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The Minimalist Guide To Futures Trading

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Futures markets can be confusing. Here's what you need to know...

If you know who Back to the Future's Marty McFly is, then you know that trying to manipulate the future is risky and usually futile.

No amount of Libyan plutonium is going to change that. But there are investors who still try, and the most dedicated of them like to mess around in the futures markets, where they can essentially bet on what's going to happen.

Of course, futures markets are harder to navigate than a DeLorean in a mall parking lot, so here are a few things you need to know about futures before you dial it up to 88 miles an hour.

Futures Contracts, Counterparties And Clearing Agents

Futures contracts are contracts giving the buyer an obligation to purchase an asset (and the seller an obligation to sell an asset) at a set price at a future point in time.

#-ad_banner-#The assets often traded in futures contracts include commodities, stocks and bonds. Grain, precious metals, electricity, oil, beef, orange juice and natural gas are traditional examples of commodities, but foreign currencies, emissions credits, bandwidth and certain financial instruments are also part of today's commodity markets.

Futures contracts are useful. For example, if you're a farmer and you plan to grow 500 bushels of wheat next year, you have two choices: Grow the wheat and sell it for whatever the price is when you harvest it, or lock in a price now by selling a futures contract. The futures contract obligates you to sell 500 bushels of wheat after the harvest for a fixed price. A bread manufacturer might want to purchase your futures contract (that is, be the "counterparty") to lock in prices and control its costs.

By locking in the price now, you eliminate the risk of falling wheat prices. On the other hand, if the season is terrible and the supply of wheat falls, prices will probably rise later -- but you will get only what your contract entitled you to. When the contract hits the expiration date, you have to sell your wheat for the agreed amount, even if the market price at the time is different. This means that you end up overcharging or undercharging for the wheat, and the bread company ends up overpaying or underpaying for the wheat.
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There are two kinds of futures traders: hedgers and speculators. Hedgers aren't trying to get rich

trading futures; they're using futures contract to try to stabilize their costs -- they usually want 500 bushels of wheat or 15,000 pounds of frozen concentrated orange juice. Speculators, on the other hand, trade contracts to make money. They just want to be on the winning side of a bet. Being a speculator is ok, too. People often vilify them, but they provide a lot of liquidity to the futures market.

The futures markets rely on clearing members, which are banks or other companies that manage the payments between buyers and sellers. CME Group is an example. Clearing members guarantee each trade and thus require traders to make good-faith deposits (called margins or performance bonds) in order to ensure that the trader can handle potential losses and won't default on the trade.

Expiration Date

The expiration date is the day a futures contract expires and the underlying commodities become the buyer's problem. It is also the last day that the parties to the contract can unwind their positions. Unwinding positions is common in the futures markets, because most of the time, traders don't really want the underlying commodities.

For example, let's say you think the price of orange juice is going to be higher in the future. You buy one futures contract that locks you into buying 15,000 pounds of frozen concentrate in 90 days for, say, $1 per pound. (It actually trades for less than a cent a pound, but that would complicate the example, now, wouldn't it?)

Your bet is that in 90 days, the price of juice is going to be more like $1.50. You've been reading a lot of reports about a looming orange juice shortage in Brazil (which grows a lot of oranges) and figure the supply of orange juice is going to plummet, and thus the price of orange juice is going to spike. Buying at $1 a pound and hopefully selling it for $1.50 seems like a no-brainer.

But let's say you're wrong. Let's say 80 days have passed, and juice prices have actually fallen to $0.40 a pound. You're 10 days away from buying a lot of overpriced OJ.

What happens when the contract expires? There are two things traders do. The first (and least common) option is to become the proud owner of 15,000 pounds of frozen orange juice. Although a giant truck will not dump juice on your lawn, it will be yours in a warehouse somewhere.

I'll explain the second option in a moment. But first, let's talk about that warehouse...

Warehouse Receipt

A warehouse receipt is a piece of paper promising that a specific quantity and quality of a particular asset is in a given location. So when your contract expires and you want the goods, you receive a warehouse receipt detailing where the juice is and that it is in the quantity specified.

If you want to swim in or sell your juice, the warehouse receipt is your proof that the juice in the warehouse is yours. Trading warehouse receipts is a whole lot easier than moving loads of coffee, beef, orange juice, or gold from place to place. Of course, that's still a huge hassle. Warehouse storage isn't free, and it might not even be in the city where you live.

Offsetting Transaction

The much more common action is to create an offsetting transaction, which cancels out the effects of your futures contract.

Remember your contract for 15,000 pounds of orange juice at $1 a pound? Well, you're locked into the contract, so you can't just ignore it -- but you could do an identical, opposite transaction to unwind the deal: entering into a contract to sell 15,000 pounds of juice for $1. The price of that contract will still cost you, but it's a way to make lemonade out of oranges, as they say.

The Investing Answer: Although the futures markets help farmers and companies control risk, they are also popular places for speculators.

However, futures are incredibly risky. Commodities prices swing wildly, and futures trading is a zero-sum game; that is, if somebody makes a million dollars, somebody else loses a million dollars. The downside is unlimited. This can create fortunes, but it can also destroy them, which is why trading futures takes a tremendous amount of skill, knowledge and risk tolerance.

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