COMMODITY FUTURES TRADING COURSE

Contents

- **Introduction**
- **Basic Future Terms**
- ***Futures Contract Specifications***
- ***Analyzing Price Chart Patterns***
- ***Selection tools***
- ***Confirming Tools***
- ***Timing Tools***
- ***Damage Control***
- ***Paper Trading***

1. Introduction

This chapter describes the objective of this course, what commodity *futures* are and how you can profit by trading them.

A. Objectives of this Commodity FUTURES Trading Course

This trading course describes a process that will help you to analyze futures markets and to develop useful trading skills. It presents you with common industry information, techniques and rules about commodity futures trading.

You will use this information to define a logical, simple and complete *Trading Plan* that will help you to intelligently pick markets that have the highest likelihood of success. You will also define a *Money Management Plan* to control your risk and loss. By doing this, you gain a significant advantage in your futures trading efforts.

I can't guarantee your success – but I will do my absolute best to teach you how to trade intelligently.

At the end of the complete **Commodity FUTURES Trading Home Study Course** you will know how to successfully do the following:

- Identify futures contract specifications and what they mean
- Recognize price chart patterns that suggest opportunity
- Use Selection Tools to identify a commodity that will likely make a big price move
- Use Confirming Tools to give additional "weight" to your market analysis
- Use Timing Tools to determine when to get into and out of a trade
- Devise a Trading Plan and a Money Management Plan
- Paper trade to safely gain valuable experience and prepare you for actual trading.

There is only one way to make money in commodities: *Buy Low* and *Sell High!* And amazingly enough, you can do it in either order. That is, you can:

- *Sell* a commodity futures contract first (even though you don't own it), and then *buy* it back at a later time; or,
- *Buy* a commodity futures contract first, and then *sell* it back at a later time.

You'll learn more about how to do this in later chapters.

B. Why trade commodities?

As a ***speculator*** (that's you), there are good reasons to trade commodity futures.

- Commodity futures trading is a *business* that deals in the buying and selling of basic, expendable items. Each in itself is a survival industry. They were here 20 years ago and they will be here 20 years from now.

- The strongest reason for trading commodities is ***high financial leverage***. It offers high profit potential for a low investment. A $1,620 security deposit or ***margin*** will control a Silver futures contract which contains 5,000 ounces of silver. So when the price of Silver is at $5/oz. the contract is valued at $25,000. The margin in this example is only 6.5% of the commodity's value. A change in the price of Silver by 1¢ results in a $50 change

in the value of your futures contract either for or against you. A price move of 10¢ in your favor makes you $500 in profit.

- Your *business* involves just you and the market. Because it has no resource-draining demands of other business activities, you don't have to manufacture or acquire a product; allocate financial resources to advertise, market and sell the product; implement and maintain telephone response capability to provide product information, accept orders and customer complaints; or pay for resources to provide order fulfillment. I think you get the idea. This is an *ideal* business to be in.

- It moves you from a *Linear Income model* to a *Geometric Income model*.

- Once you learn this process, it takes less than 30 minutes per week day of your time to *work* at your business. With more free time, you have the opportunity to change your lifestyle.

C. Commodity vs. stocks

- With stocks, you need to put up the full amount of the stock value to *buy* the stock. With commodities, you *control* commodity futures contracts with a margin deposit which is usually between 5%-10% of the value of the commodity.

- Stocks price provides no analysis information for selection except *earnings* (which is frequently manipulated by the company). Stock options allow a company to under-report wages, and therefore under-report expenses which misleadingly inflates earnings. With commodities futures, there are over 15 tools available to help you select potentially profitable commodities and time your entry and exit in the market. It's like having x-ray vision into the market!

- There are over 50,000 stocks to evaluate. There are less than 50 commodities to review for profit potential.

- Stock prices move slowly. Frequently stock price may linger in a narrow trading range (sometimes for years) causing your financial resources to be unproductively used. Commodities frequently have fast price movement, providing increased profit potential.

- If you own stock, you get taxed twice. Once when the company pays 35 cents on the dollar on its earned income. Then again when you pay personal taxes on dividends or capital gains from your shares. The *real* tax can be as high as 75%. With commodity profits, you are only taxed on your income.

- Stock is fictitious, there is no real basis for stock value other than earnings. Stock can be "delisted" overnight and become worthless. Commodities have ***intrinsic*** value and will always have value. People will always want grain and gold.

D. Notices

The Commodity Futures Trading Commission and The National Futures Association requires the following notice be stated:

There is a Risk Of Loss in Futures Trading

I am not an investment counselor or a commodity trading advisor, nor do I give advice on specific investments. This is an educational trading web site which is designed solely to give you the skills and insight that will help you to more successfully trade commodity futures.

Successful past results don't necessarily mean success in the future. There is a risk of loss in futures trading. Do not trade with money you can't afford to lose.

Over 90% of new people who trade commodities lose money. The other 10% are successful for the following reasons:

- They learned about how the futures markets work,

- They learned how to anticipate changes in the direction of a commodity futures market's price and position themselves to benefit from that price change,

- They have defined and use both a Trading Plan and Money Management Plan.

This trading course will teach you how to do these things.

It is on *strong* recommendation that you completely read this trading course three separate times. The first reading should be done to get the general idea of what is involved in the entire process – that is, you get a general grasp of things. The second time, read it to help reinforce your knowledge as well as help you to better understand the process presented in this course. The third reading will be helpful, as you should be ready to start defining your personal Trading Plan and Money Management Plan.

Resources you will find both helpful and necessary in your trading activities are described in Appendix B.

The next chapter contains *Basic Futures Terms and Information*.

top

2. Basic Futures Terms

Every specialized activity has its own unique vocabulary which needs to be learned so the free flow of information can occur. The commodity futures environment contains numerous terms which you need to become familiar with so you can precisely communicate your wishes to your broker.

This chapter contains an overview of how the futures markets work and who the participants are. It also describes basic futures terms which are used in this course. The ***Commodity Trading Glossary*** (Appendix A) contains virtually every term used in the commodity futures trading environment.

When you buy or sell a futures contract, you don't actually buy or sell the commodity. You are ***controlling*** a futures contract, which is commercial paper (i.e., a negotiable instrument). Every futures contract specifies performance criteria (whether you will make delivery, take delivery, the performance due date, the commodity quantity, etc.).

Very few *speculators* (that's you) actually intend to make or take delivery, and instead transfer their contractual obligation to someone else in the marketplace. This is called ***offsetting your position***, after which you are no longer obligated to the contract's performance criteria. However, any profit or loss which has accrued during the time which you were the holder of the contract - that is, from your entry price to your exit price is posted to your trading account.

Margin Requirement

Each Futures Exchange requires its market participants to deposit and maintain in their accounts a certain minimum amount of funds for each open position held. These funds are known as ***Margin***, and represent a performance bond that serves to provide protection against losses in the market. *Margin* is the amount of money required in your trading account to go long (buy) a futures contract or go short (sell) one futures contract of a commodity. You must have the margin amount in your trading account to open a trade. See Appendix E for typical margins.

The margin is a deposit, not a cost. Commodity trading is a ***zero sum*** or cash business. Your trading account is settled at the end of each trading day with your trading account balance changing daily. Profits are deposited in your account and all losses are withdrawn from it. If you close out a trade with a profit, your margin deposit plus your profit is posted to your trading account. If your account balance falls below the ***maintenance*** amount, you will receive a ***margin call*** from your broker. This means you must release additional funds from your trading account (or deposit additional funds if your trading account amount is inadequate) to return the margin to it's original margin amount - or close your position. The Exchange collects margin directly from each of its clearing members and brokers who, in turn, are responsible for the collection of funds from their clients.

Minimum margin and maintenance amounts are established by the various commodity Exchanges. However, individual brokerages may raise these minimums at any time, without notice, and often do to protect both the trader and the broker from increased volatility. Always check with your broker for current margin amounts for a commodity you will be trading.

The Long and the Short of Trading Commodity Futures

There are two possible positions you can take in the market. You can either be *long* or *short*. These positions have multiple terms, but mean the same thing.

Going Long means you are expecting the price of a commodity to increase and you ***buy*** a futures contract of that commodity. You expect that some time in the future you can offset the contract (that is, sell the contract back) at a higher price and profit from the price increase. The expectation of an increase in price is also referred to as being ***Bullish***.

Going Short means you are expecting the price of a commodity to decline and you ***sell*** a futures contract of that commodity. You expect that some time in the future you can offset the contract (that is, buy the contract back) at a lower price and profit from the price decrease. The expectation of an decrease in price is also referred to as being ***Bearish***.

An ***objective*** is a *target* or *goal* that you believe price will move to. It is used to identify where you expect to exit the market, and what the approximate profit *can* be. It is your job to calculate the objective. This process is described in later chapters.

A. Types of Futures Contract Orders

There are numerous types of market orders which you may give to your broker. The following information describes the ones which are most commonly used.

Open Order. An order that remains in force until it is either filled, cancelled or the contract expires. Always cancel Open Orders even if they are filled and you entered the trade. The Open Order is also known as a ***Good-Till-Cancelled*** (GTC) order.

Day Order. An order that unless filled, automatically cancels at the end of the trading day. Unless otherwise specified, any order given to your broker is a Day Order by default.

Market Order. An order to buy or sell a futures contract immediately at the prevailing market price. Market Orders are considered Day Orders. That is, if your order has not been filled by the end of the trading session that day, your Market Order will be cancelled. The market order says, "get me in or get me out *now*".

Limit Order. An order to buy or sell a futures contract only at the specific price you state (or better). The Limit Order says, "I wish to enter this market, but only if I get my price or better".

Stop Order. An order to buy or sell a futures contract if the price moves to the price you specify. When the market does reach (or *touch*) that specified price, your stop order becomes a Market Order. "Buy Stop (or Sell Stop) one [month] [commodity] contract at [price]."

Stop-Loss. The same as a Stop Order except it is meant to offset an existing Order futures position (either long or short). This is an order that says if your specified price is hit, close out your position and get you out of the market. It is used to define the amount of financial risk for the trade. You continue to move your Stop-Loss Order, keeping it behind (or trailing) the current price trend. This helps protect and *lock in* your growing profit. Moving your Stop-Loss Order is referred to as a *Cancel-And-Replace* order. Never, ever have an open position without a protective Stop-Loss Order in place!

B. The Purpose of Futures Trading

To be an informed trader, it is helpful to have an understanding of how and why the futures market is used, who the market participants are, and how they conduct their business. A competitive market would be perfect if:

- Many buyers and sellers met openly, with none controlling the market;
- The product was standardized so all participants knew the quantity and quality which was being traded; and
- Buyers and sellers could easily enter and exit the market.

While no market is perfect, futures markets come closer than most others. Because of their highly competitive nature, futures markets provide three economic benefits:

1. With many buyers and sellers competing freely, futures trading is an efficient way to determine the price of a commodity. This process is called *price discovery*.

2. Futures markets give producers, processors, and users of commodities a way to pass the price risk to speculating traders (that's you) who freely assume these risks. This allows the commercial users of the commodity to hedge their price risk and lower their business cost - resulting in a more efficient market with lower cost for consumers.

3. Because futures markets are world-wide in scope, vital market information is collected and published which helps traders make better trading decisions.

What is a Futures Contract?

A futures contract is a legally binding commitment, made through a futures Exchange, to buy (go long) or sell (go short) a futures contract. The contract describes the quantity and quality of a commodity to be delivered at a specific month in the future, and at a price agreed upon at the time the commitment is made.

Because there are different delivery months for a futures contract, each contract specifies the date which this transaction must occur, known as *settlement date*, and how the transaction will be fulfilled, known as *delivery*. If the contract is not offset (closed out) prior to the delivery date, it is settled either by the exchange of the physical commodity or in cash.

Less than 3% of futures contracts traded each year result in delivery of the underlying commodities. Instead, speculating traders generally offset their futures position before their contract expires. The difference between the entry price and the exit price at the time the contract is offset represents the realized profit or loss.

The Difference Between Cash and Forward Markets

In the days before credit was used, many stores displayed the sign, *cash and carry*. This meant that you pay your cash and carry away the merchandise you purchased. This is an example of the cash market.

The buyer finds the precise commodity that they want, pays their money and becomes the owner of the merchandise. It's a market system that is widely used in all forms of business to transfer title to goods.

Frequently, cash markets can be altered to meet a specific need. For example, a person who goes to the newsstand to buy a magazine may find it is more convenient to contract with the publisher for delivery at home. This modification is called a *forward contract*, which is used by many businesses.

The buyer and the seller agree on the product to be delivered in satisfaction to fulfill the contract. The buyer pays and the seller makes delivery. This works well when the cost of producing the commodity is known and the price is acceptable to a buyer. However, many commodities (such as coffee) compete in international markets, so there are many small producers scattered over a wide geographic area.

This makes it difficult to know what prices are available, and limits the ability of the producer, processor, and merchandiser to plan ahead. Although forward contracting can help the planning process, other things can

interfere with sound planning.

This can include fragmentation of producers, uncertainty of production capacity, unfavorable weather, war, changes in interest rates, etc. This would make it difficult to determine a fair price for coffee in the forward market. Because of this, futures trading, used for grains and similar farm commodities since 1859, was adapted for coffee and other commodities to provide everyone in the market with a guide to what these commodities are worth now as well as in the future.

Determining Price

In a competitive market, both buyers and sellers interact to determine commodity price. The price at which sellers offer to sell their goods and buyers offer to buy them are based on their best assessments of the current commodity's supply and demand.

Usually, no one knows the exact *supply* of a commodity. This is because the production, storage and ownership of most commodities is dispersed among many people. The total production and supply for any commodity is usually an estimate so these values are not exact. Because of their international scope, many commodities are also subject to incomplete production and supply reports by other countries. However, the U.S. government reports which makes production and supply data available to the public is generally better than reports available from other countries.

Demand for a commodity is even more difficult to measure because it is based on what people may decide to buy. Price changes may alter purchasing intentions - or change whether it is even wanted it at all. An available and attractively priced substitute may change demand for the original product as well as for the related one. Futures market participants will closely monitor the price relationship for both items.

The commodity futures market prices play a vital role in our economic system and help to define our living standard. The decentralized markets serve as the "nervous system" in an economy with prices being the signals transmitted throughout the system. This lets us efficiently produce goods and control the rate of their use. Price is used to ration a commodity by influencing production and consumption. If the price is right, the production and supply of a commodity should match its use.

If the price is too high, some who plans to use a product may either use less or none at all, or they may use a substitute - for example, eat chicken instead of bacon. If enough users are priced out of the market, price will drop to encourage more use and discourage production. If the price is too low, supply will be depleted and result in a shortage. Prices will then increase to discourage some use, and will also stimulate production or attract additional supplies.

Processors and merchandisers are influenced by the price people are willing to pay for an item. They make marketing decisions based on their estimates of what consumers will buy and how much they will pay. Once in the marketing system, goods are moved from the production location to the processor and distributor and finally to the consumer. Although futures trading does not enter directly into this distribution channel, it does provide traders with information, price, and risk transfer opportunity.

Collecting Information

In an active futures market, the demand for information by traders is enormous. Futures Exchanges have evolved to become repositories for statistics on supplies, transportation, storage, purchases, exports, imports, currency values, interest rates, and other useful information. This data is constantly distributed to Exchange participants, causing traders to revise their bids and offers based on this new information. As a result, prices revisions at futures Exchanges tend to accurately reflect the supply and demand for a commodity and are used to determine cash market prices.

Discovering Prices

Price discovery is used to determine the price at which one person will buy and another will sell a futures contract. In all active futures markets, the price discovery process occurs continuously from the opening to the close of the market.

Futures markets encourage wide participation and minimizes the ability of few buyers and sellers to control price. Because futures prices are competitively determined, they are generally considered to be better price estimates than privately determined prices.

All futures contracts are standardized as to quantity and quality, so buyers and sellers only bargain over price. This allows Commercial interests to better determine cash market prices. In many commodities, futures prices have become the main reference price for those who produce, process, and merchandise a commodity. This is because the cash market and futures market prices are influenced by events that cause the price in each market to rise or fall in tandem.

There are two general types of participants in each market: *Hedgers* and *Speculators*.

Hedging (Transferring Risk)

The production and consumption of many commodities frequently results in sizable financial risk and represents a cost which affects the price of a commodity. While the uncertainty of risk cannot be eliminated, futures markets can be used by producers, processors, merchandisers and others to shift some risk to speculators who willingly accept such risk because of the opportunity for making a profit.

For over a century, many have used futures contracts as financial risk offsets to the cash market. Hedging allows a market participant to lock in prices in advance and reduce the possibility of an unanticipated loss.

Hedgers give up the chance to benefit from favorable price changes in order to gain safety from unfavorable price changes. Hedging is a technique which is used mostly by producers, processors and merchandisers. The producer uses a hedge to transfer the risk that prices may decline when a sale is made. A merchandiser uses a hedge to transfer the risk that prices may increase before a purchase is made.

The process of hedging involves the concurrent use of both cash and futures markets. Since futures and cash prices tend to move together (or similar to each other), it is possible for a cotton merchant, for example, to hedge the value of an unsold inventory of cotton with a sale of a number of futures contracts whose total value is equivalent to the value of the unsold inventory. Since the merchant owns the cotton inventory, they would incur a loss if the price of cotton declined. By selling futures contracts, the merchant obtains price loss protection. This is because if price of cotton drops, the cash market loss will be at least partially offset by the gains produced by the futures contracts. When the merchant sells their inventory at the lower cash market price, they will concurrently remove their hedge by purchasing the futures contracts at the lower price. The profit from their futures contracts should roughly equal their loss in the cash market.

Conversely, a cotton mill owner may plan to sell a quantity of cloth for delivery several months from now. However, the owner does not currently have enough cotton to produce the cloth. The owner could hedge by buying enough futures contracts to cover the forward sale of cloth. The owner now has a price for raw material to which operating and production costs can be added to arrive at a base price for the cloth.

Quoting a price before buying the cotton would make the owner vulnerable to loss of profit due to a price rise, but buying futures contracts in a quantity equivalent to their needs, the owner knows that a rise in the cost of the actual cotton will be offset by a rise in futures prices to lessen the impact of loss. The idea behind establishing equal and opposite positions in the cash and futures markets is that a loss in one market should be offset by a gain in the other market. The purpose of a hedge is not to profit, but to avoid the risk of an adverse price move which would cause major financial loss.

Hedges work because both cash and futures prices tend to move together, but they converge as each delivery month reaches expiration. Even though the difference between the cash and futures prices of silver (or gold, copper, platinum, etc.) may widen or narrow as cash and futures prices fluctuate independently, the risk of an adverse change is generally much less that the risk of going unhedged. Because the cash and futures markets do not have a perfect relationship, there is no such thing as a perfect hedge, so there will almost always be some profit or loss. However, an imperfect hedge is a much better alternative than no hedge at all in a potentially volatile market.

While a hedge transfers risk, it also denies the opportunity to financially gain from favorable price movements in the cash market. For this reason, *options* on futures contracts are popular among people who seek price protection, but who do not wish to miss a favorable price movement. With the payment of a *premium*, the buyer of an option can acquire the right, but not the obligation, to buy or sell a futures contract at a specified price until the option expires. In this way, the holder of a commodity can protect against a price drop in the value of that commodity with an option, but remain free to gain from an increase in the price of the commodity. Any such increase will be offset by the amount of the premium that was paid for the option.

Other Economic Benefits of Hedging

The ability to hedge makes it possible for producers, processors and marketers to operate on narrower profit margins. For example, if the wheat miller has protected his inventory with a hedge, he can add on his milling margin and offer a firm price to the baker. Because the hedge lessens his chance of significant loss from price change, he can sell to the baker at a lower price. The baker who also hedges can reduce his risk and lower price, passing the savings on to consumers.

Another benefit of hedging involves financing. While some bankers do not consider hedges as a factor in loans, others make it a regular policy to do so. Bankers who lend to commercial borrowers say that hedgers can borrow a greater percentage of the value of their commodity, usually at lower interest rates, than can non-hedgers. The lower cost of financing thus permits higher profit margins for the hedger and lower prices for the end-user.

What A Futures Contract Does Not Do

Futures trading is not intended as a way to transfer ownership of the commodity, so few traders deliver or take delivery on futures contracts. Cash markets normally provide the most efficient way to exchange ownership of a commodity; futures markets are a way to forward price the commodity and to lessen the risk of ownership.

Futures markets do not *cause* cash market prices to rise or fall. Cash and futures markets respond to the same basic supply and demand factors. Because futures trading constantly reflects expected events and readily available price information, price changes may be noticed first in the futures market. The cash market tends to respond to situations in its market area while the futures market tends to assess the broader national or international meaning of events for the months ahead, so either price may move first or furthest.

The Role of Speculators (that's You!)

Price has a rationing effect. In other words, when supplies of a commodity appear more abundant than needed, price decreases. If supplies appear to fall short of market demand, price increases. Speculators are attracted to this challenge of foretelling price direction and either buying or selling futures contracts to profit from the price change. A successful futures market includes both hedgers and speculators.

Speculation is the opposite of hedging. A speculator willingly assumes risk by trying to predict price changes before they occur, and establish a position in the market to profit from these changes. Speculators make decisions to buy or sell based on their evaluation of general price trends and other technical factors. In doing so, they help provide the risk capital that makes hedging possible.

Speculators serve an important economic function by providing liquidity to the market and also absorbing price risk. Unlike a hedger, a speculator holds no offsetting cash market position. A speculator is an additional buyer of commodities whenever it seems that market prices are lower than they should be. Conversely, when it appears that prices are too high, a speculator becomes an active seller. Frequently, speculators provide a time bridge between a hedger who wants to sell now, and a hedger who buys later. Speculators also tend to trade smaller amounts than hedgers and they also hold market positions for a shorter time.

Few speculators agree on what is too low, or too high, a price for a commodity. Some may want to sell at a particular price, others may want to buy at that price, and some may not be interested at all. Therefore, there usually are willing buyers and sellers in the market at all times.

Someone who expects a futures price to increase would *buy* futures contracts in the hopes of later being able to sell them at a higher price. This is known as *going long*. If the futures price is expected to decline, they would *sell* futures contracts in the hope of being able to buy back identical and offsetting contracts at a lower price. Selling futures contracts in anticipation of lower prices is known as *going short*. This means it is equally easy to profit from declining prices (by selling) as it is to profit from rising prices (by buying).

Most trading occurs *at the market*, which is the current price in the Exchange trading pit. In busy markets, there may be many *resting orders* for which the customer has specified an entry price. The interaction among market participants, and the activation of resting orders causes prices to move up and down to widen or narrow the carrying charge. The result of this action is an active and liquid market.

How To Read Commodity Futures Price Tables In Investor's Business Daily

Price is the key statistic generated by futures markets. The trading Volume and the number of outstanding contracts (Open Interest) also are important. Price is available from a variety of sources, including many daily newspapers.

Because of the superior coverage of the futures industry which is provided by *Investor's Business Daily*, their format is used in this trading course. The following table shows what the futures data looks like in *Investor's Business Daily*. This example shows the futures Corn data for Friday, December 18, 1998. **Note:** The data in the newspaper is the previous day's data.

Table 2-1

Season High	Season Low		Open Interest	Open	High	Low	Close	Chg
CORN (CBOT) - 5,000 bu minimum- cents per bushel								
299.50	196.00	Dec 98	4,273	216.50	216.75	212.75	213.00	- 2.75
305.00	209.50	Mar 99	172,538	223.25	225.00	220.25	220.75	- 2.50
299.00	217.00	May 99	46,167	230.50	232.00	227.75	228.00	- 2.50
312.00	223.50	Jul 99	52,360	237.00	238.00	234.00	234.25	- 2.00
280.00	232.00	Sep 99	10,489	241.75	243.25	240.75	240.75	- 1.25
291.50	238.00	Dec 99	26,434	247.25	248.00	246.00	246.25	- 0.75
Est. Vol. 54,000 Vol. 33,210 open int 316,483 - 21								

The first and second lines at the top of the table read as follows:

The ***Season High and Low*** refer to the highest and lowest prices recorded for each contract from the first day it was recorded to the present.

Open Interest is the number of outstanding contracts for each maturity month. Some newspapers do not include this information.

The ***Open*** or opening price is the price or range of prices for the day's first trades, registered during the period designated as the opening of the market or the opening call. In the table shown, December 1998 Corn on the Chicago Board of Trade (CBOT) opened at 216.50 (two hundred sixteen and one-half cents, that is, $2.16-½) per bushel. Many publications print only a single price for the market open or close regardless of whether there was a range with trades at several prices.

The word ***High*** refers to the highest price at which the commodity sold during the day. The high price for December 1998 Corn was $2.16-¾ (that is, two dollars, sixteen and three-quarter cents) per bushel.

Low refers to the lowest price at which the commodity sold during the day. The low price for December 1998 Corn was $2.12-¾ per bushel.

The ***Close*** (closing price) is the last price used when the Exchange ceased trading for that day. December 1998 Corn closed at 213.00 ($2.13 per bushel).

Because the last few minutes of trading are often the busiest part of the day, with many trades occurring simultaneously, the exchange clearing house computes a settlement price from the range of closing prices. The settlement price, which is abbreviated ***settle*** in most pricing tables, is used by the clearing house

to determine margins for its members. It is also frequently used synonymously with closing price, although they may, in fact, differ.

The ***Chg*** (change) refers to the change in the previous day's close to the current day's close. The -2.75 change for December 1998 Corn indicates that yesterday's settlement price must have been 215.75 (i.e., 213.00 + 2.75).

At the bottom of the table is another line of information. ***Est.Vol.*** indicates the estimated volume of trading for that day was 54,000 contracts. ***Vol.*** means that the actual trading volume was 33,210 contracts. ***Open Int.*** refers to the total open interest for all contract months combined at the end of the day's trading session. The 316,483 open contracts represent a decrease (-21) of 21 contracts from the open interest of the previous day at the close.

The third line from the top of the table reads as follows:

Corn (CBOT) 5,000 bu; cents per bu. This line means that the table applies to the Chicago Board of Trade (CBOT) Corn contract; the contract size is 5,000 bushels; and the prices shown in the table are in units of cents per bushel. Thus, 263.00 (two hundred sixty three cents) means $2.63 per bushel.

The next chapter covers the *Commodity Futures Contract Specifications*.

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3. Futures Contract Specifications

Each commodity is different. There are even different delivery months of the same commodity. Understanding the futures contract specifications is at the heart of knowing the rules that govern trading a commodity futures contract, as well as the price movement value of each commodity. This chapter discusses the futures contract specifications which are printed in *Commodity Price Charts*. There are two legends which contain specifications about each commodity. The first legend is printed on the *front month* price chart (i.e., the commodity which has the closest delivery date). The information in this legend is described line by line, from top to bottom.

Symbol for the commodity:

This line contains the Exchange symbols which identifies both the commodity and the contract month. For example, *FCF* means the "Feeder Cattle" (FC) contract for the "January" (F) month. The standard symbol used for each month by all Exchanges is:

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F – January    K – May      U – September
G – February   M – June     V – October
H – March      N – July     X – November
J – April      Q – August   Z – December
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Month/Year/Commodity/Exchange:

This line contains the Month and the Year in which performance of this contract will occur. The specific commodity is identified, as well as the Exchange on which this commodity is traded designated by its initials. For example, *JAN.00 FEEDER CATTLE (CME)* means this contract is traded on the Chicago Mercantile Exchange (CME). The codes for major U.S. commodity Exchanges are:

Exchange Code:	**Exchange:**
CBOT	Chicago Board of Trade
CME	Chicago Mercantile Exchange
COMEX	Commodities Exchange Center
CSC	Coffee, Sugar, Cocoa Exchange
FINEX	Financial Instrument Exchange
IMM	International Money Market
NYC	New York Cotton Exchange
NYFE	New York Futures Exchange
NYMEX	New York Mercantile Exchange

Each Horizontal Line:

This next line identifies the extent of movement for price for each horizontal line on the price chart. For Feeder Cattle, each horizontal line normally represents 50 points. The value of price movement for each horizontal line may be different from one issue of *Commodity Price Charts* to another. This change will represent increased volatility for a market, but the point value will stay the same. For example, the price chart value for each horizontal line in Feeder Cattle may change to 100 points, or 25 points.

Point Value/Minimum Move:

This line identifies the point value (also called "tick") for price movement (in Feeder Cattle 1 point = $5.00), as well as the minimum amount price must move (2.5 points).

The vertical figures on the right side of the price chart identify the price per increment of the commodity. To determine the dollar value of a price change, you multiply the change per increment by the size of the contract.

Feeder Cattle is quoted in *cents per pound*. If the price per pound goes up one cent, the contract of 50,000 pounds will increase in value by 100 points. Each point is worth $5.00 in Feeder Cattle, so a price move of one cent (100 points) represents a profit (or loss) value of $500.00.

The horizontal values on the bottom of the price chart represents *time*. These values are organized by sequential month and dates within the month. Each vertical line on the chart represents the Monday of that week in the month. Between each vertical line are staggered dots which represent the other trading days of the week. Additional space is provided near the right edge of the chart to manually plot price changes.

FND/LTD:

FND (First Notice Day) is the first day that a notice of intention to accept delivery of the actual commodity will be made. This date is established by the Exchange. To avoid taking delivery you must offset any long positions held by you before this date. In the event you miss the FND, your broker can make arrangements to sell your contract. This is an irresponsible position to be in, and you will be charged a fee for this transaction. If you are long, get out 1-2 weeks before this date.

LTD (Last Trading Day) is when all trading ceases for a particular contract. All short contracts not closed by this date will be settled by actual delivery. If you are short, get out 1-2 weeks before this date.

OPTIONS EXPIRE:

This line identifies when the Option for this contract expires.

High/Low:

These lines identify the contract's highest price, the date the high price occurred and its value. Also identified is the contract's lowest price, the date the low price occurred and its value.

An additional graphic box also appears on the *front month* (the nearest contract month) which displays dates when the High and Low price occurred for the most current five days which appear on the chart. The Open and Close price for each date is included.

Another Legend

Another legend (which is also in a graphic box) will appear on the price chart for the contract with the next delivery date. It contains the following information.

Exchange:

The top line in the legend box contains the code for the Exchange. For Feeder Cattle, the Exchange code is CME.

Contract Size:

This second line in the legend identifies the quantity which this contract represents. For Feeder Cattle, the contract size is 50,000 pounds.

Trading Hours:

This identifies the hours when the Exchange allows trading to occur. Unless otherwise specified, the trading hours for the Exchange is in Eastern Standard Time (EST).

Minimum Move:

This is the minimum increment that the Exchange will allow price to change. Because commodities are produced and consumed in huge quantities, a small price change can involve a great deal of money for the buyer and seller. Many commodity contracts move in fractions of cents, and in some cases move in 100ths of a cent. In each case the commodity will be quoted in dollars ($1), cents ($0.01), and points ($0.0001). There are 100 cents to a dollar and 100 points to a cent. For example, the minimum move in soybeans is ¼ cent. Soybeans move from 572-½ to 572-¾ or ¼ cent per bushel. ¼ cent per bushel times 5,000 bushels = $12.50.

Coffee is quoted in cents per pound with a minimum move of 5 points or 5/100th cent. If Coffee moves from 165.00 to 165.05, it has moved 5/100th cent. 5/100th cent per pound times 37,500 pounds = .0005 x 37,500 = $18.75.

Limit Move:

The bottom line in this legend is the maximum amount that the Exchange will allow price to move in any trading day. Some contracts may be subject to a limit, while other contracts allow for unlimited price movement. This is a specification you must know and be aware of for any commodity you trade.

Note: Getting familiar with how to use this information will take time and practice. You will get this practice through Paper Trading (described later).

The next chapter describes *Analyzing Commodity Price Chart Patterns*.

top

4. Analyzing Price Chart Patterns

There are two approaches to analyze the markets. One uses ***fundamental analysis***, and the other uses ***technical analysis***.

Fundamental analysis looks at all factors which affect production and consumption of the commodity in order to determine if price will rise or decline. I believe that doing a fundamental analysis on any commodity is a waste of time because not all factors can be known by one individual – rendering the analysis incomplete. In addition, certain forces deliberately *release* deceptive information for publication in order to influence and manipulate you into making the wrong trading decisions. Most *news* is propaganda for special interests. Don't risk your money on the obvious.

Technical analysis is the art of forecasting future price direction by analyzing price patterns. All the information you need to know about the commodity regarding *supply* and *demand* is "baked" into the price. Price is used to reflect supply and demand forces in the market. Price only goes in one of three constantly changing directions: Up, Down, and Sideways. Big profits can be obtained by the technical trader who approaches the market scientifically. Technical Analysis gives you an edge when you can consistently identify trends and time your entry and exit to profit from them.

Monitoring raw price data is very cumbersome and not very useful. However, when price data is presented in a graphical or chart form it is more useful because:

- You can see the direction of price movement
- Price patterns which suggest market buying and selling pressures are more visible
- You can easily identify the current price trend and when changes in trend occur

Price is charted (either daily, weekly, or monthly – each providing a different historic perspective) with a vertical line and two attaching horizontal nubs at each side of the vertical line. This is illustrated in Figure 4-1. The nub extending to the left of the vertical line identifies the ***opening price*** and the nub extending to the right identifies the ***closing price***. The top of the vertical line identifies the ***highest price*** of the day and the bottom of the vertical line identifies the ***lowest price*** of the day. Price which is charted on the weekly or monthly charts represent the *average* for the week or month. The daily price is like a battlefield. It identifies if the buyers or sellers are in control of the day's trading.

1

Open. The first price traded that day.

High. The highest price traded that day.

Low. The lowest price traded that day.

Close. The last, or closing price, traded that day. Also called the ***settle***.

Change. The difference between the previous day's closing price and today's closing price. It's not unusual to see a disparity between one day's close (settle) and the next day's opening price.

A. Support and Resistance

Price trend is analyzed with ***trend lines*** drawn on the price chart by you. These *trend lines* are used to monitor the price changes in trend behavior. Because trends persist for long periods, a position taken with the trend will more likely be successful that one taken randomly or against the trend. The most reliable trends proceed at a 45 degree angle. In uptrending markets, the close price is higher than the open price.

Support and ***resistance*** levels identify highs and lows, trends, changes in trend, and also identify trading objectives and where to place protective Stop-Loss orders. The idea is that past support and resistance points *suggest* where there was sufficient force to oppose further price change in that direction. They also make ideal points to enter the market.

An ***uptrending*** movement in price has a line drawn by you underneath price bars of the price chart – identifying support. You would *buy* the dips (i.e., when price pulls back temporarily) to get a favorable entry price.

A ***downtrending*** movement in price has a line drawn by you on top of the price bars of the price chart – establishing resistance. You will *sell* the rallies (i.e., when price rises temporarily) to get a favorable entry price.

A ***trading range*** is a sideways price movement. It has two lines drawn by you, both on top and bottom, to define the support and resistance of the channel.

If the price has broken the trend line, considerable force (i.e., major market influence) was required to do so. A change in trend will most likely continue for some time. However, unexpected occurrences can change price trends abruptly, and without warning. For example, Orange Juice may be trending downward but a freeze warning can quickly cause price to trend upward and perhaps in a volatile manner.

B. Price Chart Patterns

There are several price chart patterns which occur frequently enough that they repeat with a high degree of probability and provide good indication of a likely change in trend. Although no pattern is ever 100% correct, it gives you some idea of how to analyze and interpret price behavior to benefit from an impending price move. Some patterns are hard to visualize so you need a good imagination.

Your job as a commodity futures speculator is to track and monitor commodity price patterns and identify those commodities that are likely to be your best trades. Study the charts as though you were a general in the field of battle watching for a strategic move, and watch for those patterns to unfold that have proven themselves in the past.

C. Common Price Patterns

Charts display fluctuating prices over periods of time. Prices can only move up, down, or sideways. Prices also tend to move in identifiable patterns. You get a different perspective between a daily chart, a weekly chart, and a monthly chart.

Study these different perspectives because they will help you to spot an opportunity, create a sound plan, establish your position in the market, and provide for contingencies. You only have to spot specific opportunities, and know what to do when you see them. You need to trade the market that is *set up* now. Wait for the right time and conditions.

A "–" (dash) on a price chart means a ***limit move*** in price occurred on that day. It tells you that price either rose or dropped the maximum amount allowed by the Exchange. Limit moves beget more limit moves. A reversal of this pattern points to a market opportunity. This topic is covered more In Chapter 6.

Major price moves are punctuated by ***retracements*** of a portion of the current trend. The market "catches its breath" by giving up some of the gains and tends to correct about 40-60% of the move in many cases. When a market's trend is very strong, retracements tend to be brief and shallow, and are about 40% rather than 60%.

D. 1-2-3 Top / 1-2-3 Bottom

Every commodity has only one high point and only one low point during each year. The ***1-2-3 Top*** and ***1-2-3 Bottom*** technique is used to spot major market tops and bottoms. When a market makes a new 12-month high or 12-month low, it's a signal to start monitoring that market's price trend for a change, looking for a trend reversal.

1-2-3 Top

To spot the potential market top of any futures price, watch for a new highest price during the past 12 months (point #1).

2

Watch for price to drop below that point #1, and then rise again (leaving behind point #2). As price rises from point #2 it approaches (but never reaches) point #1. Price then starts to drop, forming point #3.

However, if price ***exceeds*** the #1 point, you need to start over. This can happen when a *head-and-shoulders* pattern (described shortly) develops. If the price can't break the #1 point, the trend will very likely change.

When price drops towards point #2, place your ***open order*** to go short (sell) a futures contract at a price somewhere below point #2. At the same time, also place your ***stop-loss order*** slightly above either point #1 or point #3. When price drops below point #2, this is a bear signal that suggests a change in trend is likely to occur. If price declines, your open order is activated and you are in the market.

When trading on the short side, call your broker and tell them to move your stop-loss down as price moves down in your favor and profit accumulates. Keep lowering that stop-loss point to either further limit your losses, or to

help *lock in* any profit you've already earned.

Placing your stop-loss too close to the current price will cost you potential profit. The more profit you accumulate, the farther behind you can afford to place your stops. Ideal places to put your stop-loss order are at a previous resistance point on the chart.

The ideal time span for the 1-2-3 Top or Bottom price pattern to develop should be at least two weeks or more, otherwise it's *too far, too fast!*

1-2-3 Bottom

To spot the potential market bottom of any futures price, watch for a new lowest price during the past 12 months (point #1).

Watch for price to rise above point #1, and then drop again (leaving behind point #2). As price drops from point #2 it approaches (but never reaches) point #1. Price then starts to rise, forming point #3.

However, if price ***exceeds*** the #1 point, you need to start over. This can happen when a *head-and-shoulders* pattern (described shortly) develops. If the price can't break the #1 point, the trend will very likely change.

When price rises towards point #2, place your ***open order*** to go long (buy) a futures contract at a price somewhere above point #2. At the same time, also place your stop-loss order slightly below either point #1 or point #3. When price rises above point #2, this is a bull signal that suggests a change in trend is likely to occur. If price advances, your open order is activated and you are in the market.

When trading on the long side, call your broker and tell them to move your stop-loss up as price moves up in your favor and profit accumulates. Keep raising that stop-loss point to either further limit your losses, or to help ***lock in*** any profit you've already earned.

Placing your stop-loss too close will cost you potential profit. The more profit you accumulate, the farther behind you can afford to place your stops. Ideal places to put your stop-loss order are at a previous support point on the chart.

A 1-2-3 Top or Bottom can actually be a double-top or double-bottom. This is where point #2 equals but doesn't exceed point #1.

E. How to Calculate a 50% Retracement Objective

Ok, you're in the market – now what? Without a previously established and specific trading goal, it is foolish to be in the market.

Knowing where the markets may tend to be heading, and where they tend to turn around, helps you to trade more successfully. Using these market tendencies, you can identify and establish a trading objective.

The 50% Retracement Rule means price tends to *retrace* (or reverse its direction) by 50% of its current major move. To determine the 50% level, add the High Price and the Low Price of the last major move and divide by 2.

High + Low ÷ 2 = 50% target

The result is the *likely* target objective. The 50% level is a good indicator of how far prices *may* go. It is wise to close out your position once the 50% objective is reached. Don't be greedy!

F. How to Calculate (and quantify) Risk vs. Reward

Commodity futures trading is also a thinking person's game. You need to go beyond the 50% calculation and ask still another question. Is the potential profit of trade worth the risk? The greater the ratio of profit to risk, the better the trade.

Look at the distance between the #1 point (stop loss) and the #2 point (entry price) to consider how much you are risking vs. the first target objective (50% retracement).

To help quantify risk vs. reward, use the following procedure:

1. Add the High + Low of the recent price move and divide the sum by 2 to identify the 50% retracement target objective.
2. Take the 1-2-3 pattern's Point #1 and subtract Point #2. Multiply the result by the commodity's point value. The result is the ***risk amount***.
3. If you intend to go *long*, subtract Point #2 from the 50% target. Multiply the result by the commodity's point value. The result is ***profit***.

   If you intend to go *short*, subtract the 50% target from Point #2.

   Multiply the result by the commodity's point value. The result is ***profit***.

4. Divide ***profit*** by ***risk amount***. The result is the ***ratio***.

   Use the following ratios as a guide:

```
ratio             evaluation
-----------       -----------------
2.0 or less       use an option
2.0 - 2.9         Poor opportunity
3.0 - 4.9         Good opportunity
5.0 - up          Great opportunity
```

   Anticipating a 50% retracement of prices, the distance from Point #2 (your entry price) to the 50% level would be the initial profit expectation. The closer the entry price is to the 50% target, the less the profit potential. (In other words, some 1-2-3s are better than others).

G. Trading Range

When a market's price is in a ***trading range*** (also called a narrow sideways channel), this is a signal that there isn't much interest in that market right then. This is a trading opportunity you shouldn't ignore. Because traders need time to be convinced that they should put their money into the market, channels are more likely to occur near the bottom of a price move.

4

When price breaks out of the channel, the price movement will tend to continue in that direction. Set your stop-loss order just beyond the middle of the channel, away from the direction of the breakout. ***Gaps*** (described shortly) also help to identify when price is breaking out of a channel, and in which direction the breakout is occurring.

A ***base*** is a long trading range that is formed during a period of accumulation, and typically occurs at the bottom portion of the price chart. The longer the consolidation period, the greater the rally after the breakout.

Trading range rule of thumb: The upside or downside breakout of the channel will carry prices in a one-to-one (1:1) ratio. That is, if the trading range is 20 squares wide on the price chart, when price breaks out of the channel it will frequently rise or fall 20 squares. This gives you an idea of a *likely* price objective for the move.

H. Gaps

When a market becomes more volatile, the market price will *open* higher or lower than the previous day's close leaving a ***gap*** on the price chart. Gaps often occur at the onset of a major price move. Price tends to retrace and fill the gap sometime in the future before continuing. Gaps that remain unfilled become future chart objectives.

Gaps can serve several purposes. They are used to:

- Spot the beginning of a move
- Measure a move (suggest how far price is likely to go)
- Signal the end of the move
- Signal market strength and weakness
- Indicate likely buy or sell points

With gaps, if you're long, you place a stop-loss below the gap. If short, place the stop-loss above the gap. Exactly where? This depends on each commodity and its personality. You need to ***paper trade*** (covered in a later chapter) to learn the characteristics of each commodity.

There are 4 types of gaps:

Common gap:

The most frequently occurring gap. Whenever a gap occurs within a trading range, it is of no significance.

Breakaway gap:

Occurs outside of a trading range and it marks the beginning of a significant move. It's a signal that price is heading further in that direction. This type of gap remains unfilled for a long time. Heavy *Volume* breakaway gaps are usually important levels of *support* and *resistance* over the long-term as well.

Measuring gap:

The measuring gap gives you a way to determine the next market objective. It typically occurs in the middle of a price move and can *predict* how much farther price may go. Measure the distance from the breakaway gap to the measuring gap. This distance extends from the measuring gap in the trend direction to *project* how much farther price will likely go.

Exhaustion gap:

This gap often signals the end of the move. Although prices may continue further in the trend direction, the rally will not last long. An extreme exhaustion gap may form an *island reversal* (described shortly)

Note: Information about the following price chart patterns and how they are used is only available in the complete **Commodity FUTURES Trading Home Study Course**™.

- Head-and-Shoulders Top / Head-and-Shoulders Bottom
- Triangles
- Symmetrical Triangle (pennant)
- Descending Triangle (horizontal bottom)
- Ascending Triangle (horizontal top)
- Flags (bull, bear)
- Declining Wedge
- Inclining Wedge
- Key reversal
- Island reversal

The next chapter describes *Selection Tools* and how they are used.

top

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5. Selection Tools

The trading process described in this course uses numerous ***tools*** (also called *indicators* or *oscillators*), as well as graph patterns and specific price behaviors that will help you trade better. These tools are used in an objective way to analyze the futures markets. There are three types of tools which are covered in this course; ***selection tools***, ***confirming tools***, and ***timing tools***.

Selection tools are used to identify the best trade possibilities with odds in your favor.
Confirming tools tell you when the odds are heavy in favor of an up or down move.
Timing tools are used to identify when to get into and out of a market.

Each of these tools is described in a separate chapter. Although these tools will help you improve your odds of success in trading, no one can truly predict the price direction of a market. All we can do is *react* to ideal market conditions.

Note: Most of the tools described in this trading course are also displayed in *Commodity Price Charts*. You must get a subscription to this service to understand how these tools are used. Reviewing tool behavior in relation to price is valuable for insight. Also helpful is a subscription to *Investor's Business Daily* (see "Appendix B. Resources" for subscription information).

What Are Selection Tools?

In your market analysis, you need to use the *selection tools* first because they will help you to identify the best possible trades to put the odds of a successful trade in your favor. These tools deal with professional opinion, not price action. They can't time your entry point, but they are important because they help you to identify how to trade a commodity – either from the *long side* or *short side*. They will give you confidence that a sustainable price move is likely to occur, and which direction it will go. It is vitally important to only select trades with well-defined bull or bear markets.

There are several *Selection Tools* which are used to analyze each market and determine which ones offer the best likely trading opportunity. These tools are:

```
A.  Commercials    (they are 80% of all market activity)
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B.  Public         (investor sentiment, newsletter writers, and you)
C.  Open Interest  (mirrors commercial activity)
D.  Premium Market (suggests an upcoming bull market)
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Note: Information about these tools and how they are used is only available in the complete **Commodity FUTURES Trading Home Study Course**™.

The next chapter describes *Confirming Tools* and how they are used.

top

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6. Confirming Tools

Confirming tools are used to give you a trading advantage, and will help you better identify when to get in or out of the market. You must first select good trades with well-defined moves or these tools don't work. Confirming Tools should only be used after selecting your best trading opportunities using the Selection Tools.

Note: All of these tools are subject to whipsaw and error.

The more confirmation you have about an ideal trading opportunity – as evidenced by several tools being in agreement, the greater the likelihood your original trading selection will see price move in the direction you anticipate.

These tools are only an indication of where the market *may* be heading. You should wait until 3 or more of these tools confirm your initial market assessment of where price may be heading *before* you take any action.

There are several confirming tools which are used to analyze each market for likely trading opportunity. These tools are:

```
A. 10-Week Moving Avg (identifies a bull/bear market)
B. 14-Day RSI         (measures price momentum)
C. Stochastics        (measures price rate of change)
D. 14-Day ADX         (helps filters out false signals)
E. 7-Bar ADX          (longer term view of 14-day ADX)
F. Volume             (total number of contracts traded)
G. Moving Averages    (trend indicating tool)
H. Gaps & Limit Moves (identify objectives, opportunity)
I. Seasonal Tendency  (suggest recurring price activity)
```

Note: Information about these tools and how they are used is only available in the complete **Commodity FUTURES Trading Home Study Course**™.

The next chapter describes *Timing Tools* and how they are used.

top

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7. Timing Tools

Timing tools are used to get you into and out of a market. They help you to identify possible entry and exit points for a trade. The Timing Tools used in this course are:

```
A. %R  [Williams]
      (measures overbought/oversold conditions)
B. Accumulation-Distribution
      (measures market pressures)
C. 25-day Moving Average
      (signals increase/decrease in price momentum)
D. Cash Basis
      (helps time entry and exit points)
E. Cycles
      (provide additional Buy/Sell signals)
F. How to Exit a Position
      (getting out of the market)
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top

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8. Damage Control

Trading commodity futures will cause you to encounter three powerful and destructive emotions: ***fear***, ***greed*** and ***hope***. Trading which is influenced by these emotions will almost always result in losing trades so you need to develop *survival insurance*.

Risk is the probability of an event occurring. In commodity futures, risk is exposing your trading capital to loss. All traders deal with varying degrees of risk when they trade. The greatest risk in trading commodity futures

occurs from *surprise* events which moves price too fast (via *Limit Moves*) and prevents you from exiting at your pre-determined Stop-Loss point. In this situation, your losses accumulate rapidly, and there's nothing you can do about it until the market volatility subsides!

Although you will never entirely eliminate this risk, you can protect yourself against it by watching the news for those events which would result in a surprise market move. These events would include sudden weather changes (freezes, floods, drought) in different parts of the world, crop reports, changes in currency, wars, pestilence, etc.

Being aware of events which could influence a commodity's price gives you a warning signal to take *immediate* action. This can mean either getting out of a market to avoid financial loss, or getting into a market to profit from the anticipated change.

You need to control risk to survive in this business. The two ways to control risk are:

- Control *equity* risk (loss of capital is predetermined prior to the trade)
- Control *trading* risk (time is spent waiting for the right opportunity to develop)

Modern risk management techniques have their roots in gambling techniques and probability theory. Traders often don't know what risk confronts them. The trading profession is a business, not speculation or gambling. A trader's main goal is to avoid ruin. This means you should always have excess capital in reserve to cover obligations, to live on, and to make profitable trades when the right opportunity presents itself. Strategies for safety are important.

A. Money Management

Money Management is clearly the most important risk management technique that you must learn. It is a system of rules which you need to define to identify how much capital you will risk on any one trade. This discipline will remove fear and greed from your trading activities, and also provides you with *staying power*. Trading without equity control guarantees failure. Self discipline is the key to successful trading, and this discipline is attained by trusting the system that you have defined.

A sound Money Management Plan uses several rules to help you control equity risk.

1. Having a Money Management Plan gives you a trading advantage. Your personal *homework assignment* is to define the rules that establish how much money you will risk on a trade. You will religiously use this plan in all of your trading activities.

2. Establish the total dollar amount which you will deposit into your commodity fund and give that total amount to your broker. Put a limit on total trading capital. If your trading account is less than $5,000, it's best to use ***Options*** (see chapter 12).

3. Commit the amount of money you are willing to lose on the trade based on the probability that the trade will be profitable. That's why you use a Stop-Loss Order.

4. Define a percentage (10-20%) dollar amount available for all trades. This amount dictates how many contracts you can afford. As soon as you have invested that amount of your total funds – STOP Trading! Do not take on any new positions.

5. As you make money and your trading account amount grows, you increase your position with more contracts (or options) per trade. As you lose money, you decrease your position with fewer contracts (or options) per trade.

Note: An Excel file is included to help you *model* money management strategies. Instructions for using the "Money Management Form" (moneymgt.xls, included with this trading course) is described in Appendix C.

B. Trading Plan

You must have a clearly defined trading plan and religiously follow it or you will not be successful at profiting from the market. A trading plan is a predefined set of rules which you define and use to mechanically and unemotionally determine the conditions you will use to get in and out of the market. A sound trading plan will control losses better than you can. Rules which should be part of any trading plan include:

1. Have a Trading Plan (which uses charts, tools, and trading rules that tell you when to buy or sell) to give you a trading advantage. It is your *homework assignment* to define the rules for your personal trading plan. The rules for a trading plan may be different for each trader, but these rules should also include:

- How much money will you risk on the trade?
- What are the conditions which will signal when to enter the market?
- Will you stay in the trade until you achieve your objective or follow the market?

2. Use your trading plan as your religion. NEVER go against your trading plan. If it's flawed, identify the problem and modify your trading plan to eliminate the flaw. You should also continually try to improve your trading plan. You do this by changing the rules in your trading plan, and then *paper trade* the changes against your current trading plan. After several trades, you should have results that will help you determine if the changes were an improvement or not. Never use a changed trading plan until you have paper traded it sufficiently to be comfortable about its reliability.

3. Don't put on a trade and forget it. You must take a daily account of the profit or loss that has accumulated in each trade.

4. Limit your losses. Use real Stop-Loss Orders. Set them to limit your loss and give up no more than 5% (but no more than $400) per contract of the total capital in your trading account. Never expose yourself to excessive risk, and never invest too large a percent of your capital.

5. Do not be in more than 3-4 trades at one time. Don't overtrade!

6. Successful traders are very defensive of their capital. They exit quickly when they suspect they are wrong. The best trades work right away. Do not fight the market. If you make a mistake, exit the market *immediately*! Small losses hurt much less than large losses.

7. Never add to a losing position – ever.

8. Don't trade *thin* markets (i.e., markets that lack liquidity which is evidenced by low Open Interest and low Volume. You need liquidity to quickly get in and out of a market at a price close to your defined exit price.

9. Never put yourself in a position that can result in tragedy. If in doubt, stay out!

C. Stop-Loss Orders

You must use real ***Stop-Loss Orders*** with each trade to protect your trading capital. They are used to define the maximum amount of money that you can lose – if the market reverses and moves against you. Stop-Loss Orders are used to control risk and to avoid being financially wiped out. Always set your Stop-Loss Orders so you will lose no more than 5% of your trading account capital if the trade goes bad.

Note: The Stop-Loss Order does not give you a 100% guarantee that your loss will be limited to the amount you specify. Your Stop-Loss protection may not be effective if the market moves against you during a *Limit Move*. When this happens, nobody can get in or out until the market volatility subsides. By then, you could easily have sustained several thousands of dollars in loss. Fortunately, many of the tools which have been described earlier may give you advance warning of an impending reversal. This is why it is important that you monitor your active trades and the news daily.

Beginning traders often wonder where their Stop-Loss Orders should be placed. You need them to protect your trading equity, but where do you put them?

Use Stop-Loss Orders to control loss in the following ways:

- In Bull markets, the Stop-Loss Order will be about the same dollar amount that would account for a 1½ limit move (see pages 4-3, 6-9 for more about limit moves).

- In Bear markets, the Stop-Loss Order will be about the same dollar amount that a 2 limit move would produce.

- Once you have an active position, your Stop-Loss Order will also be used to get you out of the market. As price moves in your favor, the Stop-Loss Order will be used as a protective *Trailing Stop*. When price movement yields meaningful profit, you will instruct your broker to move the Stop-Loss Order in the direction of price movement.

- Your Trailing Stop is used to minimize loss and lock in profit. In general, if your Stop-Loss Order originally allowed for $400 of risk, then it would be used as a Trailing Stop each time $400 of profit was produced by the trade. Give your Stop-Loss Order a little room so that you are not stopped out of the trade. Continue this procedure until you're stopped out of the trade.

- Alternatively, every time price makes a new high, you move the stop to the lowest low of the last n days (where: n = 3-12 days).

  Use the last 12 days when you first enter, and tighten up to 3 days when market has moved close to the expected *target*.

top

9. Paper Trading

Paper trading lets you practice trading commodities without risking your money. It gives you confidence in identifying and analyzing price patterns, confidence in using your tools, and confidence in your Money Management Plan and Trading Plan. Your aim is to enter and exit markets on paper, keeping track of your profit and loss until you are successful enough to enter markets with real money. This chapter describes the process to take you from paper trading to actual trading.

This information uses common industry knowledge as a basis to define a systematic procedure for analyzing and identifying trades that puts the odds of success in your favor. For maximum success, this analysis procedure should be used to identify only *prime* trading opportunity using your Selection Tools and ignore everything else.

Trading commodity futures is a business and a discipline. You cannot learn this process overnight so you ***must*** paper trade for at least six months to learn the skills associated with trading. This is your *basic training* period.

You must have a rudimentary understanding of the futures markets and how your Trading Plain works in real trading conditions. Paper trading gives you that understanding by learning the mechanics of trading – deciding on positions and stops, entering orders, etc.

You must learn how to be disciplined, focused, and control risk. Paper trading will help you achieve that goal. When paper trading, you must be honest with yourself. Don't try to *fudge* your market positions after you establish them. The real world of trading doesn't work that way, so why should you train yourself otherwise? Live with your decisions and learn from them. If you can't be successful on paper – you won't do it with real money.

This is your time to experiment. You can trade two or three futures contracts using different approaches. All your questions will be answered during your paper trading. Be careful and go slow. Don't let the excitement of a successful trade cause you to lose your head and begin wild and reckless trading. Make success a habit.

Paper Trading is simply watching the markets and taking note when you would have gone long or short. You then decide when it's right to exit the trade and write down any profit or loss you would have incurred. An important part of your training is keeping a "trading diary". Write down the reasons you enter and exit trades.

Do not start trading with real money until you are satisfied with your *total* trading results, not just net profit.

A. Paper Trading Requirements

1. Establish a relationship with a broker.

2. Subscribe to a weekly charting service. Use a broker (or Investor's Business Daily) for daily price quotes and chart the commodities that you are following. Don't forget that the quotes in the paper are yesterday's prices.

3. Have a previously-defined and detailed trading plan for each trade which includes a Money Management plan and stick with your plan. You need to identify where you will enter the market, your objective, and how you will exit the trade – with no changes in your plan unless new information warrants the change.

4. Only take a position when the odds of success are heavily in your favor as suggested by your tools. Watch for (and identify) opportunity resulting from price patterns or news events and trade only futures markets with a high probability of profit.

5. Major moves are what you are looking for, not daily price fluctuations.

6. Keep track of profit and loss until you are successful enough to enter markets with real money.

B. Paper Trading Steps

1. Update your charts before you evaluate the markets that you are closely monitoring. Always be aware of the major trend of a market you are trading.

2. Technical chart analysis adds discipline to your trading plan because it lets you identify trends and recurring price patterns. There are two ways to analyze the markets: ***Simple*** and ***Comprehensive***. Choose the one that suits your personality.

Simple Analysis:

With the simple analysis, you will evaluate all commodities, looking for specific chart patterns (trends) in the making. These chart patterns are your best opportunities for successful trades because they have a high probability of profit. You will be looking for the following events:

a. A 12-month high or low, with either a 1-2-3 Top, 1-2-3 Bottom, or head-and-shoulders pattern emerging
b. Triangles in the making
c. Quiet narrow trading ranges, especially at market lows

When these patterns appear, they are potential opportunities in the making and should be closely monitored. Draw trend lines on the chart so you can better see the dominant trend. Use your Trading Plan to get into and out of the market if price moves in the direction that you expect.

top

10.Comprehensive Analysis:

1. Introduction

This chapter describes the objective of this course, the concept of *pyramid* and *pillar* trading, and how you can profit by using these trading strategies.

A. Objectives of this Trading Course

This **Commodity PYRAMID Trading Home Study Course**™ will give you the skills to analyze and select commodity futures trades which have a high likelihood of being profitable. You will also learn how to incorporate various pillar and pyramid strategies into your trading activities.

This is *not* a trading system. It is an educational presentation which uses common industry information and

techniques to help you define a simple *Trading Plan*. You can use this trading plan to intelligently evaluate and select commodity markets that have the highest likelihood of becoming a successful trade. This course will teach you trading techniques that minimize your chances of loss while simultaneously enhance your ability to profit from "expected" market price movement. You will also need to define a *Money Management Plan* to control your risk and loss. And finally, you need to *paper trade* for at least three months to develop the confidence and skills to be successful in your trading efforts. By doing these things, you gain a significant advantage over other traders.

I can't guarantee your success – but I will do my absolute best to teach you how to trade intelligently.

At the end of this trading course, you will know how to more successfully do the following:

- Analyze commodities with high potential for a successful pyramid trade
- Understand and use several simple pyramid and pillar trading strategies

Special Notice

The information in this **Commodity PYRAMID Trading Home Study Course** frequently refers to, and builds upon, information which is contained in my complete **Commodity FUTURES Trading Home Study Course**. The reader is assumed to have obtained and mastered the materials in this course which is available on my web site at:

B. Notices

The *Commodity Futures Trading Commission* and *The National Futures Association* requires the following notice be stated:

There is a Risk Of Loss in Futures and Options Trading.

I am not an investment counselor or a commodity trading advisor, nor do I give advice on specific investments. This educational trading course is designed to give you the skills and insight that will help you to pyramid trade commodity futures more successfully.

Successful past results don't necessarily mean success in the future. There is a risk of loss in pyramid trading. Do *not* trade using money that you can't afford to lose.

Over 90% of new people who engage in pyramid/pillar trades will lose money. The other 10% are successful for the following reasons:

- They learned about how the futures markets work,
- They learned how to anticipate and identify changes in a future's price and position themselves to benefit from that price change,
- They have defined and use both a *Trading Plan* and *Money Management Plan*.

This trading course will teach you how to do these things.

D. What You Will Need To Pyramid Trade

Here's a list of things you need to successfully pyramid trade futures contracts.

- A trading account with a broker
- A telephone to contact your broker
- A calculator
- Investor's Business Daily subscription (see Appendix A)
- Commodity Price Charts subscription (see Appendix A)
- About 10 minutes each night to assess your current position, plus about an hour every Monday evening to perform a revised analysis on your current position
- The Pyramid Trading form

It is on *strong* recommendation that you completely read this trading course three separate times. The first reading should be done to get the general idea of what is involved in the entire process – that is, you get a general grasp of things. The second time, read it to help reinforce your knowledge as well as help you to better understand the *process* presented in this course. The third reading will be helpful, as you should be ready to start defining your personal *Trading Plan* and *Money Management Plan*.