The Conti Commodity Futures Handbook

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Edited by

Martin J. Pring

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How to Use This Book

This book is intended to be used as a reference work by a broad spectrum of investors and speculators, ranging from beginners to those very knowledgeable and experienced. With this in mind, the book has been divided into seven main parts. Part 1 discusses introductory topics for those unfamiliar with the futures industry, and includes some pointers on general trends in commodity prices. Parts 2 to 5 describe the fundamentals of the main commodity and financial-instrument contracts. At the end of many of the fundamental chapters a section has been included on sources of information. Part 6, the technical part, explains how commodity traders study the action of the market itself to help them make their decisions. Any investor who wishes to adopt the technical approach is advised to study all the material presented on technical analysis because a balanced and comprehensive understanding is necessary to achieve success. Part 7 consists of a glossary and a bibliography.

While every effort has been made to furnish as much information and background for trading futures as possible, explaining the basic material is telling only half the story. The other half concerns the psychological makeup of the individual trader. All the knowledge in the world is of little help to the trader who lacks discipline, patience, and humility. The following fourteen precepts should help traders maximize their gains and minimize their losses.

1. *Don't try to go too fast or you may never get to your financial destination.* Given the tremendous leverage associated with futures, it is natural for a trader to become as fully margined as possible. As a result, if the market moves adversely, there is a very good chance that a substantial portion of the equity in the account will be wiped out. Similarly, if the trader is taking on too much risk, the significance of any minor price movement will be greatly magnified psychologically, leading to emotional rather than rational trading decisions.

2. *Don't make a trade unless you know where you are going to get out.* If a position is taken and the trader has not decided where to get out if the market moves adversely, the trader is not assessing the risk-to-reward ratio of the trade. Under such circumstances there is a tendency to hang on and let losses run.

3. *Set a loss limit and profit objective before taking a new position.* If these points are reached, stick with your original game plan by liquidating or by taking profits. Only in the most exceptional circumstances does a reevaluation justify running the position.

4. *If the market goes against you, liquidate your position and look for a better opportunity elsewhere.* If such a development takes place, chances are your judgment was incorrect. It is always hard to take a loss, but small losses have a habit of turning into big ones.

5. *Never answer a margin call.* A margin call usually results either from an unexpected adverse market move or from having too many positions. Either way it means that developments have not gone according to plan. Liquidation is the only sensible solution, for throwing good money after bad rarely works.

6. *Try to maintain some cash reserves at all times.* While cash will never earn such a high return as a fully invested futures position, it is always a good idea to maintain some reserves since an outstanding buying opportunity may arise at a time when it is inconvenient to liquidate other positions.

7. *Diversify as much as possible.* Even the best-laid plans can fail to bring success, so it is a good idea to diversify into several different markets. In case luck goes against you in one area, good judgment will save you elsewhere.

8. *Do not assume that you have to be active at all times.* There are often periods when it is not clear which way the markets are going, or when the trader is not in tune with the markets. In such cases you will make more money by being idle than by being active. Psychologically you will be in a stronger position to recognize the next major move, since you will be far more objective emotionally.

9. *Always wait for a near-perfect situation.* In most markets impor-

tant long-term buying or selling junctures come two to four times a year. Given the plethora of futures markets, it does not involve a tremendous amount of patience to wait out such situations until either the technical or fundamental signs (or, better still, both) look favorable for a long or short position. There is always risk in any situation, but if the trader can isolate and minimize such risks, the chances of success are much greater.

10. *Do not overtrade.* This rule is a natural extension of the previous one. Overtrading indicates that the trader is not really sure what to do. The trader is often trying to pick the minor moves, which tend to be random anyway, and may become so involved that he or she fails to see the big picture.

11. *Avoid counteractions to the main trend.* If traders think they have determined the direction of the main trend, they should stick to that trend and not attempt to play the counteracting corrective movements to that trend by reversing positions. This is because intermediate corrective movements are notoriously difficult to predict and, by definition, are of smaller magnitude than intermediate movements of the main trend.

12. *Never commit more than you can afford to lose.* If you cannot afford to lose the money at risk, and the market goes against you, chances are that you will be "psyched out" of the position for no reason at all and you will be unable to ride out any unexpected setbacks.

13. *Do not let success go to your head.* If you find that your positions are continually making profits, it is time to move some of those profits out of the account. In no case should you pyramid your positions by taking on a lot of additional contracts as your equity expands. Pyramids are slow to build up but can come down awfully fast. After a good run it is often better to withdraw from the markets for a few weeks. Since nobody is in tune with the markets at all times, chances are that you are about to hit a losing streak—and there is nothing like newly won profit to breed complacency. One of the largest problems facing professional traders is not in making money, but in avoiding giving a substantial portion back. Therefore it is best either to take money out of the account, and drastically reduce trading activity, or to temporarily withdraw altogether.

14. *Listen to the opinions of others, but only take action based on your own assessment of the situation.* If you are managing your own account it is you, not others, who have to bear the loss if things go wrong. Only by forming your own conclusions can you hope to have the psychological fortitude to outlast temporary setbacks.

The guidelines given above are purely commonsense, but it is amazing how many of us can start off with good intentions and then fall into bad habits. If you find that things are going against you, it is a good idea to analyze where you have been going wrong and make a definite effort not to make the same mistakes again. It also makes sense, after a cooling-off period, to try again by using a much, much smaller portion of your risk capital until confidence and good judgment return. Even if your temporary withdrawal causes you to miss a major opportunity, you should always remember that another one lies just around the corner.

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CONTENTS

PART

1

General Introduction

CHAPTER

1

The Nature and Mechanics of the Futures Markets

Martin J. Pring

The futures markets have always been viewed as a highly speculative area—and no place for the faint of heart. In recent years the increasing volatility of all financial markets, and the need of individuals to find some kind of hedge against the inflation of the 1970s and early 1980s, have led to a tremendous growth in the volume of existing contracts and to a plethora of new vehicles. The increasing volatility not only attracted a wider base of speculators but also encouraged commercial users to hedge more actively against violent price swings. The greatest expansion in new contract options has taken place in the area of financial instruments. This includes currencies, interest-rate futures, and stock market index futures. Consequently the futures industry, which used to be concerned solely with physical commodities, now embraces many more areas.

As a result of this widening base of futures participants and the general trend toward global financial instability, the futures industry has become a more widely utilized financial vehicle by the general public and the financial establishment.

MAJOR MARKET PARTICIPANTS

In any futures market there are essentially three types of participant. Those who are risk-averse and use the markets for hedging, therefore reducing risk; those who undertake the risk; and those who buy or sell to take advantage of temporary price aberrations. Those in the first category may be loosely termed