Verus

Not Herd *on the Street*

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Losers Average Losers

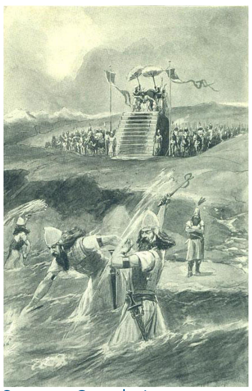
Scott Day, CFA

Paul Tudor Jones (PTJ), the extraordinary macro trader profiled in Jack Schwager's Market Wizards, is truly one of the great investors of our time. There is a famous picture of PTJ relaxing in his office, and tacked up on the wall behind him on a loose-leaf sheet of paper is the simple phrase "Losers Average Losers." Perhaps you've never heard of the picture before, but I look at it nearly every day. When I turn on my PC, there it is, set as my background, serving as a reminder to avoid the mistakes of my past. While most portfolio managers or traders do not like to admit they have been guilty of averaging down during the course of their career, the truth is, most have.

Source: Google Images

It is basic human nature; when the market shows you a loss, your ego jumps in and demands revenge. Show me a loss, will ya? Well I'll show you, I'll double my position to lower my cost and just make more money when prices finally move in my direction. Perhaps prices do indeed reverse, but as PTJ so simply states, usually the case is that "losers average losers." Suddenly, what might have started out as a small trade turns into a complete train wreck. Instead of being down 2%, you're now down 10%?! Then, prices start to turn around. Encouraged, you add more only to watch prices reach a new low. What?! The market has it wrong you think; prices are so cheap here they have to turn. Nope, the train wreck turns into a complete derailment. Exasperated, you close out your position only to watch prices finally turn around. While you may think the markets are specifically out to get only you, don't worry, it happens with greater frequency than most would like to admit. As a side note, admitting the problem and correcting it (by doing small things such as having it as a background on your PC) is an important step into becoming a profitable trader, but I digress.

The beauty of the financial markets is they are open to anyone with capital. You do not have to have a license or even experience to begin trading. Want to invest your life savings? Sure, come on in, the water's great, and the markets will teach you everything you need to know. The cost of the education is completely up to you; however with no experience or training, the cost will most likely be everything you put in. There is a reason why most professional portfolio managers fail to beat their benchmarks and most personal traders lose nearly their entire stake. Both professional and personal traders base their investment decisions on emotional responses rather than enforcing an investment discipline. Investment management deals with uncertainties and probabilities, not guarantees. With uncertainty and lack of information comes emotion. Some have a fear of missing out on the trade (prices immediately start moving in the direction they think likely, or in current vernacular, FOMO); others fear peer risk (everyone else is making money, so they need to be involved); and of course revenge trading or averaging down. Common in all these emotions is the false sense of control. We have no more control of the markets than we do the ocean. I often think of the story of Xerxes, the King of Persia (you know, the bad guy in the movie 300), who ordered his soldiers to whip the sea 300 times after a storm destroyed a bridge he was building. The markets are going to go where they go with no regard for you or your position. If so, revenge trading or averaging down would be about as useful as Xerxes having the sea whipped for its failure to obey him.



Source: Google Images

The Texas Hedge

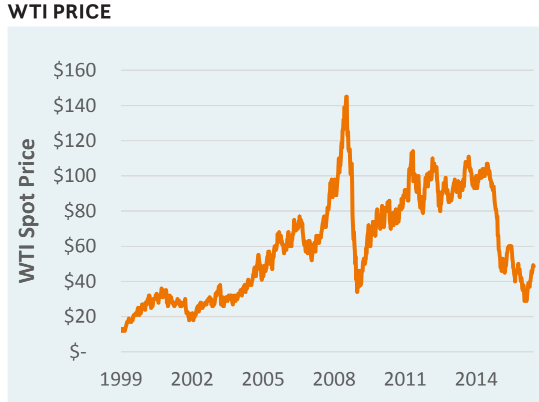
Why would buying at lower prices be a bad idea? While there are various examples we can use to explore the idea (Bill Ackman on Valeant or Bill Miller on Bear Stearns), I thought it would be interesting to take the asset that seems to have the market's attention – oil. With the price collapse from over $100 to under $30 a barrel in just 18 months, both speculators and investors have been buying oil the entire time. With the recent doubling in prices, will those averaging down prove PTJ wrong? Let's start by looking at what may be driving these wild price swings.

Inventory, rigs and disruptions, oh my!

What drives the price of oil? Supply, demand, geopolitics, other factors? Just like when offered chocolate, vanilla or strawberry ice cream, the correct answer is YES! To a fundamental-based investor, oil prices are driven by some combination of them all.

To understand the underlying fundamentals in oil, it is instructive to compare the current price decline to the 2008 period. In 2008, with the economic slowdown, consumption began declining and production soon followed. As consumption declined a bit faster than production, inventories accumulated slightly. By

WTI PRICE



Source: Bloomberg, Verus

contrast, since 2014, demand has remained steady, but has been significantly outpaced by increases in production despite lower prices. As a result, inventories have accumulated to a historic high.

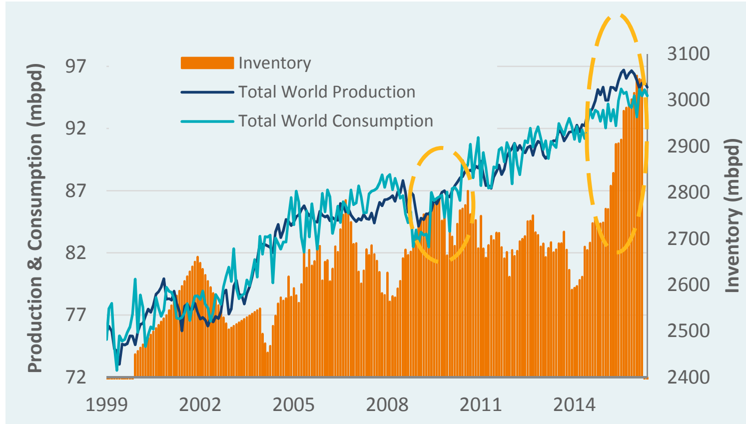
Many would correctly point out that the increased production is due to U.S. shale producers and production has recently declined as rig counts have fallen. However, unlike in 2008 when OPEC spare capacity increased significantly, current OPEC spare capacity is historically very low. In other words, OPEC continues to produce at near peak capacity and has not adjusted to lower prices.

In our modern world, geopolitics cannot be avoided. As such, there is a present concern over oil supply disruptions. Here are just some of the recent disruptions:

- Wildfires in Canada reduced supply by 1 million barrels per day (mbpd)
- Militant attacks in the Niger Delta reduced supply by 1.4 mbpd

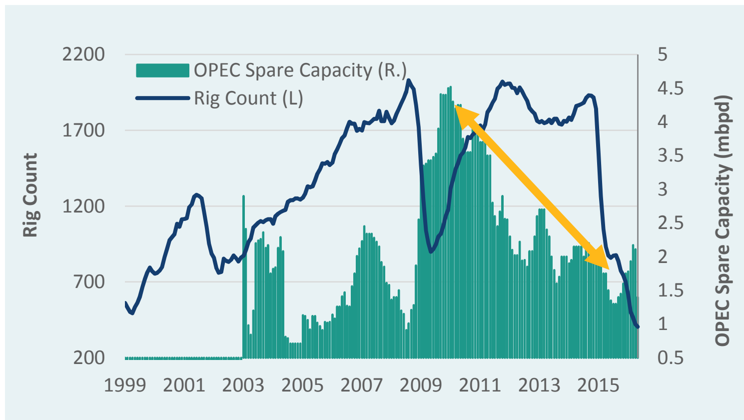
It makes sense that these supply disruptions are being associated with the recent price gains. Interestingly, the current period of unplanned supply disruptions is at nearly the same level as when oil prices were near $100. Why the recent focus? Some suggest the current unplanned supply disruptions will have a larger impact on prices than when oil was at $100 due to the low spare capacity and lower prices/profitability. Makes sense, but the impact so far on prices has been slight and does not appear to be a significant factor driving prices.

PRODUCTION, CONSUMPTION, & INVENTORY



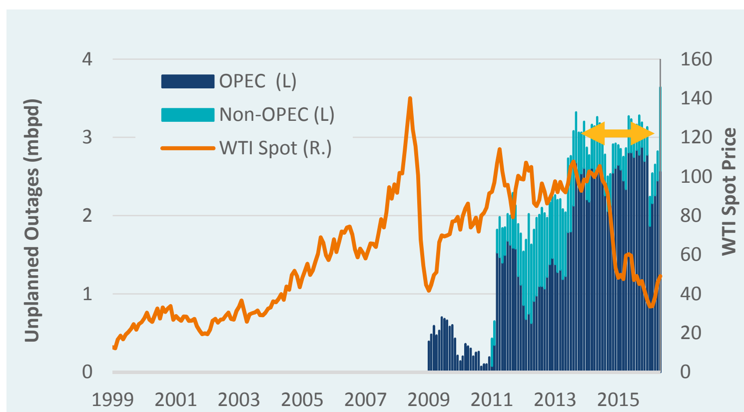
Source: U.S. Department of Energy, Bloomberg, Verus

RIG COUNT & OPEC SPARE CAPACITY



Source: Baker Hughes Inc., U.S. Department of Energy, Bloomberg, Verus

UNPLANNED OUTAGES & WTI SPOT PRICE



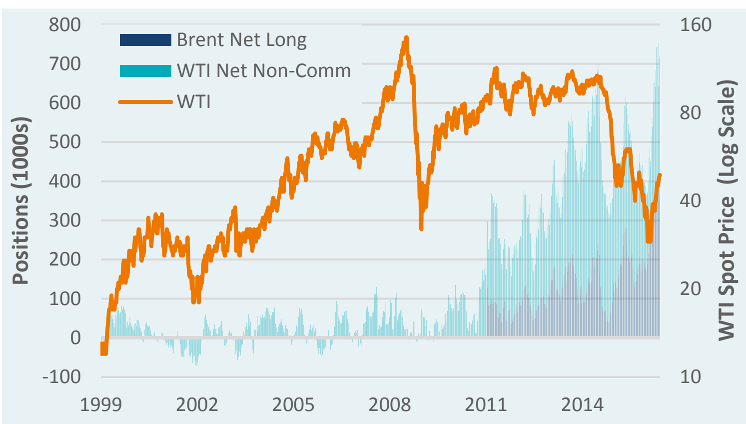
Source: Bloomberg, EIA, Verus

With record high inventories, OPEC producing at near peak capacity, and supply disruptions at nearly the same level as when prices were $100, are fundamentals the only factors driving these wild price swings? If not, or if that is not the complete answer, what else could be influencing prices and what does it tell us about averaging down?

It's all paper barrels these days

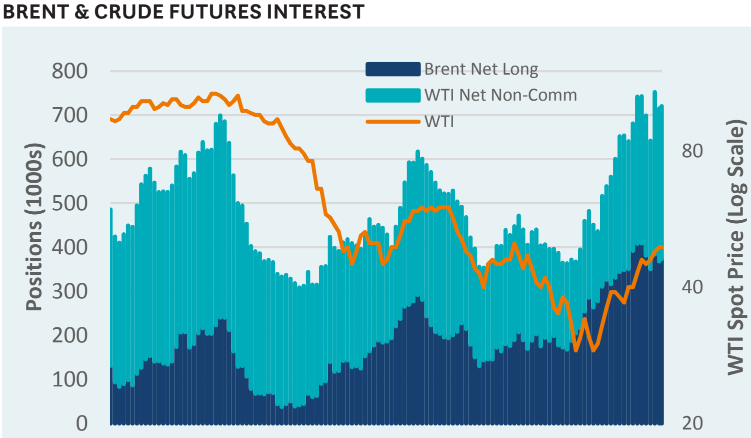
"Financialization," or the growing size of financial institutions and markets, has been an increasing trend over the past few decades. Of course, oil is no exception as oil futures (aka paper barrels) total trading volumes had increased significantly, particularly since the end of the global financial crisis (GFC). In fact, total crude futures volume has increased from 3x the size of total world demand in 2005, to currently over 15x. If other derivative instruments tied to oil are included, the ratio increases to over 30x. While total volume is interesting, net open interest is what really matters, with both Brent and crude oil futures experiencing a tremendous surge in net long positions over the past 6 years. The increase reflects both increased acceptance of long-only commodity-based indices and increased trading interest. Since 2009, the expansion in open interest occurred in stair-step fashion until 2014, as total open interest reached a record high right before prices began cascading lower. To gain a better perspective on the shorter-term movements, we will focus our attention on changes in prices and investor positions since 2014.

NET NON-COMMERCIAL POSITION AND WTI PRICES



Source: CTF, ICE, Bloomberg, Verus

BRENT & CRUDE FUTURES INTEREST

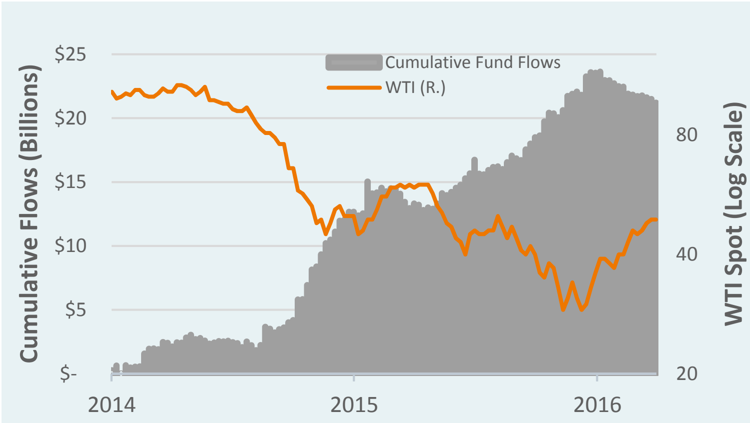


Source: Bloomberg, EIA, Verus

Before we dive in, we first need to define how we are going to measure investor positions. For purposes of this analysis, we exclude those with a commercial interest in oil as they may enter into the futures market to hedge their underlying physical product. As such, we define investors to include the net position of non-commercials (speculators) in West Texas Intermediate (WTI) futures, the net managed money position in Brent futures, and the fund flows into long-only energy ETFs. While the ETF market has expanded rapidly in size over the past few years, the futures market remains significantly larger. Thereby, the first component of the analysis focuses on the futures market, followed by the ETF market, with the two combined at the end.

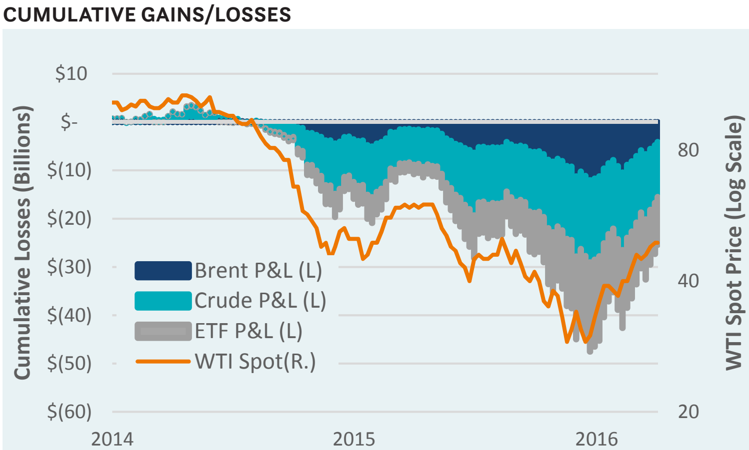
Starting in late 2014, as oil prices began moving lower (from $100 toward $40), investors trimmed their

ENERGY ETF CUMULATIVE FUND FLOWS



Source: Bloomberg, Verus

CUMULATIVE GAINS/LOSSES



Source: Bloomberg, EIA, Verus

net long futures positon until prices appeared to stabilize around $40. Investors, believing prices may have bottomed, added back to their net long position (averaging down). When prices moved lower once again, the net long position was once again trimmed. As prices reached the recent bottom near $25, investors averaged down once more. Investor sentiment has been so bullish much with the recent rally, the net long positon has reached a new, all-time peak.

While less directional than the futures market, the long energy ETFs have also experienced tremendous inflows, with very few weeks seeing any outflows. This is remarkable given prices have declined. In other words, energy ETF investors have added more and more money to losing positions – after all, if you liked oil at $50, you love it at $25 right?

Is PTJ correct that "losers average losers" or does averaging down work? Taking the weekly total return of oil since 2014 and scaling for the net futures and ETF positions, we can see the cumulative gains/losses. It is important to note the oil market is in contango, which essentially means current prices ***must*** rise about $2 over the next three months to avoid losing money. Contango exists in part due to storage and other costs, which can make it unprofitable to own commodities despite prices moving higher. As such, it is important to utilize a total return measure to determine profitability rather than the simple spot rate. Since 2014, investors (futures and ETFs combined) lost in excess of $40 billion when oil was at $25, but have since recovered a portion of their losses and now sit with ***only*** a $25 billion loss. While prices may continue higher and investors will be rewarded for averaging down, so far as PTJ said, losers average losers.

Conclusion

The idea of averaging down logically makes sense as we are conditioned through our everyday lives to buy an item at the lowest price possible. Unfortunately, the financial markets do not fit neatly into our everyday logic. The principal reason averaging down does not work and what PTJ is alluding to, is the market displays basic characteristics of momentum. It is beyond the scope of this writing to discuss the attributes of momentum investing, but the essence is that the winners keep winning and the losers keep losing. By averaging down, an investor is buying a security with negative momentum (a loser). Although prices are cheaper, the investor does not know (and cannot know) if prices will continue to get even cheaper. With the lower prices, investors convince themselves prices have fallen so much, a bounce has to be near. Perhaps, but one lesson I've learned over the years is to live in the now and not the future. What is the market telling you today? Is the momentum positive or negative? Are speculators and investors positioned long or short? Are the fundamentals supportive?

"If I hadn't lost everything I'd definitely be buying right now."

Source: Google images

In the case of oil, momentum is slightly negative to neutral, investor positions are at a record long, and fundamentals are not supportive for higher prices. All these factors combine to tell us this: *while oil prices might continue higher in the short-term as speculators continue to add to their record net long positions, the underlying long-term support appears absent and prices are more likely to move lower than higher.* As such, I will not be surprised to find those averaging down forced to capitulate and realize an even larger loss in the future. Prices usually do not find a lasting bottom until positions adjust and those caught with a losing trade are forced to realize the loss. A few years ago, we expressed a similar view by going long interest rates following the taper tantrum as we believed the bearish sentiment in bonds was so extreme that a lasting bottom in rates was not likely until the positions were corrected (which interestingly enough is occurring now). Of course, rates did indeed move to a new low and the capitulation occurred in October 2014 with the flash yield crash. In the case of oil, a similar occurrence requires the record net long position to realize their loss and cut their position, likely pushing prices lower. Will oil prices prove PTJ correct in that losers average losers? Or will Xeres begin whipping the sea of oil reserves?

Until next time,

Scott

ABOUT THE AUTHOR

SCOTT DAY, CFA
Managing Director
Portfolio Management &
Capital Markets Research

After over a decade of diligently reading the daily, weekly and monthly publications of the major Wall St. firms, Scott came to a couple important conclusions: 1) all essentially held the same position, and 2) they were all bullish at tops and bearish at bottoms. These supposedly educated, informed and well-paid opinions offered little more than the collective opinion of the crowd (the "herd"). In "Not Herd on the Street," Scott will pull from his over 20 years of investment experience focusing on macro market analysis to discuss and analyze popular opinion, and will not accept the wisdom of the crowd, but will be driven by the data. Back in the stone age (during Scott's high school), his math teacher would write an exam where the answer would seem illogical. During the exam, she would walk around the room shouting "have the courage of your convictions!" His thoughts and opinions are not driven by the collective wisdom of the herd, but rather, they express the courage of his convictions.