

## Where the Smart Money Is

By Scott Silva

Editor, *The Gold Speculator*

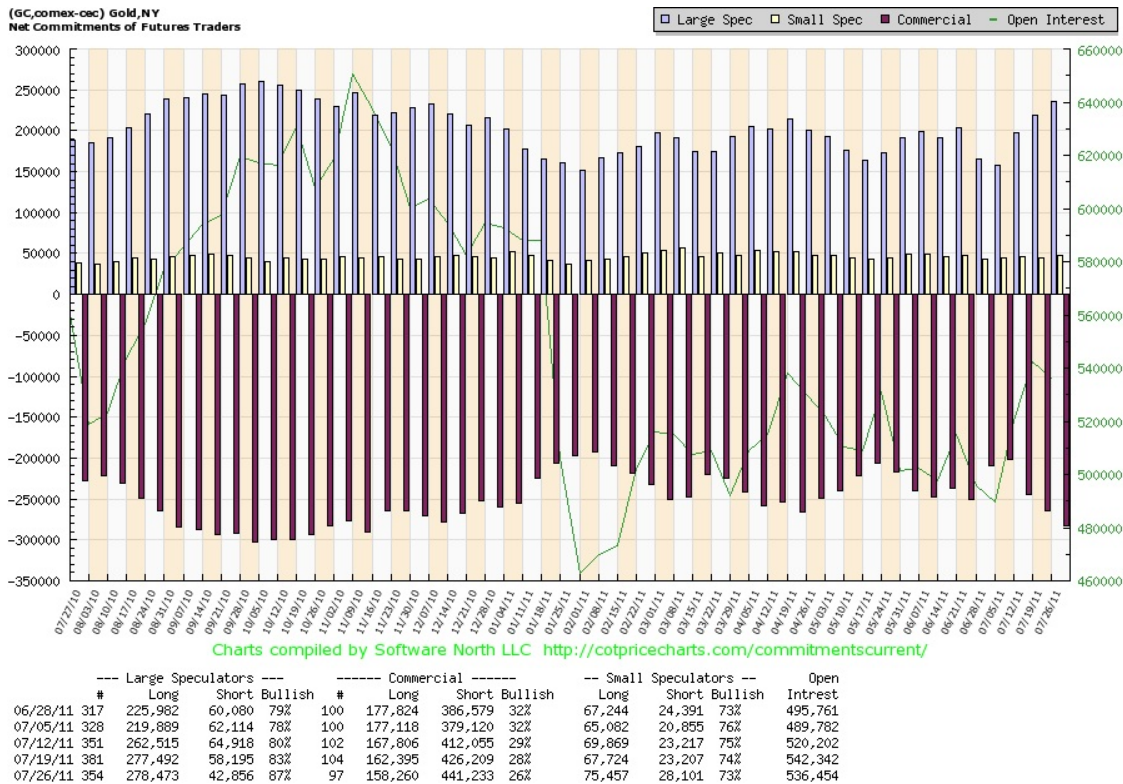
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Many who hope to succeed in the markets seem to forget one of the primary laws of market speculation: Sutton's Law. This axiom has proved correct time after time and is now used in several disciplines, ranging from law enforcement, physics, medicine, economics and market speculation. Sutton's Law is described precisely by its namesake, William "Willie" Sutton, the prolific 1920's bank robber who, when asked why he robbed banks answered, "That's where the money is." In the teaching of medicine, Sutton's law states that when diagnosing, one should first consider the obvious. Likewise, the FBI investigator puts a premium on physical evidence when building a case. Even the garage mechanic will check for fuel in the tank of the car that refuses to start before proceeding further. Sutton's Law also applies to successful market speculation, where an important key is following the flow of smart money-- "where the smart money is"

So how can one determine where the smart money is going? Well, one way is to follow the tape. That is, the ticker will show price movement, up or down, for a given traded good. And the volume of trades pushing prices up (more buyers than sellers) or down (more sellers than buyers) is a primary indicator of market sentiment (bullish or bearish) and future market direction. But, markets reverse, and there is the rub. Price action can reverse in minutes or over months. So how can the speculator profit given the fickle nature of the markets? One way that has proved itself over time is to apply Sutton's Law: go to where the smart money is. In the commodities market, we can see where a big chunk of smart money is flowing by using indicators based on the CFTC Commitment of Traders (COT) data. So let's examine the case for trading gold with the aid of COT data.

The Commodity Futures Trade Commission publishes trade data by the major players in the commodities market. These are 1) Large Speculators, professional fund managers and institutional traders, 2) Commercials, the industrial producers of the commodity, and 3) Small Speculators, private investors that speculate in commodities. Large Speculators tend to follow the market trends. Commercials tend to hedge, or bet against the trend in order to reduce price volatility risk. Small Speculators tend to follow trends as well. The Commitment of Traders data is collected weekly after the close on Tuesday and the Commitment of Traders Report is published after the close on Friday. COT data consists of the number of long and short contract positions placed by each of the player segments. Outstanding contract positions display current market sentiment of the holder. For example, if more Large Speculators hold long contracts than those with short contracts, then Large Speculator sentiment is bullish. Commercials are typically on the other side of Large Speculator trades, so Commercials tend to be short when Large Speculators are long.

We can see the disposition of each player in the gold market as of last Tuesday in the chart below. The bars above the zero line represent net long positions; bars below the line are net short positions. We can see that Large Speculators have been increasing long positions in gold over the last month. At the same time, Commercials have purchased more short contracts. We can also see that Large Speculator bullish sentiment has moved up 4 points from last week to 87%.



This is useful information to keep in mind, but as my friend Jim Cramer would say, “Fine, but can you trade with it?”

Well, it turns out that COT data can provide very good trading information. The predictive property comes from movements of the COT Index. The COT Index is the net position of each of the major players (Large Speculators, Commercials and Small Speculators) over a 26-week period. As such, it is similar to a moving average. Changes in the COT Index tend to predict future price action. This is because Large Speculators tend to be trend followers and good market timers, and Commercials tend to be good at hedging against future market movements. We can see this dynamic playing out in gold in the chart below, which shows movement in the COT Index at the bottom.



We can see the COT Index for the Large Speculators (called Large Traders here) by the green line, and Commercials, the blue line. The COT Index represents net position change, so its scale is 0 to 100 percent. As expected, the COT Index for each displays the inverse relationship to one another. What's important is the when major changes take place. For example, back in February, the Large Traders began to go long. We can see the price gold climbed in February to March. The Commercials, anticipating higher gold prices, loaded up on short contracts over the same period. In April, Large Traders added new long contracts, while the Commercials shorted some more. Gold surged to over \$1550/oz by May. In late June, Large Traders dumped their long contracts, and Commercials went long. Gold dropped \$50. In early July, the Large Traders went long in a big way; the Commercials shorted in turn. Since then gold has jumped to over \$1660/oz.

We can see that Large Speculators have earned their right to be considered "smart money" when it comes to gold. And that's part of the reason subscribers to *The Gold Speculator* benefit from going to where the smart money is.

Investors from around the world benefit from timely market analysis on gold and silver and portfolio recommendations contained in *The Gold Speculator* investment newsletter, which is based on the principles of free markets, private property, sound money and Austrian School economics.

The question for you to consider is how are you going to protect yourself from the vagaries of the fiat money and economic uncertainty? We publish *The Gold Speculator* to help people make better decisions about their money. Our Model Conservative Portfolio gained 66.7% in 2010, and 55% for 1Q2011. Subscribe at our web site [www.thegoldspeculatorllc.com](http://www.thegoldspeculatorllc.com) with credit card or PayPal (\$300/yr) or by sending your check for \$290 (\$10 cash discount) The Gold Speculator, 614 Nashua St. #142 Milford, NH 03055