

29 Questions for a Futures Broker

(Questions you should have answered, before you trade any futures contracts!)

Silver Stock Report

by Jason Hommel, February 19th, 2009

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1. When one buys a silver futures contract at the NYMEX, how far out are the contracts traded, meaning, what is the maximum length of time from now that delivery can be contracted for?

Trading is conducted during the current first three months; any January, March, May, and September falling within a 23-month period; and any July and December falling within a 60-month period beginning with the current month. So, the answer right now is December 2013.

2. And what is the typical length of time for most contracts? How far out is the largest and most heavily traded contract month?

Typically from the current month to about 9-12 months out. Right now traders are rolling out of the March 09s into the Mays and Julys...good open interest out to Dec 09.

3. Can you explain why the time limit on contracts exists, for example, why don't they trade twice as far into the future? Is it lack of liquidity, lack of desire of traders, or does the "time" become too expensive, or what?

Why is there a time limit on *anything*? Coupons, football games, mortgages, jail sentences, etc....Practicality is the reason: going out 5 years is sufficient for the purposes of the futures markets, which are risk management, price discovery, and liquidity.

4. If one buys a futures contract in silver, about 1 year out at about current prices, what kind of leverage can be purchased? What's the percentage of the value of the silver that you have to put as a down payment to buy 1 contract? In other words, what's the cost of 1 contract about 1 year out at about current prices right now?

March 2010 silver is \$14.52 per oz. or 72,600 per 5,000 oz. contract. Margin is \$8,100 or 11.15%, which is about 60% higher than it was a couple years ago due increased volatility and value of the contract.

5. I know options give one the right, but not the obligation to buy a futures contract. And thus, you can't get a margin call with options, and you can't lose more than what you pay, in case the price moves against you temporarily. What is the cost of an option on that same futures contract, about 1 year out, at current prices?

Approximately \$3.10 per oz. for the March \$14.50 option.

6. Do you prefer to trade options, or futures, or do you have no preference, or do you simply buy what is cheap depending on market conditions?

Always prefer futures and perhaps selling options (both calls and puts) in conjunction with the futures contract.

7. What is the typical liquidity of the silver options market? Specifically, how much money can one spend to move the silver options market more than 5-10%? What's a typical spread in case one were to buy and sell a silver options contract immediately, say, 1 month away, or 1 year out?

I don't see the point of the question... "...spend to move the market?...What? This just doesn't happen in the silver options. The second part of your question does not have enough information to answer correctly. It depends on the strikeprice – the question can't be answered without knowing this parameter. It could be a penny or so, or perhaps 5 or 10 cents – it all depends on the exact circumstances.

8. I understand there are position limits of 1500 contracts in a given month. How much money would it take, at a minimum, to buy 1500 silver options contracts, a year out, at the best prices, in your opinion?

What's the point and purpose of this question? Is this a math test? 1,500 contracts...that's 7.5 million ounces...how is this question relevant to your average silver trader/buyer? Anyhow, simple math: see answer to question #5 ($\$3.10 \times 5,000 \text{ ozs.} \times 1500 \text{ contracts}$) however, this is theoretical there isn't much open interest that far out.

9. What is the open interest in silver options contracts, a year out, in the most liquid contracts?

Not much at all: from zero for some strike prices to 50, or just a couple hundred. Most open interest is in options up to six months out.

10. What is the silver options market saying about future silver prices a year from now, right now? Does the options market give any sort of prediction on price, based on how the options are priced? For example, what does the silver price need to be a year from now, in order to put a silver futures option one year out, "in the money"?

Several questions here, the last one is asked incorrectly. First one, options don't "say" anything about the prices...only (question #2) what traders anticipate. The 3rd question doesn't make any sense...what is the strikeprice of the option, and are you talking about "being in the money" or being profitable after taking into account the premium paid?

11. How are most futures contracts priced, who prices them, and by what method? Do most traders use computers and a black-scholes model, or do they look at charts, or is it just "the market"?

The Black-Scholes model is used for option pricing, *not* futures. Futures are priced by an open free market, bid-ask.

12. What gives you confidence that there won't be a default in silver futures contracts at the NYMEX?

Because I'm not into highly speculative internet kook conspiracy theories. They have been saying this for *YEARS*...just google the topic and articles from seven years ago pop up about COMEX default theories. The futures markets operate at the highest level of integrity. While on the subject, why not ask me about Bigfoot and about 9-11?

13. It's my understanding that the NYMEX went public a few years ago, and was recently sold to the CME. With public ownership via stock, there comes the benefit of limited liability. Thus, it seems to me that the exchange owners have now a somewhat reduced liability in the event of a default in the silver futures, thus, it seems to me that one of the protections against default has been removed. Is my reasoning off base here?

Absolutely off base. You can take this seemingly logical (in your mind) reasoning to the extreme with *any* issue.

14. I'm concerned about default because the open interest is always so much higher than the silver that is in the warehouses, both registered and eligible for delivery.

As of 2-10, the open interest is 130,692 contracts for 5000 oz. each.

<http://www.cftc.gov/dea/options/deacmxsof.htm>

That's a total of 653,460,000 ounces, is that correct?

Right now, the silver warehouse stocks, total, registered and eligible, for all 4 warehouses, is 124.7 million ounces.

<http://cmegroup.com/trading/energy-metals/nymex-daily-reports.html>

See "Warehouse Stocks" and then "Silver Stocks" at the bottom of the page.

That seems to be quite an imbalance, so what is the guarantee that the shorts can deliver silver to the longs?

Your reasoning is all wrong and illustrates a lack of understanding of the futures markets or industry. Open interest and available stocks are totally irreverent. Say for example I short a coffee contract (37,500 lbs). I certainly don't that coffee on hand...so I EXIT the market before first notice day. A buyer has to have the full monetary value of the contract in his account...if not he will get a call and told to exit his position. Buy the time the first notice and delivery process begins open interest shrinks to a tiny fraction of what is was just as week before as these trades roll over to the next month. This is a very important point because you and others of your mindset "hang your hat" on this issue ...and its totally meaningless!

15. The CPM Group produces an annual yearbook of statistics on silver. Are you familiar with this group, and if so, what do you think of the quality of their research?

No and NA.

16. There is another major market in silver, besides the NYMEX, and I'm speaking of the LBMA, the London Bullion Market Association, which is a group of very large bullion banks that all act as market makers for bullion orders for their own clients.

http://www.lbma.org.uk/members_list.html In the 2008 CPM Group yearbook, on page 16, they list the Estimated Silver Inventories in London and Zurich at about 75 million ounces for 2006. That seems a rather small amount, what do you think?

No opinion, don't have enough info to answer.

17. The CPM group also lists that the LBMA annual trading volumes in silver are 30 billion ounces. That seems excessive in light of how little silver the CPM Group lists in the estimated silver inventories. Do you think such trading volumes are excessive, if they are based on so little silver, as it seems that the entire stock of silver is traded more than that daily! 30,000 million ounces, divided by 250 trading days, would require an average of 120 million ounces of silver traded daily, on average, which is far more than the 75 million ounces

estimated that they have. Do you find that much trading to be excessive, or do you think it's evidence that they are trading silver that they do not have?

“...they do not have”? Again your question shows that you don't understand the futures markets or industry. No, it is not excessive and there is nothing inherently problematic about trading volume that is higher than the available commodity, whatever it is.

18. Morgan Stanley, who is not a LBMA market making member, but who also trades silver for clients and offers unallocated silver accounts, recently admitted that they practice fractional reserve silver banking, as follows:

Ted Butler writes:

"I found it appalling that Morgan Stanley would claim to store silver that didn't exist and even have the chutzpah to charge for the storage."

"In fact, in the court documents summarizing the proposed settlement, one of Morgan Stanley's defenses was that they were not doing anything unusual by charging storage on metal that didn't exist, as this is a widespread industry practice."

<http://www.investmentrarities.com/10-23-07.html>

Does that concern you, and do you have an opinion or comment on that?

Yes, it seems rather unethical, but I don't know much about their practices to give an educated answer. Keep in mind you are asking questions of a *futures* broker, silver is traded and invested in a myriad of ways. I'm not particularly concerned what others are doing. I concentrate on *my* business, *my* industry, and *my* clients.

19. I would like to discuss some of the overall market silver statistics. The CPM Group and Silver Institute have somewhat similar numbers, but they both say that about 600 million ounces of silver is mined each year, and about 900 million ounces total supply, with the difference being recycling, government selling, and/or investor selling. They both say that investor buying is very small, about 40-60 million ounces per year, and this is actually a new trend, ending investor selling. This means that about 5-10% of the silver market is investor buying. At \$15/oz., that's just under \$1 billion worth of investor demand, annually. Do you see these supply and demand factors as more bullish than for gold, since there is less room for new investor demand?

Seems logical.

20. Are you aware of the reports of silver shortages for all retail forms of silver, from 1-ounce rounds, to 100-ounce bars, to Silver Eagles and Maples? For example, the U.S. Mint, although producing nearly twice as many Silver Eagles this year than last year, is trying to illegally ration them?

Yes

21. Is there any indication that 1000-ounce COMEX bars are in short supply, and if that were to happen, how would we know?

No. Deliveries would be delayed or suspended. It would big news in all the financial media.

22. It seems to me that the world has had a shortage of silver, and an excess of paper money, ever since the U.S. left off using silver in coinage, in 1964. But particularly, today, the amount of paper money that exists seems more excessive than ever, with M3 at over \$14

trillion, and silver seems to be in a particularly short supply. Are you concerned about these things as well?

I'm not concerned in general about any shortage of silver. I'm more concerned about the shortage of water for example. I am concerned about the expansion of money supply, government and consumer debt, and budget deficits.

23. It seems to me that in both the LBMA, and the NYMEX, that most silver sold is sold by institutions or traders who are "naked short", meaning that the physical silver to back the positions is not held by them. Do you think that is a fair assumption, based on the statistics I've covered above?

Again, another question showing a lack of understanding of the futures markets. So what if they are naked short? I myself and other traders "naked short" every commodity across the entire economic spectrum, why are you so concerned about silver...its no different that cocoa, oats, or pork bellies.

24. The Silver ETF claims to have over 253 million ounces of silver backing it.

http://us.ishares.com/product_info/fund/overview/SLV.htm?qt=SLV

During the time of it's inception, silver at COMEX remained essentially unchanged, and the silver price remained unchanged. Many people are wondering, where this silver came from, how could so much be bought without moving up the price, and if it really exists.

JP Morgan is the ETF custodian, and JP Morgan is also rumored to be the largest silver short at the COMEX holding down the price. That seems like a conflict of interest, to say the least. JP Morgan also holds about 7 times the gross national product of the USA in derivatives. So, given that, would you trust the ETF, or futures contracts more?

Futures.

25. What do you think of private companies that offer people "leveraged silver" programs? It seems to me that they are mostly scammers, since they offer less leverage, on worse terms, than you can get in the futures market. Is that your opinion as well?

Yes, see info below:

Comparison of costs of buying silver...
Typical Metals Dealer verses **Heritage West Financial**

For 5,000 ounces @ \$14.00

Fee	Typical leveraged silver" programs	Heritage West Financial
Commission	1.5 % = \$2,100.00	\$65
Bid/Ask	14 cents = \$700	0
Interest	6.75% w/10% down =\$708.75 <i>monthly</i>	0
Storage	\$22.50 <i>monthly</i>	0
Total	\$2,800 + \$731.25 monthly	\$65

Conclusion: Silver has to move **56 cents** to breakeven...even more for if you hold it and % and storage rates add up. Heritage West: Breakeven is **1.3 cents**

26. If someone buys a silver futures contract through your brokerage, could you help them take delivery?

Yes, we do it all the time.

27. If someone expected silver prices to rise a minimum of 25% annually from today, with the understanding that there could be times lasting 1.5 years where no gains would take place, based on those assumptions, suppose you had a client who was interested in buying silver futures contracts or options with about \$100,000 that they could afford to lose, is there a particular strategy that you could recommend?

Yes, I do this on a daily basis and been trading for 30 years and have been a futures broker for 20. I would buy futures and sell option premium (calls and puts) at varying expiration dates to subsidize drawdowns in equity and bring in additional income.

28. What do you think of precious metals dealers who sell physical silver but cannot deliver for up to, or exceeding, 60 days? Do you feel that is reasonable or not, or is it like a futures contract?

It doesn't seem a reasonable amount of time to wait.

29. I would like to thank you so much for your time and help in answering these questions for me and my readers. Is there anything you would like to add that you feel I did not cover, or that you would like to say?

Again, thank you so much for taking the time. My readers and I will really appreciate it.

Answers submitted by:

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Past performance is not necessarily indicative of future results.
There is risk of loss trading futures and options.