cornertrader

FUTURES CONTRACT BASIC STRATEGIES

WHY TRADE FUTURES CONTRACT ON COMMODITY?

The primary purpose of the futures market is to allow those who wish to manage price risk (the hedgers) to transfer that risk to those who are willing to take that risk (the speculators) in return for an opportunity to profit.

Speculation

Speculators assume the price risk that hedgers try to avoid in return for a possibility of profits. They have no commercial interest in the underlying commodities and are motivated purely by the potential for profits. Although this makes them appear to be mere gamblers, speculators do play an important role in the futures market. Without speculators bridging the gap between buyers and sellers with a commercial interest, the market will be less fluid, less efficient and more volatile.

Futures speculators take a long futures position when they believe that the price of the underlying will rise. They take a short futures position when they believe that the price of the underlying will fall.

Example of Futures trade

Let's take Corn, but the same idea applies for any king of commodity (Crude oil, Gold, Coffee, Copper, Wheat, bonds, stock indices etc…).

Corn Futures Trading

Consumers and producers of corn can manage corn price risk by purchasing and selling corn futures. Corn producers can employ a short hedge to lock in a selling price for the corn they produce while businesses that require corn can utilize a long hedge to secure a purchase price for the commodity they need.

Corn futures are also traded by speculators who assume the price risk that hedgers try to avoid in return for a chance to profit from favorable corn price movement. Speculators buy corn futures when they believe that corn prices will go up. Conversely, they will sell corn futures when they think that corn prices will fall.

Buying corn Futures to Profit from a Rise in corn Prices

You decide to go long one near-month Euronext Corn Futures contract at the price of € 174.5 per tonne. Since each Euronext Corn Futures contract represents 50 tonnes of corn, the value of the futures contract is €8725. However, instead of paying the full value of the contract, you will only be required to deposit an initial margin of €750 to open a long position.

Assuming that a week later the price of corn rises and correspondingly the price of corn futures jump to €191.5 per tonne. Each contract is now worth €9 575. So by selling your futures contract now, you can exit your long position in corn futures with a profit of €850.

Long Corn Futures Strategy:	
BUY 50 tonnes of corn at EUR 174.5/ton	EUR 8,725
SELL 50 tonnes of corn at EUR 191.5/ton	EUR 9,575
Profit	EUR 850
Investment (Initial Margin)	EUR 750
Return on Investment	113%

In the example shown above, although corn price have move by only 10 %, the Return on Investment (ROI) generated is 113%. This leverage is made possible by relatively low margin (approximately 9%) required to control a large amount of corn represented by each contract.

Leverage is a double edged weapon. The above examples only depict scenarios whereby the market is favorable towards you. If the market turns against you, you will be required to top up your account to meet the margin requirement in order for your futures position to remain open.

TRADING THE EUROSTOXX50 INDEX FUTURES CONTRACT

Scenario

Let us suppose an investor believes the eurostoxx50 index is going to rise by 10% within the next months. Instead of buying the 50 stocks component of the eurostoxx50 index, he will buy the December eurostoxx50 Futures Contract at 2125. The manager wants to invest the equivalent of €100 000 on the trade.

Strategy

He calculates the number of contracts to be bought in the following fashion:

$$\frac{\text{Sum to invest}}{\text{Future Index X multiplier}} = \frac{€100\ 000}{2125 \text{ X } €10} = 4.70$$

He therefore will buy 5 December eurostoxx50 Futures Contracts at 2125. However instead of paying the full value per contract (futures value X tick value =2125 X €10) €21,250 he will only be required to deposit an initial margin of €2,181 per contract.

If the market rises 10% to 2337.5 he will make a profit of ((2337.5-2125) X €10 X 5 contracts) €10,625.

Long Eurostoxx50 Futures Strategy:	
BUY 5 Futures Eurostoxx50Contracts at 2125	EUR 106,250
SELL Futures Eurostoxx50Contracts at 2337.5	EUR 116,875
Profit	EUR 10,625
Investment (Initial Margin)	EUR 10,905
Return on Investment	97.43%

In the example shown above, although the Eurostoxx50 index has move by only 10%, the Return on Investment (ROI) generated is 97.43%. This leverage is made possible by relatively low margin (approximately 10%) required to control the full value of the index.

On the other hand if the market is down 10%, he will lose € 10,625.

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