Getting Started in
COMMODITIES

George A. Fontanills

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This book is dedicated to my parents, Lugui and Philip.

Without your courage to leave Cuba when I was only a one-year-old child, I could never have achieved the American dream.
You are the reason I can live each and every day knowing that greater opportunities are always ahead of me.
I love you always.

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Foreword

Opportunities to make money in the commodities markets have never been better. Not only have the costs of trading come down, but technology has made the process a lot faster and more efficient. It's easier than ever for individuals to make profits and develop an income stream trading commodities. Meanwhile, the number of products has grown exponentially; countless opportunities exist today that simply weren't available a few years ago.

Yet, while the commodities markets offer a plethora of trading opportunities, entering the futures arena might seem daunting for the inexperienced trader. I am constantly amazed by all of the questions and misconceptions I've heard about commodity trading. How much capital do I need? How does it all work? Why should I even bother? What kind of commodities can I trade? Isn't it too complex and risky for the average investor? If I don't know what I'm doing, will I wake up one morning to find 100,000 bushels of corn in my front yard?

This is the beauty of the book you are about to read. In *Getting Started in Commodities*, George Fontanills demystifies commodities trading. The truth is that commodities are an important element of diversification that most investors don't know enough about. Since very little correlation exists between commodities prices and other financial markets, adding commodities to your portfolio—especially if you already own stocks or bonds outright or through mutual funds—can create some necessary diversification and actually lower your vulnerability to market volatility.

Although you might not realize it, you already have experience with many commodities. Gasoline is just one example. If you drive up to the gas pump and prices are $2.50 one day and then $2.60 a week later, you have personally experienced how a commodity's price can change over time. In the first few chapters, George Fontanills shows the reader how to take advantage of everyday life experiences and translates this knowledge into profit-making trading techniques.

Many books teach strategies, but can't really tell you what type of trading is right for you. In this book, strategy selection is discussed in detail, as well as the psychology required to implement them. When reading through the text, keep in mind that there are many ways to participate in the various commodities markets, each with its own unique characteristics. For example, both gold futures contracts and gold exchange-traded funds (ETFs) offer ways to participate in the price moves of this precious metal. However, these two investment vehicles have very different characteristics.

The first four chapters are designed to help the reader sort through the various types of investments available to trade commodities. Chapters 1 and 2 provide a closer look at commodity futures contracts, while Chapter 3 digs deep into the trading of commodity-related stocks. Chapter 4 discusses index markets including trading the indexes and exchange-traded funds. Bottom line, different types of investments will behave in their own unique ways. Traders need to determine which investment instruments are most suitable, given their own risk tolerance, goals, time, and capital.

One reason commodities sometimes get a bad rap is the leverage some traders misuse when trading futures contracts. Specifically, margin allows traders to control large amounts of a commodity with relatively little capital, but it is a double-edged sword. On the one hand, leverage gives traders the opportunity to generate relatively large-percentage returns on their capital. On the other hand, it also adds an element of risk because it can lead to large-percentage losses. Traders—especially inexperienced traders—are encouraged to fully understand the effects of margin on futures contracts before using it. Detailed discussions of margin are provided in later chapters of the book.

Options strategies are discussed in detail as well. Options are extremely versatile trading instruments and can provide opportunities to profit from the rise or fall in the price of a commodity, stock, or index. Some options strategies can even be used to take advantage of range-bound markets. George Fontanills is actually a recognized expert in the field of options. His expertise is highlighted in Chapter 8, "Options Trading in the Commodity Markets." New traders are generally encouraged to focus or specialize in one or two options strategies before branching out into others.

Like futures, options are sometimes viewed with skepticism. Since options are derivatives, they are sometimes considered too risky for the

average investor. However, while options are often used to speculate, these instruments can be used to protect positions as well. The reader is encouraged to study the strategy reviews and risk graphs in the appendix to see how options can be used to develop a variety of different risk-reward scenarios. After all, options don't lose money; people do. The key to your success lies in continually educating yourself and using that information to make smart trading decisions.

Risk management is another key to long-term trading success. This is true not just in the commodities markets, but in any financial market. Risk management starts at the most basic level by not committing too much capital to one market or one trade. It's simple really: Don't put all of your eggs into one basket!

Experienced traders also understand what to do if a trade moves against them. Risk management involves developing effective exit strategies before even entering trades. George Fontanills recommends that, before placing a new trade, investors always ask the question "What if I'm wrong?" It is often better to cut losses early rather than simply hope the market will turn around and break even someday. While developing an exit plan and sticking to it can often be a challenge for new traders, it can prove to be the key to long-term success. Additional risk management tools—such as stop-loss orders, asset allocation, and spread trading strategies—are also explained in later chapters of the book.

When looking for trading opportunities, readers are encouraged to combine fundamental and technical analysis. Fundamental analysis is the study of a market or an investment based on factors that determine value over time. For example, the decision of the Organization of the Petroleum Exporting Countries (OPEC) to raise or lower output quotas is a fundamental factor that drives crude oil prices higher or lower. A rise in gasoline prices ahead of the busy summer driving season in the United States is a fundamental factor that affects gasoline prices. Strong demand from jewelers ahead of the holidays is a fundamental event that can drive gold prices. A drought in the Midwest can affect the fundamentals of the corn market. Chapter 5 offers a complete discussion of fundamental analysis in the commodity markets.

Technical analysis, the subject of Chapter 6, is the study of price and volume. While technical analysis is most often associated with charting, it involves a lot more than just gazing at charts. Yes, technicians use charts to view trends, history, and other data related to prices, but ultimately technical analysis seeks to understand how changes in supply and

demand affect prices over time. Technical analysts seek to understand the market forces that are driving prices now, in order to predict what might happen in the future. The key considerations for technicians include price, volume, and price movement.

Most successful traders today use a combination of fundamental and technical analysis. Fundamental analysis helps traders understand the economics behind the movement in commodities prices. Technical analysis enables traders to better understand the strength of the price move, how long it might last, where it might find support or resistance, and whether a change of trend might be at hand.

In addition to fundamental and technical analysis, the tone of the market as well as trader sentiment are also important considerations. Sometimes economics seems to suggest that the commodity price should move higher, but it doesn't. When the price action is not consistent with the fundamentals, the tone of the market is not good. If so, it might be a case where investors are reacting irrationally and driving prices based on emotions such as greed and fear rather than logic. In Chapter 10, "Psychology 101: Winning the Mind Game," readers are offered some examples that can help them recognize dangerous situations where a market has been overcome by irrationality.

In Chapter 11, the reader is introduced to trading commodity-related growth stocks. A stock is a form of ownership that gives investors a piece of a company. When that company is involved in commodities, the share price tends to react to changes in commodity prices. However, not all commodity stocks are winners. It takes some time and effort to find the company that is poised to take advantage of rising commodity prices. Chapter 11 explains some of the tools and methods that George Fontanills has developed to identify winning commodity-related growth stocks.

What about timing? How do you know when to get in or out of a commodity market? Technical analysis can help. Seasonality is also important. Commodities often experience seasonal trends that are sometimes predictable. For example, natural gas prices often rise in the fall ahead of the cold winter months, as the market begins to anticipate the higher demand for heating fuel. The anticipation of cold weather causes natural gas prices to rise. Seasonal trends are an extremely powerful factor in commodity markets, and for that reason Chapter 12 is completely devoted to exploring them.

Once an opportunity is identified, whether it is based on technical analysis, seasonality, fundamental analysis, or a combination, the next

step is to initiate a position. One of the more common approaches is to wait for a buy signal and then go long the commodity, futures contract, or shares. The winning strategy is to buy low and sell high. However, in *Getting Started in Commodities*, the reader is encouraged to look beyond a "long only" approach by looking for profit opportunities to trade bearish and/or sideways-moving (flat) markets. Thinking vertically—in both directions as well as horizontally—provides the trader with an infinite number of possibilities for making money in the markets.

Regardless of the approach or strategy, your broker is an important part of the trading process. Brokers are the link between investors and the financial markets. However, not all brokerage firms are the same. Some specialize in futures and/or commodities, while others specialize in stocks and funds. One of the most important decisions a new trader must make is to decide the kind of securities he or she wants to trade and which brokerage firm is best suited to accommodate this decision. It's also vital to assess the potential brokerage's commission rates, the speed of its trade executions, as well as the research and tools it can provide. No single broker is right for every investor. The right broker for you ultimately depends on your needs, goals, and objectives. A good starting point is to ask other traders, friends, or people you trust for recommendations. However, there is no real substitute for research. Chapter 13 helps the reader narrow down the list of brokerage firms to make the process easier, as well as offering information designed to explore the online trading revolution.

Readers will find that a lot of the information, techniques, and tools discussed in this book can be applied in areas outside of commodities trading. For example, after reading the book, it will become easier to see how changes in commodities prices might affect economic activity, inflation, and interest rates—including home mortgage and car loan rates. It also might help to explain why coffee prices at the grocery store are higher this month when compared to last year. Readers can use the information on technical analysis to better understand the trends in their stock or mutual fund holdings.

Hopefully, like us, you will find the information and ideas motivating and exciting. The commodities markets are both fascinating and lucrative. This dynamic world of trading can provide a lot of personal and financial rewards to those investors who put aside the myths that the commodities markets are too complex or risky to trade and who are willing to educate themselves about how it all works.

So, as Brian Tracy, one of my favorite motivational speakers once said, "Commit yourself to lifelong learning." Opportunities to learn something new occur everyday. Learning and education are the keys to a prosperous life, and they are extremely important when pursuing a career as a successful investor or trader. If you are taking the time to read this book, you are heading in the right direction. Don't let anyone or anything stop you or stand in your way. You deserve success.

Good trading.

FREDERIC RUFFY
Senior Writer and Trading Strategist
Optionetics

Acknowledgments

When I am asked to write a new book, I initially feel excited and then slowly a little apprehension creeps in. Excitement is derived from the challenge of once again putting down on paper the information I've gleaned from many years of trading. I enjoy being able to share this knowledge with a wide range of readers who are interested in learning something that will change their lives for the better. Apprehension stems from the knowledge that time pressures and creative turmoil will certainly loom in my future. I tend to experience more than my fair share of sleepless nights as my subconscious mind digs deep to find those pieces of information that the readers might find valuable. I know how important it is to create a solid trading foundation in order to make success a reality in the future. Bottom line, writing a new book is both exciting and challenging at the same time.

Fortunately, after all these years of trading (and having a worldwide company of great traders, instructors, and writers, as well as an incredible support staff), I know that even with the tightest of deadlines, we can meet our objectives. As this manuscript goes to print, I know we have produced a great book that will help a lot of people find some success in the exciting world of commodity trading. I certainly hope this book will illuminate the lightbulb that can change your life.

To those traders/writers who contributed many long hours assisting in the writing of this book—Jay Kaeppel, Meng Ng, Frederic Ruffy, Chris Tyler, and Brad Zigler—I want to thank you for your amazing inspiration and dedication to the completion of this great book. Together, we have an incredible wealth of knowledge that has helped us to achieve our objectives. Due to the ridiculously tight deadline, I didn't get a chance to tell all of you how much I appreciated your insights and contributions. This is my chance to extend to each of you my thanks and congratulations on a job well done.

To Frederic Ruffy, who has made incredible contributions to many of my projects, I have to give a special thanks. I want you to know how much I appreciate your contributions and the many hours of hard work you put into each and every book that I write. You have done a great deal to help us get the message across regarding just how much we love trading and how we sincerely want to help motivate others to become better traders.

To Kym Trippsmith, my Editor in Chief, what can I say? Thank you for your many years of hard work and incredible editing talent, which have made me look so good. It's sometimes hard to believe how many years have passed since you joined Optionetics. You've edited virtually every book and article I have written since the very beginning. I'm grateful to know that whenever a project has to be finished—no matter how tight the deadline—if you say it can be done, it will get done. I've never once had to question your outstanding ability to finish a project and make it a success. You rock!

Thanks go to Tom Gentile (Senior Vice President and Chief Options Strategist), who continually helps me to become a better trader simply by sharing his creative ideas. Being able to bounce ideas off Tom is one of my favorite pastimes. I can't even count the number of hours we have spent doing this over the past 14 years.

I've known Tony Clemendor (Chief Operations Officer) for more than 20 years, starting with those first days sitting in class at Harvard Business School. We sure have gone through a lot. I am thankful for your innovative approach to business that just keeps the company churning ahead.

I want to thank Richard Cawood (Chief Executive Officer), who has helped build Optionetics into a worldwide powerhouse in the field of education. We've gone through a lot together, and although I don't say it enough, thank you for the many years of hard work it has taken to move this company forward. It's not always easy, but we always make new advances.

And a big thanks to all our students, who challenge us to come up with new ideas to master the markets. Thanks to you, we continue to take great strides forward. Our greatest successes are the result of your achievements.

I want to thank my wonderful wife, Charlene, who motivates me each and every day to look ahead with a positive attitude. No matter what obstacles block my way, she reminds me that anything is possible.

You can't imagine how grateful I am for your loving companionship and the daily motivations that help to foster my success.

Last, I need to thank my mom and dad. Without your sacrifices, this book would never have been even a possibility. Dedicating this book to you is but a small way that I can express my love to you both and simply say thank you.

GEORGE A. FONTANILLS
Founder
Optionetics

About the Author

Optionetics was pioneered in the early 1990s by master trader George Fontanills. The development of this innovative trading approach is a testament to human will and perseverance. Fontanills's journey was not an easy one. Having struggled to overcome a life-threatening illness as a young man, George received his MBA from Harvard Business School and went out to conquer the world. His first business failed. Undaunted, he started a second business that never left the starting gate. Running low on money, George became a real estate investor and did quite well until the bottom fell out of the real estate market.

George's next move was to begin trading. Rather than concentrate on his losses, he began studying successful traders to see what they were doing differently. Using the analysis skills he learned at Harvard, he conducted a comprehensive investigation to determine what differentiated the winners from the losers. Risking money he made in real estate, George tested his conclusions and eventually developed a creative approach that used options to mathematically control risk every time a trade is placed, thereby consistently producing profits without the stress of unbridled losses. In 1993, he founded Optionetics to teach traders to profit using these strategies. Today, more than 250,000 people in more than 50 countries have seen Optionetics' high-profit, low-risk, low-stress trading techniques in action.

As his net worth soared, George gained a reputation as one of the world's most respected traders. As a highly regarded expert in options trading, George's trading strategies have been featured in the *Wall Street Journal, Barron's*, *Red Herring*, CBS MarketWatch, TheStreet.com, and

other publications, and have led to numerous guest appearances on radio and television shows throughout the country.

Today, George spends much of his time concentrating on his own active stock and equity trading, while his strategic trading approach is taught through the popular Optionetics seminar series. Specializing in stock and index options, he has instructed thousands of traders in the United States and overseas.

In addition, George has five best-selling hardcover releases (some of which were cowritten with Tom Gentile): *The Options Course*, *Trade Options Online*, *The Stock Market Course*, *The Volatility Course*, and *The Index Trading Course* (all published by John Wiley & Sons). These definitive trading guides have added to his critical acclaim as one of the best options trading instructors in the country and around the globe.

Chapter 1

What Is a Commodity?

While this book covers a multitude of issues, it is designed to answer one central question: What is a commodity? This may seem like a difficult question to some people, but it's really quite simple. If you can touch it, see it, feel it, or eat it, it's a commodity. If you are driving through Texas and you see an oil field, there's a commodity being pumped out: oil. If you are cruising through miles of wheat fields in Kansas, then you are passing an agricultural commodity: wheat. If you are vacationing in Florida, you're sure to see fields filled with orange groves; once again, you are looking at a commodity: orange juice. Even when you find yourself in a jewelry store eyeing a beautiful gold chain, you are checking out a traded commodity: gold. Commodities are all around you, but not all commodities are traded.

Smart Trader Tip

The process of trading a commodity is done typically in a trading pit located at one of the major commodity exchanges or by computerized trading, one of the predominant means to trade commodities today. A trade occurs when a *buyer* of the commodity and the *seller* of the commodity agree on a price for that commodity based upon a standardized unit for the commodity being bought or sold.

Lumber, wheat, crude oil, heating oil, natural gas, corn, copper, gold, sugar, and coffee are just a few of the commodities you may come across every day of your life. You probably just never looked at them that way. Each time you buy a pound of coffee, the price you pay is based on the commodity price established for a pound of coffee beans. But as strange as it may sound, the future price of coffee is being traded right now, and that price can have wide fluctuations today, tomorrow, and over the many months to follow.

The next time you drive up to the gas pump to inspect the price of a gallon of regular gas, keep in mind that the price you pay is directly related to how gasoline is trading as a commodity. Today's volatile world means that this price will keep changing on a daily basis; hence, as oil is traded, prices fluctuate. These prices eventually translate to a change in the price of a traded gallon of gas, which will ultimately be filtered into what you pay at the pump.

Smart Trader Tip

The prices of commodities change frequently throughout the day. You can watch prices fluctuate by observing how they change at the commodity exchanges. For example, if you want to scrutinize how gasoline prices change throughout the day, surf the Internet to the New York Mercantile Exchange website (www.NYMEX.com).

What Is a Commodity Market?

offer
an indication by an investor or trader of willingness to sell a security or commodity. The offer, or asking price, is the price at which an investor can buy the security from another investor in the market.

As we have already explored, commodities are all around us. The prices we pay each day for just about everything have been established, in most cases, by the trading of commodities at exchanges. A commodity market is a place where buyers and sellers of commodities gather to buy and sell the raw materials used in products bought and sold in the open markets. Sellers *offer* their commodities to buyers at a certain price, while buyers *bid* for a commodity until a seller agrees to a price; a trade is then established. This is the process of trading in its simplest form.

bid
an indication that an investor or trader is willing to buy a security or commodity at a specific price. The current bid price is the price at which an investor can sell the security or commodity to another investor.

Let's take a real-world example in a market most of us are acquainted with: shopping for an automobile. Suppose you live in a small town in the middle of Texas and you would like to buy a new hybrid minivan to save money on gas and do your part to contribute less to global warming. You go to the one dealer in town who specializes in hybrids to negotiate a good deal. You want to buy the minivan for $26,000 (buyer's bid), but the dealer wants to sell it for $32,000 (seller's offer). Since there's only one dealership within a 100-mile radius, this dealer refuses to negotiate. Basically, the dealer doesn't have to compromise because there isn't any competition for many, many miles. Since you (the buyer) and the car dealer (the seller) cannot agree on a price, there is no transaction. In the trading world, this means there is no trade.

So, instead, you decide to try a bigger town that hosts two hybrid dealers. Now you have three potential sellers—the original dealer in your hometown and the two new dealers—who may be a little more willing to negotiate. The competition among these dealerships means you have a little more negotiating power.

Since more dealers means better prices, you decide to drive all the way to Dallas because a bigger city will have a multitude of hybrid dealers (making it a little more difficult to decide) including Toyota, Honda, Chevrolet, Dodge, Nissan, Ford, and Saturn. Since they all want your business, the deals are not only getting better in terms of price, they are throwing in incentives. This scenario is superior thanks to the diversity of the offers from the many dealers.

But not so fast! There's another way to find the best price available: the Internet. By surfing the Net, you can look at offers from dealers all over the world. Now that's a *liquid market!* You've gone from one local dealer and no price competition to a multitude of options. This means you can adjust your bid or just leave it as is until you get the price you want. When you finally make the purchase, you have made a *trade*—that is, the buyer (you) and the seller (the dealer) have agreed to a price and terms, and now you have formally completed a trade.

Smart Trader Tip

A *liquid market* is one in which there are a large number of buyers and sellers willing to buy and sell at various price points. For a commodity trader, a liquid market is usually a better market to trade, as you will be able to get better prices since more people are willing to make a market. *Market making* is the process of bidding (as a buyer) and offering (as a seller). The more people willing to make a market, the easier it will be to find someone to take the other side of your trade.

This is exactly how the commodity markets work. There will be a *market* in which there are buyers and sellers going back and forth—bidding (as a buyer) and offering (as a seller)—until the price and terms are agreed upon. When there is an agreement on the price and terms, a trade is made. Once a trade is completed, the details of the transaction are reported to a central reporting party who is responsible for the transmission of price of the transaction around the world. In today's highly computerized environment, this process moves extremely fast. Not too long ago, traders would have been stuck waiting for tomorrow's newspaper to get a price or have to call their broker. These days, computers enable us to get this information instantaneously!

Let's now take a look at a real commodity market: oil. Crude oil is one of the most liquid and volatile commodities and is traded at the New York Mercantile Exchange (NYMEX)—the primary open outcry exchange. Traders have either purchased or leased a seat to have the right to buy and sell the specific commodity on that exchange. The term *seat* is a bit of a misnomer. It actually provides the individual with the right to stand in a small area of the trading pit and yell and scream orders to buy and sell (in this case) oil futures. What are they trading? They are trading a standardized unit of a commodity. The standardization of the contract ensures that everyone knows exactly what is being traded.

Smart Trader Tip

Open outcry is the term used to describe the process of trading whereby traders stand eye to eye and toe to toe in a trading pit and make trades by interacting with other traders who want to take the opposite side of the trade. (Just think of the trading scenes in Eddie Murphy's movie *Trading Places* and you'll get the visual picture on this one.) They signal with their hands, and when a trade is made they signal back acknowledgment and write their trades down on a card for record keeping. Today, computers do most of this work.

Using our previous auto example, if everyone was trading a hybrid minivan with exactly the same options, color, and so on, then it would be a *standardized* unit. If you were trading a silver Toyota Prius but everyone else had a different model, no trading would occur, as no one would be on the same page. Standardized units mean that everyone knows and agrees on exactly what is being traded. For example, if traders are trading light sweet crude oil, then they are actually trading 1,000 U.S. barrels of light sweet crude oil during the hours of 9 A.M. and 2:30 P.M. (eastern standard time). That's a lot of oil for one futures contract, which is why it's so important to make sure you know exactly what you're trading.

Smart Trader Tip

Over the many years that I've been teaching people how to trade, I've learned that specializing in the study of just a couple of markets is the easiest way to attain success. The trick is to avoid analyzing too many commodities at one time. So start by picking one or two favorite commodities and then investigate them very carefully. It may take a few months until you understand the specifics and rhythms of these commodities, but after a while that knowledge will guide you to the right strategies to take advantage of specific market scenarios. Start by going to the NYMEX website (www.NYMEX.com) and take a look at everything you can trade. There's a lot to be learned simply by looking at the contract specifications of each commodity. Your success depends on your ability to do your homework on any commodity you are considering trading—the more in-depth your study, the easier it is to plan your trade.

Let's get back to our traders. At the end of the day, the traders and their assistants hand over their trades to their clearinghouse. All the accounting of the buys and sells are then tallied and the next-day profit-and-loss statements are issued for the previous day's activities. This is how the trader in a pit works day in and day out. It looks like a stressful job and it is, but it's one of the most exciting jobs I can imagine.

But to quote Bob Dylan, "The times they are a changing . . ." As the world changes thanks to the rapid integration of computer and online technologies into every possible human endeavor, the information flow at home and work continues to advance as well. In the markets, the emergence of computers have given birth to a whole slew of opportunities in the exciting world of commodity trading.

What Is the Difference between a Commodity and a Futures Contract?

The answer to this question is not as precise as I would like it to be. At first look, a commodity is a physical product (wheat, oil, lumber, soybeans, etc.) that can be touched, eaten, processed, or delivered—whether it is today, tomorrow, or next year. In contrast, a futures contract is a commodity that (as was explained in the example of the oil traders at the NYMEX) is standardized in its unit of measurement (i.e., 1,000 barrels of oil) to be delivered at some future date. For example, a light sweet crude oil futures contract can be traded in all months of many years to come. So if people want to trade oil futures contracts for December 2008 or oil futures contracts for March 2009, they are able to do so, as there is a market of traders looking to buy and sell those contracts.

Why would anyone do that? Well, the market is made up of a large number of people with diverse views and many different desires. For example, in the oil industry, a big oil company might want to sell a certain portion of what it produces next year. For example, Exxon Mobil (XOM) produces countless barrels of oil. If it sees oil prices at what it considers a good level, it may sell a certain number of barrels at that price for delivery next year. This way, the company knows specifically how much it will make on those barrels of oil. This process is known as hedging and, in this example, the oil company is considered a hedger.

Who would buy that oil? Well, let's say you are Southwest Airlines (LUV). The cost to fuel your fleet of planes is a major problem, as airplanes use a massive amount of oil every day. Airlines may choose to offset any potential rise in the cost of fuel by locking in today's prices. Hence, a futures oil contract can help Southwest Airlines avoid the risk of having to pay higher oil prices if the price of oil rises in the future. For example, if the price of oil fluctuates between $60 and $90 a barrel, it would behoove Southwest Airlines to lock in the $60 price and save a huge amount of money over the next year. It's easy to see why the airline would want to hedge its fuel risk by going to the oil futures market and buying oil contracts for delivery next year that guarantee a specific price. In this example, the airline company is also a hedger. They are turning to the futures market to lock in prices and hedge themselves against an adverse price move in the oil market.

Hopefully, this process is starting to make more sense. The buyer and the seller make a trade in order to achieve an objective that makes economic sense for both of them. In the previous example:

- Exxon Mobil, the seller, wants to lock in profits for next year by selling oil in the future at today's trading price.
- Southwest Airlines, the buyer, wants to hedge its risk so it buys oil in the future at today's trading price.

Do Southwest Airlines and Exxon Mobil call each other up to discuss their deal over the phone? Of course not; they go to the oil futures market and buy and sell from traders on the floor who act as intermediaries. This is the fastest and most liquid way to achieve the objective they both want to achieve; this kind of trading happens day in and day out.

The next party in the futures market is the *speculator*. The speculator is an individual trader (like me or you) who wants to trade a futures contract and make a profit on the price fluctuations of the oil futures contract. Let's say you believe oil prices are likely to go up. As an oil futures speculator, you can buy an oil futures contract. If you are right and oil futures rise, you can profit from being right on the move up. If the price of the oil futures contract goes from $70 to $71, you would make $1,000. If you are wrong, and the price of the oil futures contract goes from $70 to $69, then you lose $1,000. There are many speculators buying and selling futures contracts who are making money trading commodities to be delivered someday in the future. Speculators are the ones who create a great deal of the liquidity that exists in the daily trading of

speculator

a trader who hopes to benefit from a directional move in the underlying instrument, attempts to anticipate price changes, and, through buying and selling futures contracts, aims to make a profit. The speculator does not use the futures market in connection with the production, processing, marketing, or handling of a product, and thus has no interest in making or taking delivery. So, while speculators attempt to bank profits from moves in the futures contract on a short-term basis, *hedgers* turn to the commodities market to protect themselves from adverse moves in prices. Taken together, the hedgers and speculators are responsible for the buying and selling in the commodities and futures markets.

hedger
an investor who uses the futures market to minimize the risk in his or her business. Hedgers may be manufacturers, portfolio managers, bankers, farmers, and so on. Hedging can help lock in existing profits and/or reduce the overall risk of loss due to fluctuating prices.

the futures market. Unlike Southwest Airlines, speculators are not interested in receiving the actual physical commodity someday in the future. They are just speculating to make profit; hence, the name.

Back to Commodities

All over the world, farmers grow and sell a vast array of agricultural products. Regardless of the product they are farming, they are all trying to make money on their crops. Wheat farmers in Kansas are trying to maximize their yield on their many acres of farmland. Coffee growers in Colombia are trying to maximize the yield on their families' coffee plantations. Sugar growers in Brazil are working hard to harvest as much sugarcane as possible from the land. Additionally, traders of agricultural products are wise to monitor weather conditions and assess how they may affect certain markets. Even your neighborhood contractors have to assess how much they can ask for a house in order to pay for all the commodities necessary to build it. They are dependent on a variety of commodities including lumber and oil—both for their roof shingles and for the cost of transporting the materials it takes to build the house.

Day in and day out, 24 hours a day, seven days a week, commodities are affecting your life in every way. In fact, it can be asserted that the consumption of commodities makes the world go 'round. Now that you are more aware of this, you might look at the world a little differently. Next time you find yourself shopping at the local grocery, you may notice that just about everything there is a commodity. They just happen to be commodities that have now been delivered (no longer futures contracts) and now are available to you as an individual shopper. The grocer is making an *offer* to purchase; so when you buy something, you have made the trade. Advancing your knowledge of how the world revolves around commodities is one of the keys to understanding how they work. It's important to open your eyes to the big picture as well as to study the details of specific markets that make it a very profitable and exciting business.

How Can a Stock Trader Use This Information for Financial Gain?

We have already established that commodities affect your everyday life. Those who study them can make a very good living as commodity speculators or as longer-term commodities investors. If you only trade stocks, you may be wondering why you should even care about commodities. Bottom line, you can also use the knowledge you gain by studying commodities to make money in the stock market.

Since global economic cycles are very much driven by commodity prices, stock investors need to pay attention to the commodity markets. Commodity prices filter themselves into the earnings of virtually every business. For example, rising oil prices can directly increase Exxon Mobil's earnings. In contrast, rising oil prices hurt the airlines (such as Southwest, American, and Delta) and the cruise lines (like Carnival and Royal Caribbean), unless they hedge their oil price risk. If lumber prices go up, it hurts the homebuilders such as KB Homes. If coffee prices go up, it hurts Starbucks but helps the producer. If cocoa prices go up, it hurts the candy makers. This kind of trickle-down progression goes on and on. In fact, most of these companies are affected by multiple commodity prices. In essence, they can be helped (or hurt) by a variety of different commodities. As a stock trader, you must recognize the importance of investigating the commodities that affect the share price of any company you are interested in trading. As the prices of these commodities fluctuate, keep an eye on them, as company earnings may be affected as well.

On a broader scale, commodity prices affect the entire economy and the stock market. Just listen closely to what they are talking about on television regarding economic catalysts (i.e., factors that can affect the overall economy). First and foremost, the talking heads and pundits on television are constantly talking about oil. If oil prices are too high, then many companies are affected and not just because of the way this affects the price of a gallon of gas. Oil and oil by-products are used in a whole host of products. In addition, if oil prices increase too much and the price of a gallon of gas rises too high, this pinches the pockets of the average consumer, and spending patterns could shift accordingly. When consumers reduce spending, every company and the economy in general are affected.

Let's go one level higher and evaluate how commodity prices affect the global economy. Once again, let's use oil as an example. Table 1.1 shows the world's top oil producers, exporters, consumers, and importers in 2004, providing clues to international production and consumption.

TABLE 1.1 Top World Oil Producers, Exporters, Consumers, and Importers, 2004 (millions of barrels per day)

Producers	*Total Oil Production*	*Exporters*	*Net Oil Exports*	*Consumers*	*Total Oil Consumption*	*Importers*	*Net Oil Imports*
1. Saudi Arabia	10.37	1. Saudi Arabia	8.73	1. United States	20.5	1. United States	11.8
2. Russia	9.27	2. Russia	6.67	2. China	6.5	2. Japan	5.3
3. United States	8.69	3. Norway	2.91	3. Japan	5.4	3. China	2.9
4. Iran	4.09	4. Iran	2.55	4. Germany	2.6	4. Germany	2.5
5. Mexico	3.83	5. Venezuela	2.36	5. Russia	2.6	5. South Korea	2.1
6. China	3.62	6. United Arab Emirates	2.33	6. India	2.3	6. France	2.0
7. Norway	3.18	7. Kuwait	2.20	7. Canada	2.3	7. Italy	1.7
8. Canada	3.14	8. Nigeria	2.19	8. Brazil	2.2	8. Spain	1.6
9. Venezuela	2.86	9. Mexico	1.80	9. South Korea	2.1	9. India	1.5
10. United Arab Emirates	2.76	10. Algeria	1.68	10. France	2.0	10. Taiwan	1.0
11. Kuwait	2.51	11. Iraq	1.48	11. Mexico	2.0		
12. Nigeria	2.51	12. Libya	1.34				
13. United Kingdom	2.08	13. Kazakhstan	1.06				
14. Iraq	2.03	14. Qatar	1.02				

Source: Energy Information Administration (www.eia.doe.gov/emeu/cabs/).

Much of the run-up in oil prices is attributed to recent growth in the Chinese economy. Oil prices have been driven up as the once stagnant communist economy experiences massive economic growth, driving China to thirst for more and more oil. China needs virtually every type of commodity to fuel this growth, so commodity prices will most likely be affected for many years to come. Now when you drive up to the gas station pump and look at what you are paying for that gallon of gasoline, remember that this price is closely tied to what is happening in China and other countries around the world—not to mention the volatile ramifications of looming *peak oil* declines.

As you can see, commodity prices affect everything. For astute investors or traders, understanding how commodities work, locally and globally, is essential to being able to develop an edge against competing traders and investors.

peak oil

an idea originally sparked by Shell Oil geologist M. King Hubbard back in 1956 that the world will reach a peak in the rate at which it can extract oil from the ground. Once this peak is reached, production rates will decline and will not be able to keep up with demand. When demand outpaces production, the world economy will no doubt receive a major shock. The ramifications of peak oil continue to be a hot topic of discussion, but unlike global warming, the forces underlying peak oil are generally not disputed. (See Figure 1.1.)

Summary

Commodities are everywhere; the world depends on them. Every person on this planet comes in contact with commodities every day. Since commodities affect important parts of your life, this information can be used to generate profits in the commodities and futures markets. For example, do you buy coffee? Do you notice the price changes from one day to the next? What about when you are filling your gas tank? We all feel the effects from rising and falling gasoline prices. So the first step in becoming a successful commodities trader is easy: Pay attention to what is going on around you.

This book is designed as a guide to trading success in the commodity markets. It will show you how to get started in the diverse world of commodities trading and how to make a profit using this knowledge. The book is written with the novice reader in mind and starts at a very basic level, with an explanation of the different types of investments or trading vehicles that can be used to generate profits in the commodity

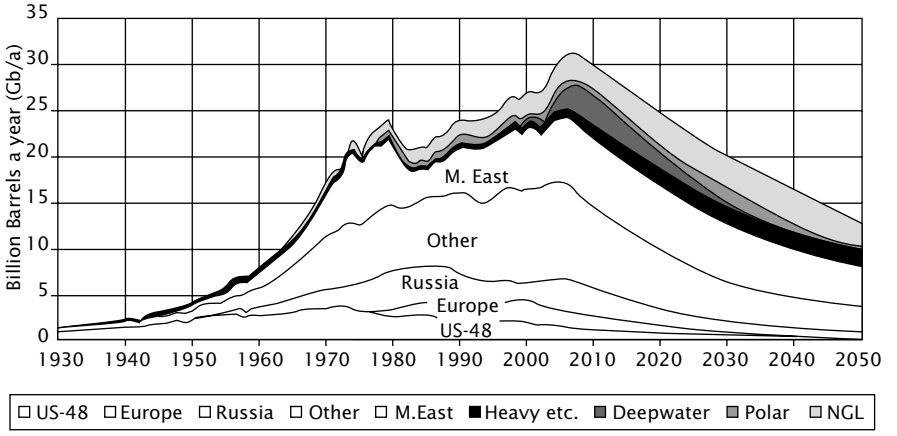

FIGURE 1.1 Peak oil timeline.
Courtesy the Association for the Study of Peak Oil & Gas.

markets. The reader is also introduced to various types of analysis tools, trading strategies, and risk management techniques. The book also explores finding the right broker, which is an extremely important part of becoming a successful trader in the commodity markets.

So get ready to learn how commodities work, how to analyze these markets and identify profitable opportunities, and how to structure trades to maximize rewards while managing risk.

Key Summary Points

1. Commodities are all around us. Lumber, oil, wheat, gold, coffee, and sugar are a few examples.
2. Not all commodities are traded in the financial markets, but many are.
3. The first step in becoming a successful trader in the commodity markets is to understand which commodities are traded and which ones are not.
4. Some of the actively traded commodities today include metals such as gold and silver, agricultural goods like wheat and coffee, energy such as oil and natural gas, as well as livestock such as cattle and pork bellies.

5. The commodities exchanges offer a central place for buyers and sellers to meet and trade the various commodities.
6. The New York Mercantile Exchange (NYMEX), the Chicago Board of Trade (CBOT), and the Chicago Mercantile Exchange (CME) are examples of active commodities exchanges.
7. Once buyers and sellers meet and agree on a price for a commodity, a trade is made.
8. For most investors, the buying and selling of commodities does not take place on the exchange but is handled by a licensed commodities broker (additional discussion in Chapter 13).
9. Many traders prefer to trade futures on commodities rather than the physical commodities themselves.
10. A futures contract is an agreement between two parties to buy or sell a commodity at a specific price sometime in the future.
11. The futures market consists of two principal players: hedgers and speculators. Hedgers, such as farmers and oil companies, turn to the futures market to lock in set prices and protect themselves from adverse moves in the market. Speculators use futures to speculate on possible moves in commodity prices.
12. While hedgers and speculators are the most active players in the futures market, commodities are all around us. Whether you are filling up the gas tank, going through the aisles at the grocery store, or buying a cup of coffee at your local Bohemian cafe, commodity prices will affect you.
13. Commodity prices have an important impact on the overall economy. Being aware of the importance of commodities not only makes you a better shopper and smarter investor, but also serves as the appropriate starting point for your journey to becoming a successful commodities trader.

Chapter 2

How the Commodities Markets Work

If you mention commodities in conversation, most people picture a trading floor packed with screaming, wildly gesturing traders. This isn't surprising. Most of us know of commodity trading only through news reports or movies punctuated with colorful pictures of the floor action from Chicago or New York. Commodity traders, by nature, are supposed to call attention to themselves by sight and sound. By doing so, they're more likely to find another trader with whom they can transact business. So what are all those people in the funny jackets actually doing?

First of all, it's important to know that floor action represents only a part of modern commodity trading. There's an ever-growing proportion of trading that takes place electronically nowadays. But let's not get ahead of ourselves. To understand how the modern commodity markets work, we first need to review a bit of history. Just how and why did commodity trading develop?

The Need for a Commodities Market

If you're a wheat farmer in southern Illinois, you can find a bevy of potential buyers for your crop in Chicago among its flour millers, cereal manufacturers, and glue factories. Naturally, Chicago's industrial consumers are

interested in buying wheat at the lowest obtainable price, while you want the highest possible price for your crop.

spot market
same as the cash market. It is the immediate market where a commodity or other investment can be bought or sold.

Without a prearranged contract with a Chicago mill or factory, you must compete with other farmers simultaneously offering their product in the *cash*, or *spot*, *market*. When supplies are ample, millers and factory purchasers are likely to offer only low prices. In a year where a hard winter or spring flooding diminishes yields, however, you can command higher per-bushel prices for your crop in the spot market.

Forward Contracts

The uncertainty of spot market prices gave rise to *forward* or *to arrive contracts*, whereby buyers and sellers agree upon a price for grain to arrive at a later date. While a price is set, no cash changes hands until the commodity is actually delivered. By negotiating a price (say, in October) that anticipates a reasonable profit for you and the flour mill, you're freed from fretting over the price of wheat the following June. Cash flows can be more reliably projected as a result, helping you—and your counterparty, the mill—make better plans.

forward contract
an agreement between two parties to buy or sell a commodity at some time in the future. Similar to futures contracts, but not as easily transferred or canceled.

Forward contracts, of course, eliminate windfall profits. As an example, suppose you negotiate a contract price of $4 per bushel for June delivery of your wheat. A poor Russian harvest might later bring big buyers into the market, pushing spot prices up to the $5 to $6 range. Unfortunately, you're still obliged to deliver your crop at $4. This is good news for the mill: Its forward contract insulated it from paying an inflated price for its grain. But it's not so good for you. However, a glut of wheat could have sent prices tumbling down to $3, giving you the advantage instead of the mill.

Forward contracts are purely commercial transactions; they're too cumbersome to use effectively for *speculation* or investment purposes. First of all, each party to a contract must be in a position to make or take delivery of the underlying commodity. If you're not ready to deal in

railcars full of grain, you don't belong in the forwards market. There's no provision for turning the contracts into cash, either. You might think the prospect of a glut would make your forward contract valuable as spot prices decline, but unless the mill is willing to let you transfer your obligation to another, you're virtually stuck.

speculation
the selection of investments with higher-than-average risk in order to profit from forecasted price movements.

In a forward contract, you also face the risk that your counterparty might *default*. If the mill goes out of business and doesn't honor its purchase commitment, you've got to find another buyer for your grain. When the market is awash with wheat, you'll probably end up losing money.

default
a failure to live up to the terms of a contract or debt obligation.

Each party to a forward contract is on its own when it comes to finding a counterparty. It was primarily for this reason that a group of merchants at the Chicago Board of Trade (CBOT)—originally a marketplace for spot grain sales—developed a centralized forwards exchange. From this, commodity futures trading, as we now know it, gradually developed.

Modern Commodity Trading

One of the key innovations wrought at the CBOT was standardization. To attract speculators, contracts had to be transformed from customized commercial vehicles into readily tradable investments. By standardizing contract sizes as well as delivery grades and procedures, the CBOT created *fungible* or interchangeable instruments. Traders now know that each wheat contract calls for the delivery of 5,000 bushels of No. 2 Red Winter or Northern Spring grain through selected warehouses in Illinois, Indiana, and Ohio. Delivery dates are also standardized, providing a range of contract lengths to suit buyers' and sellers' needs. As such, all CBOT December wheat contracts are identical in every respect except one: the delivery price.

The *fungibility* of futures contracts allows them to be readily offset, or closed out, before delivery. Buyers of futures who don't wish to actually take delivery at contract maturity, for instance, can simply sell their contracts during market hours. Likewise, contract sellers can relieve themselves of the obligation to make delivery by buying back the same

fungibility
the ability to interchange assets of identical quality. Wheat stored in a grain elevator is fungible, as it is not specifically identified regarding its ownership.

contract that was sold. Like unwinding a stock position, selling a contract previously bought, or buying a contract that had been sold, leaves the trader flat (i.e., devoid of a contract). Realizing a profit or loss is based upon the difference between the contract's purchase and sale prices. Unlike forwards, you can buy or sell commodities in the futures market whether or not you own, or need, the commodity in question. In fact, less than 4 percent of all futures contracts actually result in deliveries. The vast majority are offset prior to the delivery month.

Smart Trader Tip

When a trader has an open futures contract and closes that trade, he or she is *flat*. This means the trader has no open positions. Many short-term traders like to be flat ahead of the weekend or an important event like an economic release in order to avoid getting caught in volatile markets.

margin
a good faith deposit required to establish or maintain a commodity futures position. In the futures market, both sides of a trade—buyer and seller alike—post margin.

Another innovation that increased the attractiveness of futures as an investment was the introduction of *margin.* In the old days, forward contracts were formed with only a handshake and the promise of payment upon delivery of the commodity. When futures are traded, however, both buyers and sellers post good faith deposits. Unlike the margin used in stock trading, these deposits don't represent down payments. Instead, they are *performance bonds* that guarantee that the contracts will be honored by each side.

Futures margins are small. Speculators might be asked to put up as little as 5 percent of the total contract value to open their positions. These initial margin deposits vary by commodity and market conditions. If the commodity's price declines below its purchase price, the buyer—the long position—sees the loss deducted from his or her margin balance while the seller—the short position—is credited with

a gain. This *marked to market* ensures that both parties to the contract continue to meet their financial obligations. Traders may be required to replenish their accounts when market action goes against them.

marked to market

the process of repricing a commodity futures position against the current settlement price to reflect its current market value. Marking to market is done daily to determine account equity for margin purposes. Year-end marking to market, however, is required under the Internal Revenue Code to determine current tax liability. Each open Section 1256 position is *theoretically* closed out on the last business day of the year to arrive at a current gain or loss.

Spot Market versus Futures Contracts

A futures market, of necessity, is inextricably tied to its underlying spot market. By definition, the cash price for a commodity is its face value when available for delivery *on the spot*. The futures price for a commodity, however, reflects all the costs associated with holding it for future delivery. Take gold, for example. You can buy gold from a bullion dealer at the spot price today and walk away with your purchase. If you buy bullion through the futures market, though, you have to wait for the delivery month to get your gold. In the time you wait for delivery, your gold must be stored, it must be insured, and it must be financed.

Let's say the price of spot gold bullion in early August is $650 per ounce. If you wanted to lock in today's price of gold for delivery in, say, September—a month from now—you shouldn't be surprised when you're asked by a dealer to pay the equivalent of $652.60 per ounce. The $2.60 per ounce premium over the spot price reflects the dealer's cost for holding your gold until September. If you want the dealer to hold your gold until December, a premium of $12.00 per ounce might be levied to cover the additional storage charges.

That's exactly how the futures market works. For any given commodity, several delivery months may be trading simultaneously, each at a different price level reflecting the carrying costs for each delivery. The near-term market for gold on the COMEX division of the New York Mercantile Exchange, for example, might look like Table 2.1.

TABLE 2.1 Near-Term Market for Gold in the COMEX Division of the NYMEX

NYMEX—CMX Gold
(100 oz.—dollars per oz.)

Month	*Last*
August	650.50
September	652.60
October	655.50
December	662.00
February	669.60

Prices for different delivery months vary, reflecting the costs of storing, insuring, and financing the commodity as well as supply and demand for specific contracts. In a normal market such as this, the prices of deferred deliveries are higher than those of nearby deliveries. The spot month—in this case, August—typically trades at the lowest price.

Smart Trader Tip

The prices of commodities typically increase over time due to carrying costs such as storing, insuring, and financing the commodity.

Remember, all these contracts call for the delivery of the same quantity and quality of metal: 100 ounces of .995 fine (24-karat) gold, which currently sells in the cash market for $650.00 per ounce. The closer a contract is to expiration, and to the cash market, the smaller the carrying charges, until, at the end of a contract's delivery period, the *cash market* price and the expiring futures price converge.

cash market
another term for the spot market. It is the current price of the commodity in the open market and differs from the futures market, which is based on expectations about future prices.

This pricing phenomenon exists because of the futures markets' delivery mechanism. If the alignment of futures and cash market prices was significantly disturbed, sharp-eyed *arbitrageurs* (a.k.a. *arbs*) would likely step in to capitalize upon pricing disparities. When futures trade too far above the cash market (reflecting abnormally high carrying charges), for example, arbs could sell the

overpriced futures, buy an equivalent amount of spot gold, store it, and then deliver the gold against the short futures in the delivery month. The inflated carry premium would thus be captured as a profit. The arbitrage, too, squeezes the pricing disparity away. Sales of overpriced futures exert downward price pressure in the contract market as spot metal prices are bid up by offsetting purchases.

arbitrageurs (arbs)

players who attempt to profit from price differences between two substantially equal assets. This might involve, for instance, buying a commodity on one exchange and simultaneously selling a similar commodity on another exchange in order to profit from the price differences of the two.

If futures markets don't reflect full carrying charges for some reason, arbs could step in to exploit the mispricing by doing a reverse version of this trade. The discount would be corrected when underpriced futures are purchased and spot metal is sold (the gold received at delivery against futures offsets the arbs' short cash market sales). Cash market and futures market prices are thus brought closer together as bids increase for cheap futures against the stepped-up spot market sales.

The mere fact that arbitrage could occur keeps prices from getting out of line most of the time, as futures traders don't want to be caught in the arbs' sights for overly aggressive bids or offers. Still, different delivery months can seem to move out of step within a normal or carrying charge market without attracting the wrath of arbs. A normal market reflects ample supplies across all delivery months. Not all markets appear that way; sometimes seemingly large disparities appear because of inherent differences in supply and demand for storable commodities.

For example, winter wheat is planted in late fall, remains dormant during the winter (hence its name), and is harvested in early summer. Nearby delivery months (i.e., those before the summer harvest in May or June) reflect the old crop, while more distant delivery months reflect a market with new crop supplies. A shortage in old crop months, therefore, may not be reflected in new crop months. It wouldn't be that unusual, in fact, to see new crop months trade at a relative discount to old crop months, reflecting ample quantities of new wheat. Bullish movements in old crop months, then, may not be reflected in new crop months.

Some delivery months attract more interest than others. December gold, for example, attracts more commercial interest than others, as jewelry manufacturers *hedge* their Christmastime sales. Prices in other, more

thinly traded delivery months may be more volatile, allowing for more persistent price disparities.

Smart Trader Tip

Contract volumes for each delivery month are posted by the exchanges daily. Smart traders gravitate to high-volume contracts to minimize transaction costs and delays.

inverted markets
a term used to describe a situation where prices in the spot market are greater than in the futures market. Inverted markets can occur when there is strong present demand for a commodity.

Inverted Markets

Normal markets reflect normal supplies of a commodity. Shortages, however, can cause a market to invert. *Inverted markets* develop as spot or near-term supplies are hoarded. Inverted markets reflect consumer unwillingness to wait for delivery of a commodity. They want it *now*, not later.

The energy markets are particularly prone to inversion because a large amount of supply is controlled by a sometimes whimsical OPEC. As you can see by looking at Table 2.2, the prices of deferred deliveries are *lower* than those of nearby deliveries in an inverted market. The spot month—in this case, July—is priced highest (see Table 2.2).

As supplies increase, or demand wanes, an inverted market may return to normalcy. Arbitrage is more dangerous in an inverted market, as the natural brake (i.e., carrying charges that separate one delivery month from another) is absent. Inverted markets pose unique risks for certain trades known as *spreads*, which we'll look at a little later.

TABLE 2.2 NYMEX Crude Oil

NYMEX Crude Oil
(1,000 barrels—dollars per bbl.)

Month	*Last*
July	78.84
August	78.78
September	78.70
October	78.60
November	78.50

Speculators

Futures markets greatly depend upon speculators to supply liquidity. Somebody, after all, has to take the other side of the hedging trades made by commercial users. As previously mentioned, speculators seek profits by correctly forecasting price changes. If you think, for instance, that December cocoa will rise to $1,800 per ton, you might be tempted to speculate on that expectation by purchasing futures at the current $1,600 price. You have no intention of actually taking delivery of the cocoa in December, as you just don't need 10 tons of cocoa beans. Instead, you expect to offset your futures position before the delivery period. That, in a nutshell (cocoa husk?), describes the intent of a long speculator.

Let's say cocoa's price rises to $1,820 per ton by October. You could take $2,200 in profits ($220 per ton times the 10-ton contract size) by selling your contract. If prices move southward to $1,470 per ton as December approaches, however, you may be forced to liquidate your position at a $1,300 loss ($130 times the 10-contract size) to avoid the risk of delivery. This risk will be further explained in the "Deliveries" section.

Speculators are attracted to futures because of *leverage*. The initial margin required for your cocoa trade might be only $1,700, for instance, but you're trading cocoa with a total contract value of $16,000 ($1,600 per ton × 10 tons). Your leverage is nearly 10-to-1. In other words, you're putting up only 10.6 percent of the commodity's value, but your profits and losses are the same as those of someone who had paid the full cash price for a wholesale lot of cocoa.

leverage
using small amounts of capital to control large amounts of a commodity or other asset. Margin is an example of using leverage.

By calculating your profit and loss potential in the scenarios we've described, we'll see how leverage can work for (or against) you (see Table 2.3).

The attraction of a $2,200 gain on a $1,700 investment is obvious. Notice that the underlying commodity had to move less than 14 percent to crank out a 129 percent return. Leverage, however, is a two-edged sword that can cut deeply. Losses can pile up dramatically on small moves, too (see Table 2.4).

In either case, whether you make a profit or a loss, your transactions are limited to the futures market; you never touch the actual commodity. Keep in mind that speculators avoid deliveries because of the substantial costs associated with the transfer and storage of the underlying commodities.

TABLE 2.3 Leveraged Profits

Profit /Loss Potential

		Price per Ton	*Margin*
		$1,600	$1,700
Bought 1 contract December cocoa			
Sold 1 contract December cocoa		$1,820	
	13.8% Price gain	$220	
	Contract = 10 tons	× 10	
	Gross profit	$2,200	
	Margin	÷ $1,700	
	Return	**129.4%**	

TABLE 2.4 Leveraged Losses

Profit /Loss Potential

		Price per Ton	*Margin*
		$1,600	$1,700
Bought 1 contract December cocoa			
Sold 1 contract December cocoa		$1,470	
	8.1% Price decline	–$130	
	Contract = 10 tons	× 10	
	Gross loss	$1,300	
	Margin	÷ $1,700	
	Return	**–76.5%**	

rollover
reinvesting money from one maturing security to another one with a more distant expiration.

What if your price expectations take a little longer than you forecast to be realized? As an example, let's say December cocoa reaches only $1,760 on the eve of the delivery period and you believe there's room for a further price advance. If you wish to maintain a long position, you'll need to execute a *rollover* of your long position to the next available delivery month. To do so, you'd sell

the December contract and simultaneously buy March futures, the following contract month.

You could have just as easily speculated on a decline in cocoa's price. If you thought a drop to the $1,500 level was likely, you could sell December cocoa short at $1,600.

A short position is established by opening your futures trade with a sale instead of a purchase. How do you sell a commodity you don't already own? Remember that you're selling futures, not the actual cocoa. Futures are obligations to make or take delivery, secured by margin. A short sale is simply a wager that prices will decline before the contract's last trading day. Offsetting the short sale with a purchase before delivery precludes the need to actually deliver the commodity.

If December cocoa declines to $1,470 per ton, a $1,300 ($130 per ton × 10 tons) profit could be generated by buying back the December contract to close out your short position. This is the exact reverse of the loss in the long position described previously. Since the margin is the same for a short position as it is for a long position, you'd make (instead of lose) 76.5 percent. If you thought there was further softening in cocoa's price ahead, you could roll your short position forward by buying back December futures while simultaneously shorting March cocoa. As you can see, the possibilities are endless.

Fundamental versus Technical Analysis

Successful speculation requires a method for analyzing and forecasting price movements. There are two classic analytic approaches: fundamental analysis and technical analysis. *Fundamental analysis* focuses on the value of the asset and its true worth. For example, the fundamental analysis of a company might look at the earnings it generates, revenues, business strategy, and management. In brief, fundamental analysis seeks to identify changes in supply and demand that can then be used as justification for undertaking futures positions. A forecast of tighter supplies, for example, may be the reason for speculation with long positions. Prognostications of large overhanging supplies or weakening demand, likewise, might warrant short positions.

fundamental analysis

the study of all factors that might impact the supply and demand of a commodity. Weather is an example of a fundamental analysis tool for agricultural commodities.

technical analysis
the study of the price action of a security based on the theory that market prices display repetitive patterns that can be tracked and used to forecast future price movement; technical analysis evaluates price movement by analyzing statistics generated by market activity—such as past prices and volume—to study market performance.

Technical analysis, however, is the study of past price movement in an asset or investment security. For example, technical analysis of the gold market involves looking at the price chart, volume, and other indicators that might reveal predictable price patterns. Technical analysts (a.k.a. chart readers) rely upon noneconomic data for their projections. Projections are based upon the assumption that certain patterns in price and trading volume can be recognized and are persistent. Examples of technical analysis include Elliot Wave Theory, moving average convergence/divergence (MACD), relative strength, volume, and stochastics. (Fundamental and technical analyses are discussed later, at greater length, in their own chapters.)

Options Spreads

option
a trading instrument that enables the buyer to purchase (call) or sell (put) the underlying market at a specific strike price until a specific expiration date.

Adopting a short or long stance in a commodity is known as an *outright* position. In an outright position, you take on the full risk of any changes in the price of the commodity. As we've seen, the inherent leverage in futures trading can translate small movements into outsized profits or losses. Speculators can moderate their risk or capitalize upon more subtle price movements by trading *options, spreads,* or *straddles* instead.

spread
a trading strategy that involves the simultaneous purchase of a futures or options contract with the sale of another.

Spreads, in their simplest form, are trades in which a purchase of one futures contract is made against the sale of another in the same or a related market. Spreads are considered less risky than outright trades because the prices of the related contracts tend to move in the same general direction, providing a hedge of sorts.

In a spread, the price differential between the contracts is the subject of the speculation. For an outright trade, there's only one scenario that produces a gain for the speculator: The commodity must rise above (if long), or fall below (if short),

the entry price. There are more profitable outcomes available to the spreader, however. The long contract rising in price, or the short contract declining, can produce a gain. The potential gain would be even greater if both contracts moved favorably. Spreads may thus offer more attractive reward-to-risk ratios (RRRs) than outright trades and may be, therefore, better trades for novice speculators.

straddle
the simultaneous purchase of a call and put option with the same at-the-money strike, expiration date, and underlying market.

To understand spreads, you first must know the difference between the prefixes *intra* and *inter*. Intra means "within"; inter means "between." You'll see why this is important as we examine the three main types of spreads:

- *Intracommodity:* This is, by far, the most common type of spread. As the name implies, the spread takes place within the market for a given commodity. It's constructed by purchasing a futures contract in one delivery month while selling futures in a different delivery month of the same commodity. Going long October sugar and shorting July sugar is an example of an intracommodity spread, also known as an interdelivery spread.
- *Intercommodity:* Taking a long position in one commodity and a short position in a related commodity is an example of an intercommodity spread. The relationship between feeder cattle and live cattle, for example, can be exploited in a source/product spread. For example, feeder cattle are steers fattened in feedlots until they reach market weight. There's a futures contract on feeder cattle (the source) as well as the finished, or fattened, cattle (live cattle, the product). Some spreads may pit competing products against one another. You could, for example, buy live cattle futures and sell live hog futures if you think beef demand will outstrip that of pork in the near term. Usually, but not always, intercommodity spreads involve the same delivery months (e.g., long December live cattle/short December live hogs). Different delivery months may be used, however, when there's not a match-up in the contracts' calendars or when specific pricing disparities have been pinpointed for exploitation.
- *Interexchange:* Buying May wheat on the Chicago Board of Trade while selling May wheat on the Minneapolis Grain Exchange is an

example of an interexchange spread. Most often, this kind of spread is used to profit from seasonal or other anticipated changes in the historic price relationship between the two types of wheat. These are also known as intermarket spreads.

To get a better idea of how a spread works, let's take a closer look at the July/October sugar trade. Let's assume you've noted that the spread (i.e., the price difference between July and October futures) doesn't seem to reflect full carrying charges. In other words, either the nearby July contract is trading too rich or the more distant October delivery is too cheap. You can exploit this mispricing by selling the overpriced futures and buying the underpriced contracts (see Table 2.5).

tick
an increment of change in the price of a security. For example, if the S&P 500 futures contract rises from 1,300.00 to 1,300.25, it has increased one tick because it moves in .25 increments and each 25-point change is one tick.

On April 3, you sell July sugar at 14.10 cents per pound and simultaneously buy October sugar at 14.15 cents per pound. In futures parlance, the spread now is *five under*. Whenever interdelivery spreads are discussed, the reference point is always the nearby contract. In this case, the nearby (July) is trading for five *ticks*, or 5/100 of a cent, under the deferred (October) delivery. Selling the nearby contract and buying the distant month, puts you in a *bear spread*. That means you expect the spread to widen and become more negative over time. Another way of putting this is to say you're *short the spread*. Notice the pattern: *short* nearby + long deferred = *short* the spread. Bear spreads are so named because nearby months typically fall faster than distant months when supplies are abundant and prices are soft.

TABLE 2.5 Bear Spread Specifics

Bearish July/October Sugar Trade

	Short 1 July Sugar	*Long 1 October Sugar*	*(Short) Spread*
April 3	14.10	14.15	–0.05
April 7	14.25	14.38	–0.13
	–0.15	**+0.23**	**+0.08**

During the life of the spread, it doesn't really matter whether sugar prices go up or down, though. As long as the price of the nearby option gets cheaper in relation to the deferred option by more than five ticks, a profit will be produced. That can happen whether sugar prices are at the 24-cent or the four-cent level.

bear spread
a type of strategy that generates profits as the price of the underlying asset falls.

Now fast-forward to April 7. July sugar is trading at $14.25. Covering your short position leaves you with a 15-tick loss. October sugar, meantime, has risen to $14.38. Selling that contract earns you a 23-tick gain. The net effect is an 8-tick profit as the result of the spread widening to 13 under.

Eight ticks translate to an $89.60 gain. Each tick is equal to $11.20 based on the contract size of 912,000 pounds per contract, which doesn't sound like much until you consider your margin investment. The exchange might have set $700 as an initial requirement for an outright position in sugar, but demanded only $210 for a spread. Thus, your bear spread made a 42.6 percent *return on margin* ($89.60 ÷ $210). Had you been outright long in the October contract instead, your gain would have been $257.60 (23 ticks), or 36.8 percent ($257.60 ÷ $700). Similarly, being outright short the July contract would have left you with a 15-tick, or 24 percent, loss.

return on margin
the percentage of profit or loss based on the amount of margin used to enter the trade. If margin is $2,000 and the profit is $200, the return on margin is 10 percent.

This begs the question: Which trade has the best reward-to-risk ratio? In this case, the bear spread turns out to be the obvious winner. That may not always be the case. When more dramatic market movements occur, spread returns can seem paltry compared to those of outright trades. An outright long position in the October delivery, for example, might have earned you an 85-tick, or 136 percent, return on margin if sugar rose to the 15-cent level.

bull spread
a type of trade that makes money when the price of the underlying security moves higher.

Now, if you saw the spread as too wide in April (i.e., it reflected more than normal carrying charges), you could have created a *bull spread* by purchasing the nearby (July) and selling the deferred (October) contracts. That would make you

Smart Trader Tip

While spread margins are lower than those of outright trades, a spread may be every bit as risky as a single-contract position.

long the spread. Aside from that, this spread is deemed bullish because any perceived tightness of supply, indicative of a bull market, would tend to cause nearby deliveries to rise faster than deferred months. The pattern for your account table would then be: *long* nearby + short deferred = *long* the spread (see Table 2.6).

Here, you're wagering that the spread will narrow (become less negative) as market equilibrium is restored to reflect normal carrying charges. A 15-tick gain on the spread's long (nearby) leg, netted against a 10-tick loss on the short (deferred) leg, leaves you five ticks, or $56, in the black.

full carry
the total costs associated with holding or maintaining a securities position. It is the full cost of carry, or the carrying cost.

A bull spread is generally considered a true limited-risk trade because a deferred month's premium over the nearby is ordinarily limited to *full carry*. While occasional aberrations may pop up, they're usually short-lived in a normal market.

Carrying charges, however, aren't reflected in an inverted market. When near-term supplies are hoarded, there's no limit to the premium nearby contracts can command over deferred deliveries. Bear spreads (short the nearby, long the deferred) would be especially risky trades in inverted markets, while bull spreads could profit handsomely.

TABLE 2.6 Bull Spread Specifics

Bullish July/October Sugar Spread

	Long 1 July Sugar	*Short 1 October Sugar*	*(Long) Spread*
April 3	14.10	14.25	–0.15
April 7	14.25	14.35	–0.10
	+0.15	**–0.10**	**+0.05**

Hedging

As mentioned before, speculators provide liquidity. Futures markets need to attract speculators, so hedgers—commercial entities that use the markets to manage risk—have somebody to take the other side of their trades.

A *hedge* is really nothing more than a substitute sale or purchase used to offset the risk of a cash market position. Think of wheat farmers. When wheat is planted, and all through the growing season, they are long cash wheat. They own it. They hope that the price they obtain at harvest pays back their production costs (seed, fertilizer, fuel, irrigation, etc.) and affords them a margin of profit. Until they can actually sell their crop, perhaps seven or eight months after planting, they are exposed to the risk of wheat prices falling below their target level. To hedge against falling prices, the farmers could short wheat in the futures market now as a proxy for their harvest transaction. That will lock in today's price, subject to shifts in the relationship between prices in the local cash market and the futures market.

hedge
a position that serves to mitigate the risk associated with holding another asset or investment.

The important thing to remember is that hedgers have *two* positions in a commodity—one in the cash market and one in futures. These positions are complementary; one is long, the other short. To the extent the positions are equal in size, gains made in one market tend to offset losses in the other, insulating the hedger from much of the commodity's price *volatility*.

volatility
measure of the magnitude or speed of price moves over time.

Let's assume a farmer decides to hedge part of his winter wheat production when the cash market price is $3.70. By selling one May futures contract (5,000 bushels), he attempts to lock in the current cash price for a portion of his crop. Table 2.7 shows how his hedge might look.

If our farmer was in a position to sell wheat in February, he could fetch $3.70 per bushel in his local market. But the wheat is still in the ground and can't be harvested until May. At this point, he's worried that crop forecasts might put downward pressure on prices. Selling futures now serves as a substitute for the cash market transaction he intends to make at harvest.