

Gold ETFs Affect Futures Margins

Commodity Risk Finds Its Way To The Futures Markets

An old crude oil broker I used to execute through used to say about the risk from crude oil swaps and related products, "It finds its way to the floor somehow." That was more than twenty years ago, and the principle holds: It matters not whether you are trading commodity futures-linked ETFs such as the U.S. Oil Trust (USO) or a gold ETF such as the SPDR Gold Trust (GLD), the risk created by the market-maker or the swap dealer or the too-fancy-for-words crowd finds its way to the most liquid and transparent commodity markets, the futures markets.

Margin Driver

Precious metals traders often live in a strange psychological state; not only do they wish to see their investments rise, a normal impulse, but I sense they want to see conventional markets suffer. They also live in a world where officials are out to get them as they, the gold/silver bugs, stand in the way of government perfidy. Even as gold rose from near-\$250 in 2001 to over \$1,900 in September, they kept smelling rats. When initial margins were raised during volatile periods and selloffs followed, they screamed bloody murder.

I found the whole thing amusing as it was so predictable, but please do not tell anyone. Let it be our little secret, OK?

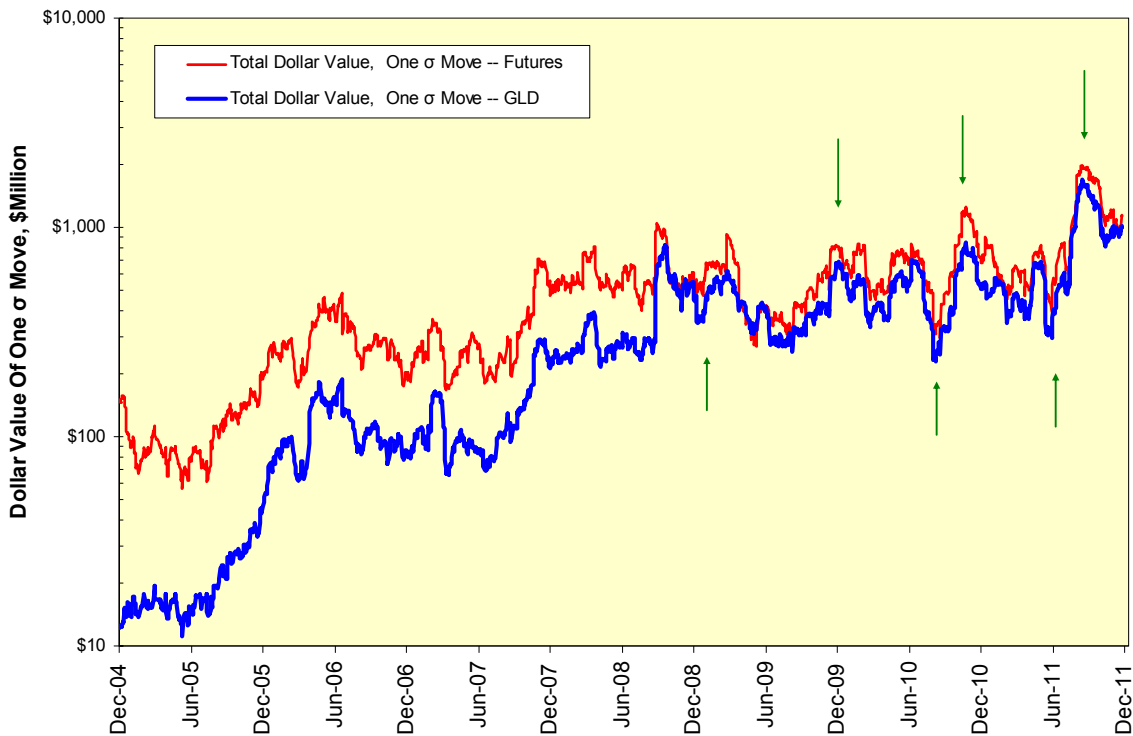
The most important factor in setting initial margins is the dollar value of a one standard deviation move in the market. As the realized volatilities involved are calculated from historic price changes they are a lagging indicator of price movements themselves. This is the reason behind the widely-held belief in the futures industry margin hikes often set the top or the bottom in a market. Let's say a market gets rowdy to the upside; realized volatility jumps and then and only then margins are raised forcing the already-stressed shorts into one final burst of short-covering. Exhausted, the market gasps, prices fall and in a tawdry cliché everyone lights up a cigarette.

Mixing Markets

What happens when you have two different margining systems for two different products representing the same underlying asset? Margins in the equity world are strategy-based and are set by the Federal Reserve as they are considered a form of credit, a down-payment on the purchase of a security. Equity margins represent ownership in a long position and while they are affected by price levels, they are not affected by realized volatility nor are they subject to the futures industry's rigorous daily variation margining system.

While the overall dollar size of gold futures is much larger than that of the GLD, \$69 billion versus \$65.7 billion, the GLD has been growing more rapidly since its November 2004 inception. Let's take a look at the history of the total dollar value of a one standard deviation move in each market.

Comparative Total Market Impacts



I marked six data points with up- and down-pointing arrows. The three downward arrows highlight periods when the total dollar risk for a one standard deviation move in GLD rose, but less than that for futures on a percentage basis. The three upward arrows highlight periods when the total dollar risk for a one standard deviation move in GLD fell, but more than that for futures on a percentage basis.

The overall conclusion is this: Risk flowing into GLD gets amplified when it moves into the futures market; risk flowing out of the GLD gets reduced in the futures market. As gold prices move higher rapidly, a common occurrence over the past decade, upward pressure increases on margins. It is an asymmetric affair: Declines in gold do not reduce the overall risk level seen in the futures market nearly as much. Restated, if gold bugs are looking for someone to blame for higher margins, they should look to their own activities in ETFs.