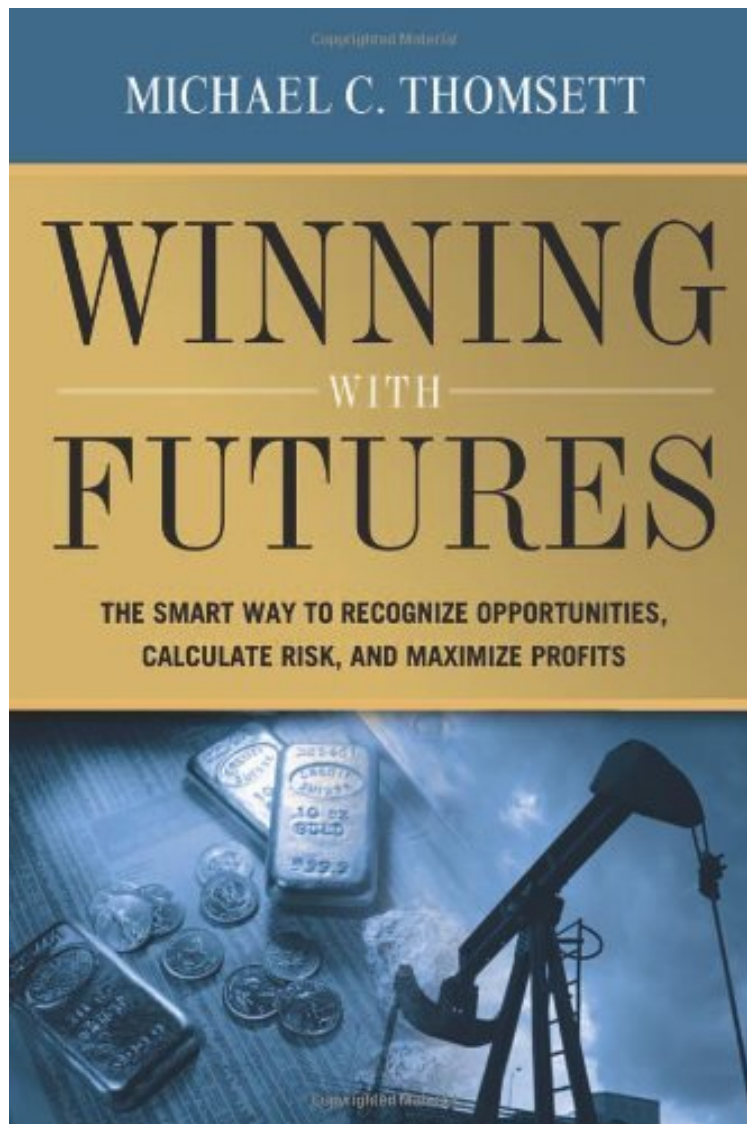


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## Winning With Futures: The Smart Way to Recognize Opportunities, Calculate Risk, and Maximize Profits

*Michael C. Thomsett*

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Whether dealing in coffee, wheat, pork bellies, silver or gold, any buyer investing in commodities is trading in the futures market. For the investor, the goal is to make money when that commodity either gains or loses in value. Winning with Futures demystifies the market, with all of its risks and opportunities, and enables readers to make the most informed decisions when betting on the outcome of a product. With easy-to-follow, practical advice, Michael C. Thomsett teaches novice investors to select the best commodities--from energy and imports to financial futures; manage risks effectively while diversifying their portfolios; and avoid selling at the wrong time. Complete with a history of the futures market as well as an evaluation of the risks involved for all types of futures, this book will help every investor make far better predictions and much bigger profits.

About the Author Michael C. Thomsett (Nashville, TN) is the author of many books, including *Winning with Options* (978-0-8144-0033-3), *The Stock Investor's Pocket Calculator* (978-0-8144-7460-0), and *Getting Started in Options*. He has been a management consultant in the securities industry and is an active stock trader. Excerpt. copy; Reprinted by permission. All rights reserved.

WHAT IS A FUTURES CONTRACT? If you could know the future value of anything, you would naturally be able to get rich. In all public markets, investors and traders share this common dream, and the anticipation of future price movement dictates how and where investment decisions get made. In fact, the futures market is a formalized version of this forward-looking pattern. But it involves commodities, indices, and financial instruments rather than stocks. One famous writer spoke of the future as "That period of time in which our affairs prosper, our friends are true and our happiness is assured." This makes an important point about all forms of investing. Optimism is often a ruling force, and those investors who look optimistically to the future expect prices to rise, hopefully immediately after they take up a position in the stock, bond, or futures contract. As a philosophy of investing, the futures market contains a never-ending series of price estimates for future goods: oil, grain, livestock, metals, coffee, currency exchange, and even stocks. Futures contracts set a price of future delivery. This does not mean that if you buy a futures contract, you expect to actually take delivery of the product involved; it does mean that if the actual price moves higher than the fixed price of the futures contract, you can sell that contract and take a profit. This is only one basic explanation of how futures contracts work and are traded. The variations involve not only different positions (long or short) but different structures as well (direct trades, indices, or exchange-traded funds, for example). Essential Definitions A good starting point is to carefully define the futures contract. This is an agreement involving the purchase and sale of a specified amount of a commodity (or index, currency, or other asset of value). The contract sets the value as well as the delivery date; it is standardized, meaning that the expiration cycles are set ahead of time, monthly or quarterly. So delivery occurs every three months. The reason for standardizing futures contracts is to make them more easily exchanged in the market. When every futures contract is set by date and amount, traders have an efficient market and can easily find the value of every existing contract. The futures contract can only be bought or sold on the futures exchange, and only a member of that exchange can execute the transaction. In a futures contract, a good-faith margin deposit is required at the time the contract is originated. The basic transaction is speculative, but it is based on anticipation of price movement. If you buy a futures contract and the value of the underlying commodity rises, then the value of that contract will rise as well. However, you can take out your profits or close out the contract whenever you want. This feature, escapability, makes futures speculation relatively easy, so that speculation in futures works very much like speculation in the options market. Investors buy and sell futures contracts for several reasons, using contracts directly or other investments designed to pool money. For example, many exchange-traded funds (ETFs) are designed specifically to provide investors with a range of coverage in several assets. There are a number of ways to participate in the market. First is pure speculation, with a trade entered in the belief that value is going to move either up or down. Second is to hedge other positions; for example, if you bought shares in an oil company, you may also go short in an oil ETF; that is one example of a hedge, meaning that a loss in one position will be offset by a gain in another. The third section of this book will explain specific futures. For now, to provide an overview of the entire futures market, the following is a list of the major commodities by type: energy--crude oil, natural gas, coal, nuclear power, solar and wind power, electricity, ethanol grains and oilseeds--corn, wheat, soybeans, soybean oil and meal, sugar, cotton livestock--live cattle, feeder cattle, lean hogs, pork bellies, lumber precious metals--gold, silver, platinum, aluminum, copper, palladium, nickel, zinc imports and tropical products--frozen concentrated orange juice, coffee, cocoa, rice financial futures--noncommodity contracts including those on single stocks, indices, and currencies Another way to think about the futures market involves risk and risk transfer. The futures market not only helps anticipate the future prices of products, it also helps investors and those wanting to hedge positions transfer risks to speculators who are willing to accept those risks in exchange for profit potential. It is this risk exchange that makes futures contracts so interesting. As specific commodity prices rise

and fall, corresponding action and price movement in futures contracts will react at once (when the market is open), and traders react by trading in those contracts. The Contract and How It Works Anyone who buys a futures contract, directly or through one of the pooled investment alternatives (like ETFs, for example) takes up a long position. Just as stockholders who buy shares of stock "go long," the same important definition applies to futures buyers as well. In a long position, the sequence of events is "buy, hold, sell," a well-known and common method of investing. A short position is the opposite. This involves first selling a futures contract (or shares of stock) and then later closing the position with a closing purchase transaction. The sequence of events in a short position is "sell, hold, buy." One of the most crucial elements of the contract is whether you take up a long or a short position. You can do either, and, because the market is facilitated by the futures exchanges, every short position is offset by a corresponding long position, and vice versa. The decision to go long or short defines and distinguishes risk as well. The level of risk in short positions in futures or in any other market is usually much higher-risk than the better-known long position. Those traders who understand markets well and who are willing to accept the risk may want to sell short when they believe prices are going to move down. Taking a short position is one way to hedge other investment positions. If you own shares of stock in a company whose price is sensitive to futures values, selling a futures contract short is one way to hedge the long stock position. Hedging can also be more complex and creative. For example, to offset a stock position, you can short an ETF for the market sector to which that company belongs. Some traders who are involved in short positions on futures contracts (or on both long and short) are operating not as hedgers but as speculators. If they believe short-term prices are going to rise, they go long; and if they think prices will fall, they go short. How much does a futures contract cost? The cash price of the commodity, for example, also known as the spot price, is defined as the current market value of the underlying commodity. The futures price is different. It is the price of a contract that anticipates future spot price levels. Futures prices tend to track spot prices, meaning that if the cost of a barrel of oil rises today, the various futures contracts for oil are going to rise too. The closest delivery month is going to be most sensitive to commodity value and how it changes, and delivery months further out will tend to change less responsively. The distinction is an important one. The spot price reflects supply and demand in the market today; futures prices are the sum of expectations about future price movement. Another important aspect of the contract is the method by which a trade order moves through from initiation to completion. The futures exchanges are clearinghouses for execution of trades by both buyers and sellers, and supply and demand define price levels and price movements. So large exchanges, including the Chicago Board of Trade (CBOT), Chicago Mercantile Exchange (CME), and the New York Mercantile Exchange (NYMEX) contain brokers who match up each side of the transaction and ensure that the trades are made in a timely manner. Valuable Resource:...