Chapter 1

The Ins and Outs of Trading Futures and Options

In This Chapter

- Trading futures and options versus traditional investing
- Finding out who's successful at trading futures and options
- Gathering your trading tools and know-how
- Checking out market analysis, short trades, and money management
- Discovering how fun trading can be

If you're one of those people who look at their mutual fund portfolios once a year and wonder how the results came about, futures trading isn't for you — at least until you make some changes in how you view the financial markets, your knowledge base, and in general, how the world works.

No, you don't have to live in a monastery and wear a virtual-reality helmet that plugs into the Internet, has satellite TV, and features real-time quotes and charts. You are, however, going to have to take the time to review your current investing philosophy and find out how futures trading can fit into your day-to-day scheme of things without ruining your family life and your nest egg.

Trading is not investing; it's speculating. *Speculating* is defined as assuming a business risk with the hope of profiting from market fluctuations. Successful speculating requires analyzing situations, predicting outcomes, and putting your money on the side of the trade on which way you think the market is going to go, up or down. Speculating also involves an appreciation of the fact that you can be wrong 70 percent of the time and still be a successful futures trader if you apply the correct techniques for analyzing trades, managing your money, and protecting your account.

Basically that means you have to chuck all your preconceptions about buy-and-hold investing, asset allocation, and essentially all the strategies that stock brokerages put out for public consumption.

And just so you don't call your brother-in-law the broker and get the publisher and me in trouble, what I mean is that buy-and-hold doesn't work in the futures markets. They're designed for trading.

Futures trading is risky business and requires active participation. It can be plied successfully only if you're serious about it and committed to it.

That means you must be able to develop your trading craft by constantly reviewing and modifying your plan and strategies.

To be a successful futures and options trader, you're going to have to become connected with the world through the Internet, television, and other news sources so you can be up-to-date and intimately knowledgeable with regard to world events. And I don't mean just picking up on what you get from occasionally watching the evening or headline news shows.

You're also going to have to spend some time and money setting up for this endeavor. You'll need a computer, trading program, and brokerage account of some sort, not to mention how much money you need or how well capitalized you have to be to be able to survive.

In essence, you must either make some changes, or your foray into trading futures and options will be nothing more than a quick endeavor.

Who Trades Futures and Options?

Aside from professional speculators and hedgers, whose numbers are many, the ranks of futures traders essentially are made up of people like you and me who are interested in making money in the markets — the wide variety of people who trade futures and options contracts at the retail level.

In his book *Starting Out in Futures Trading* (McGraw-Hill), author Mark Powers cites a study by the Chicago Mercantile Exchange (CME) that described the profile of a futures trader in the 1970s as a male between 35 and 55 years of age with middle- to upper-class income. The study indicated that

- Fifty-four percent were professionals, including doctors, lawyers, dentists, and white-collar workers, especially upper-management types.
- Sixty-eight percent were college graduates.
- Their overall tendency was toward short-term trading.

By 1999, *Futures Industry* magazine surveyed futures brokers regarding online futures trading. A summary of the results identified

- Some general tendencies but couldn't settle on a description for a typical online futures trader.
- Account sizes ranging from $14,000 to $30,000 at brokerages aimed at retail investors, with average transaction sizes within that group ranging from 1.6 to 5 contracts.
- Account sizes ranging from $40,000 to millions of dollars at brokerages with mostly institutional clienteles, with average transaction sizes within that group ranging from 17 contracts to even larger transactions.

The bottom line seems to be that to be able to trade futures and options, you need to have a certain amount of education and the necessary technological and financial means to get started.

Who Is a Successful Futures Trader?

Everyone knows that it helps to know a few things about the financial markets and that you need the ability to at least consider online trading and, of course, some finances to trade futures contracts.

But how do you become good at it? How do you manage to survive, even when you're not particularly good at it?

The answer is simple. You must have enough money and be able to develop a trading plan that enables you to keep making trades in the markets long enough to make enough money so you capitalize on your next big trade.

Simply put: If you don't have enough money, you won't last. And if you don't have a good trading plan, your money quickly disappears.

REMEMBER

Indeed, your success depends more than anything else on how you prepare yourself financially, intellectually, technologically, and personally through the development of a detailed and easy-to-implement trading plan.

What You Need to Trade

You need money, knowledge, patience, and technology to be able to trade futures and options contracts.

In terms of money, many experienced traders say that you need $100,000 to get started, but the figures from the previous section show that retail investors rarely have that much money in their accounts — at least as of 1999.

The truth is that there are many talented traders who have made fortunes after starting out with significantly less than $100,000. However, it would be irresponsible for me to lead you astray and give you the false impression, as some would, that the odds are very much in your favor if you start trading at a very low equity level.

The reality is that different people fare differently depending on their trading ability, at any level of experience. A trader with a million dollars in equity can lose large amounts just as easily as you and I with $10,000 worth of equity in our account.

My only point here is to make sure that you understand the risk involved and that you go into trading with realistic expectations.

If you don't have that much money and are not sure how to proceed, you need to either reconsider trading altogether, develop a stout trading plan and the discipline required to heed its tenets, or consider managed futures contracts. I discuss these topics in detail in Chapter 17. Would-be traders who have less than $30,000 should also consider the managed futures opportunities like the ones I tell you about in Chapter 17.

When it comes to technology, you need an efficient computer system that has enough memory to enable you to look at large numbers of data and run either multiple, fully loaded browsers or several monitors at the same time.

You also need a high-speed Internet connection. If you get serious about trading, you also need to consider having two modes of high-speed Internet access. For a home office, a full-time trader often has high-speed Internet through the cable television service and through DSL (digital subscriber line), with one or the other serving as a backup.

Trading Modalities

Trading futures and options contracts is truly a hybrid that lies somewhere between the types of trading that are separately based on technical analysis and fundamental analysis.

The fundamental side of trading (see Chapter 6 for all the details) involves your getting to know the following:

- The industry in which you're making trades
- Contract specifications
- Seasonal tendencies of the markets
- Important reports on which you need to keep an eye

The technical side of trading (at least that part that I concentrate on) focuses on what the market is doing in response to fundamentals. When you use technical analysis, you'll be looking at jargony-sounding things, such as trading volume, price charts, and open interest, and how they respond to factors like the global economy, interest rates, and politics — just a few influences on prices. To do that you need to have access to and be able to read charts and to know how to use indicators, such as trend lines, moving averages, and oscillators. (I show you how in Chapters 7, 8, and 20.) Without these instruments and indicators, your trading is likely to suffer significantly, because they help you to keep track of prices and guide you in choosing when and how best to place your trades — getting in and out of the markets.

To be sure, there are other approaches to technical analysis ranging from those listed in this book to rather esoteric techniques that are not mentioned, such as using astrology, or rather precise but not so commonly seen chart patterns. My goal here is to give you methods and examples that you can begin to see and use immediately. See Chapter 7 for more on technical analysis.

REMEMBER

It's always better to make money than to be right. The key is not what you think should happen, but rather what the market does in response to events and fundamental information and how you manage your trade. Success comes from letting winning positions go as long as possible and cutting losses short before they wipe you out.

Getting Used to Going Short

The concept of going short usually troubles stock investors. *Going short* means that you're trying to make money when prices fall. It involves borrowing a marketable asset from someone so you can sell it at a high price, wait for prices to fall, buy it back at the lower price, return the asset to the lender, and pocket the difference between what you sold it for and what you had to pay for it.

Although this may sound confusing, trading software simplifies the concept by giving you a button choice for short selling. Chapters 7 and 8 offer nice examples, including illustrations of what short selling is and when it's the correct strategy to follow.

In futures trading, every transaction involves a trader who's trading short and one who's trading long.

You can also bet on the market falling by using options called *put options.* These instruments let you decide whether you want to sell something at a predetermined price before a certain future date when the put option contract expires. For more about puts and their counterparts known as calls, turn to Chapters 4 and 5.

If this confuses you, you definitely need to read this book carefully before you consider trading futures contracts, or aggressively trading stocks, for that matter.

Managing Your Money

To be a successful trader, you must have a successful money management system that includes a minimum of these three components:

- **Having enough money to start:** You need enough money to get a good start and to keep trading. Undercapitalization is the major reason for failure. See "What You Need to Trade," earlier in this chapter.
- **Setting appropriate limits:** You need to set attainable limits on how much you'll risk, how you'll diversify your account, how much you're willing to lose, and when and how you take profits. Knowing your limits and sticking to them with regard to all these factors is important to successful trading. You'll get there by doing things like developing and regularly reviewing your trading plan, and using techniques such as placing stop-loss orders under your trades, to limit losses if you're wrong. See Chapters 17, 18, 19, and 20 for trading strategies.
- **Avoiding margin calls:** Margin calls will come if your account's equity falls below critical levels. Margin levels are different for each contract that you trade. A *margin call* is what happens when you hold a position that is falling in value beyond a limit set by the exchange. For example, if you were trading widgets with a margin set at $1,000, and your widget contracts fell below $1,000, your broker would call you and ask you for more money. If you can't put more money in the account, either by wiring it or by selling what's left of your widgets, the broker sells the widgets to raise the money, and your account is inactive until you raise the amount of money needed to meet future margins. Margin calls are explained in detail in Chapter 12.

Analyzing the Markets

One of the most important steps you can take toward being a good trader is developing a knack for analyzing the markets. That means you need to understand the technical and fundamental aspects of the market with respect to the underlying asset that you're trading.

The two basic ways for choosing what you'll trade are

- **Monitoring different markets to see which ones are moving or are likely to move.** Assuming that you have an understanding of the environment and the variables that move the markets, you can then trade them. The advantage to knowing these factors is that you're likely to have more activity in your account. The disadvantage is that when you're just getting started, you certainly won't be an expert in too many markets. Chapters 6 through 8 focus on technical and fundamental analyses of the economy, the futures markets, and basic speculating strategies.
- **Becoming an expert (on the technical and fundamental aspects) in at least one or two markets, and then trading them exclusively.** The advantage is that you get a good feeling for the subtleties of these markets and that your chances of success are likely to increase. The disadvantage is that you may have a good deal of dead time or dull stretches if the markets you choose don't move much. Chapters 10 through 16 cover the major mainstream futures markets in detail, including trading strategies.

Enjoying Your Trading Habit

I trade regularly, based on my time commitments to other activities and based on market conditions.

What I've discovered through years of trading, though, is that few times have I not enjoyed the process of analysis and decision-making that is involved in trading.

To me, trading is just about as good as it gets. Maybe it's something that's programmed into my DNA, personality, or mojo that just keeps me coming back.

As you progress through this and other books about trading futures and options, you'll discover whether your connection to the force (your karma) is good for trading.

Just remember that when you're ready to trade, you're going to be excited. That's okay, because the thrill of the hunt is one of the reasons everyone trades. However, you need to temper that excitement and hone it to your advantage. If you can manage the exhilaration of trading and turn it into an awareness of what is happening, you're likely to be more successful.

Welcome to one of the final frontiers left on the planet Earth.

REMEMBER

If you start trading and you're not enjoying it, you need to revise your trading plan or find another way to put your investment capital to work.