



Basic training: a futures primer

Picking up the phone and instructing your broker to buy or sell is relatively simple.

Performing a few mouse clicks and transmitting your order to a handheld device in the pit or to a totally electronic marketplace isn't all that hard either. It's really not all that difficult to understand how the money works. What is difficult, however, is extracting profits from the markets (something we'll tackle later in this book), but you have to start somewhere. This chapter is for those of you who need to learn the basics. So here we begin, as good a place to start as any.

Commodities are not only essential to life, but they are absolutely necessary for quality of life. Every person eats. Billions of dollars of agricultural products are traded daily on the world's commodity exchanges—everything from soybeans to rice, corn, wheat, beef, pork, cocoa, coffee, sugar, and orange juice. Food is where the commodity exchanges began.

In the middle of the nineteenth century in the United States, businessmen started organizing market forums to facilitate the buying and selling of agricultural commodities. Over time, farmers and grain merchants met in central marketplaces to set quality and quantity standards and to establish rules of business. In the course of only a few decades, more than 1,600 Exchanges sprung up at major railheads, inland water ports, and seaports. In the early twentieth century, as communications and transportation became more efficient, centralized warehouses were constructed in major urban centers such as Chicago. Business became less regional, more national; many of the smaller Exchanges disappeared.

In today's global marketplace, approximately 30 major Exchanges remain, with 80% of the world's business conducted on about a dozen of them. Just about every major commodity vital to commerce, and therefore to life, is represented. Billions of dollars worth of energy products—from heating oil to gasoline to natural gas and electricity—are traded every business day. How could we live without industrial metals (copper, aluminum, zinc, lead, palladium, nickel, and tin); precious metals

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such as gold; or platinum and silver, which are considered both industrial and precious metals? How could we live without wood products or textiles? It would be hard to imagine life without them, and yet few people are aware of just how the prices for these vital components of life are set. Unlike 100 years ago, today the world's futures Exchanges also trade financial products essential to the global economic function. From currencies to interest rate futures to stock market indices, more money changes hands on the world's commodity exchanges every day than on all the world's stock markets combined.

Governments allow commodity exchanges to exist so that producers and users of commodities can *hedge* their price risks. However, without the speculator, the system would not work. Anyone can be a speculator, and contrary to popular belief, I do not believe the odds need be stacked against the individual. In this book, I plan to share with you techniques designed to help you make money trading commodities. Actually, you as an individual have one distinct advantage over the big players, and that's flexibility. You can move quickly, like a cat, something a giant corporation can't do. Many times, several of the big commercial operators that utilize the Exchange for hedging literally hand you your profits on a silver platter—they're there for a different reason. So, let's start by looking at how the futures contract works and the various participants in the marketplace. We'll also look at what they are attempting to accomplish and how they interact with each other.

Futures markets and the futures contract

Futures markets, in their most basic form, are markets in which commodities (or financial products) to be delivered or purchased at some time in the future are bought and sold.

The **futures contract** is the basic unit of exchange in the futures markets. Each contract is for a set quantity of some commodity or financial asset and can be traded only in multiples of that amount. The futures contract is a legally binding agreement that provides for the delivery of various commodities or financial entities at a specific time period in the future. (Prior to the time I was in this business, I envisioned the parties sitting at a table and actually signing paper contracts. It's nothing like that.)

When you buy or sell a futures contract, you don't actually sign a contract drawn up by a lawyer. Instead, you're entering into a contractual obligation that can be met in only one of two ways. The first method is by making or taking delivery of the actual commodity. This is by far the exception, not the rule. Less than 2% of all futures contracts are concluded with an actual delivery. The other way to meet this obligation, which is the method you most likely will be using, is offset. Very simply, **offset** is making the opposite (or offsetting) sale or purchase of the same number of contracts bought or sold sometime prior to the expiration date of the contract. Because futures contracts are standardized, this is accomplished easily.

Every contract on a particular Exchange for a specific commodity is identical except for price. The specifications are different for each commodity, but the contract in each market is the same. In other words, every soybean contract traded on the Chicago Board of Trade is for 5,000 bushels. Every gold contract traded on the New

York Mercantile is for 100 troy ounces. Each contract listed on an Exchange calls for a specific grade and quality. For example, the silver contract is for 5,000 troy ounces of 99.99% pure silver in ingot form. The rules state that the seller cannot deliver 99.95% pure. Therefore, the buyers and sellers know exactly what they are trading. Every contract is completely interchangeable. The only negotiable feature of a futures contract is price.

The size of the contract determines its value. To calculate how much money you could make or lose on a particular price movement of a specific commodity, you need to know the following:

- Contract size
- How the price is quoted
- Minimum price fluctuation
- Value of the minimum price fluctuation

The contract size is standardized. The minimum unit tradable is one contract. For example, a New York coffee contract is for 37,500 pounds, a Chicago corn contract is for 5,000 bushels, and a British Pound contract calls for delivery of 62,500 Pounds Sterling. The contract size determines the value of a move in price.

You also need to know how prices are quoted. For example, grains are quoted in dollars and cents per bushel: \$2.50 per bushel for corn, \$5.50 per bushel for wheat, and so on. Copper is quoted in cents per pound in New York, and dollars per metric ton in London. Cattle and hogs are quoted in cents per pound, whereas gold is quoted in dollars and cents per troy ounce. Currencies are quoted in the United States in cents per unit of currency. As you begin trading, you will quickly become familiar with how this works. Your commodity broker can fill you in on how prices are quoted on any particular market you decide to trade.

The minimum price fluctuation, also known as a "tick," is a function of how prices are quoted and is set by the Exchange.

eg For example, prices of corn are quoted in dollars and cents per bushel, but the minimum price fluctuation corn can move is $1/4\text{¢}$ per bushel. So if the price of corn is \$3.00/bushel, the next price tick can either be $\$3.00\ 1/4$ (if up) or $\$2.99\ 3/4$ (if down). Prices can trade more than a tick at a time, so in a fast market, the price could jump from $\$3.00$ to $\$3.00\ 1/2$, but it could not jump from $\$3.00\ 1/2$ to $\$3.00\ 5/8$ because the minimum price fluctuation for corn is a quarter penny. Therefore, the next minimum price tick for corn from $\$3.00\ 1/2$ up would be $\$3.00\ 3/4$, or down would be $\$3.00\ 1/4$. The minimum price fluctuation for a gold contract is 10¢/ounce , so if gold is trading for \$425.50 per ounce, the minimum it can move in price would be \$425.60 if up, or \$425.40 if down. Once again, in a fast market, or if the bids and offers are wide, it might jump from \$425.50 to \$426, but in liquid and quiet markets, many times the market moves from one minimum tick fluctuation to the next.

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The value of a minimum fluctuation is the dollars and cents equivalent of the minimum price fluctuation multiplied by the contract size of the commodity.

eg For example, the size of a copper contract traded in New York is 25,000 pounds. The minimum price fluctuation of a copper contract is $5/100$ of one cent per pound (or $1/20$ of one cent). By multiplying the minimum price fluctuation by the size of the contract, you obtain the value of the minimum price fluctuation, which in this case is \$12.50 ($1/20\text{¢}$ per pound times 25,000 pounds). In the case of the grains and soybeans, a minimum price fluctuation is $1/4\text{¢}$ and a contract is for 5,000 bushels, so the value of a minimum fluctuation is also \$12.50 ($1/4\text{¢}$ per bushel times 5,000 bushels).

Except for grains, minimum fluctuations are generally quoted in points.

eg For example, sugar prices are quoted in cents and hundredths of a cent per pound. The minimum fluctuation is $1/100$ of one cent, or one point. If the price is quoted at $15\frac{1}{2}$ cents per pound, your broker would say it is trading at 1550, and if it moves up by a quarter of a cent per pound, this would be a move of 25 points, to 1575.

In some cases, the value of a minimum move may be more than a point. In the copper example, the minimum move is $1/20\text{¢}$ per pound. A penny move is 100 points (for example, if copper prices rise from \$1 per pound to \$1.02 per pound, the market has moved up 200 points), but because the minimum fluctuation is for $1/20\text{¢}$, a minimum move is 5 points, or \$12.50 per contract. A move of 1¢ is worth \$250, which is 100 points. You must understand what the value of a move is for the commodity you are trading. For example, if you are trading soybeans, you should know that a move of 1¢ is worth \$50 per contract (either up or down), and if you buy three contracts and the market closes up 10¢ that day, you would make \$1,500, or \$500 per contract. If the market closes down 10¢ , you would lose the same amount. Although this might seem confusing at first, you'll quickly understand the value of a minimum fluctuation and the value of a point at the time you write that check for your first margin call. That reminds me of an amusing true story told to me by my favorite copper broker.

On the floor of the COMEX (the world's largest metals Exchange), where copper is traded, the pit brokers always talk in terms of points instead of dollar values. You might hear a trader saying, "I made 300 points today," or "I lost 150 points on that trade." A number of years ago, there was a big commission house broker (a floor broker who makes his living filling buy and sell orders from customers who call in from off the floor) who was pressured by his wife to hire his brother-in-law. The brother-in-law wasn't all that bright, but the broker felt his brother-in-law couldn't do that much damage if he were on the phone as a clerk. After all, the clerks just take the buy and sell orders over the phone and run them into the pit to be filled.

Well, everything went reasonably well for a few weeks, and then the first inevitable error occurred. Apparently, the brother-in-law took an order to buy five contracts, and he wrote "sell" on the order ticket. By the time the error was discovered, it had resulted in a loss of 370 points (\$925) that the commission house broker had to make good. After the market closed, the broker took the brother-in-law aside and carefully spoke to him.

The broker said, "Look, mistakes happen and, fortunately, this error was for only 370 points. It could have been much worse, but you have to be more careful. We cannot afford to have any more errors like this one."

The brother-in-law replied, "What are you getting so hot under the collar for? Sure I made a mistake, but it's only points."

To this day, whenever anyone makes an error in the copper pit, the guys on the floor say, "Hey, what's your problem? It's only points!"

Some contracts have associated daily price limits, which measure the maximum amount that the market can move above or below the previous day's close in a single trading session. Each Exchange determines whether a particular commodity has a daily trading limit and for how much. The theory behind the **limit-move rule** is to allow markets to cool down during particularly dramatic, volatile, or violent price moves. For example, the rules for the soybean contract state that the market can move up or down 50¢ per bushel from the previous close if it did not close "limit" the previous day. (Limit moves result in expanded limits). So if the market closes at \$8.10 per bushel on Tuesday, then on Wednesday it can trade as high as \$8.60 or as low as \$7.60. Contrary to popular belief, the market can trade at the limit price; it just cannot trade beyond it. At times of dramatic news or price movements, a market can move to the limit and "lock." A **lock-limit move** means that there is an overabundance of buyers (for "lock limit up") versus sellers at the limit-up price, or that there is an overabundance of sellers (for "lock limit down") at the limit-down price.

eg For example, suppose that in a drought market, the weather services are forecasting rain one weekend, thereby causing the market to trade lower on a Friday. However, the rain never materializes, and on Monday morning, the forecast is back to drought with record-high temperatures predicted for the week. Conceivably, the market could open "up the limit" as shorts scramble to buy back contracts previously sold, and buyers would be willing to "pay up" for what appears to be a dwindling future supply of soybeans. Let's say the market closed on Friday at \$7.50 and that it opened at \$8 on Monday. Now it could trade at that price, or it could trade even lower that day. But suppose 20 million bushels are wanted to buy at the limit-up price of \$8, with only 10 million bushels to sell. The first 10 million would trade at \$8, with the second 10 million bushels in the "pool" wanting and waiting to buy. If no additional sell orders surface, the market would remain limit up that day, with unsatisfied buying ▶

demand at the \$8 level. However, there is nothing to say the market has to open higher on Tuesday (it could unexpectedly rain Monday evening), but all other factors remaining equal, this unsatisfied buying interest would most likely “gap the market” higher on Tuesday morning.

In fact, some markets have what are called **variable limits**, which is where the limits are raised if a market closes limit up or limit down during a trading session. Cattle is one of the markets with variable limits. If one or more contract months close at the 3¢ (300-point) limit for two successive days, the limit is raised to 5¢ on the next business day. (You can consult the Web sites of the various Exchanges for the daily price-limit rules for each market.) Limit moves are rare, but they do occur during shocks to a market. Pork bellies, for example, are notorious for moving multiple limit days after an unexpectedly bullish or bearish “Hogs and Pigs Report.”

Here’s a true story of how gutsy some of the floor traders at the Board can be at times.

Bill, who works our soybean orders, told me about one summer day when the soybean market was down the limit. It wasn’t just down the limit; it was “locked down the limit,” with five million bushels offered to sell down the limit and no buyers in sight. It was very quiet. Then, out of nowhere, one large “local” wanders into the pit and utters, “Take ‘em.” “How many?” they ask. “All of ‘em!”

The other brokers in the pit literally fell over themselves selling the entire five million to this guy. What could he be thinking? But then, as soon as the five million were bought, and the quote machines around the world tuned into soybeans showed this, the telephones around the pit started to ring. Off the floor, traders around the world assumed with such a big buyer at limit down that something was up, and they started to buy, too. The market immediately started to rally. When it moved 5¢ per bushel off the limit-down price, the large local stepped back in and sold his five million bushels. It was a quick \$250,000 profit, and it took only 20 seconds!

Trading hours are set for each individual market by the Exchange. Cattle opens at 9:00 A.M. Chicago time on the Chicago Mercantile and closes at 1:00 P.M. sharp. (If your order to sell reaches the cattle pit at 1:01 P.M., you’re out of luck, at least for that trading session.) As more and more markets become completely electronic, trading hours won’t matter as much as they used to. Many markets, particularly the financials, trade on virtually a 24-hour basis. Most of the major markets have after-hours trading, but some don’t. If you miss the Live Cattle close at 1:00 P.M. Chicago time, for example, you have no choice but to wait until the next trading day. If you miss coffee, however, you can trade it in London, but there is an eight-hour period where coffee futures are not traded anywhere in the world. If you miss corn, on the other hand, which closes at 1:15 P.M. central standard time (CST), you can trade it electronically at night from 5:30 P.M. until 4:00 A.M. the following morning.

To review thus far, before you trade in any market, you need to know, at minimum, the Exchange the market is traded on, the trading hours, the contract size, and the delivery months traded. You need to know how prices are quoted, so that you can put them in the right priced order, the minimum fluctuation, the dollar value of the minimum fluctuation, and if there are any daily trading limits. You also need to know the types of orders accepted at that particular marketplace. Finally, you want to know what the margin requirement is for the market you are trading, and what commission your broker will be charging. These topics are covered in the following sections.

It is as easy to sell short as to buy long

If you're an experienced trader, feel free to skip this section. For the rest of you, the concept of selling short is an important one. After you begin to trade, selling short will become second nature, but experience has shown that many novices initially have trouble with the concept.

Everyone knows that if you buy something at one price and sell it for a higher price, you make money. If you sell it at a lower price than what you paid for it, you lose money. When you trade futures, you can buy or sell in whatever order you like. You can buy and then sell, or sell and then buy. Whichever you choose, the idea is that the selling price should be higher than the buying price. One question I've often heard is "How can you sell what you don't own?" Well, here's how: A buyer of a futures contract is obligated to take delivery of a particular commodity or—and this is what happens most of the time—sell back the contract prior to the delivery date. The process of selling back, which can be done anytime during normal market hours (assuming the market is not "locked limit down" in those markets with limits, which is a rare occurrence), in effect, wipes the slate clean. People seem to have no trouble understanding that if you buy 200 shares of General Electric stock that you can sell back 200 shares of General Electric stock at the stock exchange. Again, if you buy at one price and sell at a higher price, you make money, and vice versa.

eg For example, if you buy soybeans at \$8 per bushel and sell them at \$8.20 per bushel, your profit is 20¢ per bushel, which is worth \$1,000 for a soybean contract. (A penny move is a profit or loss of \$50.) If you buy a contract of beans at \$8 and sell them back at \$7.80, you lose 20¢, or \$1,000 per contract. If you buy 10 contracts of July soybeans, you could cancel your obligation to take delivery by selling back 10 contracts of July soybeans. You would then be out of the market, and the difference between the price at which you bought and sold would determine your profit or loss on the trade.

When trading futures, because you are trading for future delivery, it is just as easy to sell first and then buy back later. Selling first is referred to as **shorting** or **selling short**. To offset your obligation to deliver, all you need to do is to buy back your contract(s) prior to the expiration of the contract(s). This process of buying back is known as **covering**. You "covered your short position" to wipe the slate clean. The

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purpose of shorting is to profit from a fall in prices. If you believe the price of a particular commodity is going down, due to an oversupply or poor demand, you want to go short. The objective is to cover at a lower price than you sold.

eg In the soybean example, if you believe prices at \$8 are too high and are heading for a fall, you could go short at \$8. If prices fall to \$7.80, you might want to cover your position and take the 20¢ profit. A short sale at \$8, covered at \$7.80, is a profit of 20¢, or \$1,000 per contract. Of course, if prices rise and you have to cover at \$8.20, you would have a loss on the short sale of 20¢ per contract, or \$1,000. “Sell high, buy back low” can be just as profitable as “buy low, sell high.”

Kevin ‘Mac,’ who leased my COMEX seat, once told me a humorous (and true) story: Kevin traded in the copper pit, as did Al, a big commission house broker. Al was big in more ways than one, and his weight seemed to roller coaster depending on which diet he was on at the time. Diet or not, Al was a big guy, and this was an advantage that would get him noticed in the pit. Al was also a colorful guy who liked to play the horses, but at heart he was a shy man. Still, you wouldn’t know it when you saw him in the pit because he moved frenetically and possessed a gruff voice. He “filled paper” for a living, meaning he executed customer orders in the pit.

This happened in the copper market of 1987–1988, a particularly wild time. The day of the stock market crash, the market spiked downward 10¢ per pound, a huge single-day move, to less than 80¢ per pound. (Interestingly, just a few months later, it was more than \$1.40 per pound). The market was wild and noisy that day, and Al was summoned to the phone to take a large buy order from a New York client. Al was on one of his diets, and that day he had forgotten his belt. He rushed into the pit, raised his arms to bid for the copper, and his pants fell to his ankles. It was a wild day, but for a few seconds, no one could believe their eyes. Everyone stopped trading to stare at Al’s boxer shorts. Al turned as red as the hearts on his boxers. (He had gotten them for Valentine’s Day.) Then Kevin broke the silence. As Kevin tells it, he didn’t stop to think. It just came out.) Kevin yelled, “Look at Al! He’s covering his shorts!”

Now there’s a story only commodity traders find funny.

Margin and leverage

One of the big attractions—and what makes futures exciting—is leverage. **Leverage** is the ability to buy or sell \$100,000 of a commodity with only a \$5,000 security deposit so that small price changes can result in huge profits or losses. Leverage gives you the ability to either make a killing or get killed. You need to understand how this important concept works before you trade, and a thorough understanding of the powers and pitfalls of leverage is imperative to sound money management principals, which we’ll discuss later in the book.

Each contract bought or sold on a futures Exchange must be backed by a good-faith deposit called **margin**. This is not like buying on margin in the stock market. When a stock market investor buys on margin, he is, in effect, borrowing half of the purchase price of the stock from his broker. (Stock exchange rules prohibit borrowing more than 50%.) The investor is charged interest on the balance. This provides a degree of leverage, but nothing like commodities.

To see how powerful leverage can be, let's compare a futures purchase with a stock purchase for cash. If a stock investor buys 200 shares of a stock trading at \$10, his purchase cost is \$2,000. If the stock moves up by 10% to \$11 per share, the investor has made \$200 on his \$2,000 investment, or 10%. Margin in commodity trading is like a good-faith deposit. It is a small percentage, generally in the neighborhood of 2 to 10%, of the value of the underlying commodity represented by the contract. Margin deposits are set by the Exchange, and they can change with price movements and market volatility. Because you are trading for future delivery and not borrowing anything, no interest is charged on the balance. Margin is not a partial payment or a down payment, and it's not even considered a cost. If you make money on the trade, upon liquidation, your total margin deposit is returned, along with your profits. Commissions are deducted, and they are a cost. Margin is money deposited in your brokerage account that serves to guarantee the performance of your side of the contract. Margin is a form of "earnest money" deposited by both the longs and the shorts, and it serves to ensure the integrity of every futures transaction. In effect, margin ensures that you are paid when you win, and that whoever is on the other side of your transaction is paid if you don't.

When you enter a position, you have deposited (or will deposit) the margin money in your account, but your brokerage house is required to post the margin with a central Exchange arm called the **clearinghouse**. The clearinghouse is a non-profit entity that, in effect, manages the daily process of debiting the accounts of the losers and redistributing the money to the accounts of the winners.

eg Now back to the leverage example. The margin requirement for a 5,000-ounce silver contract has been running \$2,000 on average in recent years. At \$6 per ounce, a contract is worth \$30,000 (\$6 per ounce times 5,000 ounces). If the price of silver rises by 10% to \$6.60, the same contract is worth \$33,000. However, suppose the same investor puts up his \$2,000 and instead buys a silver contract. If the price of silver rises by 10%, or 60¢, he makes \$3,000 on his contract. This is 150% on margin, not 10%. It's powerful leverage, but also a double-edged sword. If prices fall by 10%, the investor's \$2,000 is now worth a *negative* \$1,000. When you trade futures, you are responsible for the total value of a move of any position you hold. In most cases, if a market moves against you, you have time to liquidate before the account shows a deficit; however, this is not always the case. If you don't use adequate risk-control measures, or if a market moves very quickly against you, your account could go into a deficit situation, and *you are obligated by contract to pay the difference*.

There are two types of margin: initial margin and maintenance margin.

Initial margin is the amount that must be in the account before you place a trade. If you do not have enough initial margin in your account, you incur a *margin call*. Most brokerage firms require the initial margin to be in the account before they allow a trade to be placed. Some might issue credit for good customers, but they generally require that the margin call be met within one to three business days. Any firm has the right to require same-day deposit by bank wire transfer at any time and might request this during volatile markets. **Maintenance margin** is the amount that must be maintained in your account as long as the position is active. If the equity balance in your account should fall below the maintenance margin level, because of adverse market movements, you incur a margin call as well. After the margin call is issued, you are required to meet the call or liquidate the position. If you fail to meet a margin call in a timely manner, the broker has the right (and will use it) to liquidate the position for you automatically. This is done to protect the broker from additional adverse movements in the market, because he is responsible for meeting your margin call, even if you're a deadbeat and don't.

If you fail to meet a margin call, and the position is ultimately liquidated at a loss that leaves a deficit in the account, the broker is immediately responsible for the deficit, but you are legally responsible. In other words, initial margin might not be the extent of your liability. You are responsible for all losses resulting from your trading activities. If the market moves against you five, six, or seven days and you do not get out, if the market moves limit against you and eats up your margin, you are still responsible for any and all losses. Later in the book you'll learn ways to manage the risk, but at this point be aware that whenever you trade futures, your risk is not limited to the initial margin or your account balance. It can go further than that. (Options work differently; they will be discussed later in the book.)

eg Here's a typical example. Assume silver is trading at \$6 per ounce, and the initial margin requirement is \$2,000. A silver contract has a size of 5,000 ounces, so at \$6 per ounce, the total value of the contract is \$30,000. However, all that is required to purchase or sell a contract is \$2,000 (in this example, about 6%). A rule of thumb for maintenance margin is that it will be at the 75% level of initial. If the initial is \$2,000, for example, maintenance might be \$1,500. If you have an account value of \$20,000 with no other positions on, you *could* buy 10 contracts without a margin call; however, this is not recommended because you would be overtrading, or too highly leveraged, and a relatively minor price movement would move you into margin call territory.

For illustrative purposes only, let's assume your account balance is at \$20,000 and that you buy 10 silver contracts. Your maintenance level is at \$15,000. If the market starts to move your way immediately, you're OK. Because a silver contract is for 5,000 ounces, a 1¢ move results in a profit or loss per contract of \$50. In this example, the 10 contracts give you a profit or loss of \$500 per penny move. Suppose you buy the 10 contracts at \$6, and the market closes that same day at \$6.05. Your account balance is \$22,500 on the close of business that day. You have an *unrealized* profit of \$2,500. The profit is unrealized because the

position is still open. The increase in equity value of \$2,500 is the result of the 5¢ move in your favor (5¢ times \$50 per contract times 10 contracts). Suppose the next day, the price falls 10¢ to close at \$5.95. Your account value decreases by \$5,000 to \$17,500. You would *not* have a margin call, because your value still would be above the maintenance level. If on the next day prices rose 5¢ to \$6, your equity value would move back to \$20,000.

Basically, the futures is the process of generating a credit or debit daily against your initial position until you close it out. If you make money on any particular day, the unrealized credit balance is credited immediately to your account and debited from the people on the other side of the transaction. (You will never know who they are because it's completely anonymous, but they are out there.) If the market closes against your position on any particular day, the loss would be immediately debited from your account.

Now, let's get back to the example. On the fourth day, the market drops 25¢ to close at \$5.75. Your account is debited \$12,500 (25¢ times \$50 per contract times 10 contracts). Your equity balance is now down to \$7,500, which is below the maintenance margin level, so it's margin call time. You now get a communication from your broker, who informs you about your \$12,500 margin call. You see, after your equity level falls below the maintenance margin level, you are required to bring your balance up to the initial margin level. You now have two choices: You can either liquidate the position in whole or in part, enough to move your equity back above the initial margin level, or you can meet the call. In this case, you could sell out seven contracts, realize your loss on those seven, hold onto the three, get your initial margin down to \$6,000, and hope the market recovers. If you feel strongly about the position, you could opt to meet the call. Let's say you send in a check, or if required, wire transfer the \$12,500 to your account. Your account balance now shows \$20,000, so you are "off call." You have deposited \$32,500 into your account at this point, but if you close out the position at the current price of \$5.75, you have a balance remaining of \$20,000 minus any transaction costs. If your thinking is correct, and the silver market recovers to \$6, your account balance would grow back to \$32,500. You now have the right to request that the \$12,500 (the amount over the initial margin) be sent back to you. If the market falls again, however, you could certainly be issued another margin call.

It is important to leave a cash cushion in the account so that you have the ability to ride out normal market fluctuations without receiving a margin call. My general rule of thumb is to never margin yourself higher than 50%. In other words, if your account value is \$25,000, I would not put on positions that, at most, would require more than \$12,500 in initial margin.

Each market has its own margin requirement. This requirement is based on the volatility of the particular market and also the volatility of the markets as a whole. Greater volatility equals greater risk and higher requirements. The S&P 500 index and the NASDAQ are two of the more volatile contracts, and it is not uncommon to have a daily range of \$5,000 per contract or more in value. The margin requirement

for the S&P can be in a normal period from \$7,000 per contract on up. I have seen the NASDAQ in the high-priced days with \$20,000 range days and \$30,000 margin for a single contract. On the other hand, corn is traditionally less volatile, and in a normal market, it might have a price range of \$250 per contract. The initial margin might be \$400 in a quiet market, but it could move up to \$1,000 in a volatile environment for corn prices.

Here's another important point on margins: Although the Exchange sets a minimum margin requirement, individual brokerage houses have the right to charge higher than "Exchange minimum." This protects the brokerage house from overtraders who tend to **plunge** (trade in excess of prudent speculation, even in excess of their ability to pay), which would require the broker to make good on his commitment to the clearinghouse.

The entire point of this margining system is that all positions are "marked to the market" by the clearinghouse daily and revalued to the current market price. As such, profits and losses are paid daily.

One last point about margins: The Exchange allows initial margins to be posted either in cash or (in the United States) U.S. government obligations of less than 10 years to maturity. If an investor wishes to post T-Bills for margin, he can do so; most commodity brokers will pass the interest back to the customer. So, in effect, the initial margin earns interest.

Delivery months

Every futures contract has standardized months that are authorized by the Exchange for trading. For example, wheat is traded for delivery in March, May, July, September, and December. If you buy a March contract, you need to sell a March contract to offset your position and meet your contractual obligation. If you buy a March wheat contract, and you sell a May wheat contract, you have offset nothing. You are still "long" March and now "short" May. Some commodities are traded in every month, but by convention, some contract months are traded more actively than others. For example, gold trades in every month of the year, but the active months are February, April, June, August, October, and December. On the London Metal Exchange, or LME (where aluminum, copper, zinc, nickel, lead, and tin are traded), a different system, known as **prompt dates**, is used. The active contract on any particular day is the 3-month. If you buy or sell a new 3-month on say, May 10, you are in the August 10 contract (assuming August 10 does not fall on a weekend or holiday). Then, to offset your position, you need to sell the August 10 contract. You can do that prior to August 10, but your buy or sell price is based on an interpolation of the cash (or spot contract) to 3-month differential on the day you liquidate. The margining procedure is different for the LME as well, so if you are thinking of trading in these markets, talk to your commodity broker about how it works.

Which month should you trade? This is a general rule of thumb only, but unless you have a specific reason for trading a specific month, trade the active month—for example, if in May you want to be short December corn because this is the first new crop month and, despite tight supplies, you think there's a big crop coming and predict this month will fall faster. The active month is the one with the highest open

interest, and your broker can tell you which month this is for any particular commodity at any point in time. This is because the active months have the greatest number of players and, therefore, the most liquidity. Because of this, you can get in and out with a smaller degree of slippage. **Slippage**, in effect, means having your order filled at a price different from that which existed as the last trade.

eg For example, let's say you want to buy gold and the last quoted price is \$401.10, but the best bid is \$401.10 and the best offer is \$401.30. It is a fast-moving market, and you want in. You buy at the market, and even though the last trade is \$401.10, your price fill comes back at \$401.30. These 20 points represent \$20, and they're likely to go into the pocket of a floor broker. It is legal, and as long as there are no lower offers in the pit, it is the price you pay for the liquidity the floor brokers provide.

You'll learn more about this later in the book, but the point is, for minimum slippage, it is best to trade in high-volume, active markets. I've also found a good commodity broker, who uses the better floor brokers in the pit-traded commodities (there are good and bad floor brokers) who tend to, on average, get you better fills, thereby reducing the costs associated with slippage.

In most cases (and there are exceptions to this rule as well), it doesn't make sense to trade in a delivery month. Therefore, you want to avoid entering positions that are close to delivery, because you'll need to "roll over" into the next contract sooner. The rules are different for each market, but in many cases, a contract enters actual delivery the last day of the month prior to the delivery month. For example, with March wheat, the **first notice day**, or first possible day the shorts can make a delivery, is the last trading day in February. What happens if you fail to sell out and are still in the contract on first notice day? Well, there is a *possibility* you will get actual delivery of the wheat because the shorts are not required to make delivery the first day or the next. A short is required only to make delivery if you have not covered your contract prior to the last trading day. The last trading day for March wheat is in the third week of March, so the delivery period lasts about three weeks. A long can receive delivery, at the discretion of the shorts, on any one of the days in the delivery period. If the cash price is above the futures on first notice day, the shorts may not find it lucrative to deliver and wait. If the cash price is below the futures, odds increase for deliveries. Now, just because deliveries are made on any particular day does not mean you will get delivery on any particular day. Early in the delivery period, the number of open contracts exceeds the deliverable supply. If open interest in the March wheat is, say, 100 million bushels, and the deliverable supply in the elevators licensed for delivery is 20 million bushels, the odds of delivery are high only if you purchased the contract months ago instead of days ago. This is because deliveries are assigned to the oldest date first. The oldest long is first in line for delivery. However, as the delivery period progresses, the odds for receiving a delivery increase as the number of outstanding contracts is liquidated downward and your date becomes "fresher."

So what happens if you do get delivery? Contrary to popular belief, you do not get a load of wheat dumped on your doorstep—or worse yet, a load of hogs.

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Instead, you receive a warehouse receipt that shows you now own 5,000 bushels of wheat in, for example, a Toledo elevator. Because you are now in a cash contract (the delivery offsets your futures), you're now required to post the full value of the contract. Your leverage is gone. If your margin deposit was \$700 for the futures, you now need to pony up an additional \$19,300 if you received delivery at \$4 per bushel. If you don't have the money in your account, your broker will have to post this amount on your behalf, and he will charge you interest on the balance. Other fees include an additional commission, insurance, and storage costs. You can pass your delivery receipt on to someone else. Because only the shorts can make delivery (and you are *long* a warehouse receipt), you first need to sell a contract short and then instruct your broker to make your delivery on your short contract. This is the way to sell back your warehouse receipt. In most cases, there is no good reason to be trading in a delivery month unless, of course, you have a good reason. A good reason might be a belief that there is not enough of the commodity available to deliver, which could cause a **short squeeze**, a panic situation for the shorts. However, be aware that this is generally a game for sophisticated traders. Of course, as a short, you have no chance of receiving a delivery (because it is at your discretion as to when to make it), but then your chance of being squeezed increases with each day you are in the contract during the delivery period. If you are in on the last day, and your broker hasn't forced you out, good luck in making the delivery. This is a game for the commercials.

When I was at Merrill Lynch, I remember one of the commodity brokers had a client who refused to liquidate a long sugar position prior to the delivery period. The client thought there was no sugar but, alas, there was. (The sugar contract is written so that you can receive delivery at any one of a hundred ports around the world.) He got his sugar on a barge off Bangkok, and it cost him plenty for Merrill Lynch to find a cash operator and dispose of this **distress merchandise** in the cash market. (The commercials knew he had no use for 112,000 pounds of sugar on a barge.)

One last point: Most financial futures (stock indices and currencies) and even some of the agricultural futures (feeder cattle and lean hogs) are **cash settled**. Any positions still open when the contract expires are closed at the settlement price. The amount paid or received is calculated for everyone who remained in at expiration based on this common price.

Brokers and commissions

Although margin isn't a true cost (you get it back at the end of the trade, plus any profits or minus any losses), commissions are. **Commissions** are your broker's fees for his services, and they range across the board and by broker. The two major types of commission firms are the discounter and full service.

Commissions, while important, should *not* be your only consideration when choosing a broker. Low commissions do not always mean the best service. My firm is a full-service firm, and although our commissions are competitive for full service, they are generally a bit higher than discounters. I'm not trying to say there isn't a place for discount brokers. My firm also offers online trading at reduced rates for self-directed traders. If you are relatively sophisticated, know exactly what you want to do in the marketplace, do not require advice or additional services, and only need order execution (especially in the electronic markets where execution does not vary from broker to broker), then you should certainly consider using a discount or online futures broker. However, you need to evaluate what you're receiving. With some firms, discount commissions equal cheaper service, particularly when you have a problem. All firms use brokers in the open outcry pits to execute trades. Some use company brokers, but most use independents, which are members of the Exchange who fill 'paper,' or public orders.

Not all independents are equally talented. Larger firms with bigger orders tend to attract the bigger (and better) floor brokers because the floor brokers are paid a small fee per contract executed. If a floor broker is a bit louder, more aggressive, or is known to hold a large **deck** of orders, he tends to do a better job than the novice floor broker with a smaller deck. At my firm, we pay floor brokers who do an outstanding job an additional or higher-than-standard fee per contract executed. I do not believe any discount brokers do this. We do this because when a floor broker can be a bit faster, he can at times buy the bid for us or sell the offer and get us a slightly better price fill for our customers, and this means more money in for our customer and can be more important than a low commission. The bottom line? Whichever broker you ultimately choose, you should evaluate how accurate and proficient your price fills are. You also need to see how fast your broker gets back to you with price fills. Additionally, you need to evaluate how much help your broker is providing you with versus how much help you require. A knowledgeable full-service broker who provides you with profitable recommendations is worth many times the commissions charged. Just as important, is your broker helping you to control your risks properly on the bad trades? Is he helping you to avoid the classic mistakes such as overtrading? These are factors you'll need to evaluate. A brokerage relationship is extremely personal, and whom you trade with can mean the difference between profit and loss.

One last thought about commissions. When talking commodity futures, the fee per contract traded is low when compared with many other types of investments. The fee can be one-half of a percentage point of the total contract value. It is a higher percentage when compared to the margin deposit, but it's still small. The other side of the coin is that futures traders are much more active than more traditional investors, and *total* commission costs for an active trader can run up substantially over time.

One last thought about brokers: There are brokers who do both securities (stocks) and commodities business. I'm sure there must be some of these dual types who excel at both, but I've personally never met one. Many of our clients who previously

had troubles in commodities seem to have drifted to us from brokers, in many cases from a major wire houses, who were these “Jacks of all trades.” On the other side of the spectrum are those traders who know what they’re doing and trade only electronic markets, for example, the S&P “E-minis.” Price fills (the quality of order execution) are generally uniform for the electronic markets. However, if you need help, remember that commodity trading is an intense, full-time business, and you should go with a specialist.

The players

The two major classes of participants in the futures and options markets are the hedgers and the speculators.

Hedgers can account for from 20 to 40% of the volume and open interest in the major futures markets and up to half or more in some of the smaller contracts. Hedgers use exchange traded contracts to offset the risk of fluctuating prices when they buy or sell physical supplies of a commodity.

eg For example, a copper mining company might sell copper futures to lock in a sale price today for its future production. In this way, the company protects its profit margins and revenue stream should future copper prices drop. Should future copper prices rise, the company loses on its futures position; however, the value of its physical metal rises. The copper mine is a producer and is just trying to offset, or *hedge*, its price risk. A hedger can be a buyer or a seller.

A tube manufacturer, which buys copper as a raw material in the production of copper tube used for plumbing, might buy copper futures to lock in its copper cost for future purchase. If the price of copper rises, the manufacturer has a profit on its hedge, which can be used to offset the higher price of physical copper it needs to purchase in the marketplace. If copper prices fall, the manufacturer shows a loss on the futures side of the transaction, but it is able to buy the copper cheaper in the marketplace.

In either case, the copper mine or the tube manufacturer has the ability to hold its contracts into the delivery period. They then have the option to make or take copper delivery through the Exchange at an approved warehouse licensed to do business on the Exchange. This option is as important in theory as in practice because it is what allows physical commodity prices and the Exchange traded contracts to come together in price. If the price of the commodity is too high in relation to the futures price, then those people involved in the usage of a particular commodity buy the low-priced futures contracts and take delivery. Their buying, in effect, pushes futures prices up to meet the physical price. If the price of a futures contract is too high in relation to the actual commodity, then producers of that commodity sell the contract to make delivery, because the higher-priced futures (in relation to the physical) just might be their best sale. Their selling pushes the price of the futures down to the cash price. This entire process is known as **convergence**. This potential process of convergence is what makes the system work; however, in practice only, one to two percent of all commodity contracts end in delivery. Odds are that you, as a speculator, will

never get involved in a delivery, and there's no need to. In fact, even the majority of hedgers do not use the markets to actually make or take delivery; they are using the futures as a pricing tool to help stabilize their revenues and their costs.

I have a client, a major manufacturing firm that publishes a biannual catalog with prices they honor during the catalog date. They use copper and zinc in their manufacturing process, and they know what their profit margin is based on today's price of copper and zinc. If they don't hedge and lock in the six-month price of copper today, and the price goes up during the time the catalog is distributed, their entire profit margin could be wiped out. The other side of the coin is that if copper prices fall and their published price remained based on the published higher prices of the raw materials, they could reap a windfall profit. However, they are not in the business of speculation; they are in the manufacturing business. They are more than willing to forego the chance of a windfall to be assured of a profit margin that allows them to keep the plant running and avoid layoffs.

A few times each year, I sit down with them and determine where to buy copper and zinc futures to lock in a price they can live with for the next six months. After they know this price, they can publish their catalog with peace of mind knowing that their profit margin is secure. If the price of copper rises, they will have to pay the higher price in the cash copper market; however, their futures contracts will rise in value as well, and the profits from the futures offset the higher price that must be paid in the physical market. If the price of copper falls, they will show a loss on their futures, but this will be offset by the lower price they will enjoy in the cash market when they buy their copper. In this particular case, this firm has documented an additional cost savings by using futures.

In the past, they used to lock in their price by buying six months worth of copper and zinc and storing the metal in large warehouses. At times, there were so many tons of metal that they had to rent space in warehouses they didn't own. Not only does this involve the rent and the cost of maintaining these warehouses (you have to pay forklift operators to move the goods), but think of the cost of money to finance thousands of tons of heavy metal. Now that they are assured of a future price, they maintain just two to four weeks worth of physical metal on location, and they have eliminated the need for many of these warehouses. The savings in interest alone is in the hundreds of thousands of dollars. This firm has never taken delivery on the futures. Actually, they do not even use the type of copper specified in the futures contract (the pure, or virgin, metal); they use scrap copper. However, because the price of scrap moves in the same direction as the price of the virgin metal, this is a good *cross-hedge* that works well in their risk-management program.

Many of the products hedged on a futures Exchange are actually cross-hedges. For example, jet fuel is similar to heating oil, which often is priced within a few cents different from each other. A major airline might use the heating oil contract to hedge its jet fuel requirements, and a trucking company might use the same contract to hedge its diesel fuel needs.

Basis risk

The definition of **basis** is the difference between the cash, or spot price, and the futures price. Every contract traded has what are termed specifications, which make the contracts fungible and standardized.

eg For example, let's look at the contract specifications for heating oil traded on the New York Mercantile Exchange:

Trading Unit

42,000 U.S. gallons (1,000 barrels).

Price Quotation

U.S. dollars and cents per gallon.

Trading Hours (All times are New York Time)

Open outcry trading is conducted from 10:05 A.M. until 2:30 P.M.

After-hours futures trading is conducted via the Internet-based trading platform beginning at 3:15 P.M. on Mondays through Thursdays and concluding at 9:30 A.M. the following day. On Sundays, the session begins at 7:00 P.M.

Trading Months

Trading is conducted in 18 consecutive months, commencing with the next calendar month.

Minimum Price Fluctuation

\$0.0001 (0.01¢) per gallon (\$4.20 per contract).

Maximum Daily Price Fluctuation

\$0.25 per gallon (\$10,500 per contract) for all months. If any contract is traded, bid, or offered at the limit for five minutes, trading is halted for five minutes. When trading resumes, the limit is expanded by \$0.25 per gallon in either direction. If another halt is triggered, the market will continue to be expanded by \$0.25 per gallon in either direction after each successive five-minute trading halt. There will be no maximum price fluctuation limits during any one trading session.

Last Trading Day

Trading terminates at the close of business on the last business day of the month preceding the delivery month.

Settlement Type

Physical.

Delivery

F.O.B. seller's facility at New York harbor, ex-shore. All duties, entitlements, taxes, fees, and other charges have point paid. Requirements for seller's shore facility: capability to deliver into barges. Buyer may request delivery by truck, if available, at the seller's facility, and pays a surcharge for truck delivery. Delivery

also may be completed by pipeline, tanker, book transfer, or inter- or intra-facility transfer. Delivery must be made in accordance with applicable federal, state, and local licensing and tax laws.

Delivery Period

Deliveries may be initiated only the day after the fifth business day and must be completed before the last business day of the delivery month.

Grade and Quality Specifications

These generally conform to industry standards for fungible No. 2 heating oil.

Inspection

The buyer may request an inspection for grade and quality or quantity for all deliveries, but shall require a quantity inspection for a barge, tanker, or inter-facility transfer. If the buyer does not request a quantity inspection, the seller may request such inspection. The buyer and seller share the cost of the quantity inspection equally. If the product meets grade and quality specifications, the buyer and seller share the cost of the quality inspection jointly. If the product fails inspection, the cost is borne by the seller.

This contract is **standardized**, in that all contracts created are the same. Contract specifications for all contracts traded on the Exchange are available from your commodity broker or the Exchange Web site. (A listing of the Exchanges is included in the Appendix of this book.) As a speculator, you really are not concerned with the delivery specifications, because you will not be involved in delivery—you'll be out long before it starts. What about the hedger? This particular contract calls for delivery of No. 2 heating oil in New York harbor. Of course, not all heating oil is used in the New York area, and prices in other cities will vary due to differences in transportation costs, storage costs, and local supply-and-demand considerations. A wave of Arctic air sweeping through Europe would no doubt raise the price of heating oil globally, but the price would rise faster in Rotterdam than in New York. These differentials are known as the **basis**. The basis can be stable and predictable at times. For example, if it costs 3¢ per gallon to transport heating oil from New York to Boston, the basis in Boston may predictably run at "plus 3¢ per gallon," all other factors remaining equal. However, if Boston is under a deep freeze and New York isn't, the basis might move up to "plus 4¢."

For the manufacturing firm I work with, the price of scrap copper can, at times, be at the price of the virgin metal (when there is a scrap shortage). Other times, it could be as much as 4 or 5¢ per pound under. The point here is that the hedger has what's called **basis risk**. Basis risk is almost always far less than the price risks involved without a hedge. A hedger who does not hedge is just like a speculator, because he is assuming the natural risks of the marketplace. Once again, I want to point out that most hedgers close out their futures positions long before their futures contracts expire, and the majority long before the delivery period even starts. Then they take or make delivery of the physical commodity they are involved in through normal channels by using their standard suppliers. Knowing that each contract is

actually keyed into a specific actual grade of the underlying commodity keeps the value true to life. No matter what the underlying commodity is, each Exchange ultimately guarantees the purchase and sale, as well as the delivery grades for quality and quantity. This is why quotations from the Exchanges for most of the commodities traded are used as pricing standards by companies and individuals around the world.

A hedging example

The primary thrust of this book is geared toward the speculator and how he can use the commodity futures and options markets to make money. However, it is important for all traders to understand how a typical hedge might work to see why these markets exist in the first place. Remember, the perfect hedge is rare; there is just about always some basis risk. However, the concept is the same regardless of whether we are discussing a packing plant hedging its live cattle needs or a bank hedging its interest rate risk. Hedges come in two basic forms: the short and the long.

The short hedge

A short hedge is entered into to protect the value of an inventory. Consider an example using crude oil. An inventory of 1,000 barrels of crude oil constantly changes in value from wellhead to consumer, even before it is processed into gasoline or heating oil. A short hedge is used by the owner of a commodity to essentially lock in the value of the inventory prior to the transferring of title to a buyer. *A decline in prices generates profits in the futures market on the short hedge.* These profits are offset by depreciation in the inventory value.

eg Let's say an oil producer is afraid of a price decline. In August, he anticipates he will sell his August production in September. His production is 1,000 barrels a day for 25 days. The cash price in August is \$20 per barrel, and October futures are quoted in August at \$20.10 per barrel. Here's what the producer might do in the futures market: sell 25 October futures (each contract is for 1,000 barrels, so this represents his August production of 25,000 barrels) at \$20.10, which locks in a value of his inventory equivalent to \$502,500 (\$20.10 per barrel times 25,000 barrels.) Suppose he is correct about the price falling. Along comes September 15, and the price of crude falls in the cash market by \$2 per barrel. Because the futures mirror the cash fairly closely, the futures also fall in price. Let's say the futures on that date are quoted at \$18 per barrel. The cash price on September 15 is now \$18, or \$2 less than the \$20 price at production time. He sells his product in the cash market to the refinery for a total of \$450,000 (\$18 times 25,000), or \$50,000 less than what he could have received in August. However, the futures have also dropped, and he buys back his October futures contracts on September 15 for \$18. (This offsets his position; he does not have to make delivery.) Remember, he sells for the equivalent of \$502,000, he buys back at the equivalent of \$450,000, and the difference of \$52,000 is his gain in the futures. The futures gain of \$52,000 offsets the cash market loss of \$50,000, and he has, in effect, protected the value of his inventory at the August price.

What if the oil producer is wrong, and the cash price rises? Let's say that instead of falling to \$18, the cash price rises to \$21 by September 15, and the October futures rise to \$21.10. His 25,000 barrels realize him \$525,000 in the cash market, or \$25,000 more than he could have received in August. However, his futures also rise to a total value of \$527,500 (\$21.10 times 25,000). When he buys his contracts back, he realizes a futures loss of \$25,500 (\$502,000 minus \$527,500). Therefore, the futures loss of \$25,500 must be taken into consideration with the extra cash profit of \$25,000. He still comes back to approximately the August price. The short hedge has protected the value of his inventory at about \$20, which is the number he was happy with.

The Nebraska farmer, who wants to lock in the price of his corn for harvest time in the fall, while it is still in the ground during the summer, would use a short hedge in much the same way.

The long hedge

The long hedge is entered into by a commodity user (buyer) to fix acquisition costs and ensure a certain profit margin.

eg For example, let's suppose an ethanol producer (a corn-based fuel additive) uses 1 million bushels of corn to meet the ethanol requirements for his major customer during the peak summer driving season. It is April, and July corn futures are quoted at \$2.50 per bushel. By July, depending on weather, exports, and other unknowns, the price of corn could be much higher or lower. This big customer wishes to enter into a contract with the producer for delivery at today's price in August (for ethanol the producer will manufacture in July). The producer knows he can make a profit at today's ethanol prices *if* the price of corn remains at \$2.50. He calculates his gross profit at \$2.50 corn to be \$50,000. His profit would be greater if corn prices fell. His break-even is at \$2.70 corn, and if corn prices rise above this level, he would actually wipe out his profit margin and see red ink (assuming today's ethanol prices, which also could fluctuate).

To keep his customer happy and loyal and to ensure his plant continues to run at capacity, he enters into an agreement to deliver ethanol at today's price to the big customer in August. Rather than take the risk of the marketplace and run the risk of potentially selling his product at a loss in the summer *should* corn prices rise, he foregoes the gamble of a windfall profit (should corn prices fall) and enters a long hedge in the futures market. He buys 1 million bushels of July corn in the futures on April 15. This is the day he also enters into his cash contract for delivery of ethanol to his customer next August. The price of July corn on April 15 is \$2.50. A drought develops, and in July, when he needs to go into the cash market to purchase the million bushels, the price of corn has risen to \$3.00 in both the cash and futures. It has gone up by 50¢ per bushel, which is an additional cost to him, over and above the April price, of \$500,000 (1 million bushels times 50¢ per bushel). ▶

However, the futures have also risen by 50¢, and he sells the July futures contracts he purchased for \$2.50 at the then prevailing price of \$3.00. He thereby realizes a futures *gain* of \$500,000, exactly offsetting the additional cash loss of \$500,000. In this way, he assured his \$50,000 gross profit on the transaction. If he had not hedged, he would have lost \$450,000 on the cash contract instead of realizing a profit of \$50,000.

Now if the weather had been good, and it looked as if a large crop was forthcoming, prices might have fallen to, say, \$2.20 by July 15th. His cash corn cost in this case would be \$300,000 less. If unhedged, and if he had entered into a cash contract for ethanol at the April price, he could have realized a windfall profit of \$350,000 versus \$50,000, all other factors remaining equal. If hedged, he loses \$300,000 on the futures transaction (a fall of 30¢ per bushel times 1 million bushels). However, the ethanol producer makes this decision; if he can always enter into profitable contracts with his users, he knows he will remain in business. Sure, if prices of corn fall, he is out the extra \$300,000 profit in this example (and this \$300 grand probably was transferred from his account to some speculator(s) he'll never see, but this is OK—he's not in the casino business, his business is ethanol production), but he will gladly forego the chance of a windfall for the ability to keep his plant running profitably.

This simple example demonstrates that the objectives of hedgers and speculators are not the same. The speculator is always looking to make money on his transactions. The hedger, however, is not always looking to necessarily profit on the futures side of the transactions. The hedger's goals are to lock in a price that will assure a profit or prevent a loss for his business, either the production or consumption of some product. The bread baker who wants to lock in his future wheat purchase prices would use a long hedge in much the same way.

The reality

In these examples, I have kept the basis fairly constant, but in reality, it can change. If a short hedger (one who sells futures) experiences a *widening* of the basis (where cash prices have fallen to a greater degree than futures—either cash has fallen faster or risen slower than futures), a basis loss may result. In other words, the short hedger's cash position loss may be greater than the gain realized on the futures side of the transaction. Or, in a rising market, the gain on the cash side of the transaction would not be as large as the loss on the futures side.

Conversely, a basis gain would occur with a **widening** basis on a long hedge. The futures would rise in price to a greater degree than the cash. A **narrowing** basis yields additional gains for a short hedger (the cash falls less, or rises more, in relation to the futures) and incremental losses for the long hedger (the cash falls less, or rises more, in relation to the futures). Basis gains or losses are a risk to the hedger, but they're not nearly as big a risk as what is called **flat price risk**. The price of heating oil may move 20¢ per gallon in a couple of months, whereas the basis might move 1¢ either way. For example, the flat price move was a result of a warmer than

normal winter whereas the basis change was due to the fact it was colder in New Haven than New York that particular winter. The speculator might analyze basis changes to help him determine the strength or weakness of a market, but this is really more of a hedger's concern.

It doesn't matter whether the user needs copper or soybean oil or to purchase Euros six months hence; any market in which prices fluctuate creates price risk for commercial participants, which in turn creates the need for a hedging tool. Remember, hedgers are not trying to make a killing in the market; they wish to offset price risks. The speculator, on the other hand, tries to make money by buying low and selling high (or vice versa). A speculator is a marketplace participant who is neither a producer nor a consumer of a commodity or financial instrument. By definition, he does not have or want the underlying commodity, and this participant could be you or me. Without speculators that the system would not work; they add *liquidity*. Speculators often take the other side of the bids and offers in the marketplace put out by hedgers. At times they take the other side of a speculative bid and offer, and at times different hedgers may be on both sides of a transaction. However, a trade cannot be completed unless someone is willing to take the other side, and if there were only hedgers and no speculators, the system would not operate smoothly. By assuming the risks the hedgers are trying to avoid, the speculators will make money when they are right and lose when wrong. In the earlier ethanol example, when the manufacturer made the \$500,000 in the futures market, some person or persons lost that money. Those persons could have been speculators betting that the crop would be good and prices would fall. On the other hand, if prices did fall, this hedger's loss might have been made by speculators who were betting on lower prices.

Various types of traders fit the speculator category. **Pit traders** (also called *locals*) and other professional traders stand in the pit and trade for their own account, or trade for their own account from a computer screen. Many of them are *scalpers*, who are trading for ticks, or minor fluctuations. A local may, for example, scalp a small profit by selling five May copper contracts to a hedger who is buying at 98.10¢ per pound and then cover (or buy them back) from a speculator who is selling at 98¢ per pound. The tenth of a cent represents two price ticks (a tick is a minimum fluctuation); for copper this is .05¢ per pound or \$12.50 per tick, or \$25 per two ticks (or \$125) for a two-tick move on a five-contract position. In this example, the local made a profit of \$125, and he provided liquidity for both the hedger and the speculator. The hedger wanted to establish a longer-term buy hedge, and the speculator wanted to establish a new short position. The scalper is **making a market** here. At times, without the scalpers, a market can be thin, with buyers and sellers bidding and offering prices away from each other. Therefore, the local who is a scalper is providing an economic service, and this is why he is allowed to exist. I am not trying to say he is a wonderful person or a bad person; he is simply out to make a profit for himself (or herself—about 1% of pit traders are women). I am also not trying to insinuate that being a local on the floor is a license to print money. If a local's judgment is off, he can get caught in an adverse market swing, and his modest scalp will turn into a healthy loss.

When I leased my Exchange seat to a local because I was required to guarantee his performance, I received duplicate account statements. I saw as many losing trades and losing days as winning days, but on balance, he made money. He was a scalper (primarily) who traded hundreds of contracts each day, but it may have been in 2 or 5 or 10 lots at a time and for very short time periods. He was usually out, or flat, by the end of the day. At times he held a small position overnight, but most days he was out by end of the day, win or lose. The local, as an Exchange member, has the advantage of very low fees, just a few dollars per transaction. This is why the pit trader can trade so many contracts and trade them for just a few ticks and still make money. For the rest of us, commissions and **slippage** (the inevitable difference between buying the offer and selling the bid) would eat us up if we tried to scalp. Some pit traders are also **position traders**, which means they hold a position for more than minutes. Most off-the-floor speculators do not try to scalp. Although some speculators may be **day traders** (in and out during the same trading session), more hold a position for a few days, weeks, and in rarer cases months. When trading futures, holding a position for months is generally the exception (although the big money can be made with longer term positions). A speculator can be a big commodity fund manager, a lawyer in Toronto, a farmer in Montana (who is not hedging), a software engineer in London, or you! The risks in these markets can be high, so by definition, so are the rewards for the speculator.

The Exchange, 'open outcry' and the clearinghouse

Much of the public does not understand that the Exchange does not set the prices of the traded commodities. Actually, the prices are determined in an open and continuous auction on the Exchange floor by the members who are either acting on behalf of customers (you and me), the companies they work for (if a hedger), or themselves (for their own account). The process of the auction has been around for more than 100 years is called **open outcry**. (It has already been replaced outside of the United States and is losing market share in the U.S. to electronic trading primarily for financial futures.)

Open outcry is not like the typical auction at Sothebys, where a single auctioneer announces the bids. At the Exchange, people are not only competing to buy, but also to sell, and they all can be doing this simultaneously. Every floor trader is his own auctioneer. The democratic feature of open outcry is that only the best bid and offer are allowed to come forward at any point in time. If a trader is willing to pay the highest price offered, he yells it out, and by Exchange rules, all lower bids are silenced. By Exchange rules, no one can bid below a higher bid, and no one can offer to sell higher than someone else's lower offer. Although each trader in the pit can see who the other floor trader is, customers remain anonymous. At times, customers who are entering or exiting a large position act through multiple floor brokers so as not to tip their hand. Because this is an anonymous auction, prices quoted on futures Exchanges are accepted widely and are used as reference prices for the underlying commodity. This process is known as **price discovery**, because anyone, anywhere, can discover the price. For commodities not traded on the Exchange (tungsten, cobalt, bananas, and onions, for example), a few large players can set the price, and

the **bid-to-offer spread** (the difference between where the buyers can buy and the sellers can sell) is generally much wider than the Exchange-traded commodities. As a result, middlemen can take a greater percentage out of the middle, making many of these thinly traded cash markets much less efficient, which is one of the benefits of a futures Exchange to a free society. By helping to manage risks and broadcast prices, a well-run business can bring its goods and services to market at the lowest possible price more efficiently.

How is the price determined?

Conspiracy theorists would tell you price is determined by the big banks or the oil “seven sisters;” a clergyman might tell you that it’s God. A simpler explanation is supply and demand, or in other words, buyers and sellers. If the buyers are more aggressive than the sellers, prices go up. If the sellers are more eager, prices go down. In a free market, prices are determined by what the seller can get from the buyer. Prices are made by what someone is willing to pay for a given product. You might think any given price is too low or too high, but at any point in time, the market sets the price, and there’s an old adage that says that the market is always right.

How do the participants know they will get paid?

Investors trade futures to make money. Commercial interests use futures to lessen the risks in their businesses. Both groups want to make sure that if they make money on their transactions, they get paid. This is the job of the Exchange—to guarantee each trade. Although a trade may be conducted between two parties on the floor, it is ultimately the Exchange’s responsibility to act as the seller to every buyer and the buyer to every seller. Each Exchange is made up of many member firms, some of the largest and best capitalized names in banking, brokerage, and private industry. They all individually and collectively guarantee against default by any one party. Each player in the marketplace, whether he is a farmer from Des Moines or an automobile manufacturer in Stuttgart, must deal through a clearing member. Each participant must post a good-faith deposit (*margin*). If a doctor in Los Angeles buys 10 gold contracts, for example, he is required to have on account (or to quickly send in) the margin money required for 10 gold contracts to his broker. His broker is either a clearing member or dealing through one. Whether he sends the money or not, the clearing member is still obligated to post this margin money at the Exchange. The seller of the 10 gold contracts could be a mine that is hedging or another speculator who believes prices will fall, but regardless, the short is required to post the margin, and so is his clearing firm. The Exchange must know that participants have sufficient funds to handle losses they could potentially experience in the markets.

The margin is determined and set by the Exchange. It is generally stable, but it can be and is changed by the Exchange based on market volatility and risk. **Margin** is generally the amount of money the Exchange determines sufficient to cover any one-day price move. It should be noted that the Exchange determines the *minimum* margin necessary to hold each contract; however, any one brokerage firm or clearing firm can charge an individual customer a higher margin rate than the minimum if it feels it requires additional protection against customer default. As an

additional safeguard, the clearing members contribute to a pool of funds, a guarantee fund, that can be used in the event that any one member defaults. Although individual customers of clearing firms, and even clearing firms at time, have defaulted, there has never been an Exchange default. If an Exchange defaulted, it would mean the members collectively defaulted, and we would all be in trouble because the entire global financial system would be in jeopardy. The bottom line? Don't be concerned about being paid if you win.

What are they doing on the floor?

You probably have seen photos or films of the Exchange trading floors. These 'floors' have already been replaced in Europe by computer terminals. In the years to come, these trading floors may all become relics of the past, but, for now, some of the world's largest Exchanges based in the United States still use floor traders. Traders, many wearing wildly colored jackets, stand in the trading rings around a bar or in pits arranged like amphitheaters, with steps descending to the center. They gesture wildly, screaming out bids (buys) and offers (sells). Meanwhile, men and women who work for the Exchange are silently punching keys on computer terminals or, in some cases, hand-held computers. These people are reporters, who are listening for completed transactions so that they can broadcast the price to the information vendors who, in turn, transmit the price to quote machines around the world. You'll also see people running back and forth and around the floor, you'll see huge wallboards that flash a series of ever-changing numbers. The shouting, gesturing, and jumping around by the pit traders gives the floor a chaotic appearance to the uninitiated. In reality, it is quite orderly. The people who are running are carrying customer orders from the clerks, who receive them by telephone from buyers and sellers around the world, to the floor brokers in the pits who will bid, or offer, the order in the pit to the other floor brokers who also have orders to buy or sell. Also, the "runners" are taking **confirms**, or completed trades, back to the phone clerks, who then report back to their customers.

In some pits, the orders are *flashed* into the pit directly from phone clerks who are using hand signals or, at times, just plain, old-fashioned yelling. In the pits, the floor brokers, who are holding bids, are crying out to other brokers in the ring how much they are willing to pay and at what quantity they are willing to purchase. Sellers are crying out their offers with price and quantity. When a buyer and seller meet, they cry out "Sold," "Done," or "Take it!" These are the words the reporter is listening to hear, and when these words are heard, the reporters report the price (not the quantity), and this price is then transmitted almost simultaneously around the world electronically. Each floor broker wears a badge with a number of letters to identify himself to the other brokers. When a trade is completed, or executed, each selling broker must record each transaction on a card or hand-held computer that shows the commodity, quantity, delivery month, price, and the badge number or name of the buyer on the other side of the transaction. In some of the more active pits, thousands

of contracts are bought and sold each and every minute. The transaction then is sent to the data-entry room, where operators key the data into the Exchange's central computer system. Because both sides of the transaction are submitted in the same manner, there is a dual audit trail.

What's the difference between a floor broker and the broker you'll use to place your orders?

A **floor broker** is buying and selling futures on the floor, either entirely for himself or filling orders for his customers, who are the brokerage houses. He cannot take customer orders from the public, but he can fill them. The Exchange has strict rules for floor brokers who trade for their own account or filling customer orders. The basic rule is that brokers can never trade for themselves *ahead* of customer orders. A broker off the floor is licensed by the government to execute trades for the public. Your broker calls the floor (or submits an order via the Internet) to have trades executed on your behalf. The same rule applies to the broker who places orders for you. He cannot trade for his own account ahead of your customer order. The customer always comes first.

Most of the trading is done during the official hours the trading floor is open; however, all the major Exchanges, for most of their major contracts, also have in place after-hours electronic trading systems, which are active after the trading floor is closed. These are computer terminals where transactions can take place electronically, and the contracts created are the same as those created during normal trading hours, so they can be sold or bought the next day or whenever (in other words, offset), on the Exchange floor.

How Do the Floor Brokers Do It?

When you see pictures of the traders in the pit, here's what you're looking at:

- Palms in, or "I'm a buyer."
- Palms out, or "I'm a seller."
- Hands away from body, with arms outstretched, fingers moving, or "Here's my price." (Prices 1–5 are quoted with vertically extended fingers, prices 6–9 are quoted with fingers horizontal, and a closed fist indicates a zero price.)
- Hands held near head, or "This is how many I want."

Of course, these brokers are all yelling, too. Do mistakes ever happen? Well, we're dealing with human beings, right?

- Sal, an experienced floor broker, tells the story of a novice floor broker in the deferred cattle futures (the months that are traded thinly) who wrote the book on how *not* to open a market. The day after a bearish Cattle on Feed Report, the broker had orders for 30 contracts to sell and only five to buy. He bid 20 lower for the five and offered 30. A local trader sold the five immediately and, seeing that the other markets were sharply lower, *screamed* an offer to sell 50 contracts 100 lower. The novice panicked and offered his 30 contracts limit down. The local bought his five back (limit down) for a tidy profit. The novice had to answer as to why the opening range was 130 points, and he made both sides of it!

Here's a quote recently heard from a Feeder Cattle broker on a volatile, wide-ranging, whipsawing-type day:

"I've 10 left. I'll pay half on 10, sell 10 at a quarter [the lower price]. Anybody want 'em?"

- Sal tells this other story of what he terms the best order he ever received as a floor broker. He was working for the now-defunct Mitchell-Hutchins. "I was told to go into the bellies, don't bid for the front contract, but just start buying the rest. I was also told to report back to the desk every 15 minutes and report how I was doing. I was told to keep my ears open for any large offers to sell that came into the pit, and if I heard them, I was supposed to buy 'em, and after they were gone, bid higher. My final instructions were, by the end of the day, 'Have the bellies limit up!'"

Here's a quote from a pork belly trader:

"If God told me bellies would be limit up tomorrow, I would still go home long only five contracts."

Open outcry versus electronic

My first 20 years in this industry were almost wholly involved with the traditional open outcry, auction-style trading methods, and this is evident by much of what I write in this book, as well as in many of the stories from traders' lore. However, as Bob Dylan once said, "The times, they are a changin'," and although just a few years ago all futures trading took place in open outcry pits, today the volume for purely electronic markets has outpaced the traditional. Whereas the physical commodities at the U.S. Exchanges (oil, agricultural, and so on) are still primarily open outcry, virtually the rest of the world's Exchanges are purely electronic. There are no trading pits; instead, computer terminals match up trades. The advantages of the electronic markets include low cost of execution and clearing and a perception of a more level playing field (because it is first-come, first-served with an electronic timestamp). Some industry experts predict all futures trading will eventually go electronic. They just may be right, but this is probably still many years away for the United States.

Although electronic execution of trades may make for better speed and efficiency, the new technology will not help with your trading decisions; that's what this book is designed to help you with.

The regulators and regulations

The first level of regulation is the Exchange. If you recall from earlier in this chapter, the Exchange does not take positions in the market. Instead, it has the responsibility of ensuring that the market is fair and orderly. The Exchange does this by setting and enforcing rules regarding margin deposits, trading procedures, delivery procedures, and membership qualifications. Members who violate the rules can be fined and expelled. A sophisticated, intricate system of safeguards virtually guarantees against counterparty credit risk and default. Although an individual member may default, the party on the other side of the transaction always gets paid. This statement cannot be made for over-the-counter, or non-Exchange, markets. Each Exchange is composed of non-clearing members and clearing members. All members need to meet business integrity and financial solvency standards, and all members can trade on the Exchange, but the standards are higher for clearing members.

Each clearing member (the NYMEX alone has more than 60) must show a minimum working capital of \$2 million and own two seats. Clearing members must also deposit 10% of the firm's capital (up to \$2 million) into the guarantee fund, which is \$160 million for the NYMEX. Still, even if one clearing member goes under, and the guarantee fund cannot cover it (which has never happened), every clearing member has agreed to cover a loss on a prorated basis. The clearing members represent some of the largest firms in the world, from Merrill Lynch to Citibank to Exxon. As a result, the financial strength of the Exchange is based on the combined financial capability of all its clearing members. The clearinghouse ensures that all trades are matched and recorded, and that all margin is collected and maintained. The clearinghouse also is in charge of ensuring that deliveries take place in an orderly and fair manner. The compliance department of the Exchange set capital-based position limits on each clearing member. In addition, the Exchange places position limits on customers. The limits are always lower in the spot, or delivery, month. For example, the maximum number of contracts any customer or entity can hold in crude oil is 10,000 in all months, with 5,000 in any one month and 1,000 in the spot month. There is an exemption from position limits for bona-fide hedge transactions.

Looking over the Exchange regulators are the governmental regulators. In the United States, the Commodity Futures Trading Commission (CFTC) regulates the futures and options markets. Customers who maintain large positions are required to be reported to the Exchange and to the CFTC by the customer's futures commission merchant. The reporting level in crude oil, for example, is 300 contracts. In addition, in the United States, the National Futures Association, a self-regulatory body, oversees its members, which make up the brokerage community. Finally, the world's major Exchanges (in the United Kingdom, for example) have an agreement with the Securities Investment Board (SIB) to share financial information on common members.

How to place an order

Let's do a bit of time traveling and assume you've finished this book, you've done your homework, you've opened an account with a commodity broker, and you're ready to place your first trade. What's the procedure? Very simply, you need to instruct your broker (either by telephone or by Internet order entry) which commodity you want to trade, the quantity (in terms of numbers of contracts), the month, and whether you want to go long or short. You then need to tell your broker how you want your order to be executed.

Market order

This is an order to buy or sell at the prevailing price. By definition, when a commodity is bought or sold "at the market," the floor broker has an order to fill immediately at "the next best price," but in reality, it is the "next price." I've seen advice in trading manuals that effectively states that you should never use a market order. The reasoning has to do with the bid/offer spread.

In an auction market, traders make bids and offers. The **bid** is the price put out for immediate acceptance. The **offer** (sometimes known as the "asked price") is the price at which the seller is "offering" for immediate sale. In most cases, unless the floor broker is able or willing to pass along the edge to the customer, you buy at the offer and sell at the bid. You potentially lose this difference—it may be small—but you can lose it by placing a market order.

I totally disagree with the advice never to use market orders. For one thing, floor brokers are out there who *are* able to buy the bid or sell the offer and pass this along to us, the customers. If I consistently don't like the price fills received by a certain floor broker in a certain market, I go out and find myself a new one, and there are many around. In the markets I trade actively, I personally know the brokers on the floor who are filling our orders. This personal bond, I find, makes for better fills. However, this aside, there's a more important reason to use market orders in many cases, even if you have to give up the bid/offer spread. For one thing, if you use a limit order at a specific price, there is no guarantee you will be filled. The market may have to move away from the direction you think the market is moving to get filled. Most importantly, with a market order, you know you will be filled. This is important in a fast moving market, because these are the ones you most want to be in. By definition, you will be filled on every bad trade at a limit price (because it has to move against your bias first), but you could miss some good trades. If a market is moving at 50, 55, 60, 65, 60, 70, 80 to close at 120, and you place a market order at the 60 level the first time you see 60, you might get 60 or 65 or even 70, but you know you are in a trade that is at least starting out right. If you limit your price to 55, you might never get on a good move. Who knows? The next day it could open at 150.

Limit order

When you place this type of order, you know what you will get in the worst-case scenario (you could get better), but there are strings attached. With a limit order, the floor broker is prevented from paying more than the limit on a buy order, or less

than the limit on a sell order. Unless the market is willing to meet your terms, you will not get in. The drawback of a limit order is that there is no guarantee you will get in. You could miss some markets. You are not even assured you will get in if your limit is hit. In the preceding example, if you place a limit order to buy at “50 or better” and the market touches 50, this may be your trade, or it may be someone else’s. You can be only reasonably assured you are in if the market trades *lower* than 50. Nothing is more frustrating than to place an order to buy at 50, see the market trade there once, and call the floor to see whether you are filled, only to receive an “unable” just as the market’s crossing 75. That’s not to say there isn’t a place for limit orders. I like to use them in quiet, back-and-forth type markets so as not to give up the slippage seen with a market order. I also use them to take profits on a good position. I try to let the market reach out to my limit price. After all, if the market doesn’t reach my limit, I can always revert to a market order.

Stop orders

Stop orders, or stops, are used in two ways. The most common method is to cut a loss on a trade that is not working (also known as a stop loss order). A **stop** is an order that becomes a market order to buy or sell at the prevailing price only if and *after* the market touches the stop price. A **sell stop** is placed under the market, a **buy stop** above the market.

eg For example, you buy July Sugar at 11¢ (1100). You buy it because your analysis suggests that the market is going to go higher. However, you do not want to risk more than approximately 50 points, so you give your broker a sell stop, to “sell July Sugar at 1050 stop.” As long as the market moves higher—fine and good—your stop will not be elected. However, if the market trades down to 1050, your stop loss automatically becomes a market order to sell. Depending on the speed and direction of the market and the skill and luck of the floor broker who has your order, you will be out at the next best price. It most likely will be 1050 or slightly below, say, 1049. In a fast market, it could be lower, say 1048, or it even could be higher, say 1051 if the market upticks after the stop is hit.

A stop also can be used to lock in a profit and cut a loss. In the sugar example, let’s say the market starts to move in your favor, up to 1150. You might decide to cancel your 1050 stop and move it up to 1104, thereby assuring a worst-case break even or a small loss after commissions. The market continues to move up, reaching 1210. You move your stop up to 1150, thereby assuring a profit on the trade, even if it trades back down. This is, at times, termed a *trailing stop*, which occurs when you move your stop with the market. A buy stop is placed above the market to liquidate a losing short position. You go short sugar at 1201 and place your buy stop *above* the market at 1253 to limit your loss. You can always cancel and move your buy stop lower, should the market move in your favor.

Stops also can be used to initiate positions. They’re used by momentum traders who want to enter a market moving in a certain direction.

eg For example, if a trader believes gold can trade above the psychologically significant \$400 mark, it will move higher. He places a buy stop at 401. If the market remains under 401, he never enters the market and potentially avoids a “do nothing” or worse, a losing trade. If the market reaches the 401 level, he will be in at the next prevailing price. The hope is that the market keeps moving, to 402, 403, and on up. Once in, the trader can place a sell stop at, say, 396, to limit losses should this turn out to be a false signal. Of course, the risk is that the market could run up to 401 and back down again. In this case, it would have been better to limit the price at a lower level or not use the stop to initiate the trade at all.

However, when used correctly, these can be good orders to enter with. A sell stop would be used under the market to initiate a new short position if not in the market. There is, in addition, a variation of a stop order called a **stop limit**. With a stop limit order, if the stop price is touched, a trade must be executed at the exact price (or better) or held until the stated price is reached again. The risk with the stop limit is the same as with a straight limit. In other words, if the market fails to return to the stop limit level, the order is not executed, so I normally do not recommend its use. It can, in a fast moving market, defeat the purpose of the stop (to stop your loss).

Market if touched orders

Also called MITs, these are the mirror image of stops. An MIT is placed above the market to initiate a short position.

eg For example, you are long platinum 405, and you want to take profits at 410. You could place a limit order to sell at 410, but you cannot be assured that you will be filled if the price touches 410. The market would have to trade above 410 to have a reasonable assurance that you are out. An MIT at 410 becomes a market order if 410 is touched, which will ensure you are out at the next prevailing price. MITs tend to be filled better on average than stops because you are moving with the prevailing trend. In a market that moves 40950, 410, 41050, 411, an MIT at 410 would be filled at either 410 or 41050. If the next tick after 410 was 409, you certainly could be filled at 409 (because the MIT became a market order), but it is more likely that a buy stop at 410 would be filled at 41050 in this example. An MIT could also be used to initiate a new short position *above* the market. An MIT to buy is placed *under* the market to exit a short position or enter a new long. If the market is trading at 100, you might place an MIT to buy at 99, but you would place a stop to sell at 99. See the difference?

These are the major types of orders you will use. There are other exotic orders I’ve not found useful in practice, with the exception of the OCO. OCO stands for *one cancels the other*. It is used on both sides of the market either to take profits or cut losses; one cancels the other. For example, you buy silver at 700, you want to take profits at 750, or cut the loss if the market trades down to 675. You could place an order with your broker to sell at 750 or 675 stop; one cancels the other. In this way, you are assured that if one side is hit, the other side will be canceled. This is

significant in volatile markets. If you placed two separate orders, and the market first runs up to 750, takes out your position at a profit, then trades down to 675, you could be sold into a new short position you didn't want.

Conclusion

That concludes our discussion of the basics. If this is your first exposure to commodity trading, you now know just enough to be dangerous. If you're a novice, hopefully this has shed some light on the game. If you've traded awhile, this is probably nothing new, but you'll find a lot of new and exciting stuff in subsequent chapters.

Let's conclude this chapter with a true story that happened to a commodity broker friend of mine. Remember, it is a common practice (and a good one) to place your stop loss order at the same time you place your trade. A good broker will remind you of this. There is a belief that the floor traders will "run the stops." I'll talk more about this later in the book. However, I've found that the proper and judicious use of stops is essential to successful trading. The best markets will never reach your stop. I cannot count the number of times in my personal trading a stop has prevented a bad trade from turning into disaster.

● My commodity broker friend Tim tells the story of Elmer, a farmer client of his from rural Minnesota. Tim suspected Elmer was growing a bit feeble, but then again, Elmer had been trading for many years, and he had always been the eccentric type. Tim recounts the day that Elmer called him up prior to the market open.

Elmer to Tim: "Tim, a miracle happened to me this morning."

Tim to Elmer: "What's that, Elmer?"

Elmer to Tim: "Tim, I was shaving this morning, and as I looked in the mirror, the Holy Spirit came to me and said, 'Elmer, today you should buy 50 March wheat market at the open.'"

The way Tim tells it, he didn't hesitate, cross-examine, or stop to pass Go; he immediately asked Elmer, "Elmer, did he tell you where to place your stop?"