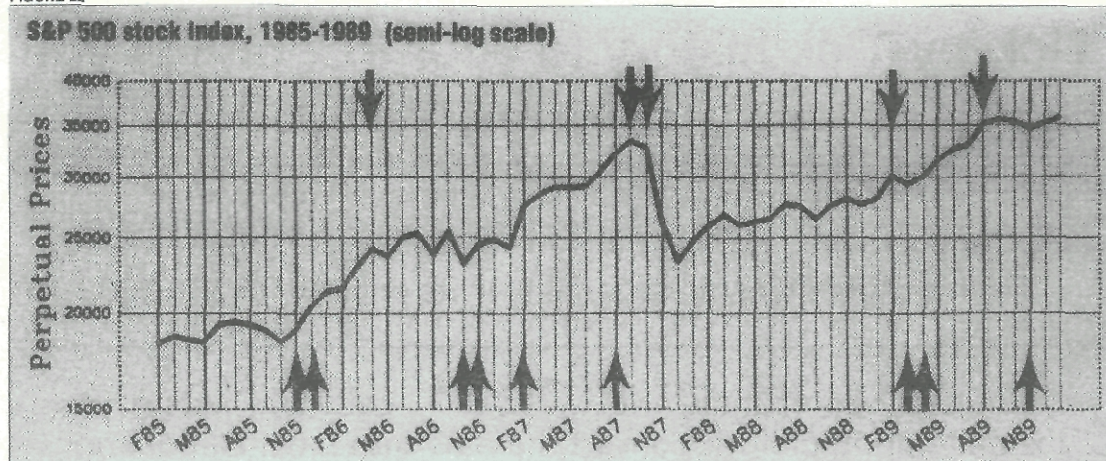
Figure 2 is the same set of charts for the S&P 500 stock index. Note that the patterns in the net-position graph (Figure 2c) show little resemblance to the sugar chart. Yet the C.O.T. Index imparts immediate reference. The advantage of the C.O.T. Index is that it is sensitive to distinct net position patterns in individual markets. As you can see, commercials hold an enviable track record in the S&P 500 market as well. In Figure 2a, up arrows indicate buy signals and down arrows are sell signals based on the following rules of thumb: A buy is signaled when the C.O.T. Index reaches 90 - 100%, a sell signal is a C.O.T. reading below 5%. These thresholds can be loosened to 75% and 25%, respectively, if the C.O.T. Index moves more than 50 points in one month.

A close inspection of Figure 2 reveals that commercials signaled the 1986, 1987 and 1989 rallies and gave timely signals of the October 1987 and October 1989 plunges. All of these signals were available well ahead of the subsequent price action. In fact, despite the one-month intervals between reports, the C.O.T. Index tends to be a leading indicator, particularly on sell signals.

Perceptive traders will notice that interpretation of the C.O.T. Index is just the reverse of that used in conventional sentiment indicators. *Oversold* is at the top of the scale, *overbought* at the bottom, because we are plotting commercial rather than public traders. The reason for this preference is twofold. The first and most obvious reason is that commercials have shown a consistently better trading performance than either of the other trader groups. Second, as I noted earlier, commercials tend to be the longest timeframe traders in the market. This is an important consideration given the monthly frequency of the data. Commercials' hedging strategy is tied to fundamental supply and demand considerations that don't change as often as most traders' perceptions. Also, the sheer size of their market holdings (commercials are exempt from position limits imposed on other traders by the CFTC) makes in-and-out trading impractical. The sugar and S&P 500 markets are not isolated examples of the correlation between commercial net positions and price trend changes. What we give up in terms of frequent surveys we make up in the quality and usefulness of the data.

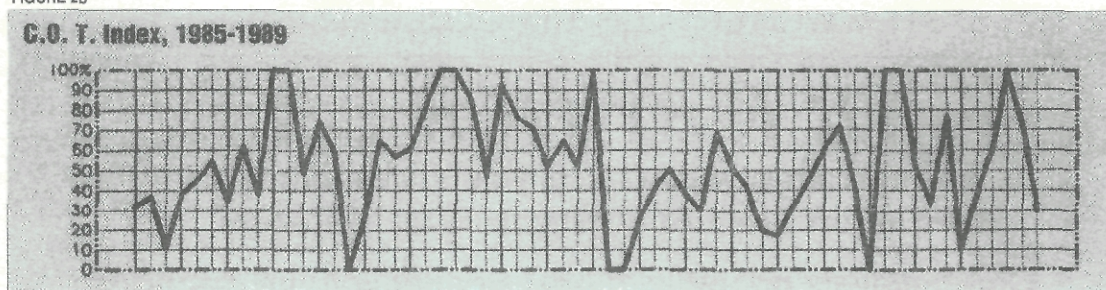
Traders have at their disposal a myriad of technical indicators calculated on price, volume and open interest statistics. Since there are a finite number of useful permutations pos-

FIGURE 2a



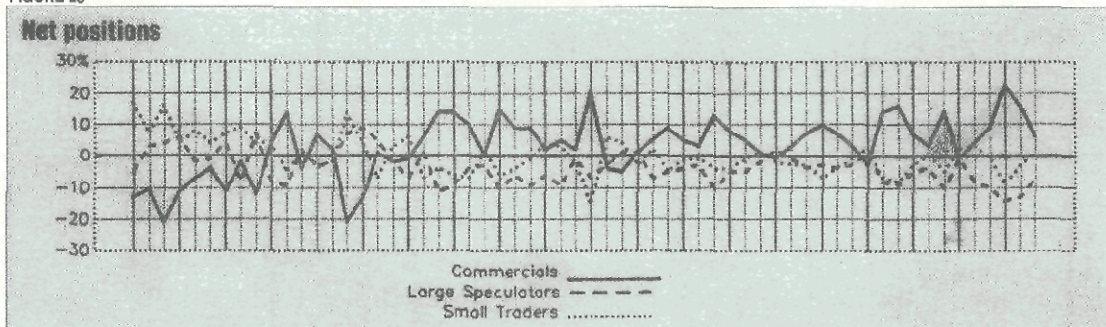
These buy and sell signals (marked by up and down arrows, respectively) are based on the highs and lows in the corresponding C.O.T. Index depicted below in Figure 2b.

FIGURE 2b



The C.O.T. Index is often a leading indicator, particularly on sell signals.

FIGURE 2c



Commercials signaled the 1986, 1987 and 1989 rallies in the S&P 500 stock index and gave timely signals of the October 1987 and October 1989 plunges.

sible, a great many of these are necessarily redundant and sketch similar patterns when plotted. The *Commitments of Traders* report provides an additional body of factual figures to massage. The C.O.T. Index is one of the few external market indicators available to traders that is based on hard numbers, external in the sense that it is not based on the big three: price, volume or open interest. On that basis alone, it should be considered a prime target for data-hungry technicians.

The C.O.T. Index is used in two ways. First, as a market selection tool, the C.O.T. Index serves as an intermediate trend change predictor. An extreme C.O.T. reading (either high or low) indicates a historic imbalance between commercial and speculative traders — a signal that the current trend is in jeopardy. By analyzing the commercial track record in a

specific market, the direction of the new trend can be anticipated. Second, as a timing aid, a drastic one-month change in net positions (indicated by a large increase or decrease in the C.O.T. reading) often portends an imminent trend reversal. In fact, a startling number of trend changes occurs virtually upon release of the data. (Buy signals were recorded in all of the continental currencies on September 11, 1989 — a key reversal week.) The C.O.T. Index is not, however, a stand-alone trading system. Its true value is that it is a non-redundant indicator that can enhance most technical trading methods.

As a final caveat, this tool cannot be used indiscriminately. Every dog has his day, and that goes for speculators as well. Small traders may not be as inept as commonly assumed. My testing shows that their performance, on average, is equal to large speculators. Neither of these groups is sufficiently inept

FIGURE 3a

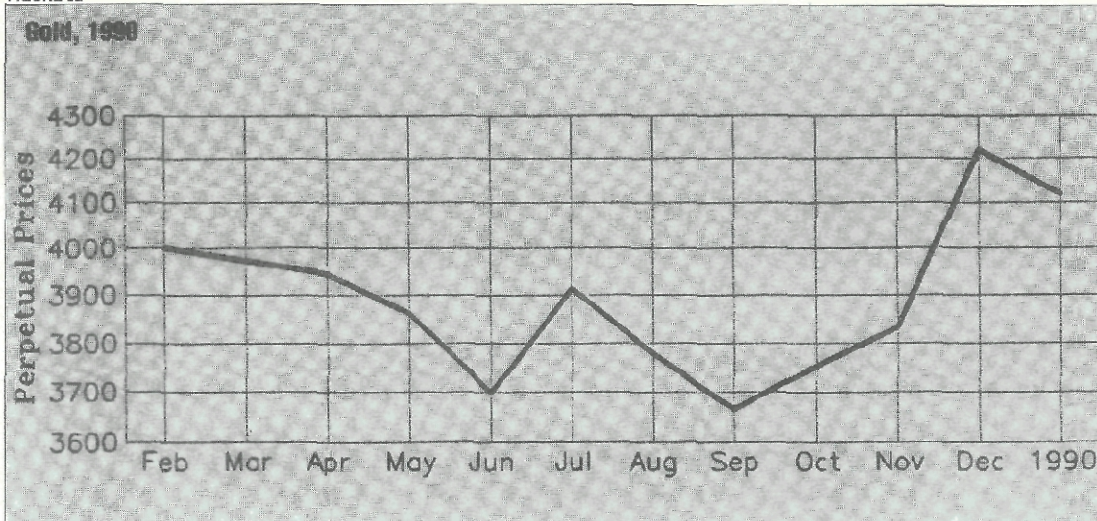
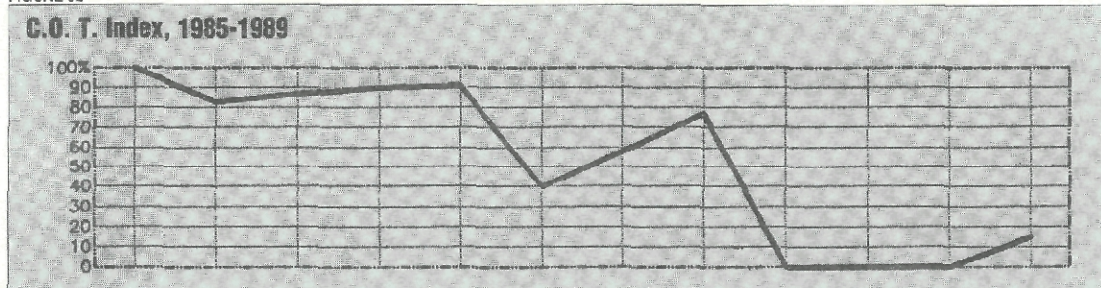
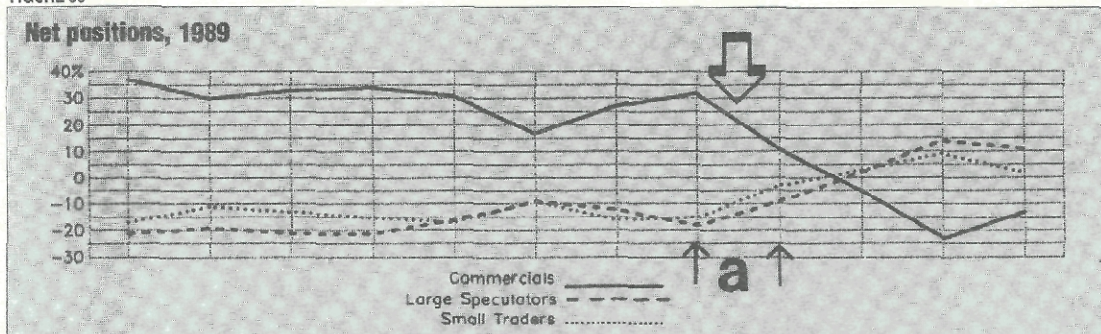


FIGURE 3b



Commercial dumping of long positions resulted in a 77-point, one-month drop in the C.O.T. Index to a zero reading.

FIGURE 3c



For gold, an important change in net positions occurred during September 1989 at point "a," although the significance of this is not apparent on this net-position chart until a month or two later.

to justify their use as a counter-indicator. It's just that commercial reliability is significantly better, on average, than any of the others.

There are a few markets, however, in which fading the commercial position is indicated. For gold (Figure 3), an important change in net positions occurred during September 1989 at point "a," although the significance of the changing market positions may not have been apparent on the net-position chart until a month or two later. Commercial dumping of long positions resulted in a 77-point, one-month drop in the C.O.T. Index to a zero reading. This signal was released on October 9, the exact day of the final low prior to the biggest rally in two years. Traders who had been following this data

were aware that commercials had been consistently on the wrong side of the gold market. (My testing showed commercial reliability in gold at only 33%.) Traders aware of these developments were watching for confirmation of a trend reversal and anticipating that commercials could be wrong again. You might compare your favorite technical indicators as of October 9 to see how many signaled an imminent major trend change at the time. The volatility of the subsequent rally was characteristic of a speculative drive and could be anticipated by knowing which traders were massed on each side of the market.

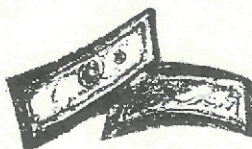
The usefulness of the *Commitments of Traders* data and derivative C.O.T. Index as a predictive tool is apparent in spite

†see Traders' Glossary for complete description

of the report's infrequent publication. Brokers report large positions daily by computer to the CFTC, and the CFTC has the capability of more frequent publication.

A bi-monthly release has been considered but as is often the case, lack of public demand has been the primary reason for maintaining the status quo. Until traders who agree that a free flow of information is vital to a fair and even playing field contact the CFTC and request a change, it appears that net position patterns may still signal traders to market opportunities earlier than more conventional tools.

Stephen E. Briese is a full-time private trader who began trading in 1973. He edits the Bullish Review of Commodity Futures Markets, providing in-depth analysis of the monthly Commitments of Traders report. He can be reached at 14600 Blaine Ave. E., Rosemount, MN 55068, (612) 423-4949.



The Commitments of Traders report

The Commodity Futures Trading Commission (CFTC) requires brokers to make daily reports showing each trader's positions on their books that exceed levels proscribed by the Commission. The CFTC makes these positions public once each month by reporting month-end open interest for markets in which five or more traders hold positions above those reporting levels. This report, *Commitments of Traders in Commodity Futures*, separates reportable (large) positions between commercial hedgers and non-commercial speculators. The balance of the open interest is composed of small traders. The *Commitments of Traders* report is released to the press within four to six trading days of the tabulation date. Inquiries can be directed to: Commodity Futures Trading Commission, Office of Communication, 2033 K Street N.W., Washington, DC 20581.

November 1990 UPDATE

Acquiescing to public pressure, the CFTC began bimonthly tabulation of the *Commitments of Traders* report and moved to electronic delivery. Net positions are now tabulated at the closest trading day to the 15th in addition to the last trading day of each month.

The data is now transmitted via modem under contract with Martin Marietta Information Systems Group. Anyone may subscribe to this service directly but at a prohibitive minimum monthly charge of \$75.00. Various financial newswires will collect and redistribute the data to subscribers. While an exact release is still not available, figures should be available within 3 to 5 trading days following compilation. This upgrade in reporting frequency and timeliness is expected to make the data a much more valuable tool to commodity futures traders. The mailed hardcopy version of the report is expected to be discontinued.

The *Bullish Review* is now published twice each month in a new format. It is available by fax or mail worldwide and is broadcast one trading day following the *Commitments* release.

Steve Briese continues to be the only market analyst devoted full time to interpreting this data. Now that the data is more accessible, his comprehensive data base and years of experience in real-time analysis provide *Bullish Review* subscribers with a material edge over less well informed traders.

Bullish Review is available on an annual subscription basis only at the rate of \$300.00 per year (more in foreign countries.) Besides being too busy to handle trial subscriptions, Briese believes that it takes this long to appreciate the value of his approach in spotting major or intermediate market turning points. Call or fax 612-423-4949 for more information.