David Martin Finds Soft Commodities a 'Last Century' Challenge

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David Stephen Martin deals in commodities that people have a hard time doing without. Take that cup of fine Colombian coffee you just drank. Or that chocolate bar. Or that soothing glass of orange juice. Martin trades the soft commodities — coffee, cocoa, sugar, orange juice and cotton. And he has fun doing it, even though these commodities are some of the most volatile products: vulnerable to frost, drought, disease, insects, animals, guerrilla wars and occasionally unstable governments. They are grown and traded all over the world.

Martin founded in early 2013 the Advisor firm Martin Fund Management, a New York City registered Commodity Trading Advisor with a core focus on exchange-listed derivatives of global soft commodities. Martin seeks to generate outsized annual returns of 15% to 20% in excess of the S&P Goldman Sachs Commodity Index. The fund employs short-to-medium term trading programs with low macro correlation and disciplined risk. Martin uses a Separately Managed Account structure.

Martin started trading for himself in 1992, with a seat on what was then the New York Board of Trade (now ICE US.) He began trading in the options pit with Cooper Neff but futures soon lured him. "I noticed in futures that no one was trading the spreads," Martin said. "They were more interested in outrights. I saw some correlations and stayed in futures." Martin's interest in soft commodities paid off in 1994 when a devastating frost and freeze struck the main Brazilian coffee growing area in late June and July. The price of a pound of raw, green coffee on New York's Coffee, Sugar and Cocoa Exchange shot up to $2.395 a pound on July 12, 1994, an eight-year high, and ended the day 47 cents higher at $2.353. The price rose 87% from the date of the first damaging frost June 25 and then a drought.

That was his first really big event as a coffee trader, Martin said. "The market really went berserk and I had my first million dollar year," he said.

The other significant coffee trading event for Martin came in 1997. He said that was an awful market for real estate and equities that year but "I had my best year ever to date." That was evidence of how coffee and some of the other soft commodities are uncorrelated to other markets, he said. One morning Martin said he and other traders were standing in the coffee pit before the open with the market called significantly higher. They were all short the market, he said. Then the outlying months started opening in rotation.

“The first 10 minutes all of us in the pit were down $140,000 to $150,000 each,” Martin said. “By the end of the day I ended up making about $400,000.”

Martin lived in Greenwich, Connecticut then and would tally up his trading cards on the commuter train ride home. He said he usually had 11 or 12 cards and would have them tallied by halfway from New York to Greenwich. That day he had 45 trading cards and he was still tallying when he got to Greenwich, about 35 miles from Grand Central Station in New York. Martin finds all the soft commodities compelling, but thinks coffee is particularly interesting. “It is a drink that if people can’t have it, they freak out,” he said, emphasizing the strong personal demand. Coffee has characteristics that make it more complex for trading than some other commodities; there is tremendous volatility, it is grown mostly in South America and mostly on hard-to-access mountainsides. It is vulnerable to weather and the beans are initially fragile, he said. Because coffee is grown and picked by hand, information on the size and quality of the crop can be scarce. “Someone has gone up on the mountains on donkeys to assess the trees,” he said, as well as to cultivate and to pick it by hand. Unlike grains that are often grown on commercial farms and harvested with massive combines, coffee still has that ‘last century’ feel. “No one really has all of the answers, but enough people have part of them,” Martin said. “You don’t have to know all of the information or who has it, but all of the information ultimately is reflected in the price,” he said.

Martin’s firm has a trading program which uses three Quantitative (statistically-based) and Systematic (rule-based) trading strategies:

- The first strategy uses options spreads to express the Advisor’s opinion on major market trends. They buy or sell to benefit from major market trends based on predetermined and limited risk parameters. Trends are confirmed using preset fundamental statistics related to certified stocks and crop forecasts;
- The second strategy uses Arbitrage of futures spreads and spread butterflies. This approach buys one futures spread and sells another related futures spread, grounded in predetermined risk parameters. It is designed to benefit from both seasonal and time-to-expiration based price ranges. They exit the position before expiration of the front month futures contract;
- In the third strategy, they use Systematic event trading of the S&P GSCI futures roll. Heavy capital-flows move through the market, trading out of the expiring front month futures contract and into the next contract. Entry and exit from this trade incorporates key quantitative data.

In addition to the Quantitative and Systematic strategies, Martin and his firm utilize the certain fundamental correlations that exist based on the physical market. The major part of the trades are in spreads rather than outrights. “We have an overlay on top of all of this, based on fundamentals and on the relationships we have in the industry, that give us access to crop estimates, the quality of coffee coming to be graded and warehouse receipts,” he said. “We think that gives us an advantage.”