

# FUTURES 101

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**Futures and options trading involves the substantial risk of loss and is not suitable for all investors. Each investor must consider whether this is a suitable investment since you may lose all of or more than your initial investment. Past performance is not indicative of future results.**

## Introduction

What determines the price of a commodity? The answer is supply and demand. If there is a large supply, and/or a lack of demand, the price of a commodity is inevitably pushed down. Alternatively, if there are few supplies available, and/or these supplies are in demand, the price of the commodity will rise. Therefore, we can see that the market mechanism for rationing supply is price. When prices are high, end users are discouraged to use a commodity, which adds to supply. When prices are low, consumers are encouraged to use the commodity, thus tightening supply. Price will then act as a stimulus for supply. High prices encourage producers to take advantage of generating more profits and supply by increasing production. Low prices cut into profit margins, inevitably leading to decreased production. The price of a commodity typically does two things: One, the price tends to move much more than traders can imagine; two, the price tends to stay at these levels longer than traders would anticipate. These price exaggerations are what hedgers attempt to protect against and what speculators look to profit from. The ability to understand the rationality of these price movements allows commodity traders to become successful.

## Futures contracts

A futures contract is a legally binding agreement to buy or sell a commodity or financial instrument sometime in the future at a price agreed upon at the time of the trade. While actual physical delivery of the underlying commodity seldom takes place, futures contracts are nonetheless standardized according to the delivery specifications: quality, quantity, time and location. The only variable is price, which is discovered through the trading process.

**Example:** When a trader purchases a December corn contract, he is agreeing to purchase 5,000 bushels of corn for delivery during the month of December. The quality of the product is standardized so that all December corn futures contracts represent the same underlying product.

These contracts are transferable and traded on regulated exchanges. The risk to the holder is unlimited, and because the payoff pattern is symmetrical, the risk to the seller is unlimited as well. Futures contracts are forward contracts, meaning they represent a pledge to make a certain transaction in the future. The exchange of assets doesn't occur until the date specified in the contract. Futures are distinguished from generic forward contracts in that they contain standardized terms, trade on a formal exchange, are regulated by overseeing agencies, and are guaranteed by a clearinghouse. Also, in order to insure that payment will occur, futures have a margin requirement that must be settled daily. Finally, making an offsetting trade, taking delivery of goods, or arranging for an exchange of goods can close futures contracts. Hedgers primarily trade futures with the intention of keeping price risk in check.

## Options

An option is a contract that gives the buyer the right, but not the obligation, to buy or sell a particular futures contract at a fixed price for a specific period of time. The contract also obligates the seller to meet the terms of delivery if the buyer exercises the contract right.

**Example:** When someone buys a call option for corn futures, they are buying the right to purchase that underlying corn futures contract at a specific price (strike price) at a future point in time (expiration date). When a trader buys a corn put, they have the right to sell the underlying corn futures contract.

Buyers of calls and puts receive these rights in return for paying the premium. Option buyers have a limited and known loss potential – the amount of premium paid. Due to the rights an option buyer has, their profit potential is virtually unlimited. On the other hand, speculators can also sell, or “write,” calls and puts. If the contract is exercised, the option “writer” is obligated to take the specified position in the underlying futures contract. In return for these obligations, the option seller receives the premium. The maximum profit for an option writer is limited to the value of the premium received, while the maximum loss is unlimited. Most traders that sell options will usually have other positions to offset the risk of their short option position.

## Position: Long or Short

With futures, the trader can profit under a number of different circumstances. When the trader initially purchases a futures contract he is said to be “long,” and will profit when the market moves higher. When a trader initially sells a futures contract he is said to be “short” and will profit when the market moves lower. Going short in a futures market is much easier than going short in other markets. Other markets sometimes require the trader to actually own the item he is shorting, while this is not the case with futures. Like most other markets, a profit is obtained if you initially buy low and later sell high or initially sell high and later buy low. See “short” for more information.

## Margin

“Margin” is an amount of money that a trader must keep in their account for each position held in the account. Different futures contracts have different margin requirements that are set by the commodity exchanges. Margin levels are a function of contract size and price volatility. Initial margin is simply the minimum amount of money a trader must have in their account (at the close of trading) on the first day they establish a new position. Maintenance margin is simply the minimum amount of money a trader must have in their account after the first day, which is less than the initial margin. In order to place a trade, the trading account will need sufficient funds to cover the initial margin the first day a trade is placed. Each day thereafter, there must be a minimum of funds equal to or above the maintenance requirement or the account will be subject to a margin call.

### **Settlement at Expiration**

Expiration is the time when the final price of the future is determined. Settlement is the act of completing the contract, and can be done in one of two ways, as specified per type of futures contract. The first, physical delivery, occurs when the specific quantity of the underlying commodity is delivered by the contract seller to the exchange, and then by the exchange to the buyer of the contract. In reality, this only occurs with a few contracts. Most are cancelled out by purchasing a covering position - that is, buying a contract to cancel out an earlier sale (covering a short), or selling a contract to liquidate an earlier purchase (covering a long). The second, cash settlement, occurs when a cash transaction is made based on the underlying reference price, such as a cash index or the closing value of a futures contract. When cash settled, the account is credited or debited the difference between the position price and the settled index price.

### **Delivery**

Traders sometimes joke about having a truckload of corn dumped in their front yard as a result of a futures trade. While the potential for delivery is vital to linking cash and futures prices, in reality, very few futures trades result in delivery. As a result of the formal delivery process and facilities, a trader should not have to worry about actually taking delivery of corn. Delivery on a futures position begins on the first business day of the contract month. Typically, the oldest outstanding long is selected to match a short's intention to deliver. Some futures contracts have a cash-settlement process rather than physical delivery. For instance, if a trader holds a position in the Dow futures contract until expiration, they would simply receive (or pay) the final gains (or losses) on the contract based on the difference between the entry price and final settlement price.

While most futures traders offset their positions, if a futures contract is not offset, the trader must be ready to accept delivery of the underlying commodity. Futures contracts for most physical commodities, such as grains, require market participants holding contracts at expiration to either make or take delivery of the underlying contract. It is this responsibility that forces futures prices to reflect the actual cash value of the commodity.

### **Volume and Open Interest**

Next to price, volume is the most frequently cited statistic in reference to a futures contract's trading activity. Each unit of volume represents one contract traded. When a trader buys a contract and another trader sells the same contract, that transaction is recorded as one contract being traded. Therefore, the volume is the total number of long or short positions. On the other hand, open interest, refers to the number of futures positions that have not been closed by either offsetting the position or taking delivery. In other words, total open interest equals the total number of long OR short futures contracts that remain open, or not liquidated, at the close of each trading session.

To illustrate, assume that a trader buys 15 contracts and then sells 10 of them back to the market before the end of the trading day. His trades add 25 contracts to the day's total volume. Since 5 of the contracts were not offset, open interest would increase by 5 contracts as a result of his activity.

Volume and open interest are reported daily and are used by traders to determine the participation in markets and the validity of price movements. For instance, if a market moves higher on low volume, some traders may not consider this an important price movement. However, the same price movement on high volume would indicate that an important trend might be emerging. Combining volume and open interest also yields an interesting perspective on the market. If a contract experiences relatively low volume levels but high open interest, it is generally assumed that commercial participation is high. This is because commercial hedgers tend to use the markets for longer-term hedging purposes, putting their trades in and keeping them until they're no longer needed to manage a given price risk. Conversely, high volume with low open interest may indicate more speculative market activity. This is because the majority of speculators prefer to get in and out of the market on a daily basis.

### **Leverage**

One of the advantages of trading futures is the ability to use financial leverage. Leverage is the ability of a trader to control large dollar amounts of a commodity with a comparatively small amount of capital. As such, leverage magnifies both gains and losses in the futures markets.

For example, if a trader buys one soybean contract (5,000 bushels) at \$7.00 per bushel (\$35,000 per contract), the required amount to trade, known as "margin," might be approximately \$1,500 (approximately 4 percent of the contract value), or about 28 cents per bushel. So, for \$1,500 the trader can purchase a contract that has a delivery value of \$35,000. The benefit of leverage is available because of the margin concept. When you buy a stock, the amount of money required is equal to the price of the stock. However, unlike trading a stock, a futures contract transaction requires both the buyer and seller to post a performance bond margin. To provide another example, the margin required for a T-bond contract worth \$100,000 may be as little as \$1,800. As you can see, minimum margin requirements represent a very small percentage of a contract's total value.

To trade a futures contract, the amount a trader must deposit in their account is called initial margin. For example, assume a trader bought 1 corn futures contract (5,000 bushels) at a price of \$3.00 per bushel and posted initial margin. At the end of the trading day, the market closed at \$3.05, resulting in a gain of 5 cents per bushel or a total of \$250 (5,000 bushels x \$.05). This amount will then be credited to that account and is available for withdrawal. Losses, on the other hand, will be debited. This process is called marked-to-market. After posting initial margin, a trader must maintain a minimum margin level called maintenance margin. If debits from market losses reduce this account below the maintenance margin level, a trader will be asked to deposit enough funds to bring their account back up to the initial margin level. This request for additional funds is known as a margin call.

Because margins represent a very small portion of a traders total market exposure; futures positions are considered highly leveraged. Such "leverage," the ability to trade contracts with large underlying values, is one reason profits and losses in futures can be greater than trading the underlying cash contract. This can be an attractive feature of futures trading because little capital is required to control large positions. At the same time, a bad trade can accrue losses very quickly. In fact, a trader can lose more than their initial margin when trading futures. This is why successful traders must develop a good trading plan that defines risk while possessing the discipline to follow that plan.



## **Liquidity**

Liquidity is a characteristic of a market to handle large transactions without a significant change in the price. Liquid markets easily match a buyer with a seller, enabling traders to quickly transact their business at a fair price. Some traders often compare liquidity with trading volume, concluding that only markets with the highest actual number of contracts traded are the most liquid. However, for some contracts, the exchange has a market maker system in place to promote liquidity. For contracts with a market maker, a trader or firm designated as the market maker then makes two-sided markets (both bids and offers) for a specific quantity.

## **Transparency**

Many futures markets are considered to be “transparent” because the order flow is open and fair. Everyone has an equal opportunity for the trade. When an order enters the marketplace, the order fills at the best price for the customer, regardless of the size of the order. With the advent of electronic trading, transparency has reached new heights as all transactions can be viewed online, in real time. In a very general sense, transparency makes all market participants equal in terms of market access.

## **Types of Traders**

Traders play a vital role in the futures markets by providing liquidity. While futures are designed primarily to assist hedgers in managing their exposure to price risk, the market would not be possible without the participation of traders, or speculators, who provide a fluid market of buyers and sellers. Speculators provide the bulk of market liquidity, which allows the hedger to enter and exit the market in a more efficient manner. In summary, the two main categories of traders are hedgers and speculators. Hedgers are those who use the futures market to manage price risk. On the other hand, speculators, are those who use the futures market for the profit motive. As such, the speculator assumes a market risk for the potential opportunity to earn a profit. Futures traders can also be categorized in a number of other ways. There are full-time professional traders, part-time traders, individual traders who trade on the trading floor. Each of these market participants plays an important role in making the markets efficient places to conduct business.

## **Retail Traders**

The vast majority of speculators are individuals trading off the floor with private funds. This diverse group is generally referred to as the “small speculator.” With the growing movement from trading on the floor to the computer screen, the small speculator is becoming more of a force in futures trading. Also, with computer-based trading, leveling the playing field between the different types of traders has become a reality.



### **Local Traders**

Perhaps the most visible and colorful speculator is the professional floor trader. Also referred to as locals, the floor trader trades for his/her own account on the floor of an exchange. Locals are usually more interested in the market activity in the trading pit as opposed to the market activity in the underlying market fundamentals. With the popularity of electronic trading sweeping the industry, a trader who operates in a fashion similar to a floor local has emerged—the “electronic local.” An electronic local will trade using the same method as the local except they do so through the internet and a computer rather than in the trading pits.

### **Proprietary Traders**

A trader who works off the floor for a professional trading firm is known as a proprietary trader. These “upstairs” traders are employees of large investment firms, commercial banks, and trading houses typically located in major financial centers. This group has a number of different trading objectives. Some engage in speculative trading activity, profiting when the market moves in their direction. Such proprietary traders are compensated according to the profits they generate. Other proprietary traders manage risk, hedging or spreading between different markets—both cash and futures. They do so in order to insulate their business from the risk of price fluctuation as well as to exploit the differences and momentary inefficiencies in market-to-market pricing.

### **Market Makers**

Market makers give liquidity to the market, constantly providing both a bid (price to buy) and an offer (price to sell). Increasingly important in electronic markets, market makers ensure that traders of all kinds can buy and sell whenever they want. Market makers can profit from the spread, or the small difference between the bid and offer prices.

### **Day Traders**

A day trader typically does not hold positions overnight, and is an active trader during the trading day. Day traders trade both on and off the floor. Proprietary traders, locals and public traders are often day traders.

### **Position Traders**

Unlike day traders, a position trader might make one trading decision and then hold that position for days, weeks, months, or longer. Position traders are less concerned with minor fluctuations and are more focused on long-term trends and market forces.

Public traders and proprietary traders are often position traders.

## **The Exchanges**

Hundreds of futures contracts are traded on exchanges in the United States and Canada and around the world. Listed below are some of the North American exchanges where commodity futures and options on futures are traded.

### **Chicago Board of Trade** – [www.cbot.com](http://www.cbot.com)

Corn, oats, soybeans, soybean meal, soybean oil, soft red winter wheat, rough rice, Dow Jones futures, U.S. Treasury bonds and Treasury notes. The ECBOT is the electronically traded market for the CBOT markets and adds gold and silver contracts.

### **Chicago Mercantile Exchange** – [www.cme.com](http://www.cme.com)

Live cattle, feeder cattle, lean hogs, pork bellies, BFP milk, S&P 500, Eurodollar, Australian Dollar, British Pound, Canadian Dollar, European Currency, Japanese Yen, Mexican Peso, and Swiss Franc are all traded on the CME.

### **New York Mercantile Exchange** – [www.nymex.com](http://www.nymex.com)

Crude oil, heating oil, unleaded gas, natural gas, gold, silver, copper, platinum, uranium.

### **Intercontinental Exchange** – [www.theice.com](http://www.theice.com)

Electronically traded New York Board of Trade and New York Mercantile Exchange markets are traded on the ICE.

### **New York Board of Trade** – [www.nybot.com](http://www.nybot.com)

Coffee, sugar, cocoa, cotton, frozen orange juice, U.S. dollar index, and the CRB index are traded on the NYBOT.

### **Kansas City Board of Trade** – [www.kcbt.com](http://www.kcbt.com)

Hard red winter wheat and the Russell Index are traded on the KCBOT.

### **Minneapolis Grain Exchange** – [www.mgex.com](http://www.mgex.com)

Soft white wheat, red spring wheat, and durum are traded on the MGEX.

### **Winnipeg Commodity Exchange** – [www.wce.mb.ca](http://www.wce.mb.ca)

Canola, flaxseed, feed peas, feed wheat, feed oats, and western feed barley are all traded on the WCE.

## **The Pit vs. Electronic trading**

In 1848, to meet the need for a central marketplace, the Chicago Board of Trade (CBOT) was founded by 82 Chicago merchants, and settled into its first home above the Gage and Haines flour store. In 1865 the CBOT formalized grain trading by developing standardized agreements called “futures contracts.” The CBOT also began requiring performance bonds called “margin” to be posted by buyers and sellers in its grain markets. This was the start of open outcry trading. A specialized area for a traded commodity within an exchange was referred to as a pit. A floor broker would go to this pit to trade or fill orders for that commodity with other brokers in the same pit. In 1992, the Chicago Mercantile Exchange (CME) introduced Globex, the first global electronic futures trading platform. This electronic system of matching bids with offers

gave traders access to markets after regular trading hours. Today, electronic trading gives traders direct access to the electronically traded markets from any computer with an internet connection.

### **Floor Brokers**

A floor broker is an employee of a commodity exchange member firm who executes trades on the exchange floor on behalf of the firm's clients. Basically, floor brokers receive orders from their firm, which have been placed by the firms' clients, and execute these orders at the best possible price. Floor traders, who execute orders for their own accounts, should not be confused with Floor brokers.

### **Floor Trader**

A member of a commodities exchange who trades on the floor for his or her own account, is known as a floor trader. The floor trader must abide by trading rules similar to those of the exchange specialists who trade on behalf of others.

### **Order Entry**

Most traders place their orders through a broker, by either telephone or electronically. Telephone orders are either hand signaled to the floor broker or given to a runner who runs the order to the floor broker. Electronic orders are either directed to an order-matching platform, or are sent to a floor broker via an electronic order clerk. The floor broker will then execute the order as directed.

### **Types of Orders**

At the most basic level, you can place an order to buy a futures contract (go long) or sell (go short). There are many different types of orders to enter a position in the futures markets: a market order, limit order, or stop order, to name a few. Which type of order to use will depend on your trading objectives and market conditions. It is very important that you and your broker understand and agree on the type of order you are entering. With clear communication, costly mistakes can almost always be avoided.

***The following are the most common order types:***

#### **Market Order**

The most common type of order is the market order. When entering a market order, state the number of contracts to buy or sell in a given delivery month. When the order reaches the trading floor it is executed at the best possible price at that moment, therefore you do not need to specify price. The market order is usually filled in a quick manner at a price based on the current bid or offer. Buy orders are filled at the offer and sell orders are filled at the bid, however, it should be noted that if the size of the buy/sell order is greater than what is currently offered on the offer/bid, a market order may trade at a higher or lower price.

**Limit Order**

A limit order specifies a price limit at which the order must be executed. In other words, it must be filled at that price or better. The advantage of a limit order is that you know the worst price (limit price) you'll get if the order is executed. In addition, there is a possibility that the price may be better than your limit. The disadvantage is that your order might not get filled if the market doesn't trade through your price level.

**Stop Order**

Stop orders are not executed until the market reaches a stated price, at which time the stop order becomes a market order. Some stop orders are referred to as stop-loss orders, which are most often used as a protective measure for gains or limiting losses. Many times, a trader will put a stop order in at a predetermined level so that if the market moves against the trader's position it will automatically liquidate the position and limit further losses.

Stop orders can also be used to enter the market. Suppose you expect a bull market only if the price passes through a specified level (i.e., a breakout point @ \$7.20). In this case, a trader could enter a buy-stop order to be executed if the market reaches this point. For instance, let's say the November soybean contract was trading at \$7.10. You could place a buy stop order at \$7.21, and when the market reached that level the order would then become a market order to buy and be filled. One variation is the stop-limit order. With this type of order, the trade must be executed at the exact price (or better) or held until the stated price is reached again. If the market fails to return to the stop-limit level, the order is not executed.

**Order Duration**

In addition to the type of order, it is also important to determine the duration of an order. Most orders are day orders and work only during that trading session, expiring each day when the market closes. On the other hand, open orders, or good 'til canceled (GTC) orders, are working until the contract expires or the customer cancels the order.

Market on close orders place a market order at the close of the trading day.

**Placing Orders**

Orders should be placed in the following manner:

1. State your account number and name
2. The type of order; "future", "option", or "spread" order
3. Buy or Sell
4. Quantity of contracts
5. Month
6. Commodity
7. If an option order, Strike Price and Call or Put
8. Price and type of order
9. Day or Open Good 'Til Cancel (GTC) order

Some samples of verbal orders would be: "Hello, this is John Trader, my account number is ABC123. I have a futures order: I want to buy 10 December Corn at the market." OR "Hello, this is John Trader, my account number is ABC123. I have a futures order: I want to sell 5 June Swiss Franc at 8070 on a stop, good til cancelled." "Hello, this is John Trader, my account number is ABC123. I have an option order: I want to buy 5 March Ten Year 107 calls at 25."

Listen carefully when the order clerk repeats the order back to you. It is a good idea to write down the time and the order for your own records. Remember your open orders. Keep a record of all open orders working and remember to cancel open order stops if you get out of a position before your stop is hit. An existing order can be changed by completing a "Cancel-Replace". The first order is cancelled and replaced with the new order. This type of order is subject to "too late to cancel" if the original order has been filled. Read your statement carefully. Make sure all activity on your statement matches your trading records. Notify your broker immediately if there are any discrepancies.

### **Risk Management**

Money management, also referred to as risk management, is absolutely critical in developing a successful trading plan. Many traders regard it as the single most important aspect of trading. The lack of discipline in money management is a major cause of failure among new traders. Traders need to exercise control over how much capital they risk per trade and on trading in general. A trading plan should define risk per trade and maximum losses per month and year. Following strict risk management rules can help the new trader overcome the emotional aspect of trading.

One of the main ideas behind money management is to preserve capital so that a trader can live to trade another day. Before a trader enters a trade, the first thing they should ask themselves is how much money they are willing to risk and can they afford to lose it? One of the most common mistakes new traders make is they often risk a large percentage of their account on one or two trades. By risking your account on one trade, you are exposed to potential devastation. Attempting to get the big gain may be exciting, but failure in the trade can wipe out the entire trading account.

There is an old investing adage about cutting losses and letting profits run. What this means is that a trader should strive to manage his/her losses, in order to ensure that a single trade doesn't incur too much damage both financially and mentally. The justification here is that if traders keep their losses small, the profits will take care of themselves. In the case of profits, a trader can exit the position once they have determined that they have gained a sufficiently "large" profit. Now, what exactly is a small loss, or a large enough profit? There is no one answer. What is right for one trader will not necessarily be right for another.

There is a so-called “rule of thumb” in the trading world which states that one should never risk more than 2% of their total trading capital on any one trade. By limiting risk to 2%, a trader can endure several bad trades. It is absolutely critical to maintain a low level of risk. The idea here is that one trade is not going to significantly affect the trader if it results in a loss. If a trade goes against them, they are not going to go broke, or have to sell their house or car in order to continue trading.

The way to define risk, for purposes of the 2% rule, is by determining the loss the trade will experience if the price moves against them. For example, if a trader buys 1 contract of May corn at \$4.00 with a 6 cent risk, your risk is defined as 6 cents \* \$50 = \$300. A trader needs to have cash amounting to at least \$15,000 in their trading account for the 2% rule.

### ***Risk/Reward***

When a trade is initiated, the risk tolerance and profit target should be determined. The ratio of what a trader risks to what they profit per trade should be at least three to one initially. For example, every \$100 at risk, the trade should have a profit potential of \$300. If a trend develops and the trader wants to let these “profits run”, they need to protect those profits with strict risk management strategies.

### ***Position and Price Limits***

In order to maintain orderly markets, futures exchanges typically set both position and price limits. A position limit is the maximum number of contracts that may be held by a single market participant. While position limits typically apply to speculators, hedgers have position limits that are related to their underlying physical market position. Price limits, also called daily trading limits, specify a maximum price range allowed each day for a contract. Price limits are lifted when the delivery process of a particular contract month begins. Many traders will usually close out their positions prior to the delivery process, because the volatility may increase beyond a level that is tolerable.

### ***Zero Sum Game***

For every winner there is a loser. “Zero-sum” describes a situation in which a participant’s gain or loss is exactly balanced by the losses or gains of the other participants. It is known as “zero-sum” because when the total gains of the participants are added up, and the total losses are subtracted, they will sum to zero.

## Trading Strategies

### Using Fundamental Analysis to Forecast Prices

There are two primary methods traders use to forecast future price movement: Fundamental Analysis and Technical Analysis. If you could predict the direction of prices with perfect accuracy, you would obviously have no trouble making a fortune in the futures markets. However, assuming that you can't, an alternative would be to learn the forecasting techniques used by successful traders. One method, called fundamental analysis, is based on market economics, also known as supply and demand information.

Fundamental analysis applies to all markets including agricultural, financial, equity and metals. A substantial amount of the fundamental trade revolves around the release of key government reports. If these official reports are in line with the market's expectations, the impact on market prices will be minimal. When actual figures vary from expectations, market prices can respond dramatically. Days on which key reports are released can present real trading opportunities due to the resulting dramatic swings in price. To take advantage of these opportunities, a trader must understand the meaning and potential impact of the report, as well as the market's prior expectations. Some exchanges, like the CBOT, provide intraday market commentary, which usually includes information from the reports and the impact on the markets. It's also important to keep in mind that price volatility is usually higher on release dates. Even if a trader doesn't intend to trade based on a given number, they may find the value of any open positions changing significantly on these days. Of course, this could work to their advantage or disadvantage. In any event, it's important to understand the impact of the major reports and other critical events, regardless of whether or not a trader intends to trade on fundamental information.

Like any trading method, fundamental analysis has its limitations. Key statistics can be reported inaccurately, resulting in the trader's interpretation of the information being wrong. New data is always filtering through the markets and creating price changes. Opportunities can come and go before the trader even has a chance to react: While one piece of information may point clearly in one price direction, other factors can combine to drive prices the other way. Although forecasting futures prices is clearly tricky business, all traders face the same set of challenges. It's probably best to concentrate, at first, on only one or two related futures markets. Since so many factors can influence prices, limiting traders efforts in this way will make fundamental analysis a much more manageable task. efutures provides traders with free monthly calendars for the agricultural and financial markets that list the economic reports scheduled for release each month. Request a free calendar by going online to [www.efutures.com](http://www.efutures.com). Whether you choose to focus on agricultural or financial futures markets, a good understanding of fundamental price information will go a long way toward improving a trader's success.



## **Using Technical Analysis to Forecast Prices**

Technical analysis is the other major trading technique. Some traders only use technical analysis to make trading decisions, while others use some combination of fundamental and technical analysis to determine if they want to be long or short and to time their trades. The technical analyst focuses purely on market information—primarily price movements, but also volume and open interest figures. The pure technician works on the assumption that all fundamental information is already reflected in the price, and that it is more important to study the market's resulting price behavior. Unlike the fundamental analyst, the market technician is not concerned with understanding the underlying fundamental news surrounding why the market moved. Rather, the technician attempts to predict future price direction by looking at previous patterns of price behavior.

For instance, if selling continually occurred at a certain price, the technician would conclude that price point represented “resistance” where sellers would likely emerge in the future to drive prices down. The technician would then sell at that point on the assumptions that prices would drop. Charts, tables and graphs are the major tools of the technical analyst. Traders can organize and analyze market data in any number of ways depending on their preference. Traders use charts to identify price trends, special patterns or formations, and areas of support and resistance. Price support occurs where there is sufficient buying of the futures contract to halt a price decline. Resistance, on the other hand, refers to a ceiling where selling pressure can be expected to stop a rally.

When the market trades sideways for an extended period of time, it is said to be in a consolidation phase.

## **Chart Formations**

The study of technical indicators is quite extensive, certainly encompassing much more detail than can be provided here. It is possible, however, to introduce the general concepts of charting and the major chart patterns. Keep in mind that while a sequence of price movements often indicates the likelihood of future direction, exceptions to past patterns can always occur. The best traders understand how to appropriately interpret these “chart patterns” and often have a back-up plan in place if the market moves in an unanticipated direction.

## **Chart Patterns**

### **Support and Resistance**

Support is a horizontal floor where interest in buying a commodity is strong enough to overcome the pressure to sell. Support can be identified on a chart by prices failing to fall below previous set of lows. Resistance is a horizontal ceiling where the pressure to sell is greater than the pressure to buy. Resistance can be found on a chart by prices holding a previous set of highs.



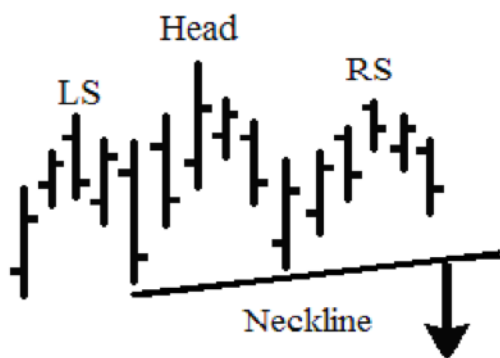
**Support**



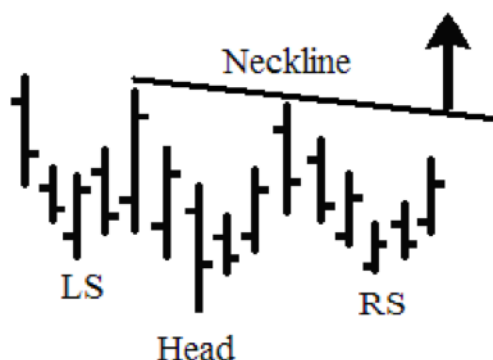
**Resistance**

### Head and Shoulders

This pattern is a reversal pattern signaling that the price is likely to move against the previous trend. A head and shoulders top is made up of a left and a right shoulder with similar price and a head that is above both shoulders' prices. The neckline is the level of support that is used to determine this uptrend is over as price drops below this level. This is the trader's signal that prices are usually headed lower and used as a sell point. Head and shoulders bottoms are the inverse of the top pattern.



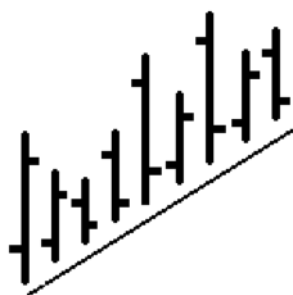
**Head and Shoulders Top**



**Head and Shoulders Bottom**

### Trend lines

This technique is simply a line extending the lows or highs of a trending market. If the market closes through a trend line, the trend usually changes. The trend line is used as support or resistance.



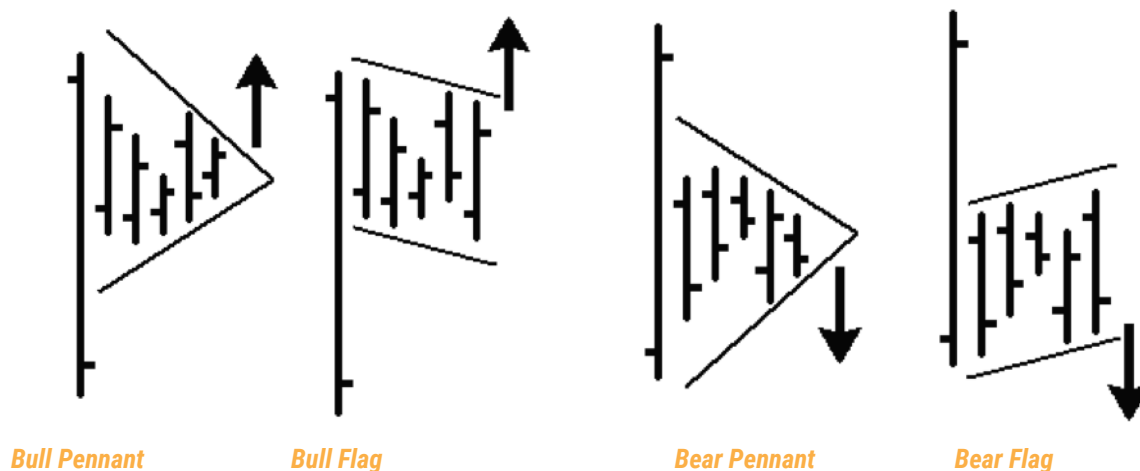
**Up trending line**



**Down trending line**

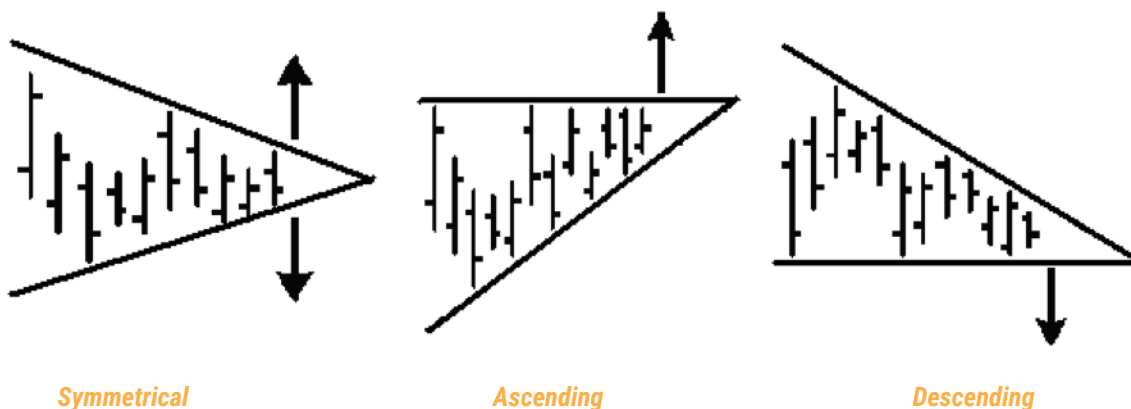
### Flags and Pennants

These two short term chart patterns are continuation patterns that are formed when there is an abrupt price movement followed by a sideways price movement. The pattern is completed by another abrupt price movement in the same direction. This is used as an entry point into the market.



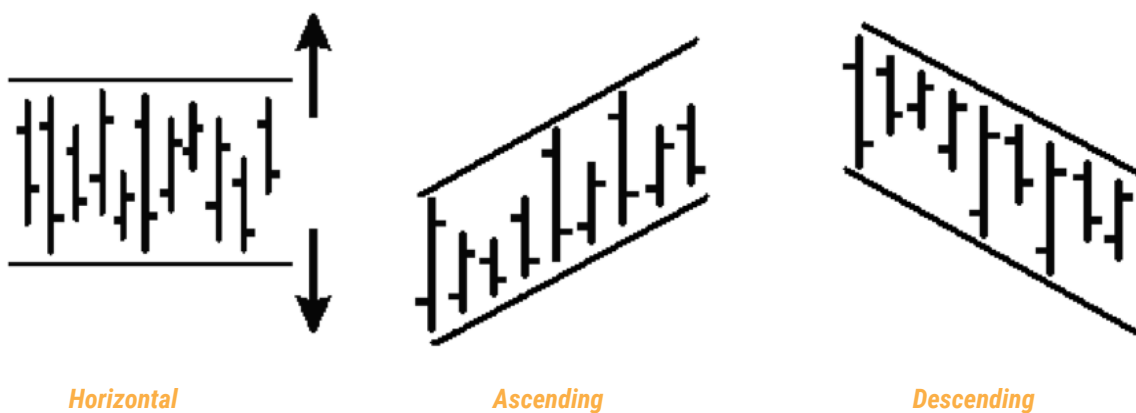
### Triangles

There are three types of triangles: symmetrical, ascending, and descending. The symmetrical triangle pattern consists of two trend lines that converge toward each other. Traders look for a breakout of the trend lines for direction. Ascending triangles are formed with a trendline sloping up towards a resistance level. Traders get long on a price move above the resistance level. Descending triangles are formed with a downward sloping trendline towards a support level. Traders get short when the price breaks below the support level.



## Channels

A horizontal, or sideways, channel is a formation that features both resistance and support. Support forms the low price trend line, while resistance provides the price ceiling. The ascending channel is a formation with parallel price barriers along both the price ceiling and floor. Unlike the sideways channel, the ascending channel has an increase in both the price ceiling and the price floor. The descending channel is a formation with parallel price barriers along both the price ceiling and floor. Unlike the sideways channel, the descending channel has a decrease in both the price ceiling and price floor. Traders use a break out of the channel for price direction.



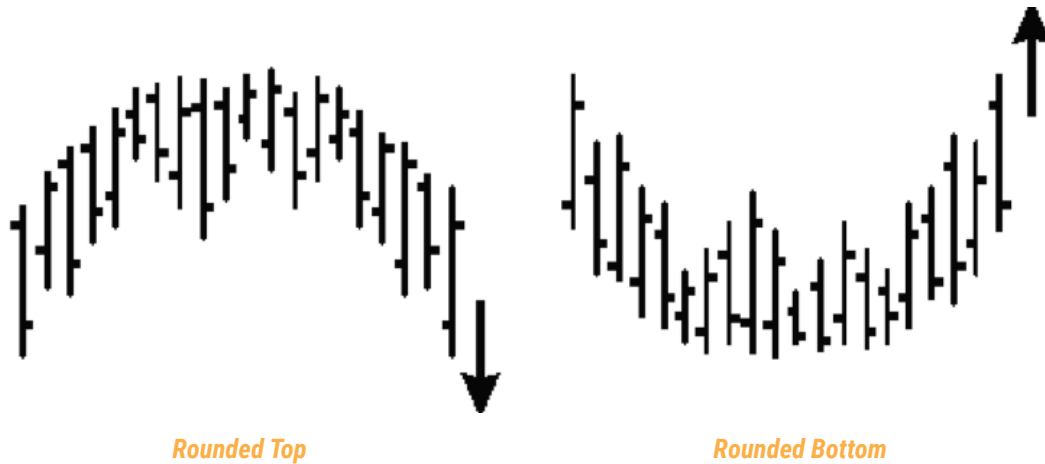
## Double Top (Bottom)

Double tops or bottoms occur when a price movement does not take out a previous high or low. This is an indication that the market has found a point where prices have unsuccessfully tried to breach twice. Prices will usually reverse direction ending the trend.



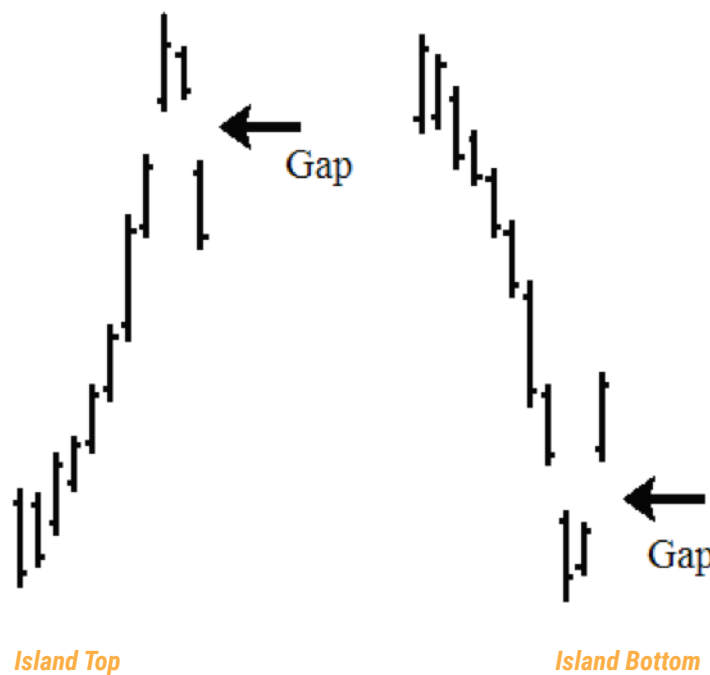
### ***Rounded Top (Bottom)***

With the market losing momentum, this chart pattern usually signals a change in its current trend. Traders will use the break out to enter a position.



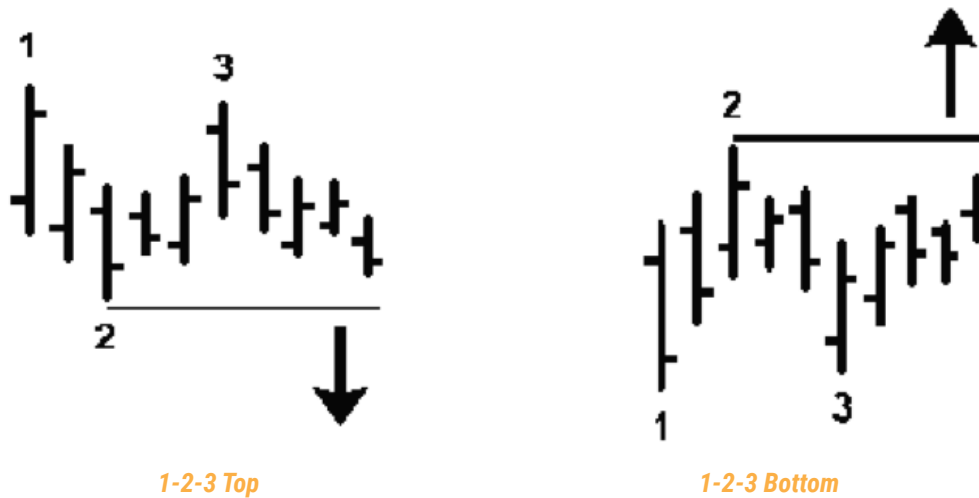
### ***Island Top (Bottom)***

Islands occur when the market makes a sudden price move to new levels and then reverses, leaving a gap in the price bars. This is usually a sign of exhaustion and a trend change. Traders will enter the market when this gap is formed and use the gap being filled as risk.



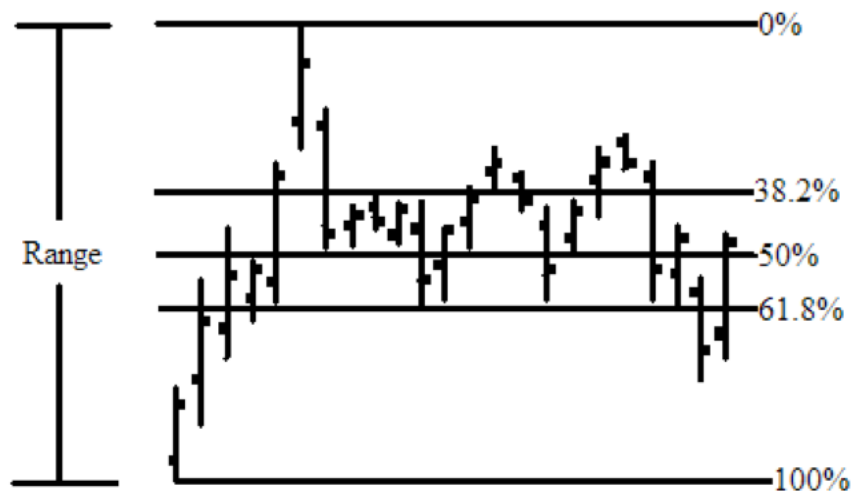
### 1-2-3 Tops (Bottom)

This chart pattern develops when a market price makes a move to new levels (1) then pulls back (2) and tries to retest the previous level (3) but does not reach that price the market made on the first attempt. Traders will use the break out of the trend line at level 2 for direction.



### Fibonacci Retracement

Retracements measure price areas where a market move is likely to pause or reverse a trend. A trader determines these retracements levels by selecting a significant high and low price point and then calculating a percentage of that range. The most common retracement values are 38.2%, 50.0%, and 61.8%. Many traders rely on Fibonacci numbers to compute levels of support and resistance.



## **Moving Averages**

A moving average is an average price of a commodity over a set period of time. An example of a simple 20 day moving average would be adding together the closing prices from the previous twenty days then dividing the sum by twenty. This gives the trader a point to use as direction. Exponential moving averages place a higher weighting on more recent data. The exponential moving average is more responsive to new price data compared to the simple moving average. Most charting systems will calculate the exponential average. Traders use moving averages to identify price trends and reversals of trends. A system that utilizes both short and long term moving averages can help identify buy and sell signals. For example, a trader could use a short term moving average that crosses above a long term moving average as a buy signal. This signal would indicate recent price strength of that commodity. Common values used in moving averages are the 20, 40, 100, and 200 day.

## **Option Trading**

### **Speculating on Market Price Direction**

Traders that do not have a high level of risk tolerance should look to trade options on futures. Trading options provides an opportunity to risk smaller amounts of money to leverage larger positions. A trader can buy options for a fraction of what it would cost to buy large quantities of an actual commodity such as crude oil, the S&P 500, or silver. A buyer of an option gives them the right, but not the obligation, to be long (or short) a futures contract at a specific price, also known as the option's strike price.

Assume an investor thinks the corn market is going to trade higher with the release of the next crop report and wishes to participate by buying 50,000 bushels. If the current price of corn is \$4.00 per bushel, that investor could expect to pay \$200,000, plus any fees to handle and store the physical corn. An options trader could buy 10 May corn 420 call options for just 15 cents per bushel. This trader would invest only \$7,500 (10 options x 15¢ x 5,000 bushels per contract), the own the right, but not obligation, to be long 50,000 bushels of corn at \$4.20, any time before the call options expire. If the crop report was bullish and the price of corn rallies to \$5.00 per bushel at expiration of the option, then the options will be worth 80¢ each (\$5.00 - \$4.20) or \$40,000 (10 contracts x 80¢ x 5,000 bushels each). The trader will have a profit of \$32,500 on a \$7,500 investment. This amounts to a return on investment of approximately 430%.

In contrast, the investor who actually spent \$200,000 to purchase 50,000 bushels of corn at a price of \$4.00 will earn a profit of \$50,000 (\$5.00 - \$4.00 x 50,000 bushels). This amounts to a return-on-investment of just 25%, and it illustrates the power of leverage. This leverage which gives the investor the ability to control large quantities of a commodity asset with a relatively small investment is the main attraction for many speculators. However, this leverage can make the risks equally high. In the previous example, if the trader's May corn 420 calls expire worthless (if corn futures prices are below \$4.20 at the option's expiration) then they would lose the entire \$7,500 investment.



### ***Hedge against Adverse Price Movement***

One of the most conservative commodity options trading strategies is to help protect assets against adverse price fluctuations. Suppose you are a soybean producer and your soon to be harvested crop is not yet priced. The cash soybean market has very favorable prices with more potential upside due to low supply or higher demand. As a producer, you would like to take advantage of these high prices and sell your production at the best possible cash price. To do this, you can hedge your production by purchasing put options to protect against a decline in soybean prices. If the prices for beans drop, your put option will gain in value, offsetting some of the decline in cash prices.

The risk is simply that if soybean prices rise instead of fall, the put option will likely expire worthless, and your cash sale profits will be reduced by the amount you paid for your puts. Think of this as an insurance policy: The put will help protect your production against a price break, and if prices rise, you will simply write-off the cost of the put as a cost of production.

With the help of your broker, you will need to decide which put options to purchase. You need to buy puts that give downside protection and are reasonably priced. A 20¢ break in futures will not affect cash prices like a \$1.20 drop. This is what the producer/hedger needs protection against. If the soybean market declines drastically then the put will gain in value, thus hedging your production. Any gains on the put option will help offset some of the cash market declines. The best scenario would be for the soybean market to rally, in which case your put would expire worthless.

### ***Generate Additional Income on Your Futures Position***

Another common conservative commodity options trading strategy is covered call writing. Many traders use this strategy to generate additional trading profits. This strategy involves initiating a long futures position in a market you believe will rally, and then selling an out-of-the-money call option. The options on more volatile commodities tend to be more expensive, so they generate more income when you sell the covered calls. If you would rather be more conservative, choose a less volatile commodity, because it is less likely you will be forced to sell it. The trade-off is that you won't earn as much income because the options on less volatile commodities are less expensive.

Depending on your risk tolerance, this is how the strategy works:

The long term forecast is cold and you expect the natural gas market to rally. The price for January natural gas is around 7.00, and your upside objective is 9.00. Therefore, you buy 1 future contract at 7.00 and wait for the price to begin climbing. If you now were to sell 1 January call with a strike price of 9.00 against the long January futures contracts in your account, this would be considered a covered call. Even if the market rallies higher than 9.00, your long futures position will more than offset the losses incurred with the short option. This position is far less risky than selling calls by themselves.

If the January 900 calls are trading at \$1.10, you could sell 1 option, generating \$1,100 in proceeds ( $\$10 \times \$1.10 \times 10,000$  MMBtu per contract). Now, all you have to do is hope the January futures contract remains at or below 9.00. If it does, you keep the \$1,100 at option expiration. If the futures rally above 9.00, you have two choices. First, you could buy the calls back and take the loss on the option and adjust your risk to preserve your profit on the futures. Or, you could wait for the option assignment, and you would be short 1 January Natural gas contract at 9.00. In this case, you still keep the \$1,100 premium you collected from selling the calls and you receive the profit when your long position at 7.00 is offset with the 9.00 short position you have been assigned from your short option being exercised.

## Spreads

A future spread is a simultaneous long and short futures position that provides exposure to the difference in two prices. Spread trading can offer reduced risk compared to trading outright futures. This is because the long and short futures that comprise a spread are usually correlated, so they tend to hedge one another. For this reason, exchanges generally have less strict margin requirements for futures spreads.

An **intra** commodity spread is long one future and short another. Both have the same futures contract, but they must be different months. An example would be long 1 July corn and short 1 December corn.

An **inter** commodity spread is a long and short position in futures on different futures contracts. Both typically have the same maturity. An example would be long 1 April Live cattle and short 1 April Feeder cattle.

A bull spread is a position in which the trader is long the nearby contract and short the deferred contract. An example would be long May, short December of the same year. On the other hand, a trader that is short the nearby contract and long the deferred contract is considered to be in a bear spread position. An example would be long September and short March of the same year. For instance, a spread being long July and short Nov Soybeans may seem viable. If the July and November soybean contracts are priced the same, beans could be looking at a tight supply situation, where the July should gain on the November contract. The trader would then gain on the spread if the July contract was 30 cents higher than November contract. A spread is quoted by the difference in price of the two commodities. If the July beans are trading at \$7.80 and the November beans are trading at \$7.50 the spread would be quoted July 30 cents over November. If this spread continues to gain it is widening; if the spread turns down it is narrowing, also known as strengthening.

## **Seasonal Trading**

The seasonal trading approach is designed to anticipate future price movement rather than constantly reacting to an endless stream of often contradictory news. Although numerous factors affect the markets, certain conditions and events recur at annual intervals. Perhaps the most obvious is the annual cycle of weather from warm to cold and cold back to warm.

However, the calendar also marks the annual passing of important events, such as the grain harvest every fall. Such annual events create yearly cycles in supply and demand. Enormous supplies of grain at harvest dwindle throughout the year and are replenished with harvest. Demand for heating oil typically rises as cold weather approaches but subsides as inventory is restocked. Tax time slows individual expenditures due to tax payments. There are many other seasonal trading strategies, and a wise trader would consult his/her broker before blindly taking a position in a seasonal.

## **System Trading**

System trading can refer to an automated trading system that automatically executes your trades or it can refer to a system a trader develops where the trades are placed by a broker. System trading should identify trades and use strict risk management to maximize opportunities and minimize risk. If a trader is well disciplined, he can follow the signals from the system to help remove the emotional side of making trading decisions.

## **Trading Guidelines**

Regardless of whether you prefer a fundamental or technical approach to making trading decisions, your ultimate success will depend on your ability to develop good trading habits. Numerous expressions of market wisdom attempt to give guidance: Phrases like “buy the rumor, sell the fact” or “the trend is your friend” are helpful but a bit vague. The following list includes 10 rules to help traders start out on the right foot.

### **1. Have a trading plan**

Before you actually enter into a futures position, develop a plan to guide your decision based on careful analysis of the market you plan to trade. The following are some of the issues you’ll want to evaluate:

- Have I researched the trade?
- What is my entry price?
- What is my risk? Will I use a trailing stop to protect profits?
- What percentage of my account is at risk on this trade?
- What is my objective? Does the trade have a favorable risk to reward ratio?

**2. Diligence/perseverance**

Perhaps two of the key elements that differentiate successful traders from the rest are discipline and emotional control. For instance, when the market moves against a trader, past an exit point he/she had previously established, a good trader can cut loose and accept the loss. Half the battle is having a good plan; the other half is sticking to that plan in the heat of the moment.

**3. "Buy low and sell high", "Cut losses short and let profits run"**

These may sound obvious, but they are cardinal rules every trader will break at some time.

**4. Determine the right size for your trading account**

Do not overtrade your capital. The funds you trade should be completely discretionary. In other words, ask yourself if you can afford to lose whatever you invest in that account—and potentially more. Savings for college, retirement or emergencies is capital that should not be used to trade with.

**5. Set definite risk parameters**

Before you trade, determine how much of a loss you are willing to accept. You can express this as a dollar figure or as a percent of the margin amount. In either case, you should always keep some money on reserve. By setting limits up front, you may lessen the risk of emotions dictating your decisions if the market happens to turn against you. Wishful thinking could easily cause you to fall into a deeper hole, but hard and fast parameters are difficult to ignore.

**6. Pick the right contracts**

There are many futures contracts to choose from. When deciding which contracts are right for you, consider the following:

**Volatility** - Futures contracts that experience wide daily trading ranges are considered more volatile and more risky. For example, soybeans usually have a higher average daily price range than corn. Some traders prefer a more volatile contract because the cost of trading (commission fees, for example) is the same, yet the potential for a profit can be greater. Of course, the risk for loss is also greater.

**Liquidity** - Make sure the futures contract you select has enough volume and open interest to ensure that you can exit your position just as easily as you entered it. It is also helpful to receive current market information: bids, offers, and their respective quantities. Your broker should be able to provide you with current market information. For some products, you can view the live markets on the website where that particular commodity trades.

**Contract Size** - For some futures, you can choose between full-sized and mini-sized contracts. Examples of mini-sized CBOT contracts include: the \$5 mini-sized Dow future (compared to the \$10 full-sized contract), the mini-sized corn, wheat, and soybeans contracts (compared to the full-sized, 5,000 bushel contract), the mini-sized T-Note or T- Bond contract (50,000 face value compared to the \$100,000 full size), and the mini-sized silver and gold contracts. While economic factors usually impact both the full-sized and mini-sized contracts, the dollar amount at risk is less with the smaller contract. Further, if your trading account is relatively small, trading smaller contracts allows you to diversify to a degree that may not otherwise be possible. This reduces your risk exposure to any one market.

**Margins** - Margin levels are a function of contract size and price volatility. While you may be comfortable trading in volatile markets, the size of your account, and the margin requirements may limit your selection of which futures contracts to trade.

## **7. Diversify**

Rather than exposing your entire trading account to a position in one futures contract, it is more prudent to take smaller positions in several contracts. At the same time, you may not want to trade too many markets at once, or you may have a difficult time tracking your positions and following the fundamental information or technical indicators for each market.

## **8. Be willing to trade long or short**

Traders frequently have a directional bias; for example, always being long a market. The market trends both up and down so a trader needs to be willing to trade from both long and short.

## **9. Begin with simulated trading**

While there is no better way to learn than when your own money is involved, it's still a good idea to practice first with simulated trading. Pick a couple of markets to follow and experiment with your trading plan. You can practice by using an electronic trading simulator located at [www.efutures.com](http://www.efutures.com).

The advantage of an electronic trading simulator is that some consider it as the closest replication of "real world" trading conditions. Simulated trading is a good way to become familiar with the price quotations, the market terminology, and the general behavior of a particular futures contract.

## **10. Select a good broker**

A broker can play an important role in your success. There are essentially two types of brokers: full-service and discount brokers. Full-service brokers provide more in the way of guidance and research support, but charge higher commissions to execute your trades. Discount brokers leave all the trading decisions to you and charge much less to execute your trades. With the popularity of electronic trading, some discount brokers offer options that allow you to

trade entirely through your computer. The National Futures Association (NFA) directly supervises the activities of all futures brokers (officially called associated persons). All members of the NFA must observe high levels of conduct that extend beyond legal requirements. The NFA investigates complaints against its members and, if necessary, issues fines and suspensions. If you want to check the status of your broker's credentials, or report a serious problem with your broker, contact the NFA, or visit the NFA web site: [www.nfa.futures.org](http://www.nfa.futures.org)

### **How much money does it take to trade commodities?**

There is no short answer to this question. First, determine the cost to margin a particular commodity contract. Second, determine how much you are willing to risk on the trade. The margin requirement and the risk amount will give you the minimum amount of money required to maintain this one trade in your account.

In order to learn how to trade, you will need to make more than one single trade. There are many popular trading courses that recommend trading accounts beginning at \$5,000 to \$10,000. Although this is the recommended starting range, what you do with the money is more important than how much you start out with. As always, only invest money that you can afford to lose. This is very important for your psychology. Some people have said, "I'm going to start with \$10,000, but if my account drops down to \$5,000 I'll stop trading." This may seem prudent, but the odds are very high that this trader will lose his/her money. The problem is that this trader will be watching their money instead of the market. The market does not care how much you have or how much you are going to risk. A successful trader will develop a written trading plan and have the discipline to execute this plan on each trade.

Commodities are traded in large, standardized, commercial size contracts. For example, grains such as soybeans and corn are traded as 5,000 bushels per contract. If soybeans are priced at \$8.00 per bushel then the value of each contract is \$40,000 (\$8 x 5,000). For most investors, if they consider buying \$40,000 worth of a company's stock, they will take a long hard look at that company. A commodity trader should also "do their homework" before initiating a trade, just like any knowledgeable stock investor.

### **Six questions to ask a broker**

**1. How long have you been in business and how secure will my funds be with you?**

The longevity of a brokerage firm demonstrates stability and growth. This long life is a result of a good reputation and customer service.

**2. How reliable and durable are your systems and what backup capabilities do you have?**

If you have a problem, who do you talk to and how soon do they respond? If you have a computer problem, is there another way to place trades?

**3. What kind of customer service do you offer?**

If I call in, can one person help me place a trade or answer my question?

**4. *How fast are orders executed and fills reported?***

A trader must know his/her position as the market moves.

**5. *What products will I be able to trade?***

Some extremely low priced firms offer access only to electronic markets. Brokers offering these basement commissions do not have the infrastructure, and cannot afford to offer access to all markets. This may limit traders who watch several markets: the fewer markets that you have the ability to trade, the more opportunities you will miss. efutures has the latest technology to trade the all-electronic markets as well as access to all the traditional open outcry markets.

**6. *What are your account requirements and commission rates?***

Some firms require a minimum account size and have pricing structures that vary with account size. Other firms advertise a very low commission rate but do not include extra fees (clearing fees, NFA fees, exchange fees, brokerage fees, etc.). These fees can add \$2 - \$4 per side to the commission rate. efutures has a commission schedule that includes all fees.

## **Selecting the type of service for your trading**

### **Full Service**

A full service broker provides specialized services such as technical / fundamental analysis and trade system development. This, combined with information direct from the floor and the latest news and report data, helps you to make more informed and confident trading decisions.

Traders with extensive market experience choose a full service broker because they need someone who is efficient and responsive to their individual needs.

Traders with some market experience select a full service broker to identify different strategies that allow them to participate in market trends while addressing strict money management rules.

Individuals new to trading choose a full service broker to discuss markets and formulate trading plans.

An efutures full service broker's market experience and dedication to customer service will benefit traders of any level.



***Self-directed***

Traders that like to make their own decisions typically prefer discount trading, where the trader handles all aspects of their trading from research to order management. Because the trader is willing to do everything on their own, they are given a discount on the commission. When choosing a discount broker, look for service, execution, and information first, and price last. A discount broker should provide knowledgeable and courteous service to every trader. Execution is important because a one tick differential can make cheap commissions expensive. Quality information gives the trader better opportunities to make knowledgeable trading decisions. These are the reasons why the selection of a discount broker should be determined by what is offered as a whole package, not just by the cheapest price.

***Why choose an efutures broker?***

In an era of electronic trading and minimal human interaction, it has never been more important to have the right trading partner. Our full service brokers believe in quality service and developing relationships with their customers. We want you to be pleased with your trading experience. Our team of select brokers wants you to be knowledgeable and successful. We will help you achieve these objectives by personalizing your level of service to fit your individual goals. Our brokers value honesty and integrity foremost. We endeavor, to the best of our ability, to act in your best interest, recommend trade opportunities, and provide you with risk management advice. In choosing an efutures broker, you can be confident you will receive professional and courteous service while developing a rewarding relationship.



## Trader Lingo

**"Dead-cat bounce"** Many times a market will experience a modest rally (bounce) from depressed price levels. Most of this price rise is due to short-covering or weak long positions getting back into a market that may exert little or no upside power.

**"The trend is your friend."** This simple sentence is a very powerful one and is important for most traders. If you trade with the market's trend, your odds for success are higher than if you trade against the trend. Most successful traders employ some type of trend-following trading strategy.

**"Buy the rumor, sell the fact."** This is a frequently occurring phenomenon whereby a market makes a price move in anticipation of an expected result of a fundamental event. Then, when the event does actually occur and the result was as expected by traders, the market price will move in the opposite direction.

For example, if grain traders expect a bullish report, the market will rally in the days before the report's release but then actually sell off once the actual bullish figures are released.

**"Bulls make money, bears make money, but hogs get slaughtered."** In other words, don't be a greedy trader. Don't try to take too much profit out of a market too fast. The two biggest and potentially most damaging human emotions in trading are "fear" and "greed."

**"Cut your losses short."** This trading truism is even more important than "The trend is your friend." Traders must limit their losses on losing trades by using strict money management, most notably – buy and sell stops. In other words, traders should never let a trade lose enough to warrant a margin call.

**"Markets 'discount' events"** This phrase is similar to "buy the rumor, sell the fact." Many times markets "factor in" or discount events before they occur. For example: Forecasters may predict a drought for the U.S. Corn Belt. Although the growing season for soybeans and corn does not end until early fall, corn and soybean futures prices may top out in June. Trader's factor in the damage to crops well before most of the damage actually occurs.

**"Short-covering"** This occurs when traders who have established short positions decide to exit the market, either to take profits or because their trading positions have moved too far "under water." Many times short-covering occurs after a market sustains a downtrend that lacks recent upside movement.

**"Long liquidation"** Traders decide to "ring the cash register" and take profits from long positions, or weaker longs exit the market when it appears to be showing weakness.

Long liquidation usually occurs when a market has been in a sustained uptrend and many bulls decide to bail out, knowing the market is vulnerable to a downside correction.

**"Consolidation"** is also known as **"sideways trading."** Many times after a market has undergone a sustained trend, it will "pause" to catch its breath, or move into what traders call a "consolidation phase." This means price action on the charts becomes more choppy and sideways.

A price **"breakout"** occurs when there is a major price move above or below a "congestion area" (or a sideways trading area) on a price chart. Many trend traders like to trade price breakouts.

**"Basing" action** is extended sideways trading at recent historic lower price levels. Prices are forming a "base" at lower levels, from which prices may eventually make an upside "breakout." Keep in mind that markets can also see a downside price breakout at what was perceived to be a basing area at lower levels.

A market **"correction"** occurs after a market sustains a price trend and subsequently makes a shorter counter move in the opposite direction. After this correction, odds favor the eventual resumption of the trending move.

**"Locals"** are individuals who trade in the open-outcry pits at the exchanges. They trade for their own accounts and are an important function of pit trading because they provide important market liquidity for better trade execution (fills).

**"Christmas"** refers to a term used to refer to the month of December. Christmas corn is synonymous with December corn.

**"Labor Day"** refers to the month of September. A Labor Day bond is synonymous with a September bond.

**"Hand full"** refers to a quantity of five. Two hand fulls would be a quantity of ten.

## Glossary

### A (Back to Top)

**Actuals:** [See Cash Commodity](#).

**Adjusted Futures Price:** The cash-price equivalent reflected in the current futures price. This is calculated by taking the futures price times the conversion factor for the particular financial instrument (e.g., bond or note) being delivered.

**Arbitrage:** The procedure of settling disputes between members, or between members and customers.

**Assign:** To make an option seller perform his obligation to assume a short futures position (as a seller of a call option) or a long futures position (as a seller of a put option).

**Associated Person (AP):** An individual who solicits orders, customers, or customer funds (or who supervises persons performing such duties) on behalf of a Futures Commission Merchant, an Introducing Broker, a Commodity Trading Adviser, or a Commodity Pool Operator.

**Associate Membership (CBOT):** A Chicago Board of Trade membership that allows an individual to trade financial instrument futures and other designated markets.

**At-the-Money Option:** An option with a strike price that is equal, or approximately equal, to the current market price of the underlying futures contract.

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**Balance of Payment:** A summary of the international transactions of a country over a period of time including commodity and service transactions, capital transactions, and gold movements.

**Bar Chart:** A chart that graphs the high, low, and settlement prices for a specific trading session over a given period of time.

**Basis:** The difference between the current cash price and the futures price of the same commodity. Unless otherwise specified, the price of the nearby futures contract month is generally used to calculate the basis.

**Bear:** Someone who thinks market prices will decline.

**Bear Market:** A period of declining market prices.

**Bear Spread:** In most commodities and financial instruments, the term refers to selling the nearby contract month, and buying the deferred contract, to profit from a change in the price relationship.

**Bid:** An expression indicating a desire to buy a commodity at a given price; opposite of offer.

**Board of Trade Clearing Corporation:** An independent corporation that settles all trades made at the Chicago Board of Trade acting as a guarantor for all trades cleared by it, reconciles all clearing member firm accounts each day to ensure that all gains have been credited and all losses have been collected, and sets and adjusts clearing member firm margins for changing market conditions. Also referred to as clearing corporation. See Clearinghouse.

**Broker:** A company or individual that executes futures and options orders on behalf of financial and commercial institutions and/or the general public.

**Brokerage House:** See [Futures Commission Merchant](#). Bull: Someone who thinks market prices will rise.

**Bull Market:** A period of rising market prices.

**Bull Spread:** In most commodities and financial instruments, the term refers to buying the nearby month, and selling the deferred month, to profit from the change in the price relationship.

**Butterfly Spread:** The placing of two interdelivery spreads in opposite directions with the center delivery month common to both spreads.

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**Calendar Spread:** See [Interdelivery Spread and Horizontal Spread](#).

**Call Option:** An option that gives the buyer the right, but not the obligation, to purchase (go "long") the underlying futures contract at the strike price on or before the expiration date.

**Canceling Order:** An order that deletes a customer's previous order.

**Carrying Charge:** For physical commodities such as grains and metals, the cost of storage space, insurance, and finance charges incurred by holding a physical commodity. In interest rate futures markets, it refers to the differential between the yield on a cash instrument and the cost of funds necessary to buy the instrument. Also referred to as cost of carry or carry.

**Carryover:** Grain and oilseed commodities not consumed during the marketing year and remaining in storage at year's end. These stocks are "carried over" into the next marketing year and added to the stocks produced during that crop year. Also referred to as carryout.

**Cash Commodity:** An actual physical commodity someone is buying or selling, e.g., soybeans, corn, gold, silver, Treasury bonds, etc. Also referred to as Actuals.

**Cash Contract:** A sales agreement for either immediate or future delivery of the actual product.

**Cash Market:** A place where people buy and sell the actual commodities, i.e., grain elevator, bank, etc. See [Spot](#) and [Forward Contract](#).

**Cash Settlement:** Transactions generally involving index-based futures contracts that are settled in cash based on the actual value of the index on the last trading day, in contrast to those that specify the delivery of a commodity or financial instrument.

**Charting:** The use of charts to analyze market behavior and anticipate future price movements. Those who use charting as a trading method plot such factors as high, low, and settlement prices; average price movements; volume; and open interest. Two basic price charts are bar charts and point-and-figure charts. See [Technical Analysis](#).

**Cheapest to Deliver:** A method to determine which particular cash debt instrument is most profitable to deliver against a futures contract.

**Clear:** The process by which a clearinghouse maintains records of all trades and settles margin flow on a daily mark-to-market basis for its clearing member. Clearing Corporation: See [Board of Trade Clearing Corporation](#).

**Clearing Margin:** Financial safeguards to ensure that clearing members (usually companies or corporations) perform on their customers' open futures and options contracts. Clearing margins are distinct from customer margins that individual buyers and sellers of futures and options contracts are required to deposit with brokers. See [Customer Margin](#).

**Clearing Member:** A member of an exchange clearinghouse. Memberships in clearing organizations are usually held by companies. Clearing members are responsible for the financial commitments of customers that clear through their firm

**Clearinghouse:** An agency or separate corporation of a futures exchange that is responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery, and reporting trading data. Clearinghouses act as third parties to all futures and options contracts acting as a buyer to every clearing member seller and a seller to every clearing member buyer.

**Closing Price:** See [Settlement Price](#).

**Closing Range:** A range of prices at which buy and sell transactions took place during the market close.

**COM Membership (CBOT):** A Chicago Board of Trade membership that allows an individual to trade contracts listed in the commodity options market category.

**Commission Fee:** A fee charged by a broker for executing a transaction. Also referred to as brokerage fee.

**Commission House:** See [Futures Commission Merchant \(FCM\)](#).

**Commodity:** An article of commerce or a product that can be used for commerce. In a narrow sense, products traded on an authorized commodity exchange. The types of commodities include agricultural products, metals, petroleum, foreign currencies, and financial instruments and indexes, to name a few.

**Commodity Credit Corporation (CCC):** A branch of the U.S. Department of Agriculture, established in 1933, that supervises the government's farm loan and subsidy programs.

**Commodity Futures Trading Commission (CFTC):** A federal regulatory agency established under the Commodity Futures Trading Commission Act, as amended in 1974, that oversees futures trading in the United States. The commission is comprised of five commissioners, one of whom is designated as chairman, all appointed by the President subject to Senate confirmation, and is independent of all cabinet departments.

**Commodity Pool:** An enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures contracts or commodity options.

**Commodity Pool Operator (CPO):** An individual or organization that operates or solicits funds for a commodity pool.

**Commodity Trading Adviser (CTA):** A person who, for compensation or profit, directly or indirectly advises others as to the value or the advisability of buying or selling futures contracts or commodity options. Advising indirectly includes exercising trading authority over a customer's account as well as providing recommendations through written publications or other media.

**Computerized Trading Reconstruction (CTR) System:** A Chicago Board of Trade computerized surveillance program that pinpoints in any trade the traders, the contract, the quantity, the price, and time of execution to the nearest minute.

**Consumer Price Index (CPI):** A major inflation measure computed by the U.S. Department of Commerce. It measures the change in prices of a fixed market basket of some 385 goods and services in the previous month.



**Contract Grades:** See [Deliverable Grades](#). Contract Month: See [Delivery Month](#).

**Convergence:** A term referring to cash and futures prices tending to come together (i.e., the basis approaches zero) as the futures contract nears expiration.

**Conversion Factor:** A factor used to equate the price of T-bond and T-note futures contracts with the various cash T-bonds and T-notes eligible for delivery. This factor is based on the relationship of the cash-instrument coupon to the required 8 percent deliverable grade of a futures contract as well as taking into account the cash instrument's maturity or call.

**Crop (Marketing) Year:** The time span from harvest to harvest for agricultural commodities. The crop marketing year varies slightly with each ag commodity, but it tends to begin at harvest and end before the next year's harvest, e.g., the marketing year for soybeans begins September 1 and ends August 31. The futures contract month of November represents the first major new-crop marketing month, and the contract month of July represents the last major old-crop marketing month for soybeans.

**Crop Reports:** Reports compiled by the U.S. Department of Agriculture on various ag commodities that are released throughout the year. Information in the reports includes estimates on planted acreage, yield, and expected production, as well as comparison of production from previous years.

**Cross-Hedging:** Hedging a cash commodity using a different but related futures contract when there is no futures contract for the cash commodity being hedged and the cash and futures markets follow similar price trends (e.g., using soybean meal futures to hedge fish meal).

**Crush Spread:** The purchase of soybean futures and the simultaneous sale of soybean oil and meal futures. See [Reverse Crush Spread](#).

**Customer Margin:** Within the futures industry, financial guarantees required of both buyers and sellers of futures contracts and sellers of options contracts to ensure fulfillment of contract obligations. FCMs are responsible for overseeing customer margin accounts. Margins are determined on the basis of market risk and contract value. Also referred to as performance-bond margin. See [Clearing Margin](#).

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**Daily Trading Limit:** The maximum price range set by the exchange each day for a contract.

**Day Traders:** Speculators who take positions in futures or options contracts and liquidate them prior to the close of the same trading day.

**Deferred (Delivery) Month:** The more distant month(s) in which futures trading is taking place, as distinguished from the nearby (delivery) month.

**Deliverable Grades:** The standard grades of commodities or instruments listed in the rules of the exchanges that must be met when delivering cash commodities against futures contracts. Grades are often accompanied by a schedule of discounts and premiums allowable for delivery of commodities of lesser or greater quality than the standard called for by the exchange. Also referred to as contract grades.

**Delivery:** The transfer of the cash commodity from the seller of a futures contract to the buyer of a futures contract. Each futures exchange has specific procedures for delivery of a cash commodity. Some futures contracts, such as stock index contracts, are cash settled.

**Delivery Day:** The third day in the delivery process at the Chicago Board of Trade, when the buyer's clearing firm presents the delivery notice with a certified check for the amount due at the office of the seller's clearing firm.

**Delivery Month:** A specific month in which delivery may take place under the terms of a futures contract. Also referred to as contract month.

**Delivery Points:** The locations and facilities designated by a futures exchange where stocks of a commodity may be delivered in fulfillment of a futures contract, under procedures established by the exchange.

**Delta:** A measure of how much an option premium changes, given a unit change in the underlying futures price. Delta often is interpreted as the probability that the option will be in-the-money by expiration.

**Differentials:** Price differences between classes, grades, and delivery locations of various stocks of the same commodity

**Discount Rate:** The interest rate charged on loans by the Federal Reserve to member banks.

**Discretionary Account:** An arrangement by which the holder of the account gives written power of attorney to person, often his broker, to make trading decisions. Also known as a controlled or managed account.

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**Equilibrium Price:** The market price at which the quantity supplied of a commodity equals the quantity demanded.

**Eurodollars:** U.S. dollars on deposit with a bank outside of the United States and, consequently, outside the jurisdiction of the United States. The bank could be either a foreign bank or a subsidiary of a U.S. bank.

**European Terms:** A method of quoting exchange rates, which measures the amount of foreign currency needed to buy one U.S. dollar, i.e., foreign currency unit per dollar. See Reciprocal of European Terms.

**Exchange For Physicals (EFP):** A transaction generally used by two hedgers who want to exchange futures for cash positions. Also referred to as against actuals or versus cash.

**Exercise:** The action taken by the holder of a call option if he wishes to purchase the underlying futures contract or by the holder of a put option if he wishes to sell the underlying futures contract.

**Exercise Price:** See [Strike Price](#).

**Expanded Trading Hours:** Additional trading hours of specific futures and options contracts at the Chicago Board of Trade that overlap with business hours in other time zones.

**Expiration Date:** Options on futures generally expire on a specific date during the month preceding the futures contract delivery month. For example, an option on a March futures contract expires in February but is referred to as a March option because its exercise would result in a March futures contract position.

**Extrinsic Value:** See [Time Value](#).

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**Federal Funds:** Member bank deposits at the Federal Reserve; these funds are loaned by member banks to other member banks.

**Federal Funds Rate:** The rate of interest charged for the use of federal funds.

**Federal Reserve System:** A central banking system in the United States, created by the Federal Reserve Act in 1913, designed to assist the nation in attaining its economic and financial goals. The structure of the Federal Reserve System includes a Board of Governors, the Federal Open Market Committee, and 12 Federal Reserve Banks.

**Feed Ratio:** A ratio used to express the relationship of feeding costs to the dollar value of livestock. See Hog/Corn Ratio and Steer/Corn Ratio.

**Fill-or-Kill:** A customer order that is a price limit order that must be filled immediately or canceled.

**Financial Analysis Auditing Compliance Tracking System (FACTS):** The National Futures Association's computerized system of maintaining financial records of its member firms and monitoring their financial conditions.

**Financial Instrument:** There are two basic types: (1) a debt instrument, which is a loan with an agreement to pay back funds with interest; (2) an equity security, which is a share or stock in a company.

**First Notice Day:** According to Chicago Board of Trade rules, the first day on which a notice of intent to deliver a commodity in fulfillment of a given month's futures contract can be made by the clearinghouse to a buyer. The clearinghouse also informs the sellers who they have been matched up with.

**Floor Broker (FB):** An individual who executes orders for the purchase or sale of any commodity futures or options contract on any contract market for any other person.

**Floor Trader (FT):** An individual who executes trades for the purchase or sale of any commodity futures or options contract on any contract market for such individual's own account.

**Forex Market:** An over-the-counter market where buyers and sellers conduct foreign exchange business by telephone and other means of communication. Also referred to as foreign exchange market.

**Forward (Cash) Contract:** A cash contract in which a seller agrees to deliver a specific cash commodity to a buyer sometime in the future. Forward contracts, in contrast to futures contracts, are privately negotiated and are not standardized.

**Full Carrying Charge Market:** A futures market where the price difference between delivery months reflects the total costs of interest, insurance, and storage.

**Full Membership (CBOT):** A Chicago Board of Trade membership that allows an individual to trade all futures and options contracts listed by the exchange.

**Fundamental Analysis:** A method of anticipating future price movement using supply and demand information.

**Futures Commission Merchant (FCM):** An individual or organization that solicits or accepts orders to buy or sell futures contracts or options on futures and accepts money or other assets from customers to support such orders. Also referred to as commission house or wire house.

**Futures Contract:** A legally binding agreement, made on the trading floor of a futures exchange, to buy or sell a commodity or financial instrument sometime in the future. Futures contracts are standardized according to the quality, quantity, and delivery time and location for each commodity. The only variable is price, which is discovered on an exchange trading floor.

**Futures Exchange:** A central marketplace with established rules and regulations where buyers and sellers meet to trade futures and options on futures contracts.

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**Gamma:** A measurement of how fast delta changes, given a unit change in the underlying futures price.

**GIM Membership (CBOT):** A Chicago Board of Trade membership that allows an individual to trade all futures contracts listed in the government instrument market category.

**Give-up:** A transaction in which one clearing firm places an order for execution on behalf of a different clearing firm which ultimately will carry the trade.

**GLOBEX:** A global after-hours electronic trading system.

**Grain Terminal:** Large grain elevator facility with the capacity to ship grain by rail and/or barge to domestic or foreign markets.

**Gross Domestic Product (GDP):** The value of all final goods and services produced by an economy over a particular time period, normally a year.

**Gross National Product (GNP):** Gross Domestic Product plus the income accruing to domestic residents as a result of investments abroad less income earned in domestic markets accruing to foreigners abroad.

**Gross Processing Margin (GPM):** The difference between the cost of soybeans and the combined sales income of the processed soybean oil and meal.

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**Hedger:** An individual or company owning or planning to own a cash commodity corn, soybeans, wheat, U.S. Treasury bonds, notes, bills, etc. and concerned that the cost of the commodity may change before either buying or selling it in the cash market. A hedger achieves protection against changing cash prices by purchasing (selling) futures contracts of the same or similar commodity and later offsetting that position by selling (purchasing) futures contracts of the same quantity and type as the initial transaction.

**Hedging:** The practice of offsetting the price risk inherent in any cash market position by taking an equal but opposite position in the futures market. Hedgers use the futures markets to protect their businesses from adverse price changes. See Selling (Short) Hedge and Purchasing (Long) Hedge.

**High:** The highest price of the day for a particular futures contract.

**Hog/Corn Ratio:** The relationship of feeding costs to the dollar value of hogs. It is measured by dividing the price of hogs (hundredweight) by the price of corn (bushel). When corn prices are high relative to pork prices, fewer units of corn equal the dollar value of 100 pounds of pork. Conversely, when corn prices are low in relation to pork prices, more units of corn are required to equal the value of 100 pounds of pork. See Feed Ratio.

**Holder:** See [Option Buyer](#).

**Horizontal Spread:** The purchase of either a call or put option and the simultaneous sale of the same type of option with typically the same strike price but with a different expiration month. Also referred to as a calendar spread.

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**IDEM Membership (CBOT):** A Chicago Board of Trade membership of trading privileges for futures contracts in the index, debt, and energy markets category (gold, municipal bond index, 30-day fed funds, and stock index futures).

**Initial Margin:** The amount a futures market participant must deposit into his margin account at the time he places an order to buy or sell a futures contract. Also referred to as original margin.

**Intercommodity Spread:** The purchase of a given delivery month of one futures market and the simultaneous sale of the same delivery month of a different, but related, futures market.

**Interdelivery Spread:** The purchase of one delivery month of a given futures contract and simultaneous sale of another delivery month of the same commodity on the same exchange. Also referred to as an intramarket or calendar spread.

**Intermarket Spread:** The sale of a given delivery month of a futures contract on one exchange and the simultaneous purchase of the same delivery month and futures contract on another exchange.

**In-the-Money Option:** An option having intrinsic value. A call option is in-the-money if its strike price is below the current price of the underlying futures contract. A put option is in-the-money if its strike price is above the current price of the underlying futures contract. See [Intrinsic Value](#).

**Intramarket Spread:** See [Interdelivery Spread](#).

**Intrinsic Value:** The amount by which an option is in-the-money. See In-the-Money Option.

**Introducing Broker (IB):** A person or organization that solicits or accepts orders to buy or sell futures contracts or commodity options but does not accept money or other assets from customers to support such orders.

**Inverted Market:** A futures market in which the relationship between two delivery months of the same commodity is abnormal.

**Invisible Supply:** Uncounted stocks of a commodity in the hands of wholesalers, manufacturers, and producers that cannot be identified accurately; stocks outside commercial channels but theoretically available to the market.

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**Lagging Indicators:** Market indicators showing the general direction of the economy and confirming or denying the trend implied by the leading indicators. Also referred to as concurrent indicators.

**Last Trading Day:** According to the Chicago Board of Trade rules, the final day when trading may occur in a given futures or options contract month. Futures contracts outstanding at the end of the last trading day must be settled by delivery of the underlying commodity or securities or by agreement for monetary settlement (in some cases by EFPs).

**Leading Indicators:** Market indicators that signal the state of the economy for the coming months. Some of the leading indicators include: average manufacturing workweek, initial claims for unemployment insurance, orders for consumer goods and material, percentage of companies reporting slower deliveries, change in manufacturers' unfilled orders for durable goods, plant and equipment orders, new building permits, index of consumer expectations, change in material prices, prices of stocks, change in money supply.

**Leverage:** The ability to control large dollar amounts of a commodity with a comparatively small amount of capital.

**Limit Order:** An order in which the customer sets a limit on the price and/or time of execution.

**Limits:** See [Position Limit](#), [Price Limit](#), [Variable Limit](#).

**Liquid:** A characteristic of a security or commodity market with enough units outstanding to allow large transactions without a substantial change in price. Institutional investors are inclined to seek out liquid investments so that their trading activity will not influence the market price.

**Liquidate:** Selling (or purchasing) futures contracts of the same delivery month purchased (or sold) during an earlier transaction or making (or taking) delivery of the cash commodity represented by the futures contract. See [Offset](#).

**Liquidity Data Bank (LDB):** A computerized profile of CBOT market activity, used by technical traders to analyze price trends and develop trading strategies. There is a specialized display of daily volume data and time distribution of prices for every commodity traded on the Chicago Board of Trade.

**Long:** One who has bought futures contracts or owns a cash commodity. Long Hedge: See [Purchasing Hedge](#).

**Low:** The lowest price of the day for a particular futures contract.

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**Maintenance Margin:** A set minimum margin (per outstanding futures contract) that a customer must maintain in his margin account.

**Managed Account:** See [Discretionary Account](#).

**Managed Futures:** Represents an industry comprised of professional money managers known as commodity trading advisors who manage client assets on a discretionary basis, using global futures markets as an investment medium

**Margin:** See [Clearing Margin](#) and [Customer Margin](#).

**Margin Call:** A call from a clearinghouse to a clearing member, or from a brokerage firm to a customer, to bring margin deposits up to a required minimum level.

**Market Information Data Inquiry System (MIDIS):** Historical Chicago Board of Trade price, volume, open interest data and other market information accessible by computers within the Chicago Board of Trade building.

**Market Order:** An order to buy or sell a futures contract of a given delivery month to be filled at the best possible price and as soon as possible.



**Market Price Reporting and Information System (MPRIS):** The Chicago Board of Trade's computerized price-reporting system.

**Market Profile:** A Chicago Board of Trade information service that helps technical traders analyze price trends. Market Profile consists of the Time and Sales ticker and the Liquidity Data Bank.

**Market Reporter:** A person employed by the exchange and located in or near the trading pit who records prices as they occur during trading.

**Marking-to-Market:** To debit or credit on a daily basis a margin account based on the close of that day's trading session. In this way, buyers and sellers are protected against the possibility of contract default.

**Minimum Price Fluctuation:** See [Tick](#).

**Money Supply:** The amount of money in the economy, consisting primarily of currency in circulation plus deposits in banks: M-1 – U.S. money supply consisting of currency held by the public, traveler's checks, checking account funds, NOW and super-NOW accounts, automatic transfer service accounts, and balances in credit unions. M-2 – U.S. money supply consisting of M-1 plus savings and small time deposits (less than \$100,000) at depository institutions, overnight repurchase agreements at commercial banks, and money market mutual fund accounts. M-3 – U.S. money supply consisting of M-2 plus large time deposits (\$100,000 or more) at depository institutions, repurchase agreements with maturities longer than one day at commercial banks, and institutional money market accounts.

**Moving-Average Charts:** A statistical price analysis method of recognizing different price trends. A moving average is calculated by adding the prices for a predetermined number of days and then dividing by the number of days.

**Municipal Bonds:** Debt securities issued by state and local governments, and special districts and counties.

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**National Futures Association (NFA):** An industrywide, industry-supported, self-regulatory organization for futures and options markets. The primary responsibilities of the NFA are to enforce ethical standards and customer protection rules, screen futures professionals for membership, audit and monitor professionals for financial and general compliance rules, and provide for arbitration of futures-related disputes.

**Nearby (Delivery) Month:** The futures contract month closest to expiration. Also referred to as spot month.

**Negative Yield Curve:** See [Yield Curve](#).

**Notice Day:** According to Chicago Board of Trade rules, the second day of the three-day delivery process when the clearing corporation matches the buyer with the oldest reported long position to the delivering seller and notifies both parties. See [First Notice Day](#).

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**Offer:** An expression indicating one's desire to sell a commodity at a given price; opposite of bid.

**Offset:** Taking a second futures or options position opposite to the initial or opening position. See [Liquidate](#).

**OPEC:** Organization of Petroleum Exporting Countries, emerged as the major petroleum pricing power in 1973, when the ownership of oil production in the Middle East transferred from the operating companies to the governments of the producing countries or to their national oil. Members are: Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela. **Opening Range:** A range of prices at which buy and sell transactions took place during the opening of the market.

**Open Interest:** The total number of futures or options contracts of a given commodity that have not yet been offset by an opposite futures or option transaction nor fulfilled by delivery of the commodity or option exercise. Each open transaction has a buyer and a seller, but for calculation of open interest, only one side of the contract is counted.

**Open Market Operation:** The buying and selling of government securities: Treasury bills, notes, and bonds by the Federal Reserve.

**Open Outcry:** Method of public auction for making verbal bids and offers in the trading pits or rings of futures exchanges.

**Option:** A contract that conveys the right, but not the obligation, to buy or sell a particular item at a certain price for a limited time. Only the seller of the option is obligated to perform.

**Option Buyer:** The purchaser of either a call or put option. Option buyers receive the right, but not the obligation, to assume a futures position. Also referred to as the holder.

**Option Premium:** The price of an option the sum of money that the option buyer pays and the option seller receives for the rights granted by the option.

**Option Seller:** The person who sells an option in return for a premium and is obligated to perform when the holder exercises his right under the option contract. Also referred to as the writer.

**Option Spread:** The simultaneous purchase and sale of one or more options contracts, futures, and/or cash positions.

**Option Writer:** See [Option Seller](#).

**Out-of-the-Money Option:** An option with no intrinsic value, i.e., a call whose strike price is above the current futures price or a put whose strike price is below the current futures price.

**Over-the-Counter (OTC) Market:** A market where products such as stocks, foreign currencies, and other cash items are bought and sold by telephone and other means of communication.

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**P&S (Purchase and Sale) Statement:** A statement sent by a commission house to a customer when his futures or options on futures position has changed, showing the number of contracts bought or sold, the prices at which the contracts were bought or sold, the gross profit or loss, the commission charges, and the net profit or loss on the transactions.

**Par:** The face value of a security. For example, a bond selling at par is worth the same dollar amount it was issued for or at which it will be redeemed at maturity.

**Payment-In-Kind (PIK) Program:** A government program in which farmers who comply with a voluntary acreage-control program and set aside an additional percentage of acreage specified by the government receive certificates that can be redeemed for government-owned stocks of grain.

**Performance Bond Margin:** The amount of money deposited by both a buyer and seller of a futures contract or an options seller to ensure performance of the term of the contract. Margin in commodities is not a payment of equity or down payment on the commodity itself, but rather it is a security deposit. See Customer Margin and Clearing Margin.

**Pit:** The area on the trading floor where futures and options on futures contracts are bought and sold. Pits are usually raised octagonal platforms with steps descending on the inside that permit buyers and sellers of contracts to see each other.

**Point-and-Figure Charts:** Charts that show price changes of a minimum amount regardless of the time period involved.

**Position:** A market commitment. A buyer of a futures contract is said to have a long position and, conversely, a seller of futures contracts is said to have a short position.

**Position Day:** According to the Chicago Board of Trade rules, the first day in the process of making or taking delivery of the actual commodity on a futures contract. The clearing firm representing the seller notifies the Board of Trade Clearing Corporation that its short customers want to deliver on a futures contract.

**Position Limit:** This limit consists of the maximum number of speculative futures contracts one can hold as determined by the Commodity Futures Trading Commission and/or the exchange upon which the contract is traded. Also referred to as “trading limit.”

**Position Trader:** A trading strategy where one either buys or sells contracts and holds them for an extended period of time

**Positive Yield Curve:** See [Yield Curve](#).

**Premium:** (1) The additional payment allowed by exchange regulation for delivery of higher-than-required standards or grades of a commodity against a futures contract. (2) In speaking of price relationships between different delivery months of a given commodity, one is said to be “trading at a premium” over another when its price is greater than that of the other. (3) In financial instruments, the dollar amount by which a security trades above its principal value. See Option Premium

**Price Discovery:** The generation of information about “future” cash market prices through the futures markets.

**Price Limit:** The maximum advance or decline from the previous day’s settlement price permitted for a contract in one trading session by the rules of the exchange. See also [Variable Limit](#).

**Price Limit Order:** A customer order that specifies the price at which a trade can be executed.

**Primary Dealer:** A designation given by the Federal Reserve System to commercial banks or broker/dealers who meet specific criteria. Among the criteria are capital requirements and meaningful participation in the Treasury auctions.

**Primary Market:** Market of new issues of securities.

**Prime Rate:** Interest rate charged by major banks to their most creditworthy customers. Producer Price Index (PPI): An index that shows the cost of resources needed to produce manufactured goods during the previous month.

**Pulpit:** A raised structure adjacent to, or in the center of, the pit or ring at a futures exchange where market reporters, employed by the exchange, record price changes as they occur in the trading pit.

**Purchasing Hedge (or Long Hedge):** Buying futures contracts to protect against a possible price increase of cash

commodities that will be purchased in the future. At the time the cash commodities are bought, the open futures position is closed by selling an equal number and type of futures contracts as those that were initially purchased. Also referred to as a “buying” hedge. See [Hedging](#).

**Put Option:** An option that gives the option buyer the right but not the obligation to sell (go “short”) the underlying futures contract at the strike price on or before the expiration date.

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**Range (Price):** The price span during a given trading session, week, month, year, etc.

**Reciprocal of European Terms:** One method of quoting exchange rates, which measures the U.S. dollar value of one foreign currency unit, i.e., U.S. dollars per foreign units. See [European Terms](#).

**Reserve Requirements:** The minimum amount of cash and liquid assets as a percentage of demand deposits and time deposits that member banks of the Federal Reserve are required to maintain.

**Resistance:** A level above which prices have had difficulty penetrating.

**Resumption:** The reopening the following day of specific futures and options markets that also trade during the evening session at the Chicago Board of Trade.

**Reverse Crush Spread:** The sale of soybean futures and the simultaneous purchase of soybean oil and meal futures. See [Crush Spread](#).

**Runners:** Messengers who rush orders received by phone clerks to brokers for execution in the pit.

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**Scalper:** A trader who trades for small, short-term profits during the course of a trading session, rarely carrying a position overnight.

**Secondary Market:** Market where previously issued securities are bought and sold.

**Selling Hedge (or Short Hedge):** Selling futures contracts to protect against possible declining prices of commodities that will be sold in the future. At the time the cash commodities are sold, the open futures position is closed by purchasing an equal number and type of futures contracts as those that were initially sold. See [Hedging](#).

**Settlement Price:** The last price paid for a commodity on any trading day. The exchange clearinghouse determines a firm’s

net gains or losses, margin requirements, and the next day's price limits, based on each futures and options contract settlement price. If there is a closing range of prices, the settlement price is determined by averaging those prices.

Also referred to as settle or closing price.

**Short:** (noun) One who has sold futures contracts or plans to purchase a cash commodity. (verb) Selling futures contracts or initiating a cash forward contract sale without offsetting a particular market position.

**Short Hedge:** See [Selling Hedge](#).

**Simulation Analysis of Financial Exposure (SAFE):** A sophisticated computer risk- analysis program that monitors the risk of clearing members and large-volume traders at the Chicago Board of Trade. It calculates the risk of change in market prices or volatility to a firm carrying open positions.

**Speculator:** A market participant who tries to profit from buying and selling futures and options contracts by anticipating future price movements. Speculators assume market price risk and add liquidity and capital to the futures markets.

**Spot:** Usually refers to a cash market price for a physical commodity that is available for immediate delivery.

**Spot Month:** See [Nearby \(Delivery\) Month](#).

**Spread:** The price difference between two related markets or commodities.

**Spreading:** The simultaneous buying and selling of two related markets in the expectation that a profit will be made when the position is offset. Examples include: buying one futures contract and selling another futures contract of the same commodity but different delivery month; buying and selling the same delivery month of the same commodity on different futures exchanges; buying a given delivery month of one futures market and selling the same delivery month of a different, but related, futures market.

**Steer/Corn Ratio:** The relationship of cattle prices to feeding costs. It is measured by dividing the price of cattle (hundredweight) by the price of corn (bushel). When corn prices are high relative to cattle prices, fewer units of corn equal the dollar value of 100 pounds of cattle. Conversely, when corn prices are low in relation to cattle prices, more units of corn are required to equal the value of 100 pounds of beef. See [Feed Ratio](#).

**Stock Index:** An indicator used to measure and report value changes in a selected group of stocks. How a particular stock index tracks the market depends on its composition, the sampling of stocks, the weighting of individual stocks, and the method of averaging used to establish an index.

**Stop-Limit Order:** A variation of a stop order in which a trade must be executed at the exact price or better. If the order

cannot be executed, it is held until the stated price or better is reached again.

**Stop Order:** An order to buy or sell when the market reaches a specified point. A stop order to buy becomes a market order when the futures contract trades (or is bid) at or above the stop price. A stop order to sell becomes a market order when the futures contract trades (or is offered) at or below the stop price.

**Strike Price:** The price at which the futures contract underlying a call or put option can be purchased (if a call) or sold (if a put). Also referred to as exercise price.

**Support:** The place on a chart where the buying of futures contracts is sufficient to halt a price decline.

**Suspension:** The end of the evening session for specific futures and options markets traded at the Chicago Board of Trade.

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**Technical Analysis:** Anticipating future price movement using historical prices, trading volume, open interest, and other trading data to study price patterns.

**Tick:** The smallest allowable increment of price movement for a contract. Also referred to as minimum price fluctuation

**Time Limit Order:** A customer order that designates the time during which it can be executed.

**Time and Sales Ticker:** Part of the Chicago Board of Trade Market Profile system consisting of an on-line graphic service that transmits price and time information throughout the day.

**Time-Stamped:** Part of the order-routing process in which the time of day is stamped on an order. An order is time-stamped when it is (1) received on the trading floor, and (2) completed.

**Time Value:** The amount of money option buyers are willing to pay for an option in the anticipation that, over time, a change in the underlying futures price will cause the option to increase in value. In general, an option premium is the sum of time value and intrinsic value. Any amount by which an option premium exceeds the option's intrinsic value can be considered time value. Also referred to as extrinsic value.

**Trade Balance:** The difference between a nation's imports and exports of merchandise.

**Trading Limit:** See [Position Limit](#). T Bill: See [U.S. Treasury Bill](#).

**T Bond:** See [U.S. Treasury Bond](#). Treasury Note: See [U.S. Treasury Note](#).

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**Underlying Futures Contract:** The specific futures contract that is bought or sold by exercising an option.

**U.S. Treasury Bill:** A short-term U.S. government debt instrument with an original maturity of one year or less. Bills are sold at a discount from par with the interest earned being the difference between the face value received at maturity and the price paid.

**U.S. Treasury Bond:** Government-debt security with a coupon and original maturity of more than 10 years. Interest is paid semiannually.

**U.S. Treasury Note:** Government-debt security with a coupon and original maturity of one to 10 years.

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**Variable Limit:** According to the Chicago Board of Trade rules, an expanded allowable price range set during volatile markets.

**Variation Margin:** During periods of great market volatility or in the case of high-risk accounts, additional margin deposited by a clearing member firm to an exchange clearinghouse.

**Versus Cash:** See [Exchange for Physicals](#).

**Vertical Spread:** Buying and selling puts or calls of the same expiration month but different strike prices.

**Volatility:** A measurement of the change in price over a given time period. It is often expressed as a percentage and computed as the annualized standard deviation of percentage change in daily price.

**Volume:** The number of purchases or sales of a commodity futures contract made during a specified period of time, often the total transactions for one trading day.

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**Warehouse Receipt:** Document guaranteeing the existence and availability of a given quantity and quality of a commodity in storage; commonly used as the instrument of transfer of ownership in both cash and futures transactions.

**Wire House:** See [Futures Commission Merchant \(FCM\)](#). Writer: See [Option Seller](#).

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**Yield:** A measure of the annual return on an investment.

**Yield Curve:** A chart in which the yield level is plotted on the vertical axis and the term to maturity of debt instruments of similar creditworthiness is plotted on the horizontal axis. The yield curve is positive when long-term rates are higher than short-term rates.

However, when short-term rates are higher than yields on long-term investments, the yield curve is negative or inverted.

**Yield to Maturity:** The rate of return an investor receives if a fixed-income security is held to maturity.

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