

A beginner's guide to futures trading for success

Futures made simple

**SIMPLE, EASY TO UNDERSTAND
STRATEGIES ANYONE CAN USE FOR SUCCESS!**



Kel Butcher

Author of *Forex Made Simple* and *20 Most Common Trading Mistakes*

Foreword by Larry Williams

Futures Made Simple

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Futures

made simple

Kel Butcher



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The future is no more uncertain than the present.

Walt Whitman

*Standard education brings standard results ... self-education
brings outstanding results.*

Jim Rohn

About the author

Kel Butcher is a private trader, entrepreneur and investor with more than 20 years' experience in financial markets, trading shares, futures, options, warrants, CFDs and forex. As well as trading his own funds, Kel is consultant to a managed fund, a boutique trading company and a share-trading software developer. He is a regular contributor to *YourTradingEdge* magazine and is the author of three other books: *Forex Made Simple: a beginner's guide to foreign exchange success*, *A Step-by-Step Guide to Buying and Selling Shares Online* and *20 Most Common Trading Mistakes and How You Can Avoid Them*. He also featured in *The Wiley Trading Guide* and *Give Your Trading the Edge*.

Passionate about money management, risk management and position-sizing techniques, Kel acts as a mentor and coach to fellow traders. He can be contacted by email at kel@tradingwisdom.com.au.

When he's not trading, Kel enjoys snowboarding, mountain-bike riding and surfing. He lives on the NSW Central Coast with his wife Cate and his two sons Jesse and Ollie.

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Foreword

I first met Kel at one of my Million Dollar Challenge workshops in Sydney, Australia in 2002. Since then he has become a successful trader, author and educator in his own right. He has developed his own unique trading style and techniques, many derived from the information and mentoring I have been able to provide him over the years.

Launching into any new business venture or activity in life involves a learning process — one that begins with building a solid foundation onto which the rest of the business structure is then built. So it is in the world of trading. To become an 'overnight' success requires years of hard work and dedication built on a solid foundation. Too often these days, people are drawn to the markets with the promises of huge riches and overnight success for less than a few hours work each day. I'll vouch for the fact that this isn't the case. Those that achieve success begin with a solid base and spend considerable time developing and refining their trading skills.

This introductory guide is just such a foundation. It provides almost all the information any trader, either new to the markets or just new to the futures markets, will need to get started on the journey to successful futures trading. It is a comprehensive resource that covers everything from the drivers of the price of corn, and the machinations of the bond markets, to the ever-important topic of money management, and a mass of information in between.

This is the book I wish I had written — it presents a concise history of this business and an understanding of how it

continues on a day-to-day basis. This is a must-read starting point for all futures traders.

Larry Williams
Commodity trader and author
August, 2012

Preface

Sydney, Australia, 18 May 2022.

As private futures trader Margaret Anderson sits down at her home office desk to begin her daily trading routine, she pauses to reflect on the price movements the market has experienced over the past few years. Triggered by increased demand for raw materials from China and for food to feed a growing world population, prices have been in a steady upward trend, providing a wealth of opportunities to participate in a great generational bull market. With persistent drought in the Southern Hemisphere, prices for corn, wheat, soybeans and other agricultural commodities have risen sharply. Base metal prices have also continued to climb, driven by production demand and the ever-present fear of inflation. Margaret notes the steady decline in the price for crude oil and other energy commodities following the development of alternative energy sources that allow today's cars to run on hydrogen derived from water, and houses and businesses to meet all their energy requirements from a combination of wind and solar energy sources. Equities and equity indexes continue to amble along, stuck in a five-year trading range that has had a devastating impact on trend traders, while short-term traders have been able to profit from trading the 'swings' from high to low in this trading range ...

Or maybe not. Here's an alternative scenario: the severe global recession that took hold in 2012 and continues in 2022 has reduced the global economy to a shadow of its former self. Demand for consumer products has been wiped out by massively high interest rates, soaring unemployment, and a general feeling of doom and gloom.

As a result, demand for base metals and other manufacturing raw materials has plummeted, sending prices down the slippery slope of a bear market. Oil prices have skyrocketed as demand continues to outstrip supply, and alternative energy sources such as wind and solar have proven too difficult and costly to harness on a commercial scale. The use of genetically modified crops has increased global food production of staples such as corn and wheat, so the prices for these commodities has fallen substantially. Equity markets have been in a long-term downtrend for years, providing rich opportunities to trade the short side of the market but giving little joy to the buy-and-hold investors, who have seen their portfolios decimated. The one shining light has been gold: still seen as the only true store of value on the planet, it has risen to over \$4000 per ounce ...

Both of these scenarios are completely fictitious, *or maybe not* ...

Margaret and others like her who have learned to trade the futures markets are presented with a constantly changing array of market conditions and trading opportunities. Futures are formalised agreements to buy or sell a commodity or financial instrument at a specified future date. Trading futures contracts allows us to participate in price moves in any direction — up, down or even sideways — in a range of commodities including grains, metals, energy products, meats, 'softs', equity indexes and interest rate products. As futures traders, we can speculate on price moves over short or long time frames in any of these and other markets. We can also use futures contracts to 'hedge' production and manufacturing outputs, to 'lock in' prices for the purchase of raw material inputs or manufacturing outputs, and even to trade the 'spread' between different

prices in the same or different contracts in different months or delivery periods.

The futures markets offer the active trader ever-changing opportunities across a wide variety of markets and trading instruments. We explore this wonderful and profitable world in this book, which is divided into three parts. Part I addresses the fundamentals of futures trading — its history, principles and practice. We begin, in [chapter 1](#), with a brief survey of the history and evolution of futures exchanges, from their ancient origins to the sophisticated electronic markets of today. [Chapter 2](#) looks more closely at what futures contracts are and introduces the role of the clearing house, the price discovery process and some basic concepts in trading. In [chapter 3](#) we examine hedging and speculating activities and discover who is drawn to each mode of trading. [Chapter 4](#) delves into the mechanics of trading, unpacking essential concepts such as short selling and stop orders, and offering basic advice on choosing and dealing with a broker. Perhaps most importantly, [chapter 5](#) discusses the risks and rewards associated with the futures markets, and the importance of risk- and money-management.

Parts II and III introduce and systematically review the major futures contracts, including a description of each contract along with its main users, contract specifications and trading characteristics. [Part II \(chapters 6 to 10\)](#) is devoted to the natural commodities contracts, including the most actively traded grains, food and fibre, energy and metal resources commodities. [Part III](#) examines financial markets futures, reviewing some of the main interest rate futures ([chapter 11](#)) and equity index futures ([chapter 12](#)).

Futures Made Simple will provide those interested in breaking into this exciting trading area with a solid understanding of what futures contracts are and how they

are traded. Futures trading is a truly global trading arena that has no boundaries or borders. From your home office in Brisbane or Bombay or anywhere else on the planet, you can trade Chicago wheat futures, German Bunds (interest rates), the Japanese Nikkei Index, Australian wool futures and a host of other futures contracts.

Let's roll the dice!

Part I: Trading futures — principles and practice

To operate in the present and prepare for the future it is necessary to understand the past. So before we delve into its mechanics we will take a look at the history of futures trading — how it began, and how it has developed and evolved over time into the futures markets as we know them today. In [part I](#) we will also discover how futures work, identify the various market participants and their reasons for trading futures contracts, explore the fundamentals of order types and order placement, and introduce the critically important subject of money management.

Chapter 1: The history and evolution of futures exchanges

The origins of the use of agreements to deliver a specific commodity at some future time for an agreed price date back to ancient Greek and Roman marketplaces. As well as centres of political and cultural life, the Agora in Athens and the Forum in Rome were commercial centres where commodities brought from distant lands were exchanged for currency or precious metals such as gold and silver. The traders, merchants, producers and buyers of the ancient world faced many of the same demands as today's traders, merchants, producers and consumers, notably the need to

manage price and delivery risk, and the need for timely and transparent market and price information. Although there is no comparison with the timeliness of today's electronically accessed information, these traders of yesteryear established and accessed information and prices through the informal networks they created. The first formalised futures exchange, however, is generally recognised as the Dojima Rice Exchange in Osaka, Japan, in the early 1700s.

Forward contracts

For many centuries commodity markets have thrived wherever producers and consumers have traded goods in exchange for cash. At some stage agreements began to be made between the counterparties to deliver a commodity at a designated time in the *future* at a price agreed on in the present. Payment would be made on receipt of the agreed quantity of the commodity at the specified quality. These agreements, which came to be known as forward contracts, meant the producer, usually a farmer, could plant his crop knowing he was guaranteed a return for his time and investment, and the buyer was assured of receiving the contracted commodity from the producer.

Initially these forward contracts were frequently not honoured by one or other party if market conditions — namely, price — had changed significantly from when the contract was first negotiated. If the price had risen dramatically because of adverse climatic conditions, for example, the seller might back out of the agreement claiming an inability to deliver the contracted quantity or quality due to the effects of drought or flood, even though they might not have suffered any ill effects on their own production, but were now able to sell at a higher price to another buyer. Similarly, in years of overproduction, when prices fell, the buyer might back out because crop prices

were now much cheaper on the open market. Other problems with these early forward contracts included lack of liquidity, quality issues, the practical difficulties of buyers and sellers locating each other and then negotiating a contract, the individual nature of each forward contract and the lack of any formal way of ensuring these contracts were honoured.

Tip

Forward contracts are not traded on a formalised exchange, but are customised on an individual needs basis and are privately negotiated.

Forward contracts can expose both parties to several risks, including credit risk if either party defaults on the deal or has insufficient funds to honour the agreement; negotiation risk if either party is operating in bad faith; and the risk that future events such as adverse weather, political or economic events could prevent one or both sides from fulfilling their obligations. Clearly a more formalised and secure commercial arrangement was needed.

The development of futures exchanges

In the 1840s Chicago emerged as the market centre for grain farmers in the United States. Each year at harvest time producers would arrive to sell their grain. In abundant years there would be too few buyers, prices would be low, and with no way of storing the excess production much of it would be dumped. In the winter, prices would rise as supply fell. Privately negotiated forward contracts were arranged between buyers and sellers. In 1848 a group of grain merchants banded together to form an organised grain exchange where buyers and sellers could meet and conduct business at a central location. The Chicago Board of Trade

(CBOT) was formed, and the first official forward contract was written on 13 March 1851.

In 1865 the CBOT introduced standardised futures contracts for corn, wheat and oats. These contracts specified the quantity and quality of the commodity being traded and the delivery date, but not the price. They were also interchangeable or 'fungible', which meant they could be exchanged between buyers and sellers many times before the specified delivery date as prices fluctuated. With a formal exchange now in place, the ability to access product year-round became a priority and storage silos were built to handle the excess that occurred each year at harvest time. This storage also helped to smooth out the wild fluctuations in price that had occurred previously.

In 1898, inspired by what had occurred in the grain markets, a group of merchants formed the Chicago Butter and Egg Board to allow the buying and selling of futures contracts on other agricultural products, including eggs, butter, hides, onions and potatoes. In 1919 its name was changed to the Chicago Mercantile Exchange (CME). Over the years more contracts were added, starting with frozen pork bellies in 1961, followed by financial and currency futures in the 1970s, interest rate products in 1981, and equity index futures and options in the 1980s. These included the first cash-settled futures contract for Eurodollar futures in 1992 and the first equity index futures contract for the S&P 500Index.

The growth of financial futures coincided with the breakdown in the late 1970s of the Bretton Woods exchange rate mechanism, under which global currency exchange rates were effectively pegged to the value of the US dollar, which itself was fixed to the value of gold via the gold standard. Once these pegs were removed a free market developed for the discovery of exchange rate values and to

allow hedgers and speculators to participate in this price discovery process. Free-floating exchange rates exposed manufacturers and consumers to currency fluctuations, and the futures markets provided a valuable mechanism for hedging. Speculators were drawn to these contracts as volumes and liquidity increased. Financial futures provided for exposure to interest rate products for both hedging and speculative purposes.

In the 1850s forward contracts for cotton were also being traded in New York. In 1870 organised trading of standardised futures contracts began on the New York Cotton Exchange, with rules and procedures formalising the process announced in 1872. That year also saw the formation in New York of the Butter and Cheese Exchange (later the New York Mercantile Exchange, or NYMEX), which was acquired by CME Group in 2008. In 1882 formalised futures trading began on the New Orleans Cotton Exchange.

During the 19th century, metal commodities and coffee were being traded in England on an informal, ad hoc basis on the grandly titled 'Royal Exchange'. More often than not, these 'trades' were conducted in one of many coffee houses where traders sat at fixed points around a circle drawn in chalk on the floor, giving rise to the term *ring trading*, the English traders' equivalent to *floor trading* or *pit trading* in the US. In 1877 a group of English merchants formed the London Metals and Mining Company trading in tin, copper and pig iron. The name was later changed to the London Metals Exchange, which remains a leading futures exchange for a range of metals contracts today.

Following the removal of currency controls and the CME's successful launch of currency futures on its sibling exchange the International Monetary Market (IMM), in 1982 the London International Financial Futures Exchange (LIFFE) was formed. In 1996 LIFFE merged with the London Commodity

Exchange and in 2002 it was acquired by the Euronext exchange group (itself created by the merger of the Amsterdam Stock Exchange, Brussels Stock Exchange and Paris Bourse). In 2007 Euronext merged with the New York Stock Exchange to form NYSE Euronext, which incorporates LIFFE, although the latter continues to operate under its own governance.

Controversy

The history of futures trading has not been without controversy, and to this day there are those who argue that it is little more than glorified gambling. Mostly these attacks come from the ignorant and uneducated, those who simply don't understand or, loudest of all, those who have either tried and failed or have never attempted any form of trading but who condemn it from some perceived higher moral ground. In this, little has changed over the 150-plus years that trading futures has been a legal and legitimate form of both hedging to protect profits and speculating to create profit. As today, many in the 1800s and early 1900s were both fascinated and appalled by the notion of trading futures. There has been endless litigation and public debate surrounding its legitimacy. The distinction between outright gambling and speculating in futures contracts was (and still is) lost on a large proportion of the general public. While gambling is essentially a game of chance in which 'lady luck' plays a significant role in the outcome and the odds are stacked against the 'punter', futures trading, like all other trading endeavours, requires education, a detailed plan, and strict trading and money management rules. Drawing on an understanding of these concepts and a solid grasp of probability, trading of any type is a legitimate business venture.

Through the 19th century there were many attempts to restrict or prohibit futures trading in the United States. To give a few examples, in 1812 short selling became illegal in New York (this legislation was repealed in 1858); in 1841 failing to cover short sales within five days was deemed a misdemeanour under Pennsylvania law (repealed in 1862); in 1879 California's constitution invalidated futures contracts (repealed in 1908); and in 1882 Ohio and Illinois tried unsuccessfully to restrict cash settlements of futures contracts.

As well as the persistent legal assaults on futures trading activities, two other challenges in the late 1800s seriously threatened the fledgling futures markets. The first was the anti-option movement, which sought to outlaw trading in both futures and options. This campaign culminated in the passage through both houses of the US Congress of two anti-option bills. Had either bill passed into law it would have spelt the end of futures trading in the US, but both eventually failed on the basis of legal technicalities.

The second challenge was the controversy surrounding 'bucket shops'. These were essentially groups of punters who met in premises outside the recognised exchanges and 'bet' on the direction of price movements. Although they relied on price data from the exchange, they did not trade on the official exchange. The 'bucket shop' era was a colourful chapter in futures history that came to an end in 1915 following a ruling by the US Supreme Court that exchanges, and in particular the CBOT, could restrict the dissemination of price information to a third party.

Hand signals

Like many other professional bodies, stock and futures traders developed their own specialised modes of communication. Originally all futures contracts were traded