

A TRADER'S FIRST BOOK

ON

COMMODITIES

— SECOND EDITION —

AN INTRODUCTION TO
THE WORLD'S FASTEST GROWING MARKET



CARLEY GARNER

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First Edition

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A Trader's First Book on Commodities

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A Trader's First Book on Commodities

An Introduction to the World's Fastest
Growing Market, Second Edition

Carley Garner

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*This book is dedicated to the resiliency of the futures industry,
the city of Chicago, whose capitalistic drive opens the door to success,
and loyal DeCarley Trading clients.*

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Contents

Introduction:	The Boom and Bust Cycles of Commodities...and Now Brokerage Firms	1
	What Has Changed?	1
	The Speculator's Role in Volatility	7
	Commodity Volatility Leads to Fortunes Made and Lost	8
	Commodity Brokers Boom and Bust Too	10
	How to Protect Yourself from Another MF Global or PFGBEST	15
	What Regulators Are Doing to Protect Clients	16
	Conclusion	16
Chapter 1:	A Crash Course in Commodities	19
	How It All Began	19
	The CME Group	21
	Evolution of the Forward Contract into a Futures Contract	23
	Cash Market Versus Futures Market	25
	Contract Expiration	28
	The Mechanics of Futures Contracts	29
	Futures Spreads	36
	A Brief Introduction to Commodity Options	38
Chapter 2:	Hedging Versus Speculating	43
	Commodity Hedgers	43
	Commodity Speculators	48
Chapter 3:	The Organized Chaos of Open Outcry and the Advent of Electronic Trading	51
	The Pit	52
	Electronically Traded Markets	54
	Side by Side	54

Chapter 4:	Account Access, Trading Platforms, and Quote Vendors	59
	Commodity Quotes Can Be Costly, But They Don't Have to Be	60
	Open Outcry Quote Reporting and Access	60
	Electronic Quote Transmission	64
	Subscribing to Quotes	64
	Charting	66
	Free Trading Platforms and Market Access	66
	Paid Trading Platforms	67
	Auto Approval Versus Manual Approval	69
	Multiple Order-Entry Methods	70
	Popular Premium Trading Platforms	71
	Order Desk ("The Desk")	72
	Is It Worth Paying Platform Fees or Subscribing to Quotes?	74
Chapter 5:	Choosing a Brokerage Firm	77
	Introducing Brokers, Futures Commission Merchants, and Broker/Dealers	78
	Fill Quality	82
	Behind the Scenes of Transaction Costs	83
	Discount Brokerage or Full-Service Specialization	85
	What You Should Know About Commission Structure: Blanket or Variable Rates?	86
	Market Access	89
	Beyond Your Broker	91
	Conclusion	95
Chapter 6:	Finding a Broker That Fits and Choosing a Service Level	97
	Understand Your Broker's Business	99
	Get to Know Your Futures Broker	100
	Full-Service Broker or Self-Directed Online?	106
	Why Using a Broker May Be a Good Idea	109
	Conclusion	112

Chapter 7:	Order Types and How to Use Them	113
	Order Types	113
	Placing a Trade with Your Broker	126
	Placing a Trade Online	129
Chapter 8:	Making Cents of Commodity Quotes	131
	Quoting Grain Futures	133
	Not All Grains Are Created Equal	137
	The Meats	140
	Foods and Fiber	143
	Precious Metals Futures	147
	Gold, Platinum, and Palladium Futures	148
	The Other Metal Futures	151
	The Energies	153
Chapter 9:	Figuring in Financial Futures—Stock Indices, Interest Rates, and Currencies	157
	The Boring But Necessary Basics	157
	Stock Index Futures	158
	Dow Jones Industrial Average Futures	161
	NASDAQ 100 Futures	163
	S&P 500 Futures	166
	Russell 2000 Futures	171
	Interest Rate Futures	172
	Treasury Bond and Note Futures	174
	Eurodollar Futures	185
	Currency Futures	187
	Conclusion	192

Chapter 10:	Coping with Margin Calls	193
	What Is Margin?	193
	Day Trading Margin Versus Overnight Margin	194
	What Are Margin Calls?	195
	How to Handle a Margin Call	196
	The Margin Call Countdown	197
	Accepting Margin Calls	200
Chapter 11:	The Only Magic in Trading—Emotional Stability	201
	Three Emotions in Trading: Fear, Greed, Frustration	203
	Vengeful Trading Is Counterproductive	209
	Capital Preservation, a.k.a. Risk Management	210
Chapter 12:	Trading Is a Business—Have a Plan	211
	The Trading Game Plan	211
	A Trading System Alone Isn't a "Business Plan"	213
	Constructing a Business Plan in Trading	217
	Price Speculation (Ideally, Prediction)	218
	Choosing a Trading Vehicle	220
	Risk Management	221
Chapter 13:	Why You Should Speculate in Futures	229
	Speculating in Futures Versus Speculating in Equities	230
	Risk Capital Only	236
	Conclusion	237
Chapter 14:	Futures Slang and Terminology	239
	Bull Versus Bear	239
	Spread	241
	Contract Month Slang	242

Red Months 242

Fill 243

Blow Out 244

Blow Up 244

Keypunch Error 244

Busted Trade or Moved Trade 245

Fat Finger Error 246

Net Liq 246

Equity 247

Customer Segregated Funds Account 248

Beans 248

Commodity Currency 248

Dead Cat Bounce 249

Bottom Fishing 249

Chasing the Market 250

Limit Moves 250

The Tape 251

Trading Solution and Front-End Platform 251

Proprietary Trading 252

Running Stops 252

Short Squeeze 253

Babysitting 253

Scalp 254

Slippage 254

Working Order 255

Unable 255

Handle 255

Overbought/Oversold 255

Debit/Account Debit	256
Round-Turns	256
Trading Environment	257
Index	259

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Garner provides free trading education to investors at www.DeCarleyTrading.com.

introduction

The Boom and Bust Cycles of Commodities...and Now Brokerage Firms

Witnessing the grain complex shatter all-time-high price records and continue to climb during the now-infamous 2007–2008 commodity rally was nothing less than breathtaking. However, by late 2008, the party had ended. Many retail traders and fund managers watched in horror as the grains made their way relentlessly lower. The selling pressure and losses in the commodity markets were so profound that hedge fund managers experienced unprecedented numbers of redemption requests, adding fuel to the already raging fire.

Ironically, the same asset class that investors swarmed to for “diversification” from stocks played a role in the demise of equities during the 2008–2009 bear market. We now know that this boom-and-bust cycle was destined to be repeated, although in slightly less dramatic fashion. Perhaps feast-or-famine trade is the new reality: high margins, high risk, high reward, and even higher adrenaline rushes.

“There is no tool to change human nature ... people are prone to recurring bouts of optimism and pessimism that manifest themselves from time to time in the buildup or cessation of speculative excesses.”

—Alan Greenspan

What Has Changed?

Several theories attempt to explain the historical volatility in the commodity markets near the turn of the decade. Valid contributors are likely ethanol demand and the government programs promoting it, the European debt crisis,

sheer market exuberance in the absence of an attractive equity market, sidelined cash looking for a home, government stimulus, and, most of all, ease of market access for the average retail trader. One thing is certain: The commodity euphoria causes the agricultural, energy, and metals markets to overshoot equilibrium prices in both directions on a seemingly regular basis.

In the midst of the excitement, the lure of a swift commodity rally clouds the judgment of many. Looking back at boom-and-bust cycles, which are now relatively common, it is rather obvious that expecting market fundamentals to maintain such lofty prices is simply unrealistic. However, in the heat of the moment, nobody knows how high is “too high,” and speculation runs rampant. Investors who enter the market “early” with bearish strategies likely pay dearly for their aggression. Yet when the tides finally turn, they do so in a vicious fashion, enabling well-timed bears to reap substantial rewards. After all, the stunning fall from grace is typically even steeper than the preceding rally.

In a speech delivered at the American Enterprise Institute in the late 1990s, then-Federal Reserve Board Chairman Alan Greenspan warned that the equity market might be overvalued through the use of “irrational exuberance.” In my opinion, this is a good explanation of the illogical rallies and bear market sell-offs in the commodity markets. In an environment in which anyone with a computer (and a mouse) can buy or sell commodities with a single click, logic sometimes has little control over the outcome. Nevertheless, such cycles of excess and price contraction open the door for speculators to achieve abnormal profits, assuming that they are willing to manage and accept the corresponding risks.

Naturally, speculators aren't buying or selling commodities on a whim. They are holding on to some fundamental story that justifies the initial price move, but the bandwagon mentality often takes reality into fantasy. Here are a few of the primary factors driving the wave of commodity market volatility that began in 2007 and has continued to thrive.

Easy Market Access

Investors trading commodities in the 1990s knew that the only way to place a trade in the commodity markets was to pick up a phone and call a broker. Because brokerage firms relied on paper tickets and statements, they weren't necessarily able to keep close tabs on client trading accounts throughout the trading day. This posed large risks to traders and the firm. Accordingly, commodity trading was typically reserved for well-capitalized and sophisticated investors. That simply isn't true anymore. Anybody with at least a thousand

dollars and an operable computer can buy or sell commodities online without ever picking up the phone.

Individually, such traders have little influence on the market, but collectively, this new breed of futures speculators can have a significant impact on price movements. If you don't believe me, look at the roller-coaster ride gold futures took following the S&P's credit downgrade of U.S. debt in Figure I.1. I speculate that much of the late-comer buying was done by inexperienced, yet convinced, retail traders who were unaware of the risks of having convenient online access to buy or sell commodities without being properly educated.

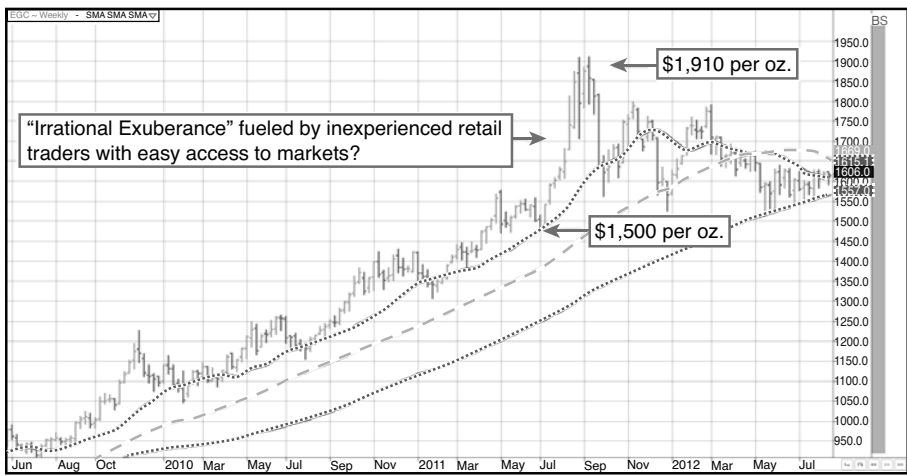


Figure I.1 It has been argued that the one-month gold rally that spanned \$1,500 per ounce to \$1,910 was largely fueled by small retail traders and a herd mentality. Once the last buyer was in, the market quickly retreated, to eliminate most of the gains, which equated to about \$40,000 per contract. (Chart courtesy of QST.)

European Debt Crisis

The U.S. credit crunch eventually sent Europe into a tailspin. For years, the domestic financial and commodity markets have been hijacked by the possibility of a credit market collapse overseas, despite improvements in the homeland. Obviously, a healthy economy leads to healthy demand for commodities, but certainly other fundamental factors are at play. Nevertheless, there are times in which traders focus on European headlines and put individual commodity market fundamentals on the back burner.

Before the 2008 U.S. debt crisis and similar chaos to follow in Europe, financial market speculation only moderately influenced commodity prices. Yet in a post-credit crunch world, when the financial markets become enthralled with European headline risk, the commodity markets follow. As a result, commodities, currencies, and the U.S. stock market often become highly correlated. When all three asset classes begin moving in the same direction, it can be nearly impossible to stop the bleeding. This is because excessive moves in all three trigger margin calls galore in all three arenas, and the liquidation becomes a seemingly never-ending endeavor.

Quantitative Easing

In late 2008, the Federal Reserve announced that it would be undertaking a little-known practice known as quantitative easing. In summer 2012, the Fed declared it would continue to implement the quantitative easing program indefinitely.

Quantitative easing is now a household phrase, but it is most commonly referred to as QE. QE is a rather complex scheme in which the U.S. government essentially buys the Treasury bonds it issues. In layman's terms, the federal government is selling bonds to itself. The net result is a cash injection into the economy, or simply money printing.

The increase in money supply stemming from the Fed's QE campaign tends to put upward pressure on asset prices of all types, including commodities. This is because, all else being equal, more money is chasing the same number of goods; therefore, prices are driven higher. Another way to look at it is, the larger the money supply, the weaker the U.S. dollar. A discounted dollar tends to put upward pressure on asset prices because it results in more purchasing power for foreign buyers and, thus, higher demand.

Accordingly, much of the boom-and-bust pattern we've seen in commodities likely is exaggerated by artificial price inflation via QE and the subsequent correction from unrealistic levels.

Fear of a U.S. Financial System Collapse

Fearful savers have been known to store wealth in nonfiat currencies, namely gold and silver. The theory is that if the financial system as we know it fails, the "gold bugs" will manage to maintain their prosperity by exchanging precious metals holdings for goods and services. For example, in summer 2012, an older man in Nevada died in a humble Carson City home with about \$200 in his bank account. As the home was being cleaned and prepared for resale, approximately \$7 million in gold bullion was found hidden within secret compartments in the

walls and in boxes in the garage. The metals hoard was said to be in response to the man’s lack of faith in the current fiat money financial system. In my opinion, this type of thinking has had a profound impact on overzealous rallies in precious metals and might continue for quite some time. Figure I.2 depicts just how far fear of a failing domestic currency can drive precious metals prices beyond reason.



Figure I.2 Fear of a U.S. financial system collapse triggered an historic rally in silver prices that simply couldn’t be sustained by fundamentals. (Chart courtesy of QST.)

The New Investment Fad

Swirling newscasts, financial newspaper editorials, never-ending infomercials, and social media buzz regarding the emerging opportunities in the commodity markets have successfully lured an enormous number of investors looking for opportunities other than traditional stocks and bonds.

For all intents and purposes, the U.S. equity markets made little or no progress throughout much of the 2000s, causing many investors to lose faith in the system. Frustrated by stocks, and with Treasury bond yields at record lows, savers found themselves intrigued by the commodity story. Accordingly, the general investment public is allotting substantial amounts of capital to self-directed or full-service commodity accounts, commodity hedge funds, commodity equity products such as electronic traded funds (ETFs), and Commodity Trading Advisors (CTAs). The newly discovered simplicity of participating in this alternative asset class has greatly benefited the industry but likely plays a part in the relentless boom-and-bust cycles. Unfortunately, in many

cases, money is flowing into commodities from investors who have little experience in the futures markets and limited knowledge of the high levels of risk involved in participating.

Not only do I believe that too many speculative investors are relatively undereducated about the futures markets, but I also argue that numerous money managers might be as well. For instance, many of them fail to recognize a few things, such as the fact that the commodity markets aren't as deep as equity markets and are thus highly influenced by bandwagon trading. Naturally, this occurs in the equity markets as well—just look at social media shares such as LinkedIn, Facebook, and Zynga—but in the futures market, it takes arguably fewer dollars chasing assets to see a price reaction. In some of the smaller commodity markets, such as rough rice or even cotton futures, it is possible for prices to make substantial moves on the buying or selling of a moderate number of contracts. In other words, it isn't difficult for deep-pocketed speculators to temporarily alter the price of some commodities. With droves of cash making its way to the long side of commodities, it doesn't take long for things to get out of hand. This is why it is important to limit your trading activity to futures contracts with ample liquidity. Leave the exotic commodity markets to the "other guy."

Additionally, commodity prices normally trade in envelopes instead of ongoing inclines, as stocks tend to do. Yet commodity market newcomers sometimes behave as if this isn't the case, causing prices to increase sharply beyond what are feasibly sustainable levels. These simple concepts seem obvious, but fear of missing out on a rally, and the greed that prevents profit taking, sometimes overshadows the red flags and concerns of commodity veterans who "know" that the hysteria can't last.

At first it is easy to confuse a bull market with trading genius, but it can't last.

Of course, this is my personal perception, and it is in stark contrast to the opinions of some other analysts. In fact, well-respected and well-known market commentators believe that the original 2007 commodity boom was purely the result of tight supply and high demand. Although I agree 100% that this was the initial cause of the skyrocketing prices, I am not convinced that fundamentals alone blazed the trail for such unprecedented high pricing and volatility.

Unfortunately, markets and their participants are complex, and this often makes pinpointing the driving force behind any price move impossible.

"If the models are telling you to sell, sell, sell, but only buyers are out there, don't be a jerk. Buy!"

—William Silber (NYU)

The Speculator's Role in Volatility

Much debate centers on the speculator's role in commodity valuation. On more than one occasion, commodity market regulators testified to Congress and participated in interrogation hearings regarding the speculator's role in excessive market pricing. The popular view in Washington seems to be that most of the blame falls on traders. Ironically, the government's own QE program arguably plays a bigger role in higher commodity prices than speculators ever could. Nonetheless, for those of us with the luxury of being within the industry and understanding the nature of the marketplace, it is nothing short of scary to see our elected leaders making such uninformed assumptions and, eventually, decisions about what are intended to be free markets. The truth is, there is plenty of blame to go around, but there probably isn't a better alternative than capitalistic price discovery.

The commodity markets are built on speculation; without it, there would be no market. The futures markets were formed to facilitate the transfer of risk from producers and users to unrelated third parties hoping to profit from price changes; I cover this in detail in Chapter 1, "A Crash Course in Commodities."

Some evidence seems to suggest that speculation causes artificially inflated prices, at least temporarily. After all, commodities boom when anxious investors pour money into the alternative asset class in search of higher returns. Additionally, what was once an investment arena utilized only by the uber-rich and risk-hungry investors now sees money inflows from average retail investors and even pension funds. However, the door swings both ways; during waves of liquidation, as investors redeem funds from their commodity holdings, the market sometimes behaves as if someone is pulling the floor out from underneath it. Consequently, prices often fall much further and faster than they might have without speculative excess. In such a scenario, the economy enjoys commodities at highly *discounted* prices. Naturally, you will never hear complaints that speculators are driving gas prices too low!

In my opinion, speculators don't cause bubbles, or even pop them, but unfamiliar, inexperienced, or greedy speculators might share some of the blame for their magnitude. Without support from basic supply-and-demand fundamentals, a market cannot sustain pricing in the end. Thus, if and when speculation does move prices beyond what the equilibrium price might be, it eventually has to correct itself. The problem is that there is no telling how far and how long prices can remain distorted. Unfortunately, many traders are introduced to this the hard way.

For every winner, there is a loser. Nonetheless, the winners get all the attention.

It is critical to realize that, from a trading standpoint, it doesn't necessarily matter whether the market is driven by fundamentals, technicals, speculators, hedgers, or the Fed's QE efforts. What does matter is that prices move, and you want to be on the right side of it—or at least get out of its way. Markets are unforgiving; regardless of how strongly you feel that prices should behave in a particular way, they are sometimes driven by irrational speculation for much longer than you can financially and psychologically afford to be involved.

Excessive commodity market volatility and price excess creates unparalleled opportunities for futures, and options on futures, traders. With that in mind, it is imperative that traders approach the markets with the simple premise that anything is possible, and positions should be taken and risks managed with this in mind.

Commodity Volatility Leads to Fortunes Made and Lost

By nature, when we think of large price moves in leveraged markets, we assume that there are riches to be made. However, this isn't necessarily the case; traders must be on the right side of the trade to make money, and that is easier said than done. Even worse than missing a big price move is being caught on the wrong side of it. The media's (and politicians') arguments against "greedy" speculators seem to imply that a majority of traders make money and that it is somehow easy to do so. This couldn't be further from the truth; if it were, wouldn't they be doing it, too? Profitable trading is possible for those who are dedicated and capable of controlling their emotions, but it is far from being a sure-fire way for the "rich to get richer," as many assume.

Because of its profound impact on the economy and our daily lives, crude oil futures are often at the center of the debate. Believe me, not all speculators in the energy complex make money. Crude oil is one of the most challenging markets to trade successfully, regardless of whether you are a futures or options trader. The margin requirement is extremely high, and so are the volatility and risk. Figure I.3 portrays the magnitude of risk and reward energy traders might face.

Surprisingly, based on my experience and conversations with those within the futures and options industry, the 2007 commodity rally was paralyzing for many veteran traders but was a likely gold mine for investors who simply didn't know that wheat shouldn't trade in double digits, nor crude oil in mid-\$150s. For investors who had been trading grains for many years, it was not only unimaginable, but in some cases, career ending.

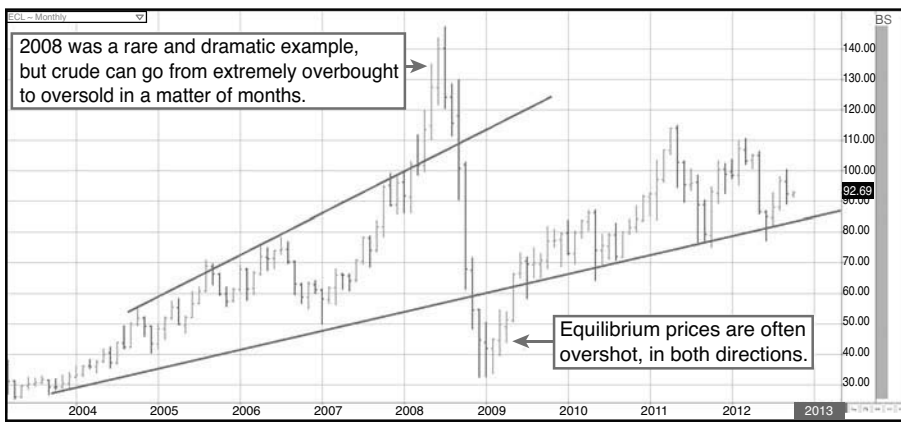


Figure I.3 Crude oil traders have the potential for large gains, but the risk is of equal magnitude. Not many could have predicted that crude oil would rally to \$150 per barrel, only to collapse to less than \$40. Such a move represents more than \$100,000 per contract. (Chart courtesy of QST.)

Traders who spent the bulk of their adulthood speculating on grain and energy prices as they moved from high to low within their historical price envelopes quickly discovered that the markets no longer had boundaries. For example, before 2007, wheat was a commodity that was most comfortable trading between \$2.00 and \$4.00 per bushel, with a few brief stints in the \$6.00 range. Looking at a long-term wheat chart, it is easy to see how a trader could unexpectedly get caught on the wrong side of a move that eventually got close to doubling the previous all-time high of the commodity. Those who did find themselves in such positions were in a state of denial and had a difficult time liquidating positions with large losses. As a result, the situation became worse as losses mounted, as did margin calls (see Figure I.4).

You might have heard about the rogue (unauthorized and reckless) wheat trader whose actions during the historic wheat rally resulted in a large loss at a major financial institution. Without permission from his brokerage firm, MF Global, the trader greatly exceeded his trading limits due to a loophole in the trading platforms. The culprit was a commodity broker located in Memphis, Tennessee, who reportedly put his account—and, ultimately, MF Global—in the hole more than \$141 million. This is believed to be the largest unauthorized loss in the history of the agricultural markets. Ironically, MF Global survived the debacle despite its stock immediately losing nearly a third of its value but claimed bankruptcy a few years later due to large losses in trades authorized by its own CEO, Jon Corzine. We'll discuss this next.



Figure I.4 Few could have predicted the magnitude of the 2007—2008 wheat rally that made a mockery of its previous all-time high. (Chart courtesy of QST.)

Prior to the unauthorized wheat trade, the MF Global broker triggering the debacle had been a responsibly registered participant of the futures industry for more than 15 years; perhaps in this case, his experience worked against him, in that he was overly bearish in a market that simply wasn't "playing by the rules."

Keep in mind that, in the precommodity boom world, the margin to hold a wheat futures position overnight was less than \$1,000. During its heyday, it was in the neighborhood of several thousand dollars. Therein lies much of the problem: As commodities become more volatile, they also become more expensive to hold. In such an environment, traders are forced to fold their hands due to a lack of margin or liquidity. The liquidation of short positions adds to the buying pressure of speculative long plays, and prices can quickly become astronomical.

Commodity Brokers Boom and Bust Too

In the late 2000s, the commodity markets made history, but in the early 2010s, it was commodity brokerage firms that were grabbing headlines. More specifically, the epic failure of two prominent players, MF Global and PFGBEST, showcased insolvency plagued by a lack of integrity. As Warren Buffett said, "Only when the tide goes out do you discover who has been swimming naked."

Brokerage Firm Business Models Break Down

For years, futures brokerage firms had operated within a business model in which revenues were generated by trading commission in conjunction with interest earned on the deposits made by clients to meet margin requirements. Simply put, if a client wires \$10,000 to a futures broker to fund a trading account, the brokerage firm is free to invest that money in regulatory-approved interest-bearing securities such as Treasuries, bank deposits, and CDs. Historically, the interest generated from such investments accounted for a rather significant percentage of a brokerage firm's income. Yet federal programs forcing interest rates to near-zero levels eliminated the capability of firms to benefit from client deposits; accordingly, profitability was hindered and exclusive to the generation of commissions and fees.

Before the Federal Reserve's never-ending quest for near-zero interest rates, futures brokerage firms enjoyed returns on client deposits between 3% and 5%. Accordingly, as technology improved trading execution, many firms traveled the path of discounting commissions to attract client funds and, in turn, relied on earning somewhere near 4% interest on client deposits. They knew that carrying large profit margins on commission wasn't necessary if they could earn "the float," which is the industry term for interest earned on client money. However, this business plan didn't account for unfathomably low interest rates and eventually proved to be highly flawed.

Unfortunately, the practice of discounting commission to attract new clients is a slippery slope that eventually results in cannibalism of the industry. Firms went from competing on service, to competing on price; ultimately, profit margins shrank to levels at which brokers simply couldn't operate profitably in a low-interest-rate environment.

In addition to low interest rates and lower commissions, the financial collapse of 2008 tightened the purse strings of many speculators. This dealt another blow to the commodity brokerage industry causing many brokerage firms to fold their hands.

I entered the commodity industry in early 2004; during that time, I've witnessed the number of registered Futures Commission Merchants (also known as futures brokers) fall from about 90 firms to fewer than 50. Simply put, nearly half of all commodity brokerage firms in operation when I stepped into the business are no longer in operation. Regretfully, I worked as a broker for one failed firm and operated as an Introducing Broker for another. Chapter 5, "Choosing A Brokerage Firm," covers the definition of an Introducing Broker and a Futures Commission Merchant.

Through no fault of my own, or any of the other hard-working employees and brokers of these collapsed firms, I faced significant challenges in regrouping my life and business. Ensuring the most efficient transition to new brokerage arrangements possible for my firm and, more importantly, my clients was a difficult task. Part of the process involved establishing new relationships with the risk management departments of our new trade-clearing arrangements to make sure each of our clients had the opportunities and leeway they needed to better their odds of success. Additionally, we faced the burden of matching our clients with new trading platforms appropriate to their strategies, ensuring favorable margining and fee structures, and much more. On the bright side, the commodity industry is known as the “last bastion of capitalism”; therefore, survival of the fittest is in play. As difficult as it is for a broker and its clients to migrate to a new brokerage firm in the wake of the collapse of another, I can attest that the odds are in favor of an overall improvement in service and quality simply because only the strongest and most efficient survive.

Hard Times and Desperate Measures

The difficult futures brokerage environment led some to turn to highly questionable and illegal practices to stay afloat. Specifically, at least two firms violated longstanding, and previously concrete, safeguards of client funds by using customer margin deposits for business operations or, worse, personal embezzlement.

In fall 2011, MF Global, a mammoth commodity brokerage house, went down in dramatic fashion while misappropriating client funds to finance a “trade gone bad” on its proprietary desk in a fast and furious demise. Less than a year later, it was learned that the owner of PFGBEST, one of the ten largest privately held commodity brokerage firms, had been secretly pilfering funds from client accounts to finance operations, pay regulator fines, and fund a comfortable lifestyle for himself. As you are probably aware, the top executive at PFGBEST was reporting false customer segregated funds figures to the overseeing bodies and using falsified bank statements to deter regulators from detecting the fraud. In a letter written before an attempted suicide, he pleaded, “I had no access to additional capital and I was forced into a difficult decision: Should I go out of business or cheat? I guess my ego was too big to admit failure. So I cheated, I falsified the very core of the financial documents of PFGBEST, the Bank Statements.”

Prior to this dramatic confession and the sudden unraveling of PFGBEST, the brokerage firm was considered to be well-respected and among the most compliant in the commodity industry. Regrettably, for these reasons I chose to use PFGBEST as the exclusive brokerage firm to clear my clients’ trades.

Customer Segregated Funds Violations

Before October 2011—more specifically, before the collapse of MF Global—few outside the futures industry were aware of the term *customer segregated funds*. In July 2012, the failure of PFGBEST to uphold the sanctity of customer segregated funds catapulted the phrase into daily usage in national media outlets, and maybe even the homes of many Americans.

Customer segregated funds are exactly what the name implies; they are monetary deposits made by clients that are segregated from the assets of the brokerage firm. Expressly, when a client wires funds to a brokerage account in his name, the money is sent to a bank account in the name of the broker but titled “Customer Segregated Fund.” All funds held within this account are to be client monies and are not to be commingled with firm money.

The requirement that brokerage firms hold client funds in segregated accounts is a safeguard against brokerage firm bankruptcies. In theory, if the FCM (Futures Commission Merchant, a fancy word for brokerage firm) suffers financial trouble and files for bankruptcy, any client funds on deposit will be unaffected. In fact, in such a case, it is common practice for the funds and open positions to simply be transferred to an alternative brokerage firm, leaving the insolvent FCM to deal with its issues. Before MF Global and PFGBEST, commodity brokerage bankruptcies, mergers, and acquisitions were perhaps an inconvenience to traders, but no client had ever lost a dime in the process; that changed in 2011.

The failure of MF Global and PFGBEST to avoid the commingling of firm and client money crudely reminded us that segregated funds rules are only as good as their followers—and enforcers. Both FCMs displayed a flagrant disregard to compliance stipulations intended to protect the very customers who had enabled their long-standing success as brokerage firms. Deplorably, in both cases, industry regulators weren’t able to detect the violations until after it was too late. Client funds had already been misappropriated and either spent or lost.

At the time this book was going to print, MF Global clients had recouped most of the money they had on deposit through liquidation of firm assets and other sources, but the process had taken approximately a year. PFGBEST clients hadn’t fared so well; it took nearly four months after the firm’s failure for the bankruptcy trustee to release 30% of the funds in what was a chaotic transfer of client assets to another brokerage firm. At the time of this writing, an uncertain amount of client funds would be recovered, but estimates ranged from 50 cents to about 80 cents on the dollar. Even with the most optimistic outcome, the burden of having funds unwillingly tied up and the emotional turmoil caused by the fiasco is substantial.

Collateral Damage

Brokerage clients are the obvious losers of the MF Global and PFGBEST breakdowns. However, other casualties are often overlooked, including the firm's employees, its brokers, third-party vendors (platforms, trading systems, and money managers), floor traders, market makers, and more. When MF Global and, later, PFGBEST went under, not only did they nearly take their clients with them, but the situation devastated the lives of many hard-working industry participants. The trading pits in Chicago saw an immediate and dramatic decline in participation, and several hundred back-office employees were suddenly out of work.

Painfully, my trading firm, DeCarley Trading, worked exclusively with PFGBEST until its demise in July 2012. I'll never forget July 9: A single email near the close of trading dashed all our hard work and dreams. Without any prior knowledge of troubles brewing at the firm, nor any reason to have suspected wrong doing, we were notified that PFGBEST's assets and client funds had been frozen pending an FBI investigation into the fraud of its president, Russell Wasendorf.

The commodity brokerage business is extremely demanding; few brokers achieve financial success, and those who do spend years building their business to get there. DeCarley Trading opened its door four years before the failure of PFGBEST and worked tirelessly around the clock to build clients' trust. Sadly, it was taken from us in the blink of an eye, through no culpability of our own. Fortunately, we were able to quickly recover by creating an even better trading environment for our brokerage clients; with some time and dedication, we are confident we will emerge as a "bigger and better" firm.

However, we were not alone in our hardship. Approximately 120 firms were engaging in a similar exclusive trade-clearing relationship with PFGBEST. As I was writing this, more than half of such firms had thrown in the towel and closed shop. After all, their ability to generate commission revenue stopped immediately; PFGBEST owed its brokers about a month and a half in commission, and the thought of starting from scratch to build a business in a nearly impossible environment for commodity brokers was a gut-wrenching task many weren't willing to attempt.

Each of us doing business with PFGBEST chose the firm with careful consideration and due diligence; nonetheless, each of us also learned that even doing your homework and confirming with the data reported by regulators isn't always enough. With that said, the industry and its regulatory bodies have gained insight and implemented practices that should successfully prevent a repeat of the PFGBEST and MF Global heartache.

How to Protect Yourself from Another MF Global or PFGBEST

The wounds left by MF Global and PFGBEST on the commodity industry were deep, but there have been positive developments in their aftermath such as the potential for deposit insurance and improvements in the way regulators audit futures brokerage houses. Similarly, futures traders should take the lessons learned by these events to safeguard themselves from potential hardships.

Follow the FCM Financial Data Report

The Commodity Futures Trading Commission (CFTC) requires that FCMs regularly report the status of their customer segregated funds account to regulators. With the data collected, the CFTC publishes a monthly report on the financial data of each FCM. Reports leading up to the PFGBEST debacle were a painful reminder that data portrayed on the CFTC's reports might not always be verified properly. However, this situation has largely changed. Government regulators now have *electronic* access to the customer segregated funds accounts of each commodity brokerage firm, for reliable and accurate real-time verification of funds.

The report includes information such as the total value of customer segregated deposits, whether the amount the brokerage firm has in the customer segregated funds account is enough to be compliant, and any excess or deficiency in the account. You might be wondering why an FCM would have more in its customer segregated funds account than its customers actually have on deposit. Cash inflows and outflows are constantly taking place as clients deposit and withdraw funds, buy and sell options and futures contracts, and pay brokerage fees. Plainly, the math isn't quite as easy as one might think; instead of being a black-and-white figure, there is quite a bit of gray. Nonetheless, the regulations in place that require brokerage firms to segregate customer funds from their own worked flawlessly to protect client funds for decades before MF Global and PFGBEST infamously pilfered customer segregated funds accounts and changed the way the industry operates.

Spread Funds Among Multiple Brokers

Clients trading substantial sums of money might consider using more than one brokerage firm to clear trades with the exchange. Traders choosing to work with

an Independent Introducing Broker (defined in Chapter 5) enjoy the luxury of having one individual broker service their trading accounts at multiple brokerage firms. This cuts down on the additional hassles of maintaining multiple accounts while providing clients the advantage of diversifying risk of a brokerage firm failure in which client segregated funds are tampered with. Accordingly, my experience in the PFGBEST debacle lead me to conclude such an arrangement is necessary for probable success as a commodity broker. Not surprisingly, I am now operating under an Independent Introducing Brokerage arrangement and therefore offer my clients access to several brokerage houses while still dealing exclusively with my firm.

Although the odds of another incident similar to those with MF Global or PFGBEST occurring are slim, having peace of mind is important. After all, if the unthinkable happens again, it certainly won't occur at more than one firm at the same time.

What Regulators Are Doing to Protect Clients

As painful as back-to-back system failures were for clients, employees, and brokers of both MF Global and PFGBEST, some long-term good might come of it. For instance, as mentioned, in the aftermath of these events, the National Futures Association (NFA) has been provided electronic access to the bank accounts of FCMs, enabling frequent verification of customer segregated funds balances. A proposed insurance fund discussed within the CFTC also would provide deposit insurance to commodity traders on up to \$250,000 of the account balance. This insurance fund would be similar to the banking system's FDIC deposit insurance and would eliminate the risk of unforeseen events such as bank insolvency or a brokerage failure to comply with segregation rules. As this book was going to print, deposit insurance for futures traders was a discussion rather than a reality, but I predict it will eventually be implemented.

Conclusion

Despite the recent hiccup in its track record, violation of customer segregated funds regulations is a rare and infrequent event. In fact, even without new regulatory safety nets in place to avoid another calamity of this sort, it likely would not happen again anytime soon. Nevertheless, those of us whose livelihood depends on a properly functioning marketplace in which we can all be confident, welcome positive changes in oversight with open arms.

Throughout this text, you find what I believe to be a realistic and candid view of the commodity markets. My intention isn't to deter you from trading commodities. After all, I am a broker who makes a living from commission, and I would love nothing more than to attract traders into what I believe to be some of the most exciting markets available to speculators. However, as a broker, it is also my job to make sure that you are aware of the potential hardships and, accordingly, that you will properly prepare yourself before putting your hard-earned money at risk.

If you walk away from this book with something, I hope it is the realization that anything is possible in the commodity markets. Never say "never"—if you do, you will eventually be proven wrong. Additionally, trading the markets is an art, not a science. Unfortunately, there are no black-and-white answers, nor are there fool-proof strategies—but that does not mean there aren't opportunities.

I am often asked what is the best technical tool or indicator to use when speculating in a market. My answer is always the same: No "best tool" exists, nor is there only a best way to use the tool. The paramount approach to any trading tool, whether technical, seasonal, or fundamental, is to use it—or, better yet, a combination of a few tools—to form an educated opinion in your expectations of market price. With their findings, traders should approach the market with a degree of humbleness and realistic expectations.

Remember, as a trader, you compete against the market—specifically, each participant in that particular market. Therefore, assuming that you can always beat the markets is assuming that you are somehow smarter and better informed than all other participants. Not only is this arrogant, but it also might be financial suicide. Instead, you should approach every trade with modesty and the understanding that you could be wrong. Having such an attitude might prevent you from sustaining large losses as the result of stubbornness.

With that in mind, in its simplest form, trading is a zero sum game. Aside from commissions paid to the brokerage firm and fees paid to the exchange, for every dollar lost in the market, someone else has gained a dollar. Becoming a consistently profitable trader isn't easy, but it isn't synonymous with chasing the proverbial end of the rainbow, either. With the proper background, hard work, and the experience that comes with inevitable tough lessons, long-term success is possible. I hope this book is the first step in your journey toward victory in the challenging, yet potentially rewarding, commodity markets.

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chapter 1

A Crash Course in Commodities

How It All Began

Given the urban nature of the city of Chicago, we often forget that it is located in the agricultural heart of the Midwest. In the mid-1840s, the Windy City emerged as the agricultural market center for neighboring states. Chicago was the meeting place for farmers looking for buyers of their crops and grain mills looking to purchase product for their operations. However, despite the central location, timing and logistic issues created inefficient means of conducting business and thus inflated commodity prices.

At the time, grain elevators were sparse, so lack of storage made it critical that a farmer sell his crop upon harvest at the annual meeting in Chicago. Even those who did have a method of storing the grain faced frozen rivers and roadways that made travelling to Chicago nearly impossible during the winter months. Likewise, the springtime trails were often too muddy for wagon travel. Thus, during and immediately after harvest, grain supply was in such abundance that it was common for unsold grain to be dumped into Lake Michigan, for lack of means to transport and store unsold portions.

As you can imagine, as the year wore on, the grain supply dwindled, creating shortages. This annual cycle of extreme oversupply and subsequent undersupply created inefficient price discovery and led to hardships for both producers and consumers. The feast-or-famine cycle created circumstances in which farmers

Commodity prices have always been a function of supply and demand, but before the futures markets, excess and shortages wreaked havoc on consumers and producers.

Established in 1848, the CBOT is the world's oldest futures and options exchange. Native Chicagoans describe the organization as "old money."

were forced to sell their goods at a large discount when supplies were high, but consumers were required to pay a large premium during times of tight supplies. Luckily, a few of the grain traders put their heads and resources together to develop a solution: an organized exchange now known as the Chicago Board of Trade (CBOT)—or, more accurately, what is now the CBOT division of the CME Group.

The Chicago Board of Trade

The Chicago Board of Trade was created by a handful of savvy grain traders to establish a central location for buyers and sellers to conduct business. The new formalized location and operation enticed wealthy investors to build storage silos to smooth the supply of grain throughout the year and, in turn, aid in price stability.

After spending the last decade and a half as one of the largest futures trading organizations in the world and a direct competitor to the Chicago Mercantile Exchange (CME), the CBOT and the CME merged July 12, 2007, to form the CME Group, creating the largest derivatives market ever.

The CBOT division of the CME Group is the home of the trading of agricultural products such as corn, soybeans, and wheat. However, the exchange has added several products over the years, to include Treasury bonds and notes and the Dow Jones Industrial Index. Since 1930, 141 West Jackson Boulevard, in downtown Chicago has been known as the Chicago Board of Trade Building. It is now designated as a National Historic Landmark.

Local Chicagoans refer to the CME as "The Merc."

The Chicago Mercantile Exchange

The success of the CBOT fueled investment dollars into exchanges that could facilitate the process of trading products other than grain. One of the offshoots of this new investment interest was the Chicago Mercantile Exchange. The CME was formed in 1874 under the operating name Chicago Produce Exchange; it also carried the title Chicago Butter and Egg Board before finally gaining its current name.

The contract that put this exchange on the map was frozen pork belly futures, or simply "bellies," as many insiders say. Hollywood and media portrayals of the futures industry often focus on the pork belly market. How

could anyone forget the infamous scene in Trading Places in which Billy Ray Valentine plots his speculation of belly futures? Ironically, the CME Group delisted pork belly futures in July 2011 due to a “prolonged lack of trading volume.”

According to New Yorkers, there is only one “Merc,” and it isn’t in Chicago.

The CME, a division of the CME Group, is responsible for trading in a vast variety of contracts, including cattle, hogs, stock index futures, currency futures, and short-term interest rates. The exchange also offers alternative trading vehicles such as weather and real-estate derivatives. At the time of this writing, and likely for some time to come, the CME has the largest open interest in options and futures contracts of any futures exchange in the world.

The New York Mercantile Exchange

Although the futures and options industry was born in Chicago, New York was quick to get in on the action. In the early 1880s, a crop of Manhattan dairy merchants created the Butter and Cheese Exchange of New York, which was later modified to the Butter, Cheese, and Egg Exchange and then, finally, the New York Mercantile Exchange (NYMEX).

The NYMEX division of the CME Group currently houses futures trading in the energy complex. Examples of NYMEX-listed futures contracts are crude oil, gasoline, and natural gas. A 1994 merger with the nearby Commodity Exchange (COMEX) exchange allowed the NYMEX to acquire the trading of precious metals futures such as gold and silver under what is referred to as its COMEX division.

In March 2008, NYMEX accepted a cash and stock offer from the CME Group that brought the New York futures exchange into the fold, along with the CBOT and the CME. On August 18, 2008, NYMEX seat-holders and shareholders accepted the proposal and the rest is history. The NYMEX division of the CME Group has been fully integrated with the CME and CBOT divisions of the exchange despite being located hundreds of miles away from downtown Chicago.

The CME Group

The CME Group consists of the three aforementioned divisions: the CBOT, CME, and NYMEX, which previously stood as independent exchanges. Accordingly, the CME is officially the world’s largest derivatives exchange. As previously mentioned, on July 12, 2007, the merger of the CBOT and the CME

created the CME Group, but NYMEX was acquired in 2008 to create a powerful and innovative entity.

Trade on the CME Group represents a majority of futures trading in the United States, but its largest competitor is the IntercontinentalExchange, known simply as ICE.

The CME Group currently serves the speculative and risk management needs of customers worldwide. Among the three divisions, the CME Group offers derivative products across nearly all imaginable asset classes.

Upon merging, the CBOT and the CME consolidated all floor-trading operations into a single location: the historic CBOT building on 141 West Jackson Boulevard in downtown Chicago. The actual move took place over three

weekends, and no details were spared. The new combined trading floor spans 60,000 square feet.

IntercontinentalExchange

IntercontinentalExchange (ICE) is the newest player in U.S. futures trading. In stark contrast to the *original* models of the CBOT, the CME, and NYMEX, ICE primarily facilitates over-the-counter energy and commodity futures contracts. This simply means that there is no centralized location; nearly all trading takes place in cyberspace. However, ICE continues to operate floor-trading operations in some of its option markets. In addition, the CME Group has followed the lead of ICE and moved a majority of its futures contract execution to electronic means, as opposed to a trading pit with a physical location. We discuss the two types of execution in greater detail in Chapter 3, “The Organized Chaos of Open Outcry and the Advent of Electronic Trading.”

ICE was established May 2000, with the mission of transforming OTC trading. By 2001, it had acquired a European energy futures exchange, but it didn't dig its claws deep into the heart of the U.S. futures industry until its acquisition of the New York Board of Trade (NYBOT) in 2007, along with the responsibility to facilitate trading in the softs complex. The term *soft* generally describes a commodity that is grown rather than mined; examples of contracts categorized as soft and traded on ICE in the United States include sugar, cocoa, coffee, and cotton. More recent additions are financial products including the Russell 2000 Index and the U.S. Dollar Index.

Evolution of the Forward Contract into a Futures Contract

The futures markets and the instruments traded there, as we know them today, have evolved from what began as private negotiations to buy and sell commodities between producers and users. The agreements that resulted from these negotiations are known as *forward contracts*. Fortunately, efficient-minded entrepreneurs discovered that standardized agreements can facilitate transactions in a much quicker manner than a privately negotiated forward contract. Thus, the futures contract was born. Next, we take a look at the advent of the forward contract and how the concept eventually bred the futures contract.

The Forward Contract

The ingenuity of agricultural trade didn't end with the creation of organized and centralized grain trade in the 1800s. Although this certainly worked toward price stabilization by leveling shortages and surpluses throughout the growing and harvest cycles, other factors worked against price efficiency. As a means of mitigating price risks, farmers and merchants began dealing in forward contracts.

A forward contract is a private negotiation developed to establish the price of a commodity to be delivered at a specific date in the future. For example, a farmer who has planted corn and expects it to be harvested and ready to sell in October might locate a party interested in purchasing the product in October. At that time, both parties might choose to enter an agreement for the transaction to take place at a specific date, price, and location. Such an agreement locks in the price for both the buyer and the seller of the commodity and, therefore, eliminates the risk of price fluctuation that both sides of the contract face without the benefit of a forward contract.

Along with a centralized grain trade, the forward contract was another big step toward price stability, but there was a problem. Forward contracts reduce price risk only if both parties to the arrangement live up to their end of the agreement. In other words, there is no protection against default. As you can imagine, a farmer who locks in a price to sell his crop in the spring through a forward contract and later discovers that he can sell the product for considerably more in the open market might choose to default on the forward contract.

In its simplest form, a futures contract is a standardized forward contract.

It is easy to see the lack of motivation for parties to a forward contract to uphold their end of the bargain. Even the most honest man would be tempted to default if it means a better life for his family.

To resolve the issue of merchants and farmers defaulting on forward contracts, the exchanges began requiring that each party of the transaction submit a good-faith deposit, or margin, with an unrelated third party. In the case of failure to comply with the contract, the party suffering the loss would receive the funds deposited in good faith to cover the inconvenience and at least part of the financial loss.

The Futures Contract

Exchange-traded forward contracts were extremely helpful in reducing the price risk that farmers and merchants normally were exposed to. Additionally, with the advent of exchange-traded forward contracts along with good-faith deposits, much of the default risk was eliminated. However, because forward contracts were negotiations between two individuals, it was a challenge to bring together buyers and sellers who shared the same needs in terms of quantity, timing, and so on. Also, forward contracts were subject to difficulties arising from uncontrollable circumstances such as drought. For example, a farmer obligated to deliver a certain amount of corn via a forward contract might not comply due to poor growing conditions, thus leaving the counterparty to the transaction in a dire predicament.

The exchanges' answer to problems arising from forward contracts was the standardized futures contract. In its simplest form, a futures contract is a forward contract that is standardized in terms of size, deliverable grade of the commodity, delivery date, and delivery location. The fact that each contract is identical to the next made the trading of futures much more convenient than attempting to negotiate a forward contract with an individual. The concept of standardization has allowed the futures markets to flourish into what they have become today.

According to the CME, the formal definition of a futures contract is as follows:

A legally binding, standardized agreement to buy or sell a standardized commodity, specifying quantity and quality at a set price on a future date.

In other words, the seller of a futures contract agrees to deliver the stated commodity on the stated delivery date. The buyer of a futures contract agrees to take delivery of the stated commodity at the stated delivery date. The only

variable of a futures transaction is the price at which it is done, and buyers and sellers determine this in the marketplace.

Although the futures contracts bought or sold represent an obligation to take or make delivery, according to the CME Group, approximately 97% of futures contracts never result in physical delivery of the underlying commodity. Instead, traders simply offset their holding prior to the expiration date. We discuss this in more detail later in the chapter.

In the evolution into the futures contract and away from the forward contract, exchanges also eliminated default risk associated with buying or selling futures contracts by guaranteeing the other side of the transaction. Thus, unlike a forward contract, or early versions of the futures contract, in which both parties are left to depend on the other to live up to their end of the contract, a futures contract is backed by the exchange. This exchange guarantee covers the entire value of the position, instead of being limited to the margin posted by participants.

Thanks to the standardization of each contract, the subsequent ease of buying or selling contracts, and a lack of default risk, futures trading has attracted price speculation. Participation is no longer limited to those who own, or would like to own, the underlying commodity. Instead, unrelated third parties can easily involve themselves in the markets in hopes of accurately predicting—and, therefore, profiting from—price fluctuations.

A cash market transaction occurs in the present, but a futures market transaction is an agreement for an exchange of the underlying asset in the future.

Cash Market Versus Futures Market

Currently, commodities are traded in two separate yet related markets: the cash market and the futures market. The cash market refers to the buying and selling of physical commodities. In a cash market transaction, the price and exchange of product occurs in the *present*. In contrast, the futures market deals with the buying or selling of *future* obligations to make or take delivery instead of the actual commodity.

Cost to Carry

Prices in the cash and futures market differ as a direct result of the disparity in the timing of delivery of the underlying product. After all, if a commodity is going to be delivered at some point in the future, it must be stored and insured in the meantime. The costs associated with holding the physical grain until the stated delivery date are referred to as the *costs to carry*.

Naturally, in normal market conditions, the cash price is cheaper than the futures price because of the expenses related to carrying the commodity until delivery. Likewise, the near-month futures price is generally cheaper than a distantly expiring futures contract. The progressive pricing is often referred to as a normal carrying charge market (see Figure 1.1). You might also hear this scenario described by the term *contango*.

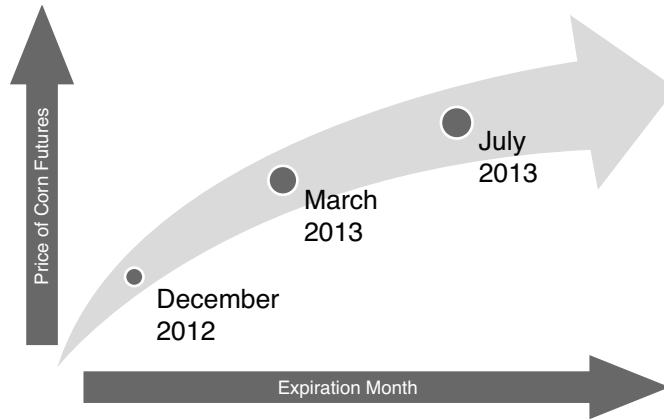


Figure 1.1 Normal carry charge market, or contango.

Normal carrying charge markets are possible only during times of ample supply, or inventory. If there is a shortage of the commodity in the near term, prices in the cash market increase to reflect market supply-and-demand fundamentals. The supply shortage can reduce the contango or, if severe enough, can actually reverse the contango if the spot price, and possibly the price of the nearby futures contract, exceeds the futures price in distant contracts, as shown in Figure 1.2.

It is important to understand that the contango shouldn't exceed the actual cost to carry the commodity. If it did, producers and consumers would have the opportunity for a "risk-free" profit through arbitrage.

"If you can take advantage of a situation in some way, it's your duty as an American to do it."

**—C. Montgomery Burns
(from *The Simpsons*)**

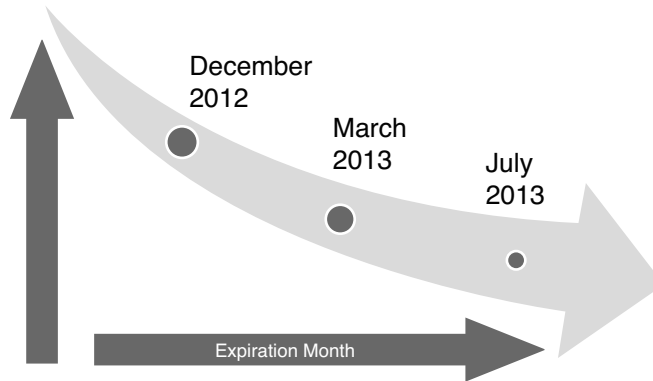


Figure 1.2 The opposite of contango is sometimes called backwardation and involves higher spot prices than futures prices.

Arbitrage

Arbitrage is the glue that holds the commodity markets together. Without arbitrage, there would be no incentive for prices in the futures market to correlate with prices in the cash market—and as I discuss in Chapter 2, “Hedging Versus Speculating,” arbitrage enables efficient market pricing for hedgers and speculators. Specifically, if speculators notice that the price difference between the cash and futures prices of a commodity exceeds the cost to carry, they will buy the undervalued (cash market commodity) and sell the overvalued (futures contract written on underlying commodity). This is done until the spread between the prices in the two markets equals the cost to carry.

The true definition of *arbitrage* is a risk-free profit. Sounds great, doesn’t it? Unfortunately, true arbitrage opportunities are uncommon, and those that do occur are opportunities for only the insanely quick. Chances are, you and I do not possess the speed, skill, and resources necessary to properly identify and react to most arbitrage opportunities in the marketplace.

For further clarification, an example of an arbitrage opportunity unrelated to cash market pricing is a scenario in which the e-mini S&P is trading at 1380.50 and the full-size version of the contract is trading at 1380.70. In theory, if you noticed this discrepancy in a timely fashion, it would be possible to buy five mini contracts and sell one big S&P. The mini contract is exactly one-fifth the size of the original and is fungible; this means that trading five mini contracts

Arbitrage is a “risk-free” profit, but for most of us, it might as well be a mirage. Markets are quick to eliminate such opportunities.

is identical to trading one big contract. Consequently, a trader who can execute each side of the trade at the noted prices can request that the positions offset each other to lock in a profit of 20 cents, or \$50 before transactions costs. It doesn't sound like much, but if it truly is an arbitrage opportunity, a \$50 risk-free profit isn't such a bad deal.

Contract Expiration

By definition, futures contracts are expiring agreements for buyers and sellers of those contracts to exchange the underlying physical commodity. Most market participants choose to avoid dealing with the underlying assets by offsetting their obligation at some point before the futures contract expires or, in some cases, prior to first notice day. I cover the process of offsetting positions later in the chapter.

First Notice Day

First notice day occurs before the corresponding futures contract expires. The official definition of *first notice day* is the day on which the buyer of a futures contract can be called upon by the exchange to take delivery of the underlying commodity. On this day, the exchange estimates the number of traders who are expected to make delivery of the commodity (those short futures contracts) and distributes delivery notices to those long futures on a first-in basis. Simply put, traders who hold long positions into the first notice day run the *risk* of being delivered upon but might not *actually* be delivered upon, depending on the amount of time the position has been open. For instance, a trader who has been long a futures contract for several weeks will receive a delivery notice before a trader who has established a position the day before first notice day. Note that the danger of receiving a delivery notice applies to those long the market only. Short traders don't have to worry about delivery until expiration day—yet they should be out of the market well before expiration because market volume and liquidity dry up immediately preceding and beyond the first notice day.

After a delivery notice is distributed, a trader isn't forced to accept it, so panicking is unnecessary. Instead, he can instruct his brokerage firm to “retender” the notice, which equates to selling the obligation in an open market to an interested party. Although the trader avoids being forced to find a home for 5,000 bushels of corn, or whatever the commodity might be, he faces substantial processing fees. All speculators should diligently avoid being part of the delivery process.

Not all futures contracts have a first notice day; some stipulate a cash settlement process instead of delivery of the underlying product. Cash settlement works just as it sounds and is explained next.

Futures Expiration

Expiration is the time and day that a particular delivery month of a futures contract ceases trading and the final settlement price is determined. The actual delivery process begins at expiration of the futures contract for markets that involve a physical commodity exchange. Conversely, a select number of futures contracts are cash settled. If this is the case, investors who hold positions into expiration agree to allow the exchange to determine a final valuation for the futures contract at hand and adjust the value of individual trading accounts accordingly. In my opinion, it is generally a bad idea to hold positions into expiration in cash-settled markets because it leaves the fate of profit and losses in the hands of a relatively arbitrary exchange-derived contract value. Likewise, unless you are willing to make, or take, delivery of the underlying commodity, you shouldn't have an open position in a deliverable commodity contract into expiration.

The Mechanics of Futures Contracts

So far, we have learned that futures contracts are standardized and are guaranteed by the exchange. However, there is a lot more to be learned, and you must fully understand the basics before you can expect to be a successful futures trader.

Futures traders don't have to own or borrow assets before they can sell.

The Long and Short of It

Commodity trading is a world full of insider lingo; it is almost as if the industry created a language of its own. If you want to be a participant, you must become familiar with commonly used terms and phrases. Doing so avoids miscommunication between yourself and your broker.

I cover several commonly used phrases and terms in a later chapter; however, the two most critical terms to be aware of are *long* and *short*. In essence, the term *long* is synonymous with *buy*, and the term *short* is synonymous with *sell*. This is the case whether the instrument in question is a futures contract or an option. Specifically, if a trader buys a futures or option contract, he is going

In futures market slang, long and short describe a speculative position.

long. If a trader sells a futures or option contract, he is going short.

It is important to realize that you will sometimes hear industry insiders say that they are *long the market* with options, futures spreads, and such. Although in strict context of the phrase *long* implies that something has been purchased, in loosely used lingo, being *long a market* might simply mean having a bullish stance. This can mean long futures, long call options, short put options, bullish option or futures spreads, or any other speculative play that profits from an increase in the price of the underlying asset. Consequently, you might hear a trader mention that she is *short the market*; this might mean that she is short futures, short call options, long puts, or engaged in a bearish option or futures spread. Despite the alternative uses, however, beginning traders should first be comfortable using *long* in the context of buying and *short* in the context of selling.

Buy or Sell in Any Order

One of the most difficult concepts for beginning commodity traders to grasp is the fact that a futures contract can be bought and sold in any order. The common thinking is that you can't possibly sell something before you own it, and even if you could, some interest likely would be charged for borrowing the asset that you intend to sell. Although that might be true in stock trading, that logic doesn't apply to the futures markets. Let's take a look at why this is the case.

Trading futures and options is as simple as buying low and selling high—but simple doesn't mean it is easy.

Unlike stocks, futures contracts are not assets; they are liabilities. The purchase of a futures contract does not represent ownership of the underlying commodity; instead, it represents an obligation to take delivery of the underlying commodity at a specified date. Likewise, the seller of a futures contract isn't selling an asset; he is simply agreeing to make delivery of the stated asset on the appropriate date.

Because there is no ownership or exchange of the asset at the time the futures trade is made, it isn't necessary to own the underlying commodity or even be prepared to take ownership. Thus, buying or selling in any order isn't an issue for futures traders.

Offsetting and Rolling Over Trades

As mentioned, most investors who participate in the futures markets are simply attempting to profit from variations in price movement and are not interested in taking or making delivery of the underlying commodity. Again, to avoid the delivery process, it is necessary to offset holdings prior to expiration—or, more specifically, the first notice day.

The notion of offsetting is simple: To offset a trade, it is necessary to execute a position opposite the one that you originally entered the market with. To illustrate, if you bought a December corn futures, you would need to sell a December corn futures to get out of the position. When you are out of the market, you are said to be *flat*. This means that you do not have any open trades and are no longer exposed to price risk or margin. Of course, being flat the market doesn't necessarily mean that the risk of emotional turmoil is eliminated. Unfortunately, many beginning traders have incorrectly looked at missed opportunities as monetary losses. We look at the psychological impact of such emotions in Chapter 11, "The Only Magic in Trading—Emotional Stability."

When a trade is offset, the trader is said to be flat the market. This means that all positions are closed and there is no exposure to price risk, aside from a potential "missed trade."

The concept of offsetting can be best explained by an example. In September 2012, the corn futures contract expiring in December 2012 experienced a minor correction and seemed to be approaching trend line support. A trader who believed that prices would appreciate might purchase a futures contract in hopes of a rally. At that point, the trader has an open long position with the exchange and continues to have an open position until it is offset. As mentioned, the only way to offset an open position is to execute a transaction opposite the one used to enter the market. Looking at Figure 1.3, you can see that the trader purchased a December 2012 corn futures contract at \$7.34. In Chapter 8, "Making Cents of Commodity Quotes," I explain the details in quoting and calculating grain futures.

To get out of the market, the trader must sell a December 2012 corn futures contract, hopefully at a higher price. Naturally, if a trader can buy low and sell high, regardless of the order, he will be profitable (see Figure 1.4). As simple as this premise is, execution can be challenging. In fact, a majority of speculators walk away from the game with less money than they started with merely because they couldn't find a way to consistently buy low and sell high.

The same concept would be true for someone who sold a December corn futures contract to enter the position rather than bought one. Aside from holding the futures into expiration and actually making delivery of the underlying asset, the only way to get out of a short December futures trade would be to buy a December futures contract to offset the position.



Figure 1.3 Futures traders can buy and sell in any order but must take the opposite action to exit. This trader is going long December corn and will later have to sell it to offset the position. (Chart courtesy of QST.)

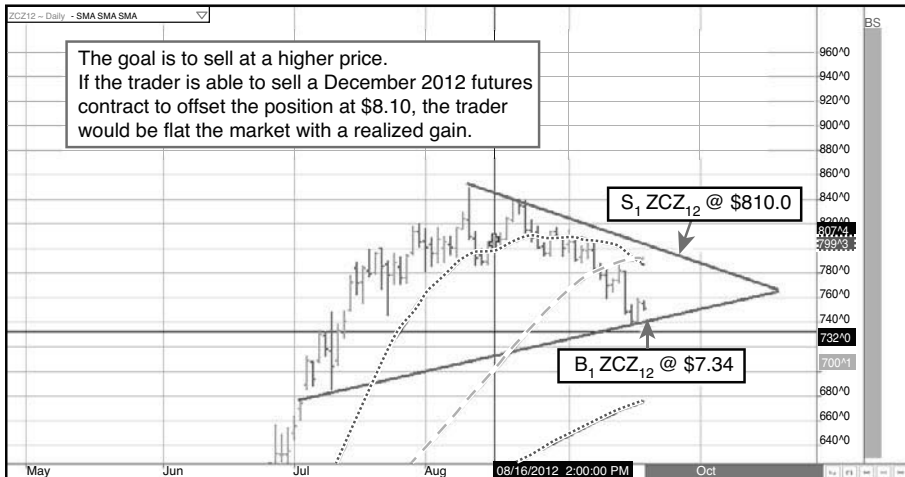


Figure 1.4 When a trader no longer has an open position, he is said to be “flat” the market. This trader is hoping to sell his contract, and his obligation with the exchange, near \$8.10. (Chart courtesy of QST.)

The term *rolling*, or *rolling over*, is commonly used to describe the practice of offsetting a trade in a contract that is facing expiration and entering a similar

position in a contract with a distant expiration date. Rolling over is simply offsetting one position and getting into another. Many beginning traders make the mistake of assuming that rolling into a new contract somehow avoids exiting the original position and simply changes the contract month. Perhaps it is wishful thinking for those who would prefer not to lock in a loss on an open position; unfortunately, in doing so is a necessary evil if the goal is to move into an alternative contract month.

To illustrate, a trader who is long a June T-note futures contract with the first notice day quickly approaching might choose to roll into the September contract to avoid delivery while still maintaining a bullish speculative position in the market. In this case, rolling would include selling the June contract and buying September.

Bid/Ask Spread

The notion of a bid/ask spread can be confusing. This is especially true given the differing perspectives of written literature available for beginning traders. Some articles and books seem to insist on explaining the bid/ask spread from both a market maker's point of view and a retail trader's perspective. However, in my opinion, providing details of both sides of the story simply creates more confusion than is necessary to get a good grasp of what a bid/ask spread is and how to cope with it as a trader.

The easiest way to understand the spread between the bid and the ask is to come to peace with the fact that there are essentially two market prices at any given time. There is a price at which you can buy the contract (the ask) and a price at which you can sell it (the bid). As a retail trader, you will always be paying the higher price and selling the lower price. It takes money to make money, and if you want to participate in a market, you must pay the bid/ask spread. For instance, a corn trader might buy corn at \$6.21 and sell corn at \$6.21[1/2]. The difference of a half a cent is the bid/ask spread, and it translates into a component of the transaction cost associated with executing a trade in this market.

Keep in mind that the bid/ask spread is how floor brokers, or market makers, are compensated for executing your trade and providing liquidity to the markets. Just as you pay a commission to the retail broker who took your order, the executing broker or market maker, must be paid in the form of the bid/ask spread. Think about it: If as a retail trader you are always paying the ask and buying the bid, you are a net loser even if the price of the futures contract

Nothing is free. Paying spreads are a part of trading costs. Don't get mad; get savvy.

remains unchanged. The beneficiary of the difference between the bid and the ask is the executing broker or market maker making fluidity of trade possible.

The spread between the bid and the ask isn't something that investors should resent—in liquid markets, anyway. After all, the executing broker must be compensated for accepting the risk involved with taking the other side of your trade. In general, he wants to offset his position and risk as soon as possible; his intention is to “make a market” and profit from the difference in the bid/ask spread, not to speculate on price movement. In highly liquid markets, there are often no market makers but there is still a natural bid/ask spread of a tick.

As a trader, it is important to be aware of the bid/ask spread and the implications that its size will have on your trading results. A couple prominent factors that affect the size of the spread are market liquidity and volatility. As market liquidity decreases, the size of the bid/ask spread widens, and thus the costs associated with participating in such a market increases. This makes sense. If the executing broker is anticipating a lack of volume and the corresponding difficulty offsetting his trade, he will require more compensation for taking the other side of your trade.

Likewise, if volatility is high, the executing broker faces more price risk during the time in which he takes the other side of your trade and can subsequently offset the position. Thus, he requires higher compensation for his efforts, which creates a relatively wide bid/ask spread.

One of the biggest mistakes I have witnessed beginning traders make is to ignore the repercussions of large bid/ask spreads. Most futures contracts are fluidly traded enough for this to be a nonissue. However, in the option trading arena, this is a big concern. It is extremely important that you understand that bid/ask spreads are a part of doing business and know how to adjust your trading strategy accordingly.

Bid/ask spreads hinder a trader's ability to make money; the wider the spreads, the more difficult it is to be profitable. In fact, certain markets have bid/ask spreads so wide that I believe investors have no incentive to trade them. This avoidance stems from the idea that excessively wide spreads create a scenario in which the trader must not only be right in the direction of the market, but must also be extremely right to overcome the hefty transaction cost. Imagine trading copper options that often have bid/ask spreads in excess of 1 cent in premium, or \$250. Immediately after initiating the trade, it is a loser in the amount of \$250, regardless of movement in the futures price. As you can see, this can make trading even more challenging.

Round Turns and Transaction Costs

Unlike the world of stocks, in which transaction costs are often quoted on a per-side basis and in the form of a *ticket charge*, commodity trades are typically charged on a round-turn basis. However, as the nature of the industry shifts from broker-assisted trading to discount online, futures brokers are beginning to quote commissions per side in an effort to make the transaction costs seem cheaper than they actually are. A single round turn consists of the purchase and sale of the same futures or option contract. Simply put, it is getting in and getting out of a market.

Many beginning traders mistakenly assume that the commission and fees charged to them depend on the number of order tickets rather than the number of contracts, but this is not the case. If a trader buys 10 e-mini crude oil contracts at \$91.00 and later sells all 10 at \$92.00, he has executed 10 round-turns and will be charged 10 commissions. This is true regardless of whether the 10 contracts were purchased and sold on single tickets or whether there were 10 separate orders to buy 1 contract at \$91.00 and then 10 separate orders to sell 1 contract at \$92.00.

Of course, not all traders are day-trading, and it is common for positions to be entered on one day and exited at some date in the future. In this case, a futures trader is charged a half of a round-turn commission on the day the trade is initiated and is then charged the other half the day that the trade is offset. Notice that I specifically noted *futures* traders; option traders normally are charged the entire round-turn commission when they enter the trade. Therefore, a trader who buys a soybean \$12.00 put would be charged a commission to enter the position but would be able to exit the trade without being charged.

Keep in mind that I have been referring strictly to commissions, which your brokerage firm charges. Each round-turn is accompanied by exchange fees, minimal National Futures Association (NFA) fees, and possible transaction fees charged by the clearing firm. Transaction fees are charged on a per-side basis, regardless of whether the instrument being traded is an option or a futures contract.

When negotiating a commission rate with your brokerage firm, be sure to confirm that the quoted rates are per round-turn. You should also be aware of whether they include the additional fees. Because exchange fees vary from product to product, most firms state commission rates on a round-turn-plus-fees basis. This means that you have to account for any exchange, NFA, and clearing fees in addition to the commission. Some firms, typically deep discount brokerages, quote rates as “all inclusive,” which already account for incremental

fees. Many of these firms also quote rates on a per-side basis simply because it “sounds” cheaper and can be an effective marketing tool.

Price Speculation

As easy as it is to have the freedom to buy or sell in any order, sticking to the overall goal of buying low and selling high can be challenging. The price of a given asset, whether it be grains, metals, energies, or Treasury bonds, depends on a seemingly unlimited number of factors. Even as a market is making a large price move, it is nearly impossible to determine the driving force behind the change in valuation and whether it will last.

Not only are prices the result of supply and demand fundamentals, but they can also be swayed by logistical issues such as light volume, option expiration, and excessive margin calls. A primary catalyst for some of the largest commodity plunges in history was the sweeping number of forced liquidations due to insufficient margin in speculative trading accounts.

In addition, a seemingly unlimited number of intermarket relationships can be used as a guide but not a guarantee. For instance, a strong dollar often works against commodity prices, but that doesn't mean that if the dollar is down, commodities will *always* rally. Another example is the negative correlation between Treasuries and stocks. In theory, investors have two major asset classes to choose from, stocks and bonds. If money is flowing into one, it is likely flowing out of the other. This is a useful but simplistic bit of information. Although this relationship tends to exist over time, in many cases, both markets travel together, and stubbornly trading according to the historical relationship could lead to large losses.

This discussion isn't intended to discourage you from attempting to speculate on the price of commodities or to insinuate that it can't be done; it can. However, I want you to recognize that analyses should be done with an open mind and a willingness to adapt to changes in what you consider to be the norm.

Futures Spreads

The practice of buying one futures contract and selling another that is similar in nature is known as *spread trading*—specifically, *futures spread trading*. The goal of a futures spread is to profit from the change in the price difference between the two related futures contracts involved. Simply, a futures spread trader isn't

necessarily concerned with the direction of the underlying market. Instead, the trader is speculating on the relationship (spread) between the prices of the two contracts in question. Two basic futures spreads exist: the intracommodity spread and the intercommodity spread.

Exchange-recognized futures spreads involve discounted margin requirements; before trading spreads be sure that you are properly capitalized.

- **Intracommodity spread.** In reference to a futures spread, there are a plethora of interpretations or meanings. However, the most commonly used spread strategy is the *intracommodity spread*, which is often referred to as a *calendar spread*. Specifically, this entails simultaneously holding a long position in one contract month of a specific commodity and a short position in another contract month of the same commodity.

For example, a grain trader might buy a July corn futures contract and sell a December corn futures contract. Whether the position is a winner or a loser doesn't depend on whether corn prices go up or down; instead, it depends on how much more July corn increases relative to the December contract or how much less it decreases. Specifically, it is concerned with whether the spread widens or narrows.

- **Intercommodity spread.** Don't get *intracommodity* and *intercommodity* spreads confused. The prefix *intra* denotes that the spread is with the same commodity; the prefix *inter* indicates that the spread is between two different but related commodities. As you can imagine, due to less obvious correlation between the components of an intercommodity spread relative to those in an intracommodity spread, intercommodity spreads tend to be much more volatile and expose traders to more risk.

An intercommodity spread consists of purchasing a futures contract in a given delivery month and simultaneously holding a short position in a related commodity market but the same delivery month. An example of popular intercommodity spreads include the *crack spread* (spreading crude oil against unleaded gasoline and heating oil) and the *crush spread* (spreading soybeans against soybean oil and soybean meal).

Similar to an option spread that can have its own quote, a futures spread can also be referenced in terms of a package. Consequently, spreads are traded in a separate trading pit located near the pit in which outright futures are traded, or electronically through designated networks and market

The term spread typically implies hedge. In theory, one or some of the components of the spread will hedge the risk of others.

makers. This enables traders to name the spread price and place the order to execute both sides of the position on a single ticket.

For example, if July corn futures are trading at \$6.00 and December corn is trading at \$7.10, the bid/ask spread on this particular intracommodity spread might be \$1.10/\$1.12. Thus, a spread trader could buy the spread for \$1.12 or sell the spread for \$1.10, or choose to work a limit order at an alternative price. Alternatively, a spread trader could choose to execute each leg of the spread separately, as opposed to a package, by executing two order tickets—one for the July corn futures and one for December.

A Brief Introduction to Commodity Options

The theory and practice of option trading is diverse and sometimes complicated. Accordingly, it is impossible to do the topic justice in such a brief mention. The purpose of this section is to merely introduce the subject.

Options can be purchased outright, in conjunction with futures contracts, or even as a package with both short and long options of various types. There are no limits to the versatility of option trading. Commodity options provide a flexible and effective way to trade in the futures markets with various amounts of potential risk and reward. For example, through the combination of long and short calls and puts, investors can design a strategy that fits their needs and expectations; such an arrangement is referred to as an *option spread*.

The method and strategy should be determined by personality, risk capital, time horizon, market sentiment, and risk aversion. Plainly, if you aren't an aggressive individual with a high tolerance for pain, you probably shouldn't be employing a trading strategy that involves elevated risk. Doing so often results in panicked liquidation of trades at inopportune times and other unsound emotional decisions.





What Is an Option?

Before it is possible to understand how options can be used, it is important to know what they are and how they work. The buyer of an option pays a premium (payment) to the seller of an option for the right, not the obligation, to take delivery of the underlying futures contract (exercise). This financial value is treated as an asset, although eroding, to the option buyer and a liability to the seller. There are two types of options, a *call* option and a *put* option.

- **Call options.** Give the buyer the right, but not the obligation, to buy the underlying at the stated strike price within a specific period of time. Conversely, the seller of a call option is obligated to deliver a long position in the underlying futures contract from the strike price if the buyer opts to exercise the option. Essentially, this means that the seller is forced to take a short position in the market when the option is exercised.
- **Put options.** Give the buyer the right, but not the obligation, to sell the underlying at the stated strike price within a specific period of time. The seller of a put option is obligated to deliver a short position from the strike price if the buyer chooses to exercise the option. Keep in mind that delivering a short futures contract simply means being long from the strike price.

Similar to futures contracts, there are two sides to every option trade: a buyer and a seller. Option buyers are paying for the underlying right, whereas sellers are selling that right. The most important point to remember is that option *buyers* are exposed to risk limited to the amount of premium paid, whereas option *sellers* face theoretically unlimited risk. Conversely, option *buyers* have the possibility of potentially unlimited gains, whereas the profit potential for *sellers* is limited to the amount of premium collected (see Table 1.1).

Table 1.1 Relationship Between Calls and Puts

	Call	Put	
Buy			Limited risk
Sell			Unlimited risk

Traders who are willing to accept considerable amounts of risk can write (or sell) options, collecting the premium and taking advantage of the well-known belief that more options than not expire worthless. The premium collected by a seller is seen as a liability until either the option is offset (by buying it back) or it expires.

Option Spreads

The majority of beginning option traders prefer trading outright options (buying or selling calls or puts), due to their simplicity. However, there are definite advantages to becoming familiar with the flexibility of risk and reward when using option spreads.

An option spread is the combination of two different option types or strike prices to attain a common goal. The term *option spread* can be used to refer to an unlimited number of possibilities. For example, an option spread can involve the purchase of both a call and a put with the same strike prices, or it can be the purchase and sale of two calls with different strike prices. The sheer number of possibilities makes this topic beyond the scope of this book, but if you are interested in learning more on option spreads, you might want to pick up a copy of *Commodity Options*, which I authored and was published by FT Press.

To add to the confusion surrounding commodity vocabulary, an *option spread* has its own bid/ask spread. Just as a single call or put would have a price that you can buy it for and a price you can sell it for, a spread is priced as a package and has both a bid and an ask that represent the purchase or sales price for the combination of options.

Fortunately, when dealing with a spread on a spread, most insiders identify the bid/ask spread by its full name and also refer to the option spread by its specific name. For example, if a broker calls the trading floor to get a quote for an option spread, she might say something like this to the clerk who answers the phone: “Will you get me the bid/ask on the 900/950 call spread?” Similarly, when accessing an option spread quote via an electronic trading platform, a trader inputs the appropriate strike prices and designates the query as a “vertical call spread,” or some other type of recognized spread structure.

It is important to realize that, when getting a quote for an option spread, it isn't necessary to decipher whether you will be buying or selling the spread. This is because the broker or trading platform gives you the quote for doing each. Therefore the bid/ask spread—the spread can be bought at the ask and sold at the bid.

Once again, option spreads are too complex to discuss in any detail within this text. However, you need to realize that, when it comes to option spreads, if the price of the long option of the spread is higher than the price of the short options, the trader is buying the spread. If it is possible to collect more premium for the short legs than is paid for the long legs, the trader is selling the spread.

The increasing popularity of electronic trading platforms, and the resulting transparent option pricing, has encouraged many traders to place separate order tickets on various legs of their spreads instead of entering a single ticket to enter the trade as a package. For instance, an option spread between a long and a short call option could be entered using a spread order in which both legs are executed simultaneously. Alternatively, a trader could simply place an order to buy the desired call option, and then another to sell the other call option to complete the spread.

For margin purposes, option spreads are treated the same whether they are entered on one ticket or multiple tickets. However, some brokers with strict order entry risk policies might prefer traders to enter spreads on a single order ticket so that they know the trader's intention before approving and executing the order. In other words, overactive risk-management desks might reject certain orders intended to be a part of a spread due to misunderstood risk and margin consequences.

In conclusion, traders are doing themselves a disservice by ignoring the potential benefits of incorporating option trading into speculation. Although option trading can seem complex on the surface, you owe it to yourself to be familiar with all the tools available to you as a trader. After all, taking the "easy road" in life often fails to be beneficial in the end, and this may be no different.

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Index

A

accepting margin calls, 200
access to information. *See*
 information access
account liquidation, 196
account minimums for futures trading, 233
account size in commission structure, 89
Amsterdam, Max, 207
Arb (trading floor language), 51
arbitrage, 27-28, 171
Aussie, 249
Australian dollar futures, quoting, 190
automated trading systems. *See*
 trading systems
automatic order approval, 69-70
availability of broker, 102

B

babysitting a trade, 253
back testing, 215
Background Affiliation Status Information
 Center (BASIC), 101
backwardation, 27
BASIC (Background Affiliation Status
 Information Center), 101
bean oil, 137
bean oil futures, quoting, 139-140
beans, 248
bear market, 239-241
bid/ask spreads, 33-34, 40, 241

Big Dow futures, 163
bills, 175
Bloomberg, Michael, 212
blow out, 244
blow up, 244
bonds. *See also* T-bond futures
 defined, 174-175
 price/yield relationship, 173
borrowing fees, lack of, 233-234
bottom fishing, 249-250
British Pound futures, quoting, 190-191
broker/dealers, 82
brokerage firms
 choosing, 77-78
 broker/dealers, 82
 commission structures, 86-89
 customer service department, 91-92
 discount versus full-service
 brokerages, 85-86
 FCMs (Futures Commission
 Merchants), 78-79
 fill quality, 82-83
 IBs (Introducing Brokers), 79-82
 margin policy, 93-95
 market access, 89-91
 technical support department, 92-93
 transaction costs, 83-84
commodity brokers, 10
 flawed business models, 11-12
 illegal practices of MF Global and
 PFGBEST, 12-14
 protection from illegal practices,
 15-16

- brokerage houses. *See* FCMS
 - brokers, choosing, 97-99
 - availability of broker, 102
 - 80/20 rule, 99-100
 - full-service versus self-directed online brokers, 106-109
 - future plans, 106
 - incentives for brokers, 99
 - market research availability, 105
 - professional requirements, 100
 - reasons to employ brokers, 109-111
 - researching broker qualifications, 101-102
 - trade execution fill quality, 104
 - trading background, 103-104
 - trading platform choices, 105
 - what to consider, 100-101
 - work experience, 102-103
 - Buffett, Warren, 10, 131, 202
 - bulk transfers, 81
 - bull market, 239-241
 - business models of commodity brokerage firms, 11-12
 - business trading plan. *See* trading plan
 - busted trades, 245-246
 - buying options, 39
 - buying/selling futures
 - in any order, 232-233
 - before/after selling, 30
- C**
- cable, 249
 - calculating profit/loss/risk
 - in Big Dow futures, 163
 - on copper futures, 152-153
 - in currency futures, 190
 - in Dow futures, 163
 - in e-mini Dow futures, 162
 - in e-mini NASDAQ futures, 165
 - in e-mini S&P 500 futures, 168-170
 - on energy futures, 154-155
 - in Eurodollar futures, 187
 - in 5-year note futures, 184
 - on grain futures, 135-137
 - on meat futures, 141-142
 - in NASDAQ futures, 164-165
 - on precious metals futures, 149-151
 - in Russell futures, 171
 - in S&P 500 futures, 167
 - on silver futures, 151-152
 - on softs futures, 144-147
 - on soybean byproduct futures, 137-140
 - in T-bond futures, 178-180
 - in T-bond options, 180-182
 - in 10-year note futures, 183
 - in 2-year note futures, 184
 - calculating prices. *See* pricing commodities
 - calendar spreads, 37
 - call options, 39
 - call spreads, 242
 - calling in orders, information needed for, 128-129
 - Canadian dollar futures, quoting, 190
 - cancel/replace orders, 126
 - canceling orders, 124-125
 - capital preservation, 210
 - cash market
 - futures market versus, 25
 - arbitrage, 27-28
 - cost to carry, 25-27
 - speculation, 44
 - cash settlement, 29
 - CBOT (Chicago Board of Trade), 20
 - CFTC reparations, 102
 - Change, Kenneth, 204
 - charting services, 66
 - charts
 - crude oil fluctuations, 9
 - gold rally, 3
 - silver rally, 5
 - wheat rally, 10
 - chasing the market, 250
 - Chicago, grain trading in, 19-20
 - Chicago Board of Trade (CBOT), 20
 - Chicago Mercantile Exchange (CME), 20-21
 - choosing
 - brokerage firms, 77-78
 - broker/dealers, 82
 - commission structures, 86-89
 - customer service department, 91-92
 - discount versus full-service brokerages, 85-86
 - FCMs (Futures Commission Merchants), 78-79
 - fill quality, 82-83
 - IBs (Introducing Brokers), 79-82
 - margin policy, 93-95
 - market access, 89-91
 - technical support department, 92-93
 - transaction costs, 83-84
 - brokers, 97-99
 - availability of broker, 102
 - 80/20 rule, 99-100

- full-service versus self-directed
 - online brokers, 106-109
- future plans, 106
- incentives for brokers, 99
- market research availability, 105
- professional requirements, 100
- reasons to employ brokers, 109-111
- researching broker qualifications, 101-102
- trade execution fill quality, 104
- trading background, 103-104
- trading platform choices, 105
- what to consider, 100-101
- work experience, 102-103
- trading vehicles, 220-221
- client risk to brokers, 86-89
- CME (Chicago Mercantile Exchange), 20-21
- CME Group, 21-22
- cocoa. *See* softs futures
- coffee. *See* softs futures
- collateral damage from MF Global and PFGBEST illegal practices, 14
- COMEX (Commodity Exchange), 21
- commission houses. *See* FCMs
- commissions. *See* transaction costs
- commodities
 - cash market versus, 25
 - arbitrage, 27-28
 - cost to carry, 25-27
 - defined, 172
 - ETF correlation with, 230
 - forward contracts
 - described, 23-24
 - disadvantages of, 24
 - as fungible products, 157
 - futures contracts
 - bid/ask spreads, 33-34
 - buying and selling, order of, 30
 - described, 24-25
 - expiration, 28-29
 - long and short, defined, 29-30
 - offsetting, 31-32
 - rolling over, 32-33
 - transaction costs and fees, 35-36
 - futures market, 25-28
 - hedging
 - insurance comparison, 44-45
 - leverage in, 49-50
 - long versus short hedges, 48
 - mitigating price risk with futures
 - contracts, 45-47
 - reasons for, 43-44
 - history of
 - Chicago Board of Trade (CBOT), 20
 - Chicago Mercantile Exchange (CME), 20-21
 - CME Group, 21-22
 - grain trading in Chicago, 19-20
 - Intercontinental Exchange (ICE), 22
 - New York Mercantile Exchange (NYMEX), 21
 - option spreads, 39-41
 - options, 38-39
 - reasons for volatility, 1-2
 - ease of market access, 2-3
 - European debt crisis, 3-4
 - fear of U.S. financial system collapse, 4-5
 - investment fads, 5-6
 - quantitative easing (QE), 4
 - speculation, 7-8
 - speculation, hedging versus, 48-49
 - volatility in, 8-10
- commodity brokerage firms, 10
- flawed business models, 11-12
- illegal practices at MF Global and PFGBEST, 12
 - collateral damage, 14
 - customer segregated funds, 13
 - protection from illegal practices, 15
 - customer segregated funds
 - reports, 15
 - investing with multiple brokers, 15-16
 - regulator actions, 16
- commodity brokers. *See* brokers
- commodity currencies, 248-249
- Commodity Exchange (COMEX), 21
- commodity quotes
 - currency futures, 187-188
 - Australian/Canadian dollar
 - futures, 190
 - British Pound futures, 190-191
 - Euro/Franc/Yen futures, 188-190
 - electronic quote reporting, 64
 - energy futures, 153-155
 - grain futures, 133-137
 - industrial metals futures, 151-153
 - interest rate futures, 172-174
 - Eurodollar futures, 185-187
 - Treasury futures, 174-184
 - lack of uniformity, 131-132
 - meat futures, 140-142
 - multipliers versus contract sizes, 132-133

- open outcry quote reporting, 60-64
 - positive versus negative
 - calculations, 133
 - precious metals futures, 147-151
 - softs futures, 143-147
 - soybean byproduct futures, 137-140
 - stock index futures, 158-161
 - Dow futures, 161-163
 - mini contracts, 159-161
 - NASDAQ futures, 163-166
 - Russell futures, 171-172
 - S&P 500 futures, 166-171
 - subscriptions to, 64-65
 - when to pay, 74-75
 - communication with broker, 102
 - contango, 26
 - contingency orders, 67, 119-120
 - contract expiration, 28-29
 - contract month slang, 242
 - contract sizes
 - in currency futures, 188
 - in energy futures, 153
 - in Eurodollar futures, 185
 - in gold, platinum, and palladium futures, 148
 - in grain futures, 135
 - in industrial metals futures, 151
 - in meat futures, 140
 - multipliers versus, 132-133
 - in softs futures, 143
 - in soybean byproduct futures, 137
 - in stock index futures, 158
 - in Treasury futures, 178
 - copper
 - copper futures, quoting, 152-153
 - trading options in, 117
 - corn. *See* grain futures
 - Corzine, Jon, 9
 - cost to carry, 25, 27
 - costs
 - of give-up brokers, 90
 - of information access, 60, 74-75
 - for NinjaTrader, 72
 - of open outcry quote reporting, 60
 - of order desk usage, 72-73
 - of QST (Quick Screen Trading), 71
 - of quote subscriptions, 64-65
 - for R-Trader, 72
 - for T4 (trading platform), 72
 - transaction costs
 - choosing brokerage firms, 83-84
 - flat monthly fees versus, 68-69
 - cotton futures, quoting, 146-147
 - coupon bonds, 174
 - coupon payments, 173
 - crack spreads, 37
 - Cramer, Jim, 110
 - crop year, 133
 - crude oil fluctuations (chart), 9
 - crude oil futures, quoting, 154
 - crush spreads, 37, 137
 - currencies
 - commodity currencies, 248-249
 - currency futures, quoting, 187-188
 - Australian/Canadian dollar futures, 190
 - British Pound futures, 190-191
 - Euro/Franc/Yen futures, 188-190
 - customer segregated funds, 13
 - defined, 248
 - financial reports about, 15
 - customer service department (brokerage firms), 91-92
- ## D
- day trading
 - automatic versus manual order approval, 69
 - day trading margin, 194-195
 - importance of trading platforms, 90
 - margin policy, 93-94
 - dead cat bounce, 249
 - debit, 256
 - DeCarley Trading, 14
 - default risk
 - eliminating, 25
 - of forward contracts, 23
 - deliverable securities, 176
 - delivery notices, first notice day, 28-29
 - Dennis, Richard, 216
 - desks, 53
 - discount brokerages, 85-86
 - discount securities, 175
 - DOM panels, 54, 70
 - double-out policy, 223
 - Dow futures, quoting, 161-163
- ## E
- E-micro gold futures, 150
 - e-mini Dow futures, 161-162
 - e-mini NASDAQ futures, quoting, 165-166
 - e-mini S&P 500 futures, 168-170

- ease of market access, 2-3
 - Eckhardt, Bill, 216
 - 80/20 rule, 99-100
 - electronic contract execution, 91
 - electronic order-entry platforms, 70-71
 - electronic quote reporting, 64
 - electronic trading, 51
 - described, 54
 - in side-by-side trading, 54-57
 - open outcry versus, 52
 - Emerson, Ralph Waldo, 221
 - emotions in trading, 201-203
 - fear, 203-205
 - frustration, 206
 - greed, 205-206
 - humility, 209
 - losing trades, 207-208
 - revenge, 209-210
 - taking profits early, 206-207
 - energy futures, quoting, 153-155
 - equity, 247-248
 - ETFs
 - correlation with commodities, 230
 - stability versus commodities listings, 235-236
 - Euro futures, quoting, 188-190
 - Eurodollar futures, 172, 185-187
 - European debt crisis, 3-4
 - exchange floor, organization of, 52
 - exchanges for gold and silver futures, 148
 - excitement of futures trading, 235
 - expendable funds, 236-237
 - expiration of futures contracts, 28
 - cash settlement, 29
 - Eurodollar futures contracts, 186
 - first notice day, 28-29
 - stock index futures, 159
 - T-bond futures, 177
- F**
- face value, 175
 - fat finger errors, 246-247
 - FCMs (Futures Commission Merchants), 78-79
 - fill quality, 82-83
 - relationship with IBs (Introducing Brokers), 80
 - transaction costs, 83-84
 - fear in trading, 203-205
 - fear of U.S. financial system collapse, 4-5
 - feeder cattle futures, 140
 - feelings. *See* emotions in trading
 - fees, 35-36
 - Fill or Kill (FOK) orders, 121-122
 - fill quality, 82-83, 104
 - fills, 243
 - financial markets
 - European debt crisis, 3-4
 - fear of U.S. financial system collapse, 4-5
 - first-day calls, 198
 - first notice day, 28-29
 - fixed-income securities, 174
 - 5-year note futures, 183-184
 - Flash Crash, 62
 - flat, 31
 - flat commissions, 86-89
 - floor presence, 90
 - FOK (Fill or Kill) orders, 121-122
 - forward contracts, 23-24
 - Franc futures, quoting, 188-190
 - free trading platforms, 66-67
 - front-end platform, 251
 - frustration in trading, 206
 - full handles, 255
 - full-service brokerages
 - discount firms versus, 85-86
 - self-directed online trading versus, 106-109
 - fungible, 157
 - future cash flows in interest rate futures, 173
 - future plans of brokers, 106
 - Futures Commission Merchants (FCMs), 78-79
 - fill quality, 82-83
 - relationship with IBs (Introducing Brokers), 80
 - transaction costs, 83-84
 - futures contracts
 - bid/ask spreads, 33-34
 - buying and selling, order of, 30
 - described, 24-25
 - electronic trading, 51, 54
 - expiration, 28
 - cash settlement, 29
 - first notice day, 28-29
 - hedging price risk with, 45-47
 - long and short, defined, 29-30
 - offsetting, 31-32
 - open outcry, 51-54

- reasons for trading, 229-230
 - buying/selling order, 232-233
 - excitement of trading, 235
 - IRAs and futures trading, 236
 - lack of interest charges and borrowing fees, 233-234
 - level playing field, 234
 - leverage and margin, 230-232
 - liquidity, 232
 - low account minimums, 233
 - stability of commodities listings, 235-236
 - tax benefits, 234-235
- rolling over, 32-33
- side-by-side trading, 54-57
- terminology, 239-257
 - babysitting a trade, 253
 - beans, 248
 - blow out, 244
 - blow up, 244
 - bottom fishing, 249-250
 - bull versus bear, 239-241
 - busted trades, 245-246
 - chasing the market, 250
 - commodity currencies, 248-249
 - contract month slang, 242
 - customer segregated funds
 - accounts, 248
 - dead cat bounce, 249
 - debit, 256
 - equity, 247-248
 - fat finger errors, 246-247
 - fills, 243
 - front-end platform, 251
 - handles, 255
 - keypunch errors, 244-245
 - limit moves, 250-251
 - moved trades, 245-246
 - overbought/oversold, 255-256
 - proprietary trading, 252
 - red months, 242
 - round-turns, 256-257
 - running stops, 252-253
 - scalping, 254
 - short squeezes, 253
 - slippage, 254-255
 - spreads, 241-242
 - tape, 251
 - trading environment, 257
 - trading solution, 251
 - unable, 255
 - working orders, 255
- transaction costs and fees, 35-36

- futures markets. *See* commodities
- futures spreads, 36-38
 - defined, 242
 - intercommodity spreads, 37
 - intra-commodity spreads, 37
- futures strangle strategy, 118

G

- gasoline futures, quoting, 154
- give-up brokers, 90, 104
- going debit, 198
- going negative, 198
- gold futures. *See also* precious metals futures
 - exchanges on, 148
 - quoting, 149-151
- gold rally (chart), 3
- Good Till Canceled (GTC) orders, 121
- grain futures, quoting, 133-137
- grain trading in Chicago, 19-20
- greed in trading, 205-206
- Greenspan, Alan, 1-2
- GTC (Good Till Canceled) orders, 121

H

- handle, 178
- handles, 255
- heating oil futures, quoting, 154
- hedging
 - defined, 43
 - insurance comparison, 44-45
 - leverage in, 49-50
 - long versus short hedges, 48
 - mitigating price risk with futures
 - contracts, 45-47
 - reasons for, 43-44
 - speculation versus, 48-49
- history of commodities
 - Chicago Board of Trade (CBOT), 20
 - Chicago Mercantile Exchange (CME), 20-21
 - CME Group, 21-22
 - grain trading in Chicago, 19-20
 - Intercontinental Exchange (ICE), 22
 - New York Mercantile Exchange (NYMEX), 21
- hit the bid, 241
- Hubbard, Frank, 199
- humility in trading, 209

I

IBs (Introducing Brokers), 79-82
 fill quality, 82-83
 transaction costs, 83-84

ICE (Intercontinental Exchange), 22, 143

IIB (Independent Introducing Broker), 81

illegal practices
 of MF Global and PFGBEST, 12
 collateral damage, 14
 customer segregated funds, 13
 protection from, 15
 customer segregated funds
 reports, 15
 investing with multiple brokers,
 15-16
 regulator actions, 16

Immediate or Cancel (IOC) orders, 122

incentives for brokers, 99

Independent Introducing Broker (IIB), 81

individual nature of trading plan, 226-227

industrial metals futures, quoting, 151-153

information access, 59
 charting services, 66
 cost of, 60
 electronic quote reporting, 64
 free trading platforms, 66-67
 open outcry quote reporting, 60-64
 order desk, 72-73
 paid trading platforms, 67-69
 quote subscriptions, 64-65
 trading platforms
 automatic versus manual order
 approval, 69-70
 examples of, 71-72
 multiple order-entry methods, 70-71
 when to pay, 74-75

initial margin, 194

insurance, hedging compared to, 44-45

intercommodity spreads, 37

Intercontinental Exchange (ICE), 22, 143

interest charges, lack of, 233-234

interest rate futures, quoting, 172-174
 Eurodollar futures, 185-187
 Treasury futures, 174-184

interest rate risk, 173

intracommodity spreads, 37

intraday trading. *See* day trading

Introducing Brokers (IBs), 79-82
 fill quality, 82-83
 transaction costs, 83-84

investment fads, commodities as, 5-6

IOC (Immediate or Cancel) orders, 122

IRAs, futures trading in, 236

J-K

Jefferson, Thomas, 202

keypunch, 124

keypunch errors, 244-245

knockout policy, 94

L

Lau Tzu, 70

LeFevre, William, 211

leverage. *See also* margin
 advantages of, 230-232
 in hedging and speculation, 49-50

limit down, 251

limit moves, 250-251

limit orders, 115-117

limit up, 251

Lincoln, Abraham, 113

liquidation, 196

liquidity
 bid/ask spread and, 34
 of futures markets, 232

live cattle futures, 140

Livermore, Jesse, 116

locked limit, 250

long, 29-30

long bond. *See* T-bond futures

long hedges, 48

long squeezes, 253

Loonie, 249

losing trades, emotions in, 207-208

loss, calculating
 in Big Dow futures, 163
 from commodities volatility, 8-10
 on copper futures, 152-153
 in currency futures, 190
 in Dow futures, 163
 in e-mini Dow futures, 162
 in e-mini NASDAQ futures, 165
 in e-mini S&P 500 futures, 168-170
 on energy futures, 154-155
 in Eurodollar futures, 187
 in 5-year note futures, 184
 on grain futures, 135-137

- on meat futures, 141-142
- in NASDAQ futures, 164-165
- on precious metals futures, 149-151
- in Russell futures, 171
- in S&P 500 futures, 167
- on silver futures, 151-152
- on softs futures, 144-147
- on soybean byproduct futures, 137-140
- in T-bond futures, 178-180
- in T-bond options, 180-182
- in 10-year note futures, 183
- in 2-year note futures, 184
- lumber futures, quoting, 147
- Lynch, Peter, 108

M

- maintenance margin, 194
- manual order approval, 69-70
- margin. *See also* leverage
 - advantages of, 230-232
 - day trading versus overnight margin, 194-195
 - defined, 193
 - initial margin, 194
 - maintenance margin, 194
 - margin calls
 - accepting, 200
 - advantages of brokers in, 111
 - defined, 195
 - handling, 196-197
 - measuring, 197-199
 - margin policy, choosing brokerage firms, 93-95
- margin calls
 - accepting, 200
 - advantages of brokers in, 111
 - defined, 195
 - handling, 196-197
 - measuring, 197-198
 - first-day calls, 198
 - second-day calls, 199
 - third-day calls, 199
- margin policy, choosing brokerage firms, 93-95
- market access, 89
 - ease of, 2-3
 - electronic contract execution, 91
 - floor presence, 90
- market data, accessing. *See* information access
- market depth, 54
- Market If Touched (MIT) orders, 120-121
- market makers in option markets, 61
- Market on Close (MOC) orders, 123-124
- Market on Open (MOO) orders, 122-123
- market orders, 114
- market research availability, choosing brokers, 105
- marrying a trade, 209
- maturity, 174
- measuring margin calls, 197-198
 - first-day calls, 198
 - second-day calls, 199
 - third-day calls, 199
- meat futures, quoting, 140-142
- MEME(Multiple Entry, Multiple Exit) orders, 125
- MF Global
 - illegal practices, 12
 - collateral damage, 14
 - customer segregated funds, 13
 - wheat rally losses, 9
- mini gold contract, 151
- mini stock index contracts, 159-161
- minimum accounts for futures trading, 233
- minimum tick, 134
- miNY silver futures contract, 152
- miNY gold contracts, 150
- MIT (Market If Touched) orders, 120-121
- MOC (Market on Close) orders, 123-124
- modified orders, 126
- monthly fees, per-side transaction costs versus, 68-69
- MOO (Market on Open) orders, 122-123
- moved trades, 245-246
- multiple brokers, investing with, 15-16
- Multiple Entry, Multiple Exit (MEME) orders, 125
- multiple order-entry methods, 70-71
- multipliers
 - contract sizes versus, 132-133
 - in currency futures, 188
 - in energy futures, 153
 - in Eurodollar futures, 185
 - in gold, platinum, and palladium futures, 148
 - in grain futures, 135
 - in industrial metals futures, 151
 - in meat futures, 140
 - in softs futures, 143
 - in soybean byproduct futures, 137
 - in stock index futures, 158
 - in Treasury futures, 178

N

NASDAQ futures, quoting, 163-166
 natural gas futures, quoting, 154
 negative calculations, 133
 net liq, 246
 New York Mercantile Exchange (NYMEX), 21
 NFA arbitration, 102
 NFA (National Futures Association), 101
 NinjaTrader, 71
 normal carrying charge market, 26
 normal curve, 178
 notes
 defined, 174-175
 5-year note futures, 183-184
 10-year note futures, 183
 2-year note futures, 184
 NYMEX (New York Mercantile Exchange), 21

O

oats. *See* grain futures, quoting
 OCO (One Cancels the Other) orders, 119-120
 offsetting futures contracts, 31-32
 on paper, 91
 One Cancels the Other (OCO) orders, 119-120
 one-lot orders in risk management, 224-225
 online, 91
 online account access, 89
 online order placement, 129-130
 online trading, full-service brokers versus, 106-109
 open orders, 121
 open outcry, 51
 described, 52-54
 electronic trading versus, 52
 organization of, 52
 quote reporting, 60-64
 in side-by-side trading, 54-57
 S&P options, 167
 opportunity cost of hedging, 45
 option chains, 64
 option quotes, 61-64
 option selling as risk management, 222-223
 option spreads, 38-41, 242
 option trading in copper, 117

options, 38
 buying/selling, 39
 call options, 39
 put options, 39
 T-bond options, 180-183
 “or better” orders. *See* limit orders
 orange juice futures, 144-145. *See* softs futures
 order desk, when to use, 72-73
 orders
 order-entry methods, 70-71
 order types
 cancel/replace orders, 126
 FOK (Fill or Kill) orders, 121-122
 GTC (Good Till Canceled) orders, 121
 IOC (Immediate or Cancel) orders, 122
 limit orders, 115-117
 market orders, 114
 MEME (Multiple Entry, Multiple Exit) orders, 125
 MIT (Market If Touched) orders, 120-121
 MOC (Market on Close) orders, 123-124
 MOO (Market on Open) orders, 122-123
 OCO (One Cancels the Other) orders, 119-120
 stop orders, 117-119
 straight cancel orders, 124-125
 placing
 online order placement, 129-130
 order placement risk, 110-111
 via telephone, 128-129
 tips for, 126-127
 overbought, 255-256
 overnight margin, 194-195
 oversold, 255-256
 overtrading, avoiding, 109-110

P

packages
 futures spreads, 37
 in option spreads, 40
 paid trading platforms, 67-68
 examples of, 71-72
 transaction costs versus monthly fees, 68-69

- palladium future, quoting, 151
- panic liquidation, avoiding, 109-110
- par value, 175
- partial account liquidation, 196
- partial fills, 243
- pay the ask, 241
- pay the spread, 241
- per-side basis (transaction costs), 35-36
- per-side transaction costs, flat monthly fees
 - versus, 68-69
- personal nature of trading plan, 226-227
- PFGBEST illegal practices, 12
 - collateral damage, 14
 - customer segregated funds, 13
- phone orders, information needed for, 128-129
- pit trading, 51
 - described, 52-54
 - electronic trading versus, 52
 - in side-by-side trading, 54-57
 - organization of, 52
- placing orders
 - online order placement, 129-130
 - order placement risk, 110-111
 - tips for, 126-127
 - via telephone, 128-129
- plan for trading. *See* trading plan
- platinum futures, quoting, 151
- positive calculations, 133
- Pound, 249
- Pound Sterling, 249
- precious metals futures
 - fear of U.S. financial system collapse, 4-5
 - precious metals crash, 63
 - quoting, 147-151
- premium trading platforms. *See* paid trading platforms
- price charts, placing orders from, 71
- price DOM (depth of market), 70
- price ladder, 160
- price limits, 250
- price risk, hedging with futures contracts, 45-47
- price speculation. *See* speculation
- price/yield relationship in bonds, 173
- pricing commodities
 - currency futures, 187-188
 - Australian/Canadian dollar futures, 190
 - British Pound futures, 190-191
 - Euro/Franc/Yen futures, 188-190
 - energy futures, 153-155
 - grain futures, 133-137
 - industrial metals futures, 151-153
 - interest rate futures, 172-174
 - Eurodollar futures, 185-187
 - Treasury futures, 174-184
 - lack of uniformity, 131-132
 - meat futures, 140-142
 - multipliers versus contract sizes, 132-133
 - positive versus negative
 - calculations, 133
 - precious metals futures, 147-151
 - softs futures, 143-147
 - soybean byproduct futures, 137-140
 - stock index futures, 158-161
 - Dow futures, 161-163
 - mini contracts, 159-161
 - NASDAQ futures, 163-166
 - Russell futures, 171-172
 - S&P 500 futures, 166-171
- pricing data. *See* quotes
- probability of success in risk management, 222
- production of commodities, hedging price risk of, 46
- professional requirements for brokers, 100
- profit
 - calculating
 - in Big Dow futures, 163
 - on copper futures, 152-153
 - in currency futures, 190
 - in Dow futures, 163
 - in e-mini Dow futures, 162
 - in e-mini NASDAQ futures, 165
 - in e-mini S&P 500 futures, 168-170
 - on energy futures, 154-155
 - in 5-year note futures, 184
 - in Eurodollar futures, 187
 - on grain futures, 135-137
 - on meat futures, 141-142
 - in NASDAQ futures, 164-165
 - on precious metals futures, 149-151
 - in Russell futures, 171
 - in S&P 500 futures, 167
 - on silver futures, 151-152
 - on softs futures, 144-147
 - on soybean byproduct futures, 137-140
 - in T-bond futures, 178-180
 - in T-bond options, 180-182
 - in 10-year note futures, 183
 - in 2-year note futures, 184
 - emotions in taking early, 206-207

prop desk, 252
 proprietary trading, 252
 protection from illegal practices of
 commodity brokers, 15
 customer segregated funds reports, 15
 investing with multiple brokers, 15-16
 regulator actions, 16
 put options, 39
 put spreads, 242
 put-fly, 242

Q-R

QE (quantitative easing), 4
 QST (Quick Screen Trading), 71
 quantitative easing (QE), 4
 quotes. *See* commodity quotes

R-Trader, 72
 real-time quotes. *See* quotes
 red months, 242
 reducing risk in margin calls, 196-197
 regulations on trading systems, 215
 regulators, protecting clients from illegal
 practices, 16
 requirements for brokers, 100
 researching broker qualifications, 101-102
 retirement accounts, futures trading in, 236
 revenge in trading, 209-210
 risk
 calculating
 in Big Dow futures, 163
 on copper futures, 152-153
 in currency futures, 190
 in Dow futures, 163
 in e-mini Dow futures, 162
 in e-mini NASDAQ futures, 165
 in e-mini S&P500 futures, 168-170
 on energy futures, 154-155
 in Eurodollar futures, 187
 in 5-year note futures, 184
 on grain futures, 135-137
 on meat futures, 141-142
 in NASDAQ futures, 164-165
 on precious metals futures, 149-151
 in Russell futures, 171
 in S&P 500 futures, 167
 on silver futures, 151-152
 on softs futures, 144-147
 on soybean byproduct futures,
 137-140
 in T-bond futures, 178-180

 in T-bond options, 180-182
 in 10-year note futures, 183
 in 2-year note futures, 184
 capital preservation and, 210
 client risk to brokers, 86-89
 interest rate risk, 173
 order placement risk, 110-111
 price risk, hedging with futures
 contracts, 45-47
 risk capital, 236-237
 risk management in trading plan,
 221-222
 one-lot orders, 224-225
 with option selling, 222-223
 personal nature of, 226-227
 probability of success, 222
 stop orders, 225-226
 10% rule, 224
 risk premium, 134
 risk reduction in margin calls, 196-197
 risk capital, 236-237
 risk premium, 134
 Rocco, Richard, 216
 rollover over futures contracts, 32-33
 Roosevelt, Franklin Delano, 205
 round-turns, 35-36, 256-257
 runners, 53
 running stops, 252-253
 Russell futures, quoting, 171-172

S

S&P 500 futures, quoting, 166-171
 safe haven, 149
 Santayana, George, 65
 scalping, 254
 second-day calls, 199
 selecting. *See* choosing
 self-directed online trading, full-service
 brokers versus, 106-109
 selling options, 39
 selling futures contracts
 in any order, 232-233
 before/after buying, 30
 serial options, 159
 Shaw, George Bernard, 201
 short, 29-30
 short hedges, 48
 short option margin policies, 94-95
 short squeezes, 253
 side-by-side trading, 54-57

- Silber, William, 6
 - silver futures. *See also* precious metals futures
 - exchanges on, 148
 - quoting, 151-152
 - silver rally (chart), 5
 - slippage, 111, 142, 254-255
 - softs commodities, 22
 - softs futures, 143-147
 - soybean byproduct futures, quoting, 137-140
 - soybean meal futures, quoting, 138-139
 - soybean oil futures, quoting, 139-140
 - SPAN (Standard Portfolio Analysis of Risk), 111
 - speculation. *See also* spreads
 - cash market speculation, 44
 - difficulty of, 36
 - hedging versus, 48-49
 - leverage in, 49-50
 - price speculation, difficulty of, 36
 - role in volatility, 7-8
 - in trading plan, 218-220
 - split fills, 243
 - “splitting the bid,” 116
 - spreads
 - bid/ask spreads, 33-34
 - defined, 241-242
 - futures spreads, 36-38
 - intercommodity spreads, 37
 - intracommodity spreads, 37
 - option spreads, 38-41
 - stability of commodities listings, 235-236
 - stock index futures, quoting, 158-161
 - Dow futures, 161-163
 - mini contracts, 159-161
 - NASDAQ futures, 163-166
 - Russell futures, 171-172
 - S&P 500 futures, 166-171
 - stock trading, leverage and, 232
 - stop orders, 117-119
 - emotions in, 208
 - in risk management, 225-226
 - when to use, 118-119
 - stop running, 252
 - storage of commodities, hedging price risk of, 45
 - straight cancel orders, 124-125
 - strangle strategy, 118
 - subscriptions to quotes, 64-65, 74-75
 - sugar futures, quoting, 145-146. *See also* softs futures
 - symbols, electronic versus open outcry, 56-57
 - system trading. *See* trading systems
- ## T
- T-bond futures, quoting, 177-180
 - T-bond options, 180-183
 - T4 (trading platform), 72
 - taking profits early, emotions in, 206-207
 - tape, 251
 - tax benefits, futures versus stock trading, 234-235
 - technical support department, choosing brokerage firms, 92-93
 - telephone orders, information needed for, 128-129
 - 10% rule in risk management, 224
 - 10-year note futures, 183
 - terminology of futures contracts, 239-257
 - babysitting a trade, 253
 - beans, 248
 - blow out, 244
 - blow up, 244
 - bottom fishing, 249-250
 - bull versus bear, 239-241
 - busted trades, 245-246
 - chasing the market, 250
 - commodity currencies, 248-249
 - contract month slang, 242
 - customer segregated funds
 - accounts, 248
 - dead cat bounce, 249
 - debit, 256
 - equity, 247-248
 - fat finger errors, 246-247
 - fills, 243
 - front-end platform, 251
 - handles, 255
 - keypunch errors, 244-245
 - limit moves, 250-251
 - moved trades, 245-246
 - overbought/oversold, 255-256
 - proprietary trading, 252
 - red months, 242
 - round-turns, 256-257
 - running stops, 252-253
 - scalping, 254
 - short squeezes, 253
 - slippage, 254-255
 - spreads, 241-242
 - tape, 251

trading environment, 257
trading solution, 251
unable, 255
working orders, 255
third-day calls, 199
30-year bond. *See* T-bond futures
Thoreau, Henry David, 99
ticker tape, 251
time and sales data, 251
timing, importance in price speculation, 218-220
total account liquidation, 196
trade alteration in margin calls, 196-197
trade execution, choosing brokers, 104
trading background, choosing brokers, 103-104
trading environment, 257
trading plan
choosing trading vehicle, 220-221
components of, 218
creating, 217-218
flexibility in, 212
importance of, 211-212
price speculation in, 218-220
risk management, 221-222
one-lot orders, 224-225
with option selling, 222-223
personal nature of, 226-227
probability of success, 222
stop orders, 225-226
10% rule, 224
trading systems versus, 212-217
trading platforms
automatic versus manual order approval, 69-70
examples of, 71-72
free platforms, 66-67
importance to day traders, 90
multiple order-entry methods, 70-71
paid platforms, 67-69
recommendations from brokers, 105
when to pay, 74-75
trading solution, 251
trading style in commission structure, 89
trading systems
disadvantages of, 214-216
regulations on, 215
trading plan versus, 212-217
trading vehicles, choosing, 220-221
trading volume in option markets, 63
transaction costs, 35-36
choosing brokerage firms, 83-84
commission structures, 86-89

determining fair rates, 107-108
flat monthly fees versus, 68-69
Treasury bills, 175
Treasury futures, quoting, 174-184
Turtle Trading System, 216
2-year note futures, 184

U-V

unable, 255
undercapitalization, fear from, 204-205
variable commissions, 86-89
vengeful trading, 209-210
VIX (CBO Evolatility index), 219
volatility in commodities
bid/ask spread and, 34
large losses from, 8-10
reasons for, 1-2
ease of market access, 2-3
European debt crisis, 3-4
fear of U.S. financial system collapse, 4-5
investment fads, 5-6
quantitative easing (QE), 4
speculation, 7-8

W

Wasendorf, Russell, 14
Welch, Jack, 220
wheat. *See* grain futures
wheat rally (chart), 10
wire houses. *See* FCMs
wired funds in margin calls, 197
work experience, choosing brokers, 102-103
working orders, 255

X-Y-Z

Yavneh, Raphael, 203
Yen futures, quoting, 188-190
yield curve, 177
yield/price relationship in bonds, 173