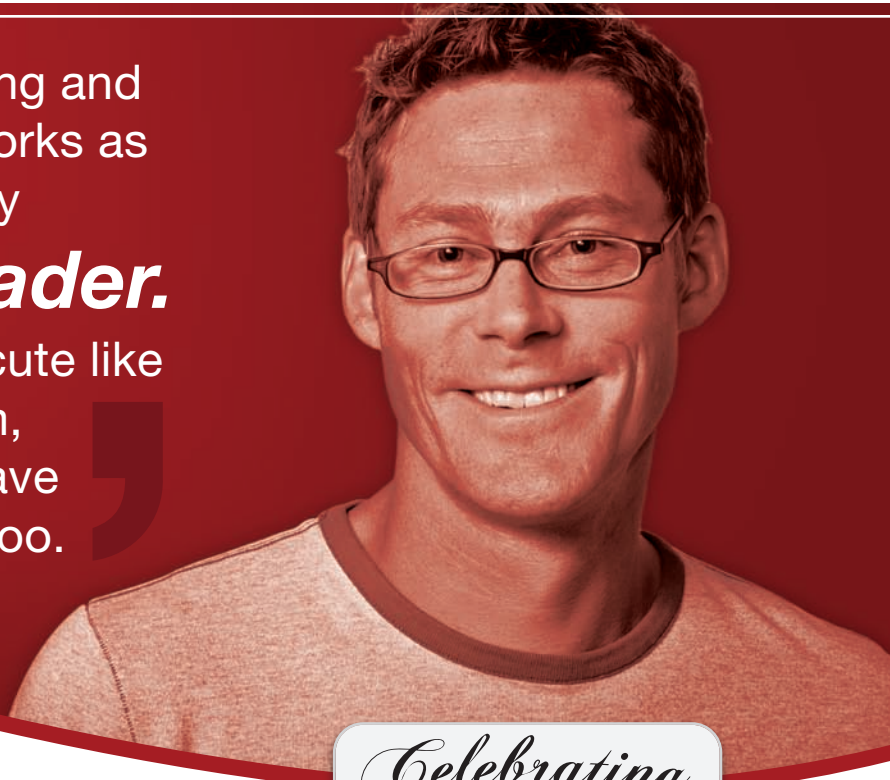


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Risk Management

by JOHN E. ROSENSTOCK

The portfolio approach to commodity trading is a big selling point for commodity funds. ("Portfolio approach" is diversifying and spreading risk through a completely mechanical trend analysis.) However, history has shown that the mechanical trend following systems that maintain positions in all commodities all the time tend to generate heavy commissions and sustain unnecessary losses when prices enter narrow trading ranges. Trend following by definition is a lagging indicator. In a trading range, prices move back and forth, violently changing direction every two or three days. Under these conditions, trend following systems wind up buying near the top and selling near the bottom, often many times before prices finally keep moving in one direction! Also, there is a school of thought which questions the redundancy of being long Swiss francs, Deutschmarks, and Japanese Yen, all at the same time. Many investors in commodity funds using trend following systems lost heavily in the "October 79 massacre" when the President announced his famous dollar support program.

Risk capital should be employed where it will get the most "bang for the buck" with the least risk. In this respect, the strongest or weakest commodity in a complex should be determined and traded rather than the whole complex. A portfolio might have positions in one currency, one grain, one meat, one precious metal, one interest rate market, one wood, one of the bean complex, with copper, cotton, sugar, other related commodities and spreads treated as individual complexes. For example, during the past three years platinum, gold, and silver have been alternating for the position of acceleration. It made no sense to be long silver accelerating at five percent a month if platinum was doing ten percent.

THE TREND MODEL

Predicting the future is a lot to ask of a mortal. Technical analysis is the study of boundaries and known cycles are very useful in defining these boundaries. The first step then is to set the boundaries, and the simplest method is the trend model. The rule is: **trade a market only in the direction of the trend. The trend is price versus time, and the time is the known cycle.** Now this is very simple if the trend is moving up or down. In an uptrend, short term timing methods can be used to buy when the market tests the resources of the bulls by pulling back from new highs. In a downtrend, short term timing methods can be used to sell when the market rises to give reluctant sellers another chance to get out. Side trends are either a pause or a reversal. Until a reversal is confirmed, congestion indicators can be used to sell to the bulls when rallies fail, and buy from the bears on declines finding support. During this "sorting out" period, accumulation/ distribution and momentum indicators can be used to determine if the trend prior to the congestion will continue or reverse. On price confirmation of direction, positions can be taken with predetermined risk and appropriate stop. If correct, prices will move out of the congestion and the trend model will follow shortly after. The trend model, by defining what will **not** be done, is the **first** step in reducing risk. **Other** methods must be used to avoid whipsaws and to determine the timing of trades for maximum risk/reward ratios.

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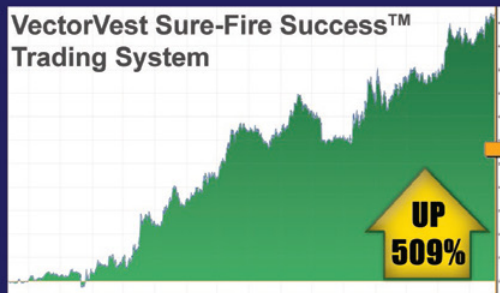
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