

**CHAPTER 1**

# Introduction to Futures and Options

*Understanding the Mechanics*

*Success is turning knowledge into positive action.*

*Thinking is easy, acting is difficult, and to put one's thoughts into action is the most difficult thing in the world.*

—Johann Wolfgang von Goethe

Goethe could have been referring to paper trading versus the act of actually trading when he wrote the phrase above. Trading is exactly that: putting your thoughts or convictions about a price move into action by entering an order and placing money at risk.

Investing is a totally different ball game. This book is about trading. The purpose of trading is to turn over or buy and sell (sell and buy) to build cash in an account by capitalizing on changes in price. It is not about acquiring and holding assets or property.

Futures trading is becoming more attractive than ever before as investors transfer their knowledge and trading skills from the stock market boom of the late 1990s to more active markets where the idea of creating wealth is still alive. As the equity markets became consumed by the bear market mentality liquidation phase, investors with knowledge of technical analysis and computer skills flocked to open futures accounts to trade e-mini S&P 500 and e-mini Nasdaq 100 index futures.

Stock market firms and brokers have developed futures divisions, and day-trading education experts have crawled out of the woodwork to teach investors the art of day trading those products. Some of the numerous quality instructors come with a very high tuition cost; others are not so expensive.

Most likely, learning about trading at a reasonable price is why you are reading this book. However, reading this book alone will not guarantee that you will succeed in trading. You need to read this book, practice its principles, and continue your trading education, realizing that the biggest obstacle in trading is what is between your left and right ears. I believe the techniques in this book are excellent strategies, and I hope you will apply and benefit from them. Teaching someone to become a successful trader and letting them experience the power of financial rewards is a satisfying and rewarding pursuit.

As investors look for markets beyond stocks or mutual funds in which to put their money, they will find a whole new world out there with different products to trade, among them futures. You may be among those investors who are afraid of and concerned about trading futures because of what you heard about them in the past. There are good reasons for being nervous about trading into any new market. But consider the scandals that have plagued Wall Street in the post-bubble era and may continue for some time. As history shows, there have been countless scandals on Wall Street in the past, and there almost certainly will be more in the future. So-called traditional investing in stocks is not immune to risk and has its own set of problems.

The question is: Will confidence in America's corporate leadership return sooner rather than later? Stock ownership is at the highest level per capita in America's history. More investors and private traders participate in the markets than ever before. In addition to stocks and mutual funds, there are a host of stock-related derivative products—exchange-traded funds such as QQQs, options such as the OEX, and many, many others including a relatively new and spectacular market development called single stock futures. The price direction of equities and all of these derivative instruments boils down to what will happen to the underlying forces of earnings and growth.

Here is a brief story that may shed light on Americans' changing viewpoint about investing. I was giving a seminar on the futures markets to an investment club. One older gentleman said his money was safe in the bank, and he wouldn't give his money to the stock market again.

I asked, "Why do you feel that way?"

He responded, "They are all crooks!"

"Well, if you think like that, why are you at a futures seminar?" I asked.

"I always thought they were risky, but now I want to learn for myself," he replied.

"Futures trading is risky," I agreed, "but what gave you the impression not to open a futures account before?"

"My stock broker told me not to trade commodities, that I would lose my shirt," he said. "So I kept buying the stocks he recommended, and, instead, I lost my shirt with him."

Not a happy story, but the amazing development is that the gentleman is getting back on the horse after falling off, this time getting his own education and finding out for himself whether futures are for him.

This book is designed for people like him and for the more experienced technical trader as well. If you had a similar experience, then keep reading and studying and you will continue to increase your knowledge and competence. With that, you will gain confidence. The more knowledge and information you have about a subject, the better you will become in dealing with it. As we all know, knowledge is power.

Every investor should know that trading is like riding an elevator. You get on if you want to go up and then get out once you are where you want to be. If you want to go up but then realize that you are going down instead, bail out. Get off the elevator and get back on another ride going up. Risk management and turnover are the keys to successful trading.

## **TRADING MENTALITY**

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Most new investors are not familiar with trading the short side of the market. I have listened to many novices say that they have a hard time comprehending how to sell something they do not even own. I always tell them that even if they buy a futures contract to go long, they are not going to own anything (except in rare instances where they may take actual delivery of some physical commodities).

All futures traders are doing is speculating on the direction of prices on a given product during a given time period. If they are right, they get rewarded; if they are wrong, of course, they get penalized. Remember the elevator analogy. If a building has 100 floors and you are on the 50th floor, you can play a guessing game to see if the elevator goes up or down and by how many floors. You can take the ride, but you don't have to own the elevator to do so.

The principle of trading is a very simple concept although we, as humans, tend to make it quite complicated, especially those who have a hard time comprehending selling short. Trading is just a matter of interested parties coming together and speculating whether the price of a specific commodity is going to go up or down. It is that simple.

Let's say Bill believes the price of commodity XYZ is going up, so he buys. A second trader, Pete, believes the price is going down, so he sells short. One could win, one could lose. Or, believe it or not, both Bill and Pete can be right and make money during the same day with their opposite positions. Similarly, both could also lose within the same trading day doing the exact opposite trade at the same time. It happens all the time. Volatility

is the reason. Get to know that term as well as *whipsaw*, *choppy*, *erratic market behavior*, and other terms used in connection with volatility.

The market's behavior reflects the emotional condition of those who are doing the trading. The market is the by-product of those who use it. Sometimes it seems like a jungle. It can be financially rewarding and exciting like discovering a wealth of mineral deposits in a hidden cavern behind thick brush. It can also be like enjoying the beauty and splendor of a sunset off the coast of Florida with the sun's light descending on the low clouds as palm trees sway in the breeze. But it can also provide some of the scariest and most financially dangerous adventures you will ever experience.

Trading will probably test your emotional strength and psyche. It will be the ultimate financial, emotional, and intellectual challenge you will ever encounter. Fear, doubt, complacency, greed, anxiety, excitement, false pride—all can interfere with rational and intellectual thoughts. It is those feelings that create the jungle, and you may need help to overcome that jungle of emotion. Conquer those feelings and you may find the holy grail of trading: a confident winning attitude.

Reading this book will give you the knowledge necessary to improve your life as a trader. You will be taught to take the emotion out of trading and to develop a method or trading plan. Remember, "Those who fail to plan, plan to fail." I have devoted a chapter to the mental aspect of trading (Chapter 11) because I believe about 80 percent of successful trading is based on emotional makeup. The way to increase your confidence and competence levels is through knowledge, and that comes from learning solutions to problems and then applying or executing what you learn.

## **HOLDING PENALTY**

As you learn different trading styles, remember this key concept: Futures are a trading vehicle and not—I repeat, not—a buy-and-hold, long-term investment platform. Do not try to dictate or get married to an idea about the direction you think the market should go. This approach can lead to financial donations to other traders' wealth, to an increase in your knowledge about your brokerage firm's money wire transaction process, and, worse yet, to getting wiped out.

You need to work at this business. You need to manage and maintain your positions and monitor price action. Game plans need to be established, and you will need to be flexible and quick to act. Access and communication to stay in touch with the market is important when you are trading.

Futures trading should be used to make money on a price movement. It should not be a personal vendetta, trying to prove that you are right in your opinion of what the market should do. That outlook is why there are all kinds

of clichés about taking profits. For instance, “A profit is a profit, no matter how small.” That is a great line, but let’s define “small profit.” Coming to this business to risk thousands of dollars to make a hundred dollars or so isn’t the way this trading environment should be used.

Another old saying describes someone who takes small profits and lets big losers ride: “Eating like a bird and crapping like an elephant.” That is the essence of a habit you don’t want. If this is a syndrome that you fall into, Chapter 11 offers exercises to help you work through it. If you catch yourself getting into that habit, stop trading. Try not to get used to taking small profits constantly and letting losses get large before taking them. You need to develop good discipline and strong emotional traits. Otherwise, fear of losing will hinder your performance.

Think about this: If trading were easy and such a sure thing, why would you have to sign all of those disclaimers about how dangerous it is when you fill out an account application at a brokerage firm?

So far I have mentioned buying, selling, winning, losing, and human emotions, and I have not yet covered a single aspect of technical analysis. This approach to the subject reflects my belief about what I consider the most important aspect of trading: your mental and emotional capacity.

## **GETTING TECHNICAL**

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Technical analysis is the study of a market’s price data, which is created by the emotions of the participants. Price reflects the current or anticipated value of a market from a supply and demand perspective. Price is the true and absolute reflection of value, as perceived by the various market participants at a particular point in time.

There are a number of different forms of analysis. This book will go into further detail on most aspects of technical analysis, but my focus is on market reversals incorporating pivot point analysis with other methods to nail down time and price predictions.

All traders have access to four common denominators: open, high, low, and closing price. How you analyze, interpret, and act on the information available is what gives you a trading style that differentiates you from other traders. Successful traders interpret correctly and act swiftly. There are five business days in every week and usually four weeks in every month. One day within a month will usually mark a price high, another day will generally mark a low, and the market will close somewhere between those points. Those facts define the monthly range. The successful trader does not consistently make a habit of buying the high of the range or selling the low of the range.

But before jumping ahead of ourselves into subjects covered later in the book, we need to review what the futures markets are all about. Seasoned

traders may be able to skip over the next sections, but those new to futures should read them carefully because they contain important concepts and terminology that make futures different from most other markets.

## GETTING INTO FUTURES

For futures traders, the choice of products varies from the traditional to the exciting new trading vehicles now available. Everyone can relate to many of these markets that you use every day, from energy products such as crude oil or natural gas to agricultural markets such as meats, grains, and the so-called softs (coffee, sugar, cocoa). Prices are dictated by supply and demand functions that often are affected by weather.

In addition to supply/demand influences, futures markets may provide a safe-haven security function. Precious metals such as gold may start to increase in price as investors on a global scale believe it is necessary to hold on to hard assets instead of paper assets in times of political tension or because they fear potential inflation resulting from the massive liquidity pumped into the global economy from 2001 through 2003. Financial instruments such as Treasury notes and bonds and currencies are also popular trading vehicles.

In short, diversified products in all of these areas are available to futures traders and provide advantages in liquidity and leverage. Many of these markets also offer direct electronic access to traders. As long as there are products subject to supply/demand and price fluctuations that carry an element of risk, there will be a role for futures in the business world.

## THE FUTURES INSTRUMENT

Many people, including traders, refer to commodities and futures as one and the same thing. To clarify that point first, the term *commodities* means an actual physical product such as corn, wheat, soybeans, cattle, gold, coffee, crude oil, cotton, and the like. The term *futures* refers to the instrument or the contract that is actually traded on these underlying products. Futures contracts have set standards for quantity, quality, financial requirements, and delivery points, if any (many futures contracts have cash-settlement provisions so there is no delivery).

As the years have passed, futures contracts have been developed for new “commodities” such as foreign currencies and a number of financial instruments including interest rate products such as Treasury bonds and notes, stock indexes such as the S&P 500 index and Dow Jones Industrial Average,

and, most recently, an innovative derivative product called single stock futures.

Unlike equities, where stocks are quoted in dollars per share, different commodities have different contract values and different point values. The table of contract specifications for major U.S. futures markets (Table 1.1) lists the symbols and sizes of various futures contracts. For example, the contract size for corn is 5,000 bushels. If the value of one bushel is, say, \$2.00, then the overall contract value is \$10,000. The full-size S&P 500 index futures contract has a value of \$250 times the index. If the index is at, say, 1,000, the value of the contract is \$250,000, considerably larger than the value of the corn contract.

Exchanges require a good-faith deposit—usually called *margin*, although it does not have the same meaning as margin in stocks—to play the game. For most futures contracts, you usually need to put up only 3 percent to 10 percent of the total contract value to trade. On the one hand, corn may have an initial margin requirement of \$500 to \$600—about 5 percent of the contract's value—with a maintenance margin of \$300. For that amount of money, you control 5,000 bushels of corn and can go long, speculating that prices will climb in the future, or sell short, speculating that the price will decline. The more volatile S&P contract, on the other hand, has a margin requirement closer to 7 percent or 8 percent or \$18,000 to \$20,000. The amount of money required to trade a contract may dictate what you trade if you have a small account.

It has been argued that physical commodity products will find a fair value or an absolute value when they reach certain lows based on historical price comparisons and will never go to zero due to laws of supply and demand (Economics 101). Unlike stocks, commodities do not declare bankruptcy or go out of business.

The reason futures will always have some value is because they do not exist solely for traders to bet on price movement. Producers and end users are also major participants in most futures markets as they use futures to reduce risk from adverse changes in price and to discover the current fair value for products they have to buy or sell to stay in business. Traders in this category are referred to as *commercials* or *hedgers*.

You probably are in a second group: the individual speculator trying to capitalize on price swings created by the up and down forces in the marketplace. You may be trading from your home as a business or on the trading floor or trading as a sideline.

A third category of futures traders includes the large speculators or fund managers who pool investors' money together. These are sometimes referred to collectively as the *commodity funds*.

One advantage of futures trading is that the government gives you an idea what each of these groups of traders is doing each week in the

**TABLE 1.1** Major U.S. Futures Contract Specifications

Symbol <sup>a</sup>	Futures Contract	Contract Size	Contract Months <sup>b</sup>	Exchange <sup>c</sup>
<b>Interest Rates</b>				
ED	Eurodollar, 90-day	\$1,000,000	H, M, U, Z	CME
TB	Treasury bills, 90-day	\$1,000,000	H, M, U, Z	CME
FF	Fed funds, 30-day	\$5,000,000	All months	CBOT
EM	Libor	\$3,000,000	All months	CME
TU	Treasury notes, 2-year	\$ 200,000	H, M, U, Z	CBOT
FV	Treasury notes, 5-year	\$ 100,000	H, M, U, Z	CBOT
TY	Treasury notes, 10-year	\$ 100,000	H, M, U, Z	CBOT
US	Treasury bonds, 30-year	\$ 100,000	H, M, U, Z	CBOT
MB	Municipal bonds	\$ 100,000	H, M, U, Z	CBOT
<b>Indexes</b>				
SP	S&P 500 Stock Index	\$250 × index	H, M, U, Z	CME
ES	E-Mini S&P 500 Index	\$ 50 × index	H, M, U, Z	CME
DJ	Dow Jones Industrial Avg.	\$ 10 × index	H, M, U, Z	CBOT
YJ	Mini-sized Dow	\$ 5 × index	H, M, U, Z	CBOT
YX	NYSE Composite Index	\$500 × index	H, M, U, Z	NYBOT
MV	Mini-Value Line Index	\$100 × index	H, M, U, Z	KCBOT
NK	Nikkei 225 Stock Avg.	\$ 5 × average	H, M, U, Z	CME
ER	Euro-top 100 Stock Index	\$100 × index	H, M, U, Z	NYMEX
FI	FT-SE 100 Stock Index	\$ 50 × index	H, M, U, Z	CME
MD	S&P Mid-Cap 400 Index	\$500 × index	H, M, U, Z	CME
CR	CRB Futures Index	\$500 × index	F, G, J, M, Q, X	NYBOT
GI	Goldman Sachs Com. Index	\$250 × index	All months	CME
<b>Currencies</b>				
AD	Australian dollar	100,000 AD	H, M, U, Z	CME
BP	British pound	62,500 BP	H, M, U, Z	CME
CD	Canadian dollar	100,000 CD	H, M, U, Z	CME
EC	Euro currency	125,000 Euros	H, M, U, Z	CME
FR	French franc	500,000 FF	H, M, U, Z	CME
JY	Japanese yen	12,500,000 JY	H, M, U, Z	CME
MP	Mexican peso	500,000 MP	H, M, U, Z	CME
SF	Swiss franc	125,000 SF	H, M, U, Z	CME
DX	U.S. Dollar Index	\$100 × index	H, M, U, Z	NYBOT
<b>Metals</b>				
GC	Gold	100 troy oz.	All months	NYMEX
SI	Silver	5,000 troy oz.	All months	NYMEX
HG	Copper	25,000 lbs.	All months	NYMEX
PL	Platinum	50 troy oz.	All months	NYMEX
PA	Palladium	100 troy oz.	All months	NYMEX
AL	Aluminum	44,000 lb.	All months	NYMEX
YG	Gold	33.2 troy oz.	All months	CBOT
YI	Silver	1,000 troy oz.	All months	CBOT

**TABLE 1.1** Continued

Symbol <sup>a</sup>	Futures Contract	Contract Size	Contract Months <sup>b</sup>	Exchange <sup>c</sup>
<b>Energy</b>				
CL	Crude oil	1,000 bbl.	All months	NYMEX
HO	Heating oil	42,000 gal.	All months	NYMEX
HU	Unleaded gasoline	42,000 gal.	All months	NYMEX
NG	Natural gas	10,000 MBTU	All months	NYMEX
<b>Grains</b>				
C	Corn	5,000 bu.	H, K, N, U, Z	CBOT
W	Wheat, soft winter	5,000 bu.	H, K, N, U, Z	CBOT
S	Soybeans	5,000 bu.	F, H, K, N, Q, U, X	CBOT
BO	Soybean oil	60,000 lb.	F, H, K, N, Q, U, V, Z	CBOT
SM	Soybean meal	100 tons	F, H, K, N, Q, U, V, Z	CBOT
O	Oats	5,000 bu.	H, K, N, U, Z	CBOT
KW	Wheat, hard red winter	5,000 bu.	H, K, N, U, Z	KCBOT
MW	Wheat, spring	5,000 bu.	H, K, N, U, Z	MGE
<b>Meats</b>				
LC	Live cattle	40,000 lb.	G, J, M, Q, V, Z	CME
FC	Feeder cattle	50,000 lb.	F, H, J, K, Q, U, V, X	CME
LH	Lean hogs	40,000 lb.	G, J, M, N, Q, V, Z	CME
PB	Frozen pork bellies	40,000 lb.	G, H, K, N, Q	CME
<b>Foods, Other</b>				
KC	Coffee "C"	37,500 lb.	H, K, N, U, Z	NYBOT
SB	Sugar #11 (world)	112,000 lb.	F, H, K, N, V	NYBOT
CO	Cocoa	10 metric tons	H, K, N, U, Z	NYBOT
CT	Cotton	50,000 lb.	All months	NYBOT
OJ	Frozen orange juice	15,000 lb.	F, H, K, N, U, X	NYBOT
LB	Lumber, random length	110,000 bd. ft.	F, H, K, N, U, X	CME

<sup>a</sup>Exchange symbols; data vendors may use other symbols.<sup>b</sup>Contract months:

F = January	N = July
G = February	Q = August
H = March	U = September
J = April	V = October
K = May	X = November
M = June	Z = December

<sup>c</sup>Exchange abbreviations:

CBOT	= Chicago Board of Trade
CME	= Chicago Mercantile Exchange
KCBOT	= Kansas City Board of Trade
MGE	= Minneapolis Grain Exchange
NYBOT	= New York Board of Trade
NYMEX	= New York Mercantile Exchange

Commodity Futures Trading Commission's *Commitments of Traders* report. I cover this subject in more detail later in the book, but the report is sort of like getting the inside scoop on who is doing what—like a delayed report on legalized insider trading.

## EXCHANGE FUNCTION

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Exchanges provide the contracts and the facility (trading pit or computer) where buyers and sellers can come together to trade, all monitored carefully by the exchange under the oversight of federal regulators to preserve the integrity of the market. Futures exchanges make a major point of providing a level playing field for all participants and ensuring that the integrity and financial soundness of the marketplace remains intact. After all, if you have a winning trade and want to take your profits, you need to trust that the money you earned and deserve will be available. The futures industry is built on the principle of integrity.

A few years ago the Chicago Board of Trade celebrated its 150th anniversary. Originally established as a centralized marketplace for grain trading, it has become known for its financial products and is one of the highest volume exchanges in the world. The Chicago Mercantile Exchange, also mostly known today for its financial products, and the New York futures exchanges also trace their roots to the 19th century. So futures markets have been around for a long time and will continue to exist in the future.

Just as the Chicago Mercantile Exchange moved from trading eggs and butter to products such as currencies, the Eurodollar, and stock indexes, exchanges are constantly evolving to meet the changing needs of consumers and producers, adding new and exciting trading vehicles to the futures industry. For example, milk producers saw a need to hedge their risk against often-volatile price movement in the cash market as values move from an extreme low to an extreme high. The Chicago Mercantile Exchange recognized the dairy industry's needs and created a marketplace for participants to hedge their production or purchase needs. Major corporations such as Kraft Foods can now use futures to hedge against losses in the cash market.

## DIGGING INTO FUTURES

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Futures have a number of features that require more attention, beginning with the concept of margin. As previously mentioned, margin in futures is really a security deposit or performance bond.

Typically, only a small fraction of the contract value (usually 3–10 percent) is required as a security deposit. With such a small deposit, it takes only a small price move to produce a big percentage return, providing the power of leverage for which futures are known.

Exchanges set the minimum performance bond requirements for each contract and can change those requirements without notice, depending on market conditions. Brokerage firms may increase the amount of money required beyond what the exchange has set if additional protection is deemed necessary. Sometimes this is done if volatility or price swings are larger than normal and the firm believes clients are at more risk than usual. For example, if the Federal Reserve makes a sudden interest rate adjustment, the market may panic, causing wild price moves. These volatile price fluctuations may be the basis for a decision that the amount of money required to trade should go up (or down) significantly at a moment's notice.

Although brokerage firms can require more than a minimum performance bond, they cannot lower the amount below the minimum requirements that the exchanges have set. Most trading firms post their margin requirements on their web sites. For exact updates, you can always contact the exchanges for quick access to current information.

The current system used in the industry is known as SPAN margining—Standard Portfolio Analysis of Risk System, developed by the Chicago Mercantile Exchange in 1988. Basically, it is a computer-generated calculation that takes into account a trader's total position to help determine the risk associated with that position. This position could include strictly futures or could involve an intricate options and futures strategy.

Margin and leverage give futures an advantage over other investment instruments, but it is also a two-edge sword. During an adverse price move against your position, the concept of leverage can turn into a bad situation as losses can grow exponentially. Overleveraged positions and undercapitalized investors do get blown out, that is, positions and accounts can be liquidated with large losses and sometimes can leave large debits. However, traders do have control over leverage. By simply adding funds to the account to match the full value of the contracts you are trading, you can set up a situation where you no longer have investment leverage.

Within the system of margin, you should be familiar with two terms: initial margin and maintenance margin. *Initial margin* is the amount of money you must have in your account to establish a futures position. If the market moves against your position and the amount in your account drops below the *maintenance margin*, you will get a *margin call* and must replenish your account to the initial margin level immediately to maintain your position.

We can illustrate the margin system using coffee futures. With coffee futures trading around 60–65 cents a pound in 2003, the New York Board of

Trade's initial margin requirement was about \$1,700 and the maintenance margin was \$1,200. Based on a contract of 37,500 pounds and a price of 60 cents a pound, the total contract value was \$22,500, putting the initial margin at about 7.5 percent of the contract's value. If the price of coffee futures goes up just 2 cents a pound, you have a gain of \$750 or a return of about 44 percent on your initial margin money. However, if the price of coffee drops 2 cents a pound—not an unusual occurrence—you have a loss of \$750 or 44 percent.

Some traders think they are required to have \$1,700 plus \$1,200 or a total of \$2,900 in their account to trade one coffee futures position. This is not so. The rules of margin are that you need at least \$1,700 in your account to enter a coffee position. If your account balance drops below \$1,200 at any time, as it would with a 2-cent price decline, then you may receive a request to send in more money to get your account balance back to the original \$1,700 level.

When a margin call is generated, it is advisable to discuss the situation with your broker/trading advisor. From a regulatory standpoint, margin calls must be discussed with the client and met as soon as possible. Generally, clients are given a reasonable time to meet a margin call, depending on the amount of money involved and the nature of the situation. Brokerage firms have the right and the obligation to ensure the financial integrity of the marketplace and, therefore, may liquidate your positions to ensure that your account is restored to the proper margin requirements. Thus, it is important to stay in tune with the markets and in touch with your broker when you are holding positions.

There are two other ways to meet a margin call: (1) You may liquidate the position at a loss or (2) the market may make a reversal, trading back in your favor and taking you off margin call status.

The open trade equity in your account is credited or debited each day as the settlement price fluctuates. This futures industry practice is called *marked to market*. Traders often do not regard a setback as a loss until they are out of the market, and they are only looking at a so-called paper profit until they close out a winning position. It is a good idea to have excess capital in your account beyond what is required. I recommend having at least 50 percent more than the initial margin requirement for each position you plan to take as a longer-term trade. For day traders, maintenance margin is sufficient.

Futures contracts often involve large quantities of product with a fraction of the total contract value needed as a good-faith deposit. Not many people have \$200,000 in cash to purchase a home, so they apply for a mortgage and put 3 percent to maybe 20 percent down. But buying a home and trading futures aren't the same because of the leverage factor, and that is why options have become extremely popular since the early 1990s.

Investors who buy options have a right, but not an obligation, to fulfill the terms of an options contract at a specific strike price. They can buy calls to take advantage of price increases or buy puts to take advantage of price decreases. The risk in buying options is limited to the initial premium paid to acquire the option plus the commission and transaction fees associated with the transaction; that means no margin calls in the event of a short-term adverse price move. Simply stated, option buyers can enjoy staying power and a predetermined risk level.

However, buying options is limited to a certain time period, and if the market does not move enough in your direction in that prescribed period of time, your entire premium or investment will be lost.

Chapter 13 is devoted to a comprehensive description of trading in options and the logical approach for understanding the terms and uses of different strategies.

## **CONTRACT SPECIFICATIONS**

In addition to the margin/security deposit difference, futures contracts have several other features that make them different from equities, as Table 1.1 indicates. Futures come in different contract sizes and expire in specific months. Equities all are priced on a uniform per-share basis, and they do not expire (although a company may go out of business, which could cause your investment to “expire”). Stocks may also have splits and reverse splits, and some even pay dividends.

With equities, you can maintain a long-term position indefinitely. With futures, you can also have a long-term position, but that will require that you roll over from one contract to the next, liquidating your holding in an expiring contract and establishing a new position in a contract month that is further away.

Novice traders and even traders coming off an exchange floor to trade from a computer need to realize that different futures markets trade in different contract months, at different times of the day, and at different exchanges. In stocks, you have one symbol for Intel (INTC) or IBM (IBM) or every other individual stock. In futures, a June contract for Japanese yen is not the same as a September Japanese yen contract, for example, and they have different symbols.

First, you need to know the symbol for the market you want to trade—CL for crude oil, for example. Most quote vendors use the same symbols as they are pretty much a universal language in the futures industry. However, some vendors use the symbol CC instead of CO for cocoa or SU instead of SB for sugar. The mini-sized Dow contract may be YJ, YM, ZJ, or some other

symbol specific to a data service or brokerage firm. Most applications have a menu of symbols so you can look up the quotes or charts you want.

Second, you need to know the symbols for each month. This can be somewhat confusing, especially to newcomers. The list of symbols for each contract month is shown at the bottom of Table 1.1. Notice that March is the only month that even contains the month's symbol, H, as a letter in the name of the contract month. The trickiness in properly identifying a futures contract is one reason new traders find futures trading more complicated than equity trading.

It can lead to a hazardous situation when you are rolling out of a contract that has been trading for a while and switching to a new one. For example, if you have been trading a June contract and have to shift to the September contract as the June contract expires, you may still be in the habit of using June. When placing orders, a slip in identifying a contract can create problems and cost you money. Placing an order for a June contract when you really mean to trade the September contract can easily happen in futures trading if you get careless. There is a window of time when the June contract will still be trading but not actively as most of the trading activity shifts into the next month. For commodities, that time period is between the first notice day and the last trading day for a contract. Orders will still be accepted for the expiring month in that time frame, and it will be up to you to cover your error if your order gets you into the wrong contract month. (Note: The trading tactics section in Chapter 12 provides a technique that some big traders and floor professionals use as first notice day approaches. It may benefit you to be aware of the first notice day trick.)

Third, you may need to know the exchange where the contract you want is traded. Although a number of futures markets are traded on only one exchange, some are traded at several exchanges. For example, if you want to trade hard red winter wheat, you have to specify the wheat contract traded at the Kansas City Board of Trade, not the wheat contracts traded in Chicago or Minneapolis.

Fourth, you may need to be specific about the time of day you want to trade or the size of the contract you want to trade. Table 1.1 does not show all the symbols differentiating between the day session's regular trading hours and the electronic or after-hours night sessions. Nor are the symbols given for most of the mini-sized electronic products traded at the Chicago Mercantile Exchange and the Chicago Board of Trade.

## **ELECTRONIC ERA**

More than 70 percent of all futures markets now trade around the clock, including agricultural markets that once were traded only in the pits of an ex-

change during a relatively short daily session. Orders can be placed electronically on most companies' online trading platforms, although many firms do not accept open orders and contingency orders for some markets. Chapter 10 explains the order process and contingency orders. It is also advisable to check with your trading firm regularly regarding any changes in trading hours and to see which orders are acceptable.

The electronic product that started it all for the futures industry came from the Chicago Mercantile Exchange, as you might expect, when it developed Globex and launched trading in the e-mini S&P 500 and Nasdaq 100 index futures contracts. These contracts have been particularly attractive to former investors in the stock market and are now among the most actively traded futures contracts.

The Chicago Board of Trade launched a mini-sized contract based on the Dow Jones Industrial Average in April 2002, and its popularity accelerated in 2003, reaching a daily volume of more than 60,000 contracts a year later. The contract has several key features that make it an attractive trading vehicle:

- A 100 percent electronic market with 24-hour access.
- Lower margin than other stock index futures in dollars and as a percentage of contract value (\$2,700 versus \$3,563 for the e-mini S&P in the middle of 2003).
- Simpler calculating and tracking components as the Dow only has 30 underlying stocks to monitor.
- For those with blue-chip stock portfolios, easier hedging by being able to go short the Dow as easily as going long. Dow futures correlate closely with the underlying Dow Jones Industrial Average.
- More spreading opportunities because the mini-sized Dow can be traded against individual single stock futures, Diamonds or S&P 500, Nasdaq 100, or other index futures.
- Smaller minimum price fluctuations. Each point or tick in the mini-sized Dow is \$5. Each point in the e-mini S&P is \$50, with the minimum tick size a quarter of a point or \$12.50. The two contracts trade in about a 10-to-1 relationship—a 10-point move in the e-mini S&P and a 100-point move in the mini-sized Dow are each worth \$500. A move of that size would equate to an 18.52 percent gain for the mini-sized Dow versus a 14 percent gain for the e-mini S&P, using the margin amounts previously mentioned.

Perhaps the biggest attraction of the mini-sized Dow is that it is based on the best-known U.S. stock market barometer, which is more than a century old and recognized around the world. When you ask how the stock market did today, most people think of the Dow.

## **INVESTMENT REVOLUTION?**

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Next to the electronically traded stock index contracts, probably the most exciting new futures market area is single stock futures (SSF). SSFs were launched on two new U.S. exchanges on November 8, 2002, after a two-decade moratorium on that type of contract. They had been trading on foreign exchanges with moderate success for some time but had been banned in the United States by an agreement that allowed trading to begin in stock index futures in 1982. The realization that the United States might lose out on market share to foreign competitors in a potential major new market was high on the list of factors that prompted politicians and regulators at the Securities and Exchange Commission and Commodity Futures Trading Commission to finally resolve jurisdictional issues to allow trading in SSFs.

SSFs are an innovative product and could change the way the world invests on Wall Street in the future. Investors who have limited their investments to the stock market especially may benefit from this new market. Imagine having the leverage to trade 100 shares of a popular stock for only a 20 percent margin requirement and not having to pay a stock firm the broker loan rate to sell a stock short (if they can loan it to you at all). Assume, for example, that Microsoft is priced at \$25 per share. The futures contract size is 100 shares so the contract value is \$2,500. With an initial margin requirement of 20 percent of the value of the contract, you have to put up only \$500 to either buy or sell Microsoft futures instead of \$1,250 it would take to buy 100 shares of Microsoft shares at the minimum margin rate in the stock market.

With SSFs you can open a futures trading account, buy a cash Treasury bill, and trade a broad range of markets beyond SSFs while earning interest instead of paying interest. The best part is being able to go long or short without prejudice and having access to the market by trading from your computer at home or work. These developments may not make broker-dealers happy but are good news for individual traders.

## **BULL MARKET FOR FUTURES**

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These stock-related trading vehicles reinforce my optimism about the popularity of futures trading, not only in the United States but also around the globe as people attempt to increase their wealth and raise their standard of living. I believe the explosive growth in futures has come out of the dismal losses many investors suffered during the great bear market in equities since the peak in 2000.

Investors are now becoming more educated and open to other opportunities rather than limiting themselves to recommendations from their stock-

broker or investment advisor. The story earlier in this chapter about the gentleman who never traded futures because his stockbroker said he would lose his shirt is a testimonial to the fact that more and more investors—most likely, people just like you—want to learn more.

Here is another example. I gave a seminar presentation in August 2002 to the Chicago chapter of the Cornerstone Investors Group, speaking to about 70 people. I asked how many folks in the audience were trading futures. I believe about three people raised their hands, and I think two were clients of mine.

The president of the group, Mark Anderson, invited me back in April 2003, reminding me that I said to his group in 2002, “If the balance of you are not trading futures, then you will be sooner or later.” Just eight months after that 2002 seminar, I asked the same question at the April seminar, which had about 85 people. First, the investment club membership had grown and, second, it seemed like almost everyone raised their hands. I was shocked!

What happened here? Well, this investor group had started to learn and discovered the benefits of trading futures and how to apply technical analysis to the markets. They were taking control of their own financial destiny.

A whole lot of people are now interested in the futures markets and not just from the town of Schaumburg, Illinois, or in Tampa Bay, Florida, where the Cornerstone group was founded. The reach of traders wanting to learn this form of derivative trading stretches to Ireland, England, Europe, Asia, Australia—worldwide. I hope this book helps to keep you focused and financially prepared for the years ahead and helps you with the process of continually learning the ebb and flow of the markets.

