Part I

FUTURES AND CURRENCIES

Taking the Mystery Out of Futures

Of all the markets discussed in this book, the futures market is probably the one least understood by most investors. It is also one of the fastest growing. Trading volume in futures has expanded more than twentyfold during the past twenty years. In 1988, the dollar value of all futures contracts traded in the U.S. exceeded $10 trillion!* Obviously, there is a lot more than pork belly trading involved here.

Today's futures markets encompass all of the world's major market groups: interest rates (e.g., T-bonds), stock indexes (e.g., the S&P

*This is a rough but conservative estimate based on 246 million contracts traded and assuming an average contract value well over $40,000. (Excluding short-term interest rate futures, such as Eurodollars, single contract values ranged from about $11,000 for sugar at 10¢/lb. to $150,000 for the S&P 500 at an index value of 300.)

500), currencies (e.g., Japanese yen), precious metals (e.g., gold), energy (e.g., crude oil), and agricultural commodities (e.g., corn). Although the futures markets had their origins in agricultural commodities, this sector now accounts for only about one-fifth of total futures trading. During the past decade, the introduction and spectacular growth of many new contracts has resulted in the financial-type markets (currencies, interest rate instruments, and stock indexes) accounting for approximately 60 percent of all futures trading. (Energy and metal markets account for nearly half of the remaining 40 percent.) Thus, while the term commodities is often used to refer to the futures markets, it has increasingly become a misnomer. Many of the most actively traded futures markets, such as those in the financial instruments, are not truly commodities, while many commodity markets have no corresponding futures markets.

The essence of a futures market is in its name: Trading involves a standardized contract for a commodity, such as gold, or a financial instrument, such as T-bonds, for a future delivery date, as opposed to the present time. For example, if an automobile manufacturer needs copper for current operations, it will buy its materials directly from a producer. If, however, the same manufacturer was concerned that copper prices would be much higher in six months, it could approximately lock in its costs at that time by buying copper futures now. (This offset of future price risk is called a hedge.) If copper prices climbed during the interim, the profit on the futures hedge would approximately offset the higher cost of copper at the time of actual purchase. Of course, if copper prices declined instead, the futures hedge would result in a loss, but the manufacturer would end up buying its copper at lower levels than it was willing to lock in.

While hedgers, such as the above automobile manufacturer, participate in futures markets to reduce the risk of an adverse price move, traders participate in an effort to profit from anticipated price changes. In fact, many traders will prefer the futures markets over their cash counterparts as trading vehicles for a variety of reasons:

1. *Standardized contracts*—Futures contracts are standardized (in terms of quantity and quality); thus, the trader does not have to find a specific buyer or seller in order to initiate or liquidate a position.

2. *Liquidity*—All of the major futures markets provide excellent liquidity.
3. *Ease of going short*—The futures markets allow equal ease of going short as well as long. For example, the short seller in the stock market (who is actually borrowing stock to sell) must wait for an uptick before initiating a position; no such restriction exists in the futures markets.
4. *Leverage*—The futures markets offer tremendous leverage. Roughly speaking, initial margin requirements are usually equal to 5 to 10 percent of the contract value. (The use of the term *margin* in the futures market is unfortunate because it leads to tremendous confusion with the concept of margins in stocks. In the futures maikets, margins do not imply partial payments, since no actual physical transaction occurs until the expiration date; rather, margins are basically good-faith deposits.) Although high leverage is one of the attributes of futures markets for traders, it should be emphasized that leverage is a two-edged sword. The undisciplined use of leverage is the single most important reason why most traders lose money in the futures markets. In general, futures prices are no more volatile than the underlying cash prices or, for that matter, many stocks. The high-risk reputation of futures is largely a consequence of the leverage factor.
5. *Low transaction costs*—Futures markets provide very low transaction costs. For example, it is far less expensive for a stock portfolio manager to reduce market exposure by selling the equivalent dollar amount of stock index futures contracts than by selling individual stocks.
6. *Ease of offset*—A futures position can be offset at any time during market hours, providing prices are not locked at limit-up or limit-down. (Some futures markets specify daily maximum price changes. In cases in which free market forces would normally seek an equilibrium price outside the range of boundaries implied by price limits, the market will simply move to the limit and virtually cease to trade.)
7. *Guaranteed by exchange*—The futures trader does not have to be concerned about the financial stability of the person on the other side of the trade. All futures transactions are guaranteed by the clearinghouse of the exchange.

Since by their very structure, futures are closely tied to their underlying markets (the activity of arbitrageurs assures that deviations are relatively minor and short lived), price moves in futures will very closely parallel those in the corresponding cash markets. Keeping in mind that the majority of futures trading activity is concentrated in financial instruments, many futures traders are, in reality, traders in stocks, bonds, and currencies. In this context, the comments of futures traders interviewed in the following chapters have direct relevance even to investors who have never ventured beyond stocks and bonds.