

A TRADER'S FIRST BOOK

on

COMMODITIES

AN INTRODUCTION TO
THE WORLD'S FASTEST GROWING MARKET



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introduction

The Rise and Fall of Commodities

It was nothing less than breathtaking to witness the grain complex shatter all-time high price records and continue to climb during the 2007/2008 rally. 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 was so profound that hedge fund managers experienced unprecedented numbers of redemption requests, which added fuel to the already raging fire.

Ironically, the same asset class that investors swarmed to for “diversification” from stocks later played a role in the demise of equities. As investors pulled money from hedge funds, margin issues and client redemptions forced funds to liquidate positions in both commodity-related and noncommodity-related speculative bets.

“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

A Commodity Rally for the History Books

Several theories attempt to explain the now infamous commodity rally, including ethanol demand, long only hedge funds, ETFs, sheer market exuberance in the absence of an attractive equity market, and sidelined cash looking for a home. One thing is certain...the euphoria caused the agricultural, energy, and metals markets to overshoot their equilibrium prices.

In the midst of the excitement, the lure of the commodity rally clouded the judgment of many. Looking back, it seemed obvious that expecting market fundamentals to maintain \$7 corn, \$13 wheat, \$17 soybeans, and my favorite, \$148 crude oil, was simply unrealistic. However, nobody knew just how high prices might go before coming to a more rational level, and those that entered the market “early” with bearish strategies likely paid a high price. Yet, when the tides turned they did so in a vicious fashion; the stunning fall from grace was even steeper than the preceding rally.

The Perfect Storm of Fundamentals

The perfect storm is a term used to refer to a series of simultaneous events that, if occurring individually, would have little impact on their surrounding circumstances. However, by chance combination of such events, the net result can be dramatic. I believe this to be the best explanation for the magnitude of price volatility in the commodity markets during the 2007/2008 rally. Under the influence of increasing demand, tight supplies, roaring energy costs, and a weak dollar among others, logic had little control over the outcome.

The Demand Side of the Equation

The commodity rally that began in 2007 and evaporated in 2008 was originally sparked by considerable increases in global demand for agricultural and energy products. Much of the fundamental price support was the direct result of a swiftly growing Chinese economy, combined with technological advances and rapidly growing infrastructure in developing countries. Furthermore, improved diet and nutrition in the emerging markets, along with U.S. mandates for bio-fuels such as ethanol, were catalysts for soaring prices in markets such as corn and soybeans.

The Supply Side of the Equation

Along with increased demand for commodities due to global economic growth and modernization, many commodities suffered from tight supplies and this aggravated the upward price pressure. For example, the wheat harvest suffered from freeze, drought, and flood throughout various growing regions. The odds of such widespread damage to crops were rather minute, but as we have said, this was the perfect storm of fundamentals.

Additionally, floods and droughts plagued other agricultural commodities such as corn and soybeans; whereas petroleum products began to feel the supply pinch on OPEC manipulation and dwindling sources of fuels. Consequently,

tight supplies along with unprecedented demand gave investors the green light to pour money into the sector, and they did so in droves. Nonetheless, what I believe to be the silent culprit behind a rallying grain market was the implications of higher energy costs.

The Crude Reality

According to many analysts, the world is said to be beyond *peak oil*, which is the point in time when the maximum rate of global petroleum extraction is reached. Beyond peak oil, the rate of production is said to be terminally in decline because the supply of fossil fuels is limited and is no longer being naturally formed.

As you can imagine, in an environment such as 2007 and early 2008 in which undeveloped nations quickly crossed over into industrialization, declining supply can be a significant issue. Specifically, as the population in China and India have begun looking toward motorized transportation, a dwindling supply of crude oil grows increasingly critical. For instance, the global consumption rate for crude oil was roughly 80 million barrels per day in early 2009. Many reports suggest that production near 75 million barrels per day could easily drop to 60 million per day should OPEC (Organization of Petroleum Exporting Countries) dramatically cut output.

OPEC is an oil cartel consisting of twelve countries that are large exporters of crude oil and believed to maintain a significant amount of price control. This reputation is deserving; OPEC countries account for about two-thirds of the world's oil reserves, and a disruption of their production, or an intentional decline in the amount produced, can have a considerable impact on crude oil prices.

Another undeniably bullish factor in crude oil pricing is the political unrest in many of the world's largest oil producers such as Iran, Iraq, Venezuela, and Russia. The high demand for energy experienced in 2007 and 2008 created a situation in which any disruption of production could have a noteworthy impact on already tight supplies, and in such a volatile political atmosphere, disruptions seemed likely. Accordingly, speculators bid the price of crude oil higher to compensate for the risk of such an event actually occurring. For traders that were involved in commodity speculation in the 1970s, it seemed like the beginning of what might have been a repeat of the now infamous oil embargo in which OPEC refused to ship oil to western countries that supported Israel in the Yom Kippur War.

It is easy to see how all these factors combined could have triggered a large rally in the energy markets. However, what might not be as obvious is the impact that higher crude oil and gasoline prices had on other commodity markets.

Many grains that were considered viable candidates for alternative fuel gained strength as scientists and consumers scrambled to find “cheaper” and domestically produced sources of energy. Some of the largest gains were witnessed in the corn market, which happened to be the lucky beneficiary of the ethanol hype.

Ethanol is a fuel created as an alternative to gasoline and is derived from purely renewable resources such as sugar, corn, and even potatoes. Although it was later determined that the use of corn in producing ethanol isn't necessarily efficient, as it turns out, sugar is a much better alternative to producing ethanol. Similarly, the sudden interest in biodiesel fuels created from plants with high amounts of vegetable oils, namely soybeans, paved the way for new all-time highs in soybeans and bean oil.

In addition, not only did ethanol and other bio fuel hopes increase the demand for grain products, but higher crude and gasoline prices also amplified the costs associated with growing agricultural products. For instance, if farmers must pay more in fuel costs to operate their tractors and other necessary farm equipment, they will then be forced to charge more for the goods that they produce.

Furthermore, many farmers dedicated relatively more acreage to crops that could see higher demand and prices due to their alternative food uses. Meanwhile, the price of commodities unrelated to energy or bio fuel, such as cotton, benefited from tighter supplies resulting from less dedicated acreage.

Plummeting U.S. Greenback

There's more. Along with supply and demand fundamentals, the U.S. dollar witnessed a significant devaluation. The Dollar Index, now traded on ICE (IntercontinentalExchange) but previously traded on the NYBOT (New York Board of Trade), fell from a value above 90 in late 2005 to the low 70s by the end of the first quarter in 2008 (see Figure I.1).

A declining greenback offers underlying support in grain prices because it makes U.S. grain exports more competitive on the world market and, in turn, increases demand for those products. Likewise, crude oil is quoted in U.S. dollars and cents and reacts positively to a cheaper dollar.

With this simple rule in mind, it is important to realize that grain prices are extremely complex, and price movements can't be attributed to any single

factor. Grain prices are highly dependent on weather and growing conditions; at times they will be minimally influenced by currency fluctuations. Equally, crude oil is often driven by geopolitical tension. With the dollar considered a “flight to quality” currency, it is likely that crude and the greenback can move higher together if Middle East turmoil occurs. Nonetheless, in general, commodity traders should keep the strength of the U.S. dollar in mind when constructing their analyses because it is part of the equation. During the 2007 commodity rally, it appears as though dollar weakness played a significant role.



Figure I.1 A lower domestic currency makes goods and services produced in that country more affordable for foreign buyers and, therefore, increases the demand and price for such.

The Overflow

The commodity bull overflowed into the precious metals markets, namely gold and silver. Although, cash market supply-demand fundamentals weren't necessarily as intriguing as the others, the market psychology was.

Conversely, industrial metals such as copper were seeing incredibly high levels of demand as China and India raced to modernize. Thus, investors were convinced that the fundamental picture was supportive of \$4 copper. We now know that this wasn't necessarily sustainable.

The New Investment Fad

In addition to the swirling newscasts and financial newspaper editorials regarding the emerging opportunities in the commodity markets, an enormous amount of unallocated funds were looking for investment opportunities. At the time, the stock market had essentially made little to no progress over the span of nearly a decade. Frustrated investors were easily intrigued by the commodity story and began allotting large amounts of capital to commodity hedge funds, commodity equity products such as electronic traded funds (ETFs), and Commodity Trading Advisors (CTAs). The simplicity of participating in this alternative asset class with the advent of ETFs greatly benefited the industry and likely played a part in the relentless rally. In many cases, money flowed into commodities from both retail and institutional investors with little experience in the futures of markets and limited knowledge of the high levels of risk involved in participating.

Not only do I believe that many speculative investors were relatively uneducated about the futures markets, I argue that many of the money managers were as well. There were a few things that many of them failed to recognize, such as the fact that the commodity market isn't as deep as equity markets, and prices normally trade in envelopes as opposed to ongoing inclines as stocks tend to do. In the aftermath, these simple concepts seem obvious, but at the time commodity newcomers ignored the red flags, and the concerns of commodity veterans were going unheard.

In some of the smaller commodity markets, such as rough rice 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 a commodity. With droves of cash making its way to the long side of commodities, it is easy to see that it didn't take long for things to get out of hand.

It is important to realize that this is my personal perception, and it is in stark contrast to the opinions of some other analysts. In fact, well-respected and known analysts believe that the 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 it was fundamentals alone that blazed the trail for such unprecedented high pricing.

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

A Day of Reckoning

What goes up must eventually come down...and commodity prices weren't an exception. Although some are reluctant to refer to the 2007/2008 rally as a bubble, I am not. In finance, a bubble is defined as a scenario in which market prices rise and become overvalued by any measure of valuation, and in my opinion this seems to fit the bill.

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

A market bubble is a rally that is artificially and temporarily driven by a mentality of market participants. In reality, it is difficult to quantify and analyze the true driving force behind prices as they are moving, but what happens next can provide insight. I believe that what ultimately categorizes a market move as a bubble is the manner at which prices adjust to more realistic levels. The sharp price decline that succeeded the 2007/2008 commodity rally suggests that the market was grossly overvalued and this conforms to the characteristics of a bubble.

During the commodity "bubble," the benchmark index for commodity prices, the Reuters-Jefferies CRB Index, nearly doubled in value. Commonly referred to simply as the CRB, it is designed to provide a representation of a diversified holding of long-only futures.

The CRB reached its peak of nearly 475 on July 3, 2008. From there the commodity bull came crashing down in a magnificent fashion. In December 2008, the Reuters-Jefferies CRB Index had fallen more than 50% from its peak and was valued near 200. This was the lowest level in 6½ years and became the perfect example of the tendency for market prices to go down faster than they go up regardless of the slope of the incline, as shown in Figure I.2.

As prices deflated to what were debatably more rational levels, traders were faced with difficult decisions in terms of speculation. Historical price envelopes had been intensely magnified; thus, in a post-bubble world, speculation in the commodity markets potentially became more lucrative, but the risks were exaggerated as well.

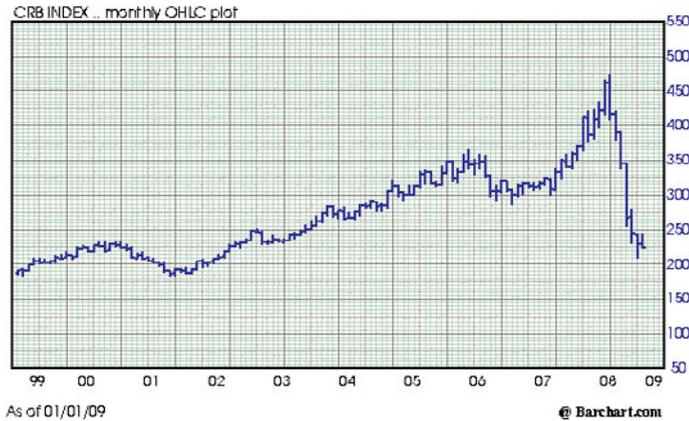


Figure 1.2 The irrational exuberance in commodities can best be depicted by the rally and subsequent plunge in the CRB Index.

The Speculators' Role

There is much debate as to the speculator's role in the commodity markets. You likely witnessed Congressional testimony and other hearings regarding the matter. For those of us with the luxury of being within the industry and understanding the nature of the marketplace, it was nothing short of scary to see our elected leaders making such uninformed assumptions and eventually decisions about what are intended to be free markets.

"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 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." Nevertheless, many would argue that in 2007 and 2008 the speculators contributed to artificially inflated commodity prices to unsustainable levels.

There seems to be some evidence suggesting that this is the case. After all, commodities boomed as anxious investors poured money into the alternative asset class in search of higher returns. How much capital made its way into commodities is unknown, but some have estimated \$30 billion in the first quarter of 2008. (Don't forget about the leverage.) Additionally, what was once

an investment arena utilized only by the über-rich and risk hungry investors, began to see money inflows from average retail investors and even pension funds. However, as investors began redeeming funds from their commodity holdings, it was as if someone had pulled the floor from underneath the markets. In my opinion, speculators didn't *cause* the bubble, but unfamiliar and inexperienced speculators might share some of the blame for the *size* of it.

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 were introduced to this the hard way. This is a phenomenon that is not exclusive to commodities; I am sure that you remember the tech bubble in the 1990s in which similar market actions took place.

Perhaps the single largest contributing factor to the speculator's role in the commodity bubble was the increasing popularity of the Electronic Traded Fund. Before the existence of commodity related ETFs retail investors were largely excluded from the asset class due to fears of the futures markets in terms of leverage, margin calls, and perceived risk.

During the 2007/2008 commodity frenzy, investment firms issued several new commodity-based ETFs. This should have been a warning sign as fund companies are notorious for providing sector-specific products near the bursting of a bubble. This makes sense; by the time that a firm identifies the trend, assembles the fund, and gets approval from the Securities and Exchange Commission (SEC), the sector might have exhausted its popularity.

Keep in mind that the magnificent rally and retreat was highly correlated with available leverage. Many of the gains made on the way up were backed by leverage as opposed to actual capital. As traders and fund managers de-levered, the markets suffered dramatically.

The role of speculators in the commodity rally was exacerbated by the toll that margin calls took on the markets. As the commodity boom began to fizzle, exchanges and brokerage firms began issuing margin calls to those that entered long positions at the tail end of the rally. As positions were liquidated to satisfy margin calls, prices dropped sharply, and new margin calls were issued. It isn't difficult to identify the snowballing effect of such events and how they could quickly alter the mentality of the market and, more important, prices.

It is critical that you realize that from a trading standpoint, it doesn't necessarily matter whether the market is driven by fundamentals, technicals, speculators, or hedgers. What does matter is that prices move, and it is up to you to

be on the right side of it or at least get out of its way. Markets are unforgiving, regardless of how strongly that you feel that prices are overvalued due to irrational speculation; they might remain so for much longer and much farther than you can financially and psychologically afford to be involved.

Fortunes Made and Lost

By nature, when we think of a bull market, we assume that there are riches to be made. However, in an arena such as commodities in which it is just as common for traders to be short (sold futures in anticipation of lower prices) as it is to be long, this isn't necessarily the case. Additionally, the media's arguments against "greedy" speculators seem to imply that a majority of traders make money, and it is somehow easy to do so. This couldn't be further from the truth.

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

I learned this lesson the hard way in 2007. What I thought was going to be one of the best times in history to be bearish in the wheat market quickly turned into a nightmare as prices made new all time highs and didn't look back. Suddenly prices were moving more (against our clients' positions) in a single trading session than was often the case in an entire year. I recall our inaccurate speculation being made even more painful by the media euphoria in regards to the "riches" to be made in commodities.

Because of its profound impact on the economy and our daily lives, crude oil futures were in the center of the debate. Believe me, not all speculators in the energy complex made money as crude oil tripled in price. Crude oil is one of the most difficult markets to trade successfully, regardless of whether you are a futures or options trader. The margin requirement is extremely high, and so is the volatility and risk.

Unless you have deep pockets or a high tolerance for risk, energy futures are a treacherous market in which to be a speculator. A crude oil price chart can be deceiving in that it seems as though it would have been "easy" to make large profits by simply being long. Nevertheless, for the average retail trader, the intraday and daily price swings can be financially unmanageable and psychologically unbearable.

Try to imagine being long in crude oil futures as it bounced between \$130 and \$140 on its way up to nearly \$150. A trader would have made or lost \$10,000 per contract several times over, and that is hard to watch. It is likely that many retail traders gave up on the position before the market ever made it to its all-time high price. In theory, a trader might have been able to buy the dips

to \$130 and sell the rallies. Knowing what we know now, this would have been lucrative enough to afford a savvy trader a new luxury-priced car, but for many trading it in real time, it might have been pure agony. Better yet, imagine being long crude from the high \$140s after hearing predictions for \$200 crude oil from some of the industry's most respected analysts. We all know what happened next (see Figure I.3).

The oil futures “tycoons” that you hear about on TV rumored to have netted millions of dollars buying crude oil futures contracts are few and far between. Those who were the beneficiaries of the now infamous energy rally were likely people who had significant risk capital backing their speculation or simply a magnificent streak of luck and an incredible amount of fortitude. Unlike you and me, the success stories were, based on my observations, traders that executed a position and stepped back without micromanaging the details or even losing sleep.

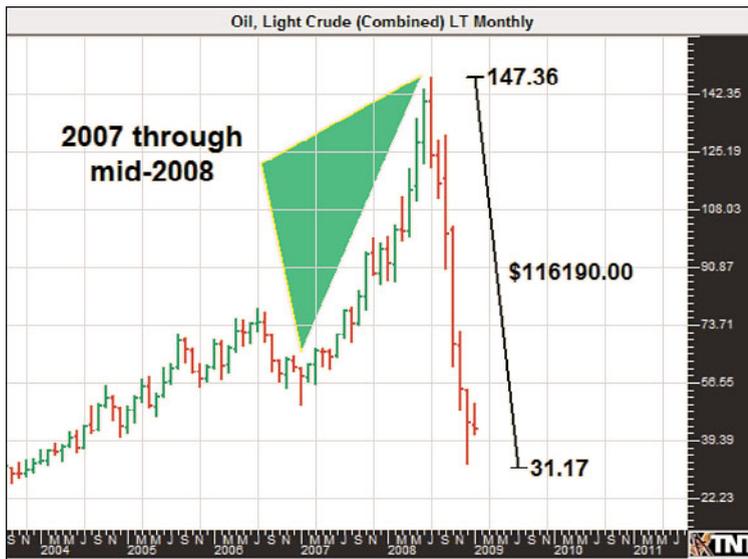


Figure I.3 This chart is a continuous front month futures chart and is therefore an approximation and might not represent the most-active contract data. Nonetheless, the magnitude of the move is identifiable by this depiction. A trader exposed to the market during the entire move would have made or lost approximately \$116,000 per contract!

I will be the first to admit that I was wrong in my expectations of crude oil in 2007/2008. I never anticipated to see prices above the \$100 mark, or at least not in such a short time frame. Clearly, I was wrong. Luckily, I *was* wise enough

to realize that that the energy markets aren't for everyone. Although I recognize that my clients are free to speculate in any market that they choose, and there can be great opportunities in energies, I took the opportunity to kindly remind them of the potential hazards.

Ironically, based on my experience and conversations with those within the futures and options industry, the commodity rally was paralyzing for many veteran traders. The price moves were impossible for those unfamiliar with the markets to fathom, but for those that have been trading grains and energies for many years, it was not only unimaginable but in some cases career-ending.

Traders that spent the bulk of their adulthood speculating as grain prices moved from high to low within their historical price envelopes, quickly discovered that the markets no longer had boundaries. For example, prior to 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 that 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 even worse as losses mounted, as did margin calls (see Figure I.4).

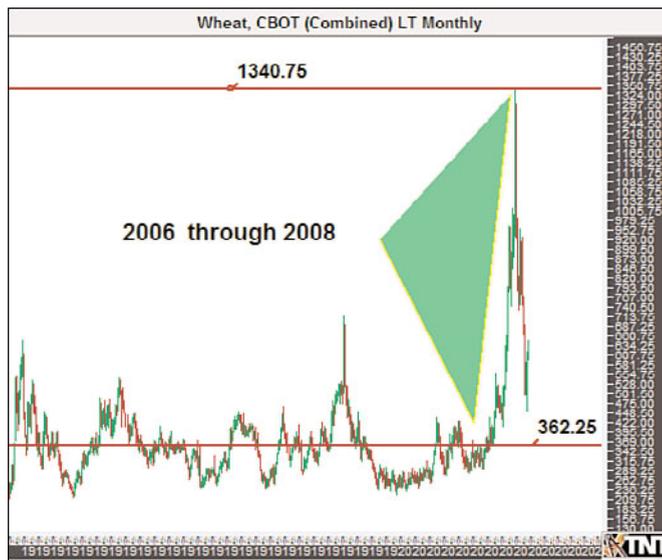


Figure I.4 Few could have predicted the magnitude of 2007/2008 wheat rally that made a mockery of its previous all-time high.

You might have heard about the rogue (unauthorized and reckless) wheat trader whose actions resulted in a large loss at a major financial institution. The trader, without permission, 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 his brokerage firm, in the hole more than \$141 million. The broker had been a registered participant of the futures industry for more than 15 years at the time of the incident; 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 a precommodity boom world, the margin to hold a wheat futures position overnight was less than \$1,000. During its "hay day" it was in the neighborhood of several thousand dollars. Therein lies much of the problem, as commodities became more and more expensive to hold, short traders were forced to fold their hands. The liquidation of short positions added to the buying pressure of speculative long plays, and prices became astronomical.

Conclusion

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. In fact, I am a broker that makes a living from commission and 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 ensure that you are aware of the potential hardships and, accordingly, 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 because if you do, you will eventually be proven wrong. Additionally, the markets, and trading them, 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 that 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; there isn't a "best tool," 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—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 with 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, it also might be financial suicide. Instead, you should approach every trade with modesty and with the understanding that you could be wrong. Having such an attitude might prevent you from sustaining large losses as the result of stubbornness or a lack of ability to admit to being incorrect in your speculation.

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 that this book will be the first step in your journey toward victory in the challenging, yet potentially rewarding, commodity markets.

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 mid-West. 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, which made it critical that a farmer sell his crop upon harvest at the annual meeting in Chicago due to a lack of storage. Even for those who did have a method of storing the grain, frozen rivers and roadways made it nearly impossible to travel to Chicago 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 would dwindle to create shortages. This annual cycle of extreme oversupplies and subsequent undersupplies created inefficient price discovery and led to hardships for both

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.

producers and consumers. The feast-or-famine cycle created circumstances in which farmers 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.

The Chicago Board of Trade

The Chicago Board of Trade (CBOT) 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.

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

The CBOT is still located in downtown Chicago and is the world's oldest futures exchange. 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 9, 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.

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 offsprings of this new investment interest is 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.

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

The contract that put this exchange on the map was frozen pork belly futures, or simply "bellies" as many insiders would say. Hollywood and media portrayals of the futures industry is often encompassed by 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, pork belly futures are among the *least* traded contracts on the CME today in terms of volume and open interest.

The CME 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 finally the New York Mercantile Exchange (NYMEX).

*According to New Yorkers,
there is only one "Merc,"
and it isn't in Chicago.*

The NYMEX 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, the NYMEX accepted a cash and stock offer from the CME Group that would bring the New York futures exchange into the fold along with the CBOT and the CME. On August 18, 2008, the proposal was approved by NYMEX seat-holders and shareholders. It is expected that by late 2009, the NYMEX systems will be fully integrated into the CME Group.

The CME Group

The CME Group is 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 the NYMEX was acquired in 2008 to create a powerful and innovative entity.

The CME Group currently operates the CME, CBOT, and the NYMEX and serves the speculative and risk management needs of customers worldwide. Between the three divisions, the CME Group offers derivative products across all the previously mentioned major asset classes.

Upon merger, the CBOT and the CME consolidated all floor-trading operations into a single location; the historic CBOT. The actual move took place over three weekends, and no details were spared. The new combined trading floor spans 60,000 square feet and facilitated the execution of nearly 3.3 million open outcry contracts in the first quarter of 2008.

IntercontinentalExchange

The newest player in the U.S. futures trading industry is the IntercontinentalExchange, most often referred to as ICE or simply “ice.” In stark contrast to the original models of the CBOT, CME, and NYMEX, ICE facilitates over-the-counter energy and commodity contracts. This simply means that there is no centralized location; instead all trading takes place in cyberspace.

ICE is a newcomer to the domestic futures markets and wasn't necessarily welcomed with open arms. However, recent platform improvements, such as the acceptance of Good 'Til Canceled orders and stop orders, have improved popularity of the exchange.

ICE was established May 2000, with the mission of transforming OTC trading. By 2001, it acquired an 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 is generally used to describe 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 the Russell 2000 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, and 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 to mitigate 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 that 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 may 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 that locks in a price to sell his crop in the spring through a forward contract and discovers that he can sell the product for considerably more in the open market might choose to default on the 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 deposit 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 would normally be exposed to. Additionally, with the advent of exchange-traded forward contracts along with good-faith deposits, much of the default risk

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

was eliminated. However, because forward contracts were negotiations between two individuals, it was a challenge to bring buyers and sellers together that 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 counter-party 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. It is the concept of standardization that 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 this is determined by buyers and sellers in the marketplace.

Although the futures contracts bought or sold represent an obligation to take or make delivery, according to the CME 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 contract by guaranteeing the other side of the transaction. Thus, unlike a forward contract, or early versions of the futures contract, in which each 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 as opposed to 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.

Cash Market Versus Futures Market

There are currently two separate, yet related, markets in which commodities are traded; 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 rather than the actual commodity.

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.

Cost to Carry

Prices in the cash and futures market differ from one another 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 is referred to as the *cost to carry*. Specifically, the costs to carry include items such as storing and insuring the commodity prior to the date of delivery.

Naturally, in normal market conditions, the cash price will be cheaper than the futures price due to the expenses related to carrying the commodity until delivery. Likewise, the near-month futures price will be 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*.

Normal carrying charge markets are only possible 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 it can actually reverse the contango should the spot price, and possibly the price of the nearby futures contract, exceed the futures price in distant contracts, as shown in Figure 1.2.



Figure 1.1 Normal carry charge market, or contango.

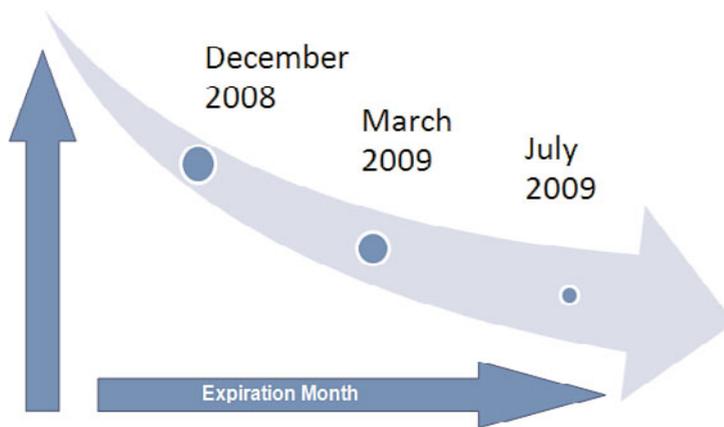


Figure 1.2 The opposite of contango is sometimes called backwardation and involves higher spot prices than futures prices.

It is important to understand that the contango can'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.

Arbitrage

Arbitrage is the glue that holds the futures 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 only opportunities for the insanely quick. The chances are that you and I do not possess the speed, skill, and resources necessary to properly identify and react to most arbitrage opportunities in the marketplace.

“If you can take advantage of a situation in some way, it's your duty as an American to do it.” C. Montgomery Burns (*The Simpsons*)

An example of an arbitrage opportunity unrelated to cash market pricing would be a scenario in which the e-mini S&P is trading at 1080.50 and the full-sized version of the contract is trading at 1080.70. 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 of the size of the original and is fungible.). Consequently, a trader that can execute each side of the trade at the noted prices can request for the positions to offset each other to lock in a profit of .20 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.

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.

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 prior to expiration of the futures contract, 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 prior to expiration of the corresponding futures contract. The official definition of *first notice day* is the day in 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 that are expected to make delivery of the commodity (those short futures) and distributes delivery notices to those long futures on a first-in basis. Simply put, traders that hold long positions into the first notice day run the risk of being delivered upon but might not be depending on the amount of time that the position has been open. For instance, a trader that has been long a futures contract for several weeks will receive a delivery notice before a trader that has established a position the day before first notice day. Please 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 will 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 it in an open market to an interested party. Although the trader will avoid being forced to find a home for 5,000 bushels of corn, or whatever the commodity might be, he *will* face substantial processing fees. With that said, being a part of the delivery process is something that all speculators should diligently avoid.

Not all futures contracts have a first notice day; some stipulate a cash settlement process as opposed to delivery of the underlying product. Cash settlement is just as it sounds and will be 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 those markets that involve a physical commodity exchange. Conversely, a select number of futures contracts are cash settled. If this is the case, those holding positions into expiration are agreeing 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, either.

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 taught, and before you can expect to be a successful futures trader you must fully understand the basics.

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, I suggest that you become familiar with commonly used terms and phrases. Doing so will avoid miscommunication between yourself and your broker.

In futures market slang, *long* and *short* are used to describe a speculative position.

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 option. Specifically, if a trader buys a futures or option contract, he is going 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 call options, short put options, bullish options, or futures spreads, or any other speculative play that profits from an increase in prices. Consequently, you might hear a trader mention that she is *short the market*, and 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

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

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 there would likely be some interest 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.

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

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."

As mentioned, most of those participating 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 of 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. After 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 incorrectly look 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."

The concept of offsetting can be best explained by an example. In August 2008, the corn futures contract expiring in December 2008 experienced a healthy correction and seemed to be approaching trend line support. A trader that 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 to the one used to enter the market. Looking at Figure 1.3, you can see that the trader purchased a December 2008 corn futures contract at \$5.18 1/4, or as shown on the chart as 518.25. 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 2008 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.

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



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.



Figure 1.4 When a trader no longer has an open position, he is said to be “flat” the market.

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

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 will somehow avoid exiting the original position and simply change the contract month. Perhaps it is wishful thinking for those who would prefer not to lock in a loss on an open position; unfortunately, it is a necessary evil if the goal is to move into an alternative contract month.

To illustrate, a trader that 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 perspective of written literature available for beginning traders. Some

articles and books seem to insist on explaining the bid/ask spread from both a floor broker's point of view and a retail trader. However, in my opinion providing details of both sides of the story simply creates more confusion than is necessary to have a good grasp of what it is and how to cope with it as a trader.

The easiest way to understand the spread between the bid and ask is by coming 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 one in 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 \$4.21 and sell corn at \$4.21 1/2. The difference of a half of a cent is the bid/ask spread and 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. Just as you pay a commission to the retail broker who took your order, the executing broker 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 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 should be resented...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 would like 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.

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 of 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

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

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 that 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 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, there are certain markets in which I believe the bid/ask spreads to be so wide that there is 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 he 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 imagine, 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 what is known as a *ticket charge*, commodity trades are charged on a round turn basis. 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 will 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 \$61.00 and later sells all 10 at \$62.00, he has executed 10 round turns and will be charged 10 commissions. This is true regardless of whether or not the 10 contracts were purchased and sold on single tickets or there were 10 separate orders to buy 1 contract at \$61.00 and then 10 separate orders to sell 1 contract at \$62.00.

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 that the trade is initiated and 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 \$7.00 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 are charged by your brokerage firm. Each round turn is accompanied with exchange fees, minimal NFA (National Futures Association) 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 make a point of confirming that the rates they are quoting 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 will 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, it can be challenging to stick to the overall goal of buying low and selling high. The price of a given asset, whether it be grains, metals, energies, or Treasury bonds, is dependent on a seemingly unlimited number of factors. Even as a market is making a large price move, it is nearly impossible to determine what exactly was 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, or excessive margin calls. Again, part of the catalyst for the 2008 commodity plunge was the sweeping number of forced liquidations due to insufficient margin in speculative trading accounts.

In addition, there are a seemingly unlimited number of inter-market relationships that can be used as a guide, but not a guarantee. For instance, as mentioned in the Introduction, “The Rise and Fall of Commodities,” 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, there are many cases in

which 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

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

The practice of buying one futures contract and selling another that is similar in nature is known as *spread trading*, or 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 he is speculating

on the relationship (spread) between the prices of the two contracts in question. There are two basic futures spreads: the intracommodity spread and the intercommodity spread.

1. 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 isn't dependent on whether corn prices go up or down; instead it is dependent on how much more July corn increase relative to the December contract or how much less it decreases. Specifically, whether the spread widens or narrows.

2. 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* identifies 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 the purchase of 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. This enables traders the ability 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 \$4.00 and December corn is trading at \$5.10, 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 in some cases 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 in which both short and long options of various types are used. 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 risks. Doing so often results in panic 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 should the buyer opt to exercise the option. Essentially, this means that the seller would be forced to take a short position in the market upon the option being 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 thing 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.

Table 1.1 Call buyers are Bullish, but put buyers are Bearish; the opposite is true of call and put sellers.

	Call	Put	
Buy			Limited Risk
Sell			Unlimited Risk

Traders that 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 the option is either 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* that 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 will have both a bid and an ask that represents the purchase or sales price for the combination of options.

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

Fortunately, when dealing with a spread on a spread, most insiders identify the bid/ask spread by its full name while referring to the option spread by its specific name as well. 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 that answers the phone, "Will you get me the bid/ask on the 900/950 call spread?"

It is important to realize that when getting a quote for an option spread from a broker, it isn't necessary to decipher whether you will be buying or selling the spread. This is because the broker will give you the quote for doing each. Thus, the bid/ask spread.

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 it costs more for the long option of the spread than it does for any 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.

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, I think we all agree that taking the "easy road" in life often fails to be beneficial in the end, and this may be no different.

Index

Symbols

10% rule, risk management, 202-203
10-year note, 162
2-year note, 163-164
30-year bond, 153-154
5-year note, 162-163
80/20 rule, brokers, 83

A

accepting margin calls, 177-178
access
 “ample market access,” 53
 open outcry quote, 54
account debit, 233
account minimums, speculating in
 futures, 210
adjusting margins through trade and
 risk alteration, 174
“ample market access,” 53
approval, manual versus auto (trading
 platforms), 60-62
Arb (arbitrage), 45
arbitrage, 23, 45, 150
Ask Size, 140
Australian dollars, 168, 226
auto approval versus manual approval,
 trading platforms, 60-62
automated trading systems, 190-191

B

babysitting trades, 230
back office operations, brokerage
 firms, 77-78
BASIC (Background Affiliation Status
 Information Center), 85
beans, 225
bear markets, 217-219
bearish, 218
Bid Size, 140
bid/ask spreads, 28-30, 219
big board, 138
Big Dow, 139, 143
blanket premiums, 74
blow out, 222
blow up, 222
bonds, 152-154
borrowing fees, speculating in
 futures, 211
bottom fishing, 227
British Pound, 169-170, 226
broker liability, 73
broker/dealers, 68-69
brokerage firms, 58
 back office operations, 77-78
 choosing, 65
 customer service, 77-78
 discount brokerage versus full-
 service specialization, 71-72

- margin policy, 79
 - tech support, 78-79
 - brokers
 - 80/20 rule, 83
 - advantages of, 91
 - avoiding over-trading and panic liquidation, 91
 - companionship, 93
 - limited slippage, 93
 - margin calls, 92
 - shifting risk of order placement, 91-92
 - becoming familiar with, 84-85
 - future, 88
 - resources, 85
 - trade execution, 87
 - trading background, 86-87
 - work ethic, 86
 - work experience, 86
 - choosing, 81-82
 - commission, 83
 - commodity brokers, 84
 - full service brokers versus self-directed online trades, 88-90
 - full-service brokers, 81
 - give up brokers, 76
 - placing trades with, 108-109
 - communication, 109-111
 - retail traders, 82
 - bubbles, 7
 - Buffet, Warren, 180
 - bulk transfers, 68
 - bull markets, 217-219
 - bullish, 218
 - business plans, constructing in trading, 195-196
 - busted trades, 223
 - buying futures contracts, 26
- C**
- cable, 226
 - calculating
 - profit, loss, and risk in grain futures, 117-119
 - results of option trades, 120
 - calendar spread, 32
 - call options, 34
 - calls, margin calls, 173
 - accepting, 177-178
 - eliminating, 173-175
 - measuring, 175-177
 - Canadian dollars, 168, 226
 - cancel/replace order, 108
 - capital, risking, 214-215
 - capital preservation, 188
 - cash market bond securities, 155
 - cash market speculators, 38
 - cash markets, 21
 - CBOE (Chicago Board of Options Exchange), 197
 - CBOT (Chicago Board of Trade), 16
 - CFTC (Commodity Futures Trading Commission), 85, 194
 - charting, 58
 - chasing the market, 227
 - Chicago, 15
 - Chicago Board of Options Exchange (CBOE), volatility index, 197
 - Chicago Board of Trade (CBOT), 16
 - Chicago Mercantile Exchange (CME), 16-17
 - choosing
 - brokerage firms, 65
 - brokers, 81-82
 - trading vehicles, 198-199
 - clients, risk (commission structure), 73-75
 - CME (Chicago Mercantile Exchange), 16-17
 - CME Group, 17-18
 - CBOT, 17
 - ICE (Intercontinental Exchange), 18
 - cocoa, 125
 - coffee, 125-127
 - COMEX (Commodity Exchange), 17
 - commission, 88-91
 - brokers, 83
 - commission structure
 - flat-rate commission structures, 74-75
 - risky clients, 73-75
 - commodities, 137
 - speculating in futures, 213
 - commodity brokers, 4
 - commodity currencies, 226

- Commodity Exchange (COMEX), 17
 - Commodity Futures Trading
 - Commission (CFTC), 194
 - commodity hedgers, 37-39
 - long hedge versus short hedge, 42
 - reasons for, 38
 - using futures to hedge price risk, 39-41
 - commodity options, 33-35
 - option spreads, 35-36
 - commodity prices, 15
 - commodity quotes, 113-114
 - cost, 54
 - multipliers, 114-115
 - staying positive, 115
 - commodity rally of 2007/2008, 2-6
 - day of reckoning, 7
 - speculators's role, 8-10
 - winners and losers, 10-13
 - commodity speculators, 42-43
 - leverage, 43-44
 - Commodity Trading Advisors (CTAs), 6
 - communicating with your broker, 109-111
 - companionship, brokers, 93
 - constructing business plans in trading, 195-196
 - contango, 21
 - contract expirations, 23
 - first notice day, 24
 - futures expiration, 24
 - contract months, 220
 - contracts
 - forward contracts, 18-20
 - futures contracts, 18-21
 - copper, 130, 133-134
 - corn, ethanol, 4
 - cost
 - commodity quotes, 54
 - deciding if it's worth paying
 - platform fees or subscribing to quotes, 63-64
 - full-service brokers, 89
 - transaction costs, 70-71
 - cost to carry, 21-22
 - cotton, 125, 128
 - coupon bonds, 154
 - coupons, 154
 - crack spread, 33
 - CRB, 7
 - crop year, 116
 - crude oil, 3, 10, 134-136
 - crush spread, 33
 - soybeans, 120
 - CTAs (Commodity Trading Advisors), 6
 - currencies, commodity currencies, 226
 - currency futures, 167
 - Australian and Canadian dollars, 168
 - British Pound, 169-170
 - euro, franc, and yen, 167-168
 - customer service, brokerage firms, 77-78
- ## D
- day trading margins versus overnight margins, 172-173
 - dead cat bounce, 226
 - Deal or No Deal*, 185
 - debit balance, 233
 - deliverable securities, 155
 - Dennis, Richard, 194
 - discount brokerage firms versus full-service specialization, 71-72
 - discount securities, Treasury bills, 154
 - Dollar Index, 4
 - DOM (Depth of Market) Panels, 140
 - Dow Jones Industrial Average, 138
 - Dow Jones Industrial Average
 - futures, 141
 - Big Dow, 143
 - e-mini Dow, 141-142
 - original Dow, 142-143
- ## E
- e-mini Dow, 141-142
 - e-mini NASDAQ, 145-146
 - e-mini S&P 500, 148-150
 - E-Signal, 57
 - Eckhardt, Bill, 194
 - electronic contract execution, 76
 - electronic quote transmission, 56

- electronic symbols, side-by-side trading, 50
 - electronically traded markets, 47-48
 - eliminating margin calls, 173-175
 - emotional stability, 179
 - emotions
 - excitement, speculating in futures, 212
 - fear, 181-182
 - frustration, 184
 - taking profits early, 184-185
 - greed, 183-184
 - humility, 187
 - pain of taking a loss, 185-187
 - trading and, 180
 - end-of-the-day data subscription packages, 58
 - energies, 134-136
 - equities versus futures, speculating, 208-214
 - equity, 224-225
 - errors, key punch errors, 222
 - ETFs (electronic traded funds), 6
 - short products, 213
 - ethanol, 4
 - euro, 167-168
 - Eurodollar futures, 164-166
 - excitement, speculating in futures, 212
 - execution
 - electronic contract execution, 76
 - speculating in futures, 210
 - experience, brokers, 86
- F**
- failure, system trading, 192-195
 - FCM (Futures Commission Merchant), 44, 66-67
 - transaction costs, 70
 - fear, 181-182
 - fees, borrowing fees (futures), 211
 - fiber, 125-130
 - Fill or Kill (FOK), 49, 104
 - fill quality, 69
 - fills, 221
 - first day call, 176
 - first notice day, 24
 - fixed income securities, 154
 - flat-rate commission structures, 74-75
 - floor presence, 76
 - FOK (Fill or Kill), 49, 104
 - foods, 125-130
 - Forex, Eurodollars, 164
 - forward contracts, 18-20
 - franc, 167-168
 - free-trading platforms, market access and, 58-59
 - front-end platform, 229
 - frustration, 180, 184
 - taking profits early, 184-185
 - full handles, 232
 - full service brokers, 81
 - versus self-directed online trades, 88-90
 - full-service specialization, versus discount brokerage firms, 71-72
 - funds, wiring, 175
 - fungible, 137
 - future, brokers, 88
 - futures
 - currency futures, 167
 - Australia and Canadian dollars, 168
 - British Pound, 169-170
 - euro, franc, and yen, 167-168
 - Dow Jones Industrial Average, 141
 - Big Dow, 143
 - e-mini Dow, 141-142
 - original Dow, 142-143
 - Eurodollar, 164-166
 - hedging price risk, 39-41
 - interest rate futures, 151-152
 - NASDAQ 100, 143
 - e-mini NASDAQ, 145-146
 - original NASDAQ, 144
 - Russell 2000, 151
 - S&P 500, 146
 - arbitrage, 150
 - e-mini S&P 500, 148-150
 - open outcry S&P
 - options, 147
 - original S&P 500, 147
 - soybean meal futures, 120
 - soybean oil futures, 121-122
 - speculating, 208
 - buying and selling in any order, 210

- commodities, 213
 - excitement, 212
 - IRAs, 214
 - level playing field, 211
 - leverage and margins, 208-209
 - liquidity and execution, 210
 - low account minimums, 210
 - no interest and fees, 211
 - taxes, 212
 - T-bond futures, 156-159
 - Treasury futures, 153-154
 - 10-year note, 162
 - 2-year note, 163-164
 - 5-year note, 162-163
 - contracts, 155-156
 - T-bond futures, 156-159
 - T-bond options, 159-162
 - Treasury bills, 154
 - versus equities, speculating, 208-214
 - Futures Commission Merchant.
 - See* FCM
 - futures contracts, 18-21
 - bid/ask spread, 28-30
 - buying and selling in any order, 26
 - long, 25
 - price speculation, 31-32
 - round turns, 30-31
 - short, 25
 - trades, offsetting and rolling over, 26-28
 - transaction costs, 30-31
 - futures expiration, 24
 - futures markets, 21
 - futures spread trading, 32
 - futures spreads, 32, 220
 - intercommodity spreads, 32
 - intracommodity spreads, 32-33
 - Futuresource, 57
- G**
- Gecko, Gordon, 183, 188
 - give up brokers, 76
 - gold, 130-132
 - gone debit, 233
 - gone unable, 232
 - Good 'Till Canceled (GTC) order, 103-104
 - grain, 4
 - soybeans, 119
 - meal futures, 120
 - oil futures, 121-122
 - grain futures, quoting, 115-117
 - calculating profit, loss, and risk, 117-119
 - grain prices, crop year, 116
 - greed, 183-184
 - GTC (Good 'Till Canceled) order, 103-104
- H**
- handles, 157, 232
 - heating oil, 135
 - hedging
 - commodity hedgers, 37-39
 - long hedge versus short hedge, 42
 - reasons for, 38
 - using futures to hedge price risk, 39-41
 - defined, 37
 - leverage, 43-44
 - hit the bid, 219
 - humility, 187
- I**
- IBs (Introducing Brokers), 67-68
 - transaction costs, 70
 - ICE (IntercontinentalExchange), 18, 125
 - Immediate Or Cancel (IOC) order, 104-105
 - initial margins, 172
 - intercommodity spreads, 32
 - IntercontinentalExchange (ICE), 18, 125
 - interest charges, speculating in futures, 211
 - interest rate futures, 151-152
 - intracommodity spread, 32-33

IOC (Immediate Or Cancel) order, 104-105
 IRAs, speculating in futures, 213-214

J-K

keypunch errors, 222

L

level playing field, speculating in futures, 211
 leverage
 in hedging and speculating, 43-44
 speculating in futures, 208-209
 liabilities, broker liability, 73
 limit down, 228
 limit moves, 228
 limit order, 97-99
 limit up, 228
 liquidation
 eliminating margins, 174
 net liquidity, 224
 liquidity, speculating in futures, 210
 live cattle futures, 123
 long, 25
 long bond, 153
 long hedge versus short hedge, 42
 long maturities versus short maturities, 152
 Loonie, 226
 losers in commodity rally of 2007/2008, 10-13
 loss
 calculating in grain futures, 117-119
 pain of taking, 185-187
 low account minimums, speculating in futures, 210
 lumber, 125, 129

M

maintenance margins, 172
 manual approval versus auto approval, trading platforms, 60-62

margin calls, 173
 accepting, 177-178
 brokers, 92
 eliminating, 173-175
 measuring, 175-177
 margin policy, brokerage firms, 79
 margins, 79, 171
 adjusting through trade and risk alteration, 174
 day trading margins versus overnight margins, 172-173
 initial margins, 172
 maintenance margins, 172
 speculating in futures, 208-209
 market access
 free trading platforms and, 58-59
 online account access and trading platforms, 75-77
 market bubbles, 7
 market depth, 48
 Market If Touched (MIT) order, 49, 103
 Market On Close (MOC) order, 106
 Market On Open (MOO) order, 105-106
 market orders, 96
 market reporters, 54
 markets, electronically traded markets, 47-48
 maturities, long versus short, 152
 measuring margin calls, 175-177
 meat futures, 122
 metals, 133-134
 energies, 134-136
 precious metals, 130-132
 silver, 133
 mini contracts, stock index futures, 139-140
 mini Dow, 139
 minimum tick, 116
 MIT (Market If Touched) order, 49, 103
 MOC (Market On Close) order, 106
 monthly fees versus per-side transaction costs, 59-60
 MOO (Market On Open) order, 105-106
 moved trades, 223
 multipliers, commodity quotes, 114-115

N

NASDAQ 100, 138
 NASDAQ 100 futures, 143
 e-mini NASDAQ, 145-146
 original NASDAQ, 144
 National Futures Association. *See* NFA
 natural gas, 136
 net liq, 224
 New York Board of Trade
 (NYBOT), 18
 New York Mercantile Exchange
 (NYMEX), 17
 NFA (National Futures Association),
 31, 66, 85, 194
 normal curves, 157
 notes, 153-154
 NYBOT (New York Board of
 Trade), 18
 NYMEX (New York Mercantile
 Exchange), 17, 130

O

OCO (One Cancels the Other) order,
 102-103
 oil, 3, 135-136
 on paper, 77
 One Cancels the Other (OCO) order,
 102-103
 one-lot orders, risk management, 203
 online, 77
 online account access, trading
 platforms and, 75-77
 online trades, placing, 111-112
 OPEC (Organization of Petroleum
 Exporting Countries), 3
 open outcry, 45-46
 option data, quotes, 54-56
 trading pit, 46-47
 open outcry option traders, 87
 open outcry quotes, reporting and
 access, 54
 open outcry S&P options, 147
 option chains, 56
 option data, open outcry (quotes),
 54-56
 option spreads, 35-36, 220
 option trades, calculating results
 of, 120
 options, 33
 call options, 34
 defined, 34
 put options, 34
 selling, risk management,
 201-202
 short-option trading, 201
 T-bond options, 159-162
 or better orders, 97-99
 orange juice, 125-127
 order desk, 62-63
 order of buy and sell, speculating in
 futures, 210
 orders, 95
 cancel/replace order, 108
 FOK (Fill Or Kill) order, 104
 Good 'Till Canceled (GTC) order,
 103-104
 Immediate Or Cancel (IOC) order,
 104-105
 limit order, 97-99
 Market On Close (MOC)
 order, 106
 Market On Open (MOO)
 order, 105-106
 market order, 96
 MIT (Market If Touched)
 order, 103
 OCO (One Cancels the Other)
 order, 102-103
 stop order, 99-101
 straight cancel order, 107
 working orders, 232
 original Dow, 142-143
 original NASDAQ, 144
 original S&P 500, 147
 OTC (Over the Counter), 45
 outcry, quotes (reporting and
 access), 54
 Over the Counter (OTC), 45
 overbought, 233
 overnight margins versus day trading
 margins, 172-173
 oversold, 233

P

paid trading platforms, 59
 per-side transaction costs versus flat
 monthly fees, 59-60
 palladium, 131-132
 partial fills, 221
 pay the ask, 219
 pay the spread, 219
 peak oil, defined, 3
 per-side transaction costs versus
 monthly fees, 59-60
 perfect storms
 commodity rally of 2007/2008, 2-6
 day of reckoning, 7
 speculators' role, 8-10
 winners and losers, 10-13
 defined, 2
 personal perceptions of risk, 205-206
 petroleum, 134
 pit, open outcry, 46-47
 pit trading, 45
 placing
 trades, online, 111-112
 trades with brokers, 108-109
 communication, 109-111
 plans for trading, 190
 automated trading systems,
 190-191
 platform fees, deciding if it's worth the
 cost, 63-64
 platinum, 131-132
 playing fields, speculating in
 futures, 211
 Pound Sterling, 226
 precious metals, 130
 price ladders, 140
 price risk, hedging with futures, 39-41
 price speculation, 196
 futures contracts, 31-32
 timing, 196-198
 profit, calculating in grain futures,
 117-119
 prop desk, 229
 proprietary trading, 229
 put butterfly, 220
 put options, 34
 put-fly, 220

Q

quality, fill quality, 69
 quotes
 commodity quotes, 113-114
 costs, 54
 multipliers, 114-115
 staying positive, 115
 deciding if it's worth the cost, 63-64
 electronic quote transmission, 56
 grain futures, 115-117
 calculating profit, loss, and risk,
 117-119
 open outcry, option data, 54-56
 open outcry quotes, reporting and
 access, 54
 subscribing to, 57

R

red months, 220
 relationships, price and yield (interest
 rate futures), 152
 reporting open outcry quotes, 54
 resources for brokerage
 information, 85
 retail traders, 82
 Reuters-Jefferies CRB Index. *See* CRB
 revengeful trading, 187-188
 risk, calculating in grain futures,
 117-119
 risk management, 188, 196, 199-200
 10% rule, 202-203
 knowing probability of success, 200
 one-lot orders, 203
 option selling, 201-202
 personal perceptions of risk,
 205-206
 stops, 203-205
 risk premiums, 116
 risk profiling, 74
 risking capital, 214-215
 risky clients, commission structure,
 73-75
 role of speculators in commodity rally
 of 2007/2008, 8-10
 rolling over, trades, 26-28

- round turns, 234
 - futures contracts, 30-31
- running stops, 229-230
- Russell 2000, 138
- Russell 2000 futures, 151

S

- S&P 500, 138
- S&P 500 futures, 146
 - arbitrage, 150
 - e-mini S&P 500, 148-150
 - open outcry S&P options, 147
 - original S&P 500, 147
- scalping, 231
- self-directed online trades versus full
 - service brokers, 88-90
- selling futures contracts, 26
- shifting risk, brokers, 91-93
- short, 25
- short hedge versus long hedge, 42
- short maturities versus long
 - maturities, 152
- short products, 213
- short squeezes, 230
- short-option trading, 201
- side-by-side trading, 48-49
 - electronic symbols, 50
- silver, 130, 133-134
- simulated trading accounts, 79
- slippage, 231-232
- softs, 125-130
- Southwest Airlines, hedging, 38
- soybean meal futures, 120
- soybean oil futures, 121-122
- soybeans, 119
- SPAN (Standard Portfolio Analysis of Risk), 92
- speculating
 - in futures versus equities, 208-214
 - leverage, 43-44
- speculation (prices), 196
 - timing, 196-198
- speculators
 - commodity speculators, 42-43
 - leverage, 43-44
 - role in commodity rally of 2007/2008, 8-10

- split fills, 221
- spread trading, 32
- spreads, 219
 - bid/ask spreads, 28-30, 219
 - calendar spreads, 32
 - crack spreada, 33
 - crush spreads, 33
 - futures spreads. *See* futures spreads
 - intracommodity spreads, 32
 - option spreads, 35-36, 220
- Sterling, 226
- stock index futures, 138-139
 - minis, 139-140
- stop loss, 99-101
- stop order, 99-101
- stop running, 229-230
- stops
 - risk management, 203-205
 - running stops, 229-230
- straight cancel order, 107
- subscribing to quotes, 57
- sugar, 125-128
 - ethanol, 4
- symbols, electronic symbols (side-by-side trading), 50
- system trading, 191. *See also* trading systems
 - possibilities of failure, 192-195
 - trading, 195
- system vendors, 193

T

- T-Bond, 153
- T-bond futures, 156-159
- T-bond options, 159-162
- tape, 228
- taxes, speculating in futures, 212
- tech support, brokerage firms, 78-79
- “the meats,” 122-124
- ticker tape, 228
- timing, price speculation, 196-198
- trade execution, brokers, 87
- traders, 14
- trades
 - babysitting, 230
 - busted trades, 223
 - moved trades, 223

- offsetting, 26-28
- placing online, 111-112
- placing with brokers, 108-109
 - communication, 109-111
- trading, 189
 - constructing business plans, 195-196
 - emotion and, 180
 - plans for, 190
 - automated trading systems, 190-191
 - proprietary trading, 229
 - revenge, 187-188
 - side-by-side, 48-49
 - electronic symbols, 50
 - trading systems, 195
- trading background, brokers, 86-87
- trading environments, 234
- trading pit, open outcry, 46-47
- trading plans versus trading systems, 191-192
- trading platforms, 234
 - auto approval versus manual approval, 60-62
 - free, 58
 - online account access and, 75-77
 - paid, 59
 - per-side transaction costs versus flat monthly fees, 59-60
- trading solution, 229
- trading systems. *See also* system trading
 - trading, 195
 - versus trading plans, 191-192
- trading vehicles, choosing, 198-199
- transaction costs, 70-71
 - futures contracts, 30-31
- transfers, bulk transfers, 68
- Treasury bills, 154
- Treasury futures, 153-154
 - 2-year note, 163-164
 - 5-year note, 162-163
 - 10-year note, 162
 - contracts, 155-156
 - T-bond futures, 156-159
 - T-bond options, 159-162
 - Treasury bills, 154
- Turtle Trading System, 194

U

- U.S. dollar, commodity rally of 2007/2008, 4
- undercapitalization, fear, 182
- unleaded gasoline, 135

V

- vendors, system vendors, 193
- VIX (volatility index), CBOE, 197

W

- winners in commodity rally of 2007/2008, 10-13
- wiring funds, 175
- work ethic, brokers, 86
- work experience, brokers, 86
- working orders, 232

X-Y-Z

- Yen, 167-168