Futures contract: an investment to pursue larger profits or to limit risk

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Abstract

Futures Contracts (markets) have been described as continuous auction markets and as clearing houses for the latest information about supply and demand. They are worldwide meeting places of buyers and sellers of an ever-expanding list of products that includes financial instruments such as oil, energy, power, treasury bonds, stock indexes, and foreign currencies as well as traditional agricultural commodities, metals, coal and petroleum products. There is also active trading in options on futures contracts allowing option buyers to participate in futures contracts (markets) with known risk. Electronic order placement is increasingly commonplace. As such developments help make futures markets more useful to more people, it therefore depicts that they have become broadly and extensively used.

Notwithstanding the changes that have and are continuing to occur, the primary purpose of futures contracts (markets) remains unchanged: To provide an efficient and effective mechanism for the management of price risks. By buying or selling futures contracts that establish a price now for a purchase or sale that will take place at a later time, individuals and businesses are able to achieve what amounts to insurance protection against adverse price changes. It is called hedging.

Simultaneously, other futures contracts (markets) participants are speculators. By buying or selling, depending on which direction they expect prices to move, they hope to profit from the very price changes that hedgers seek to avoid. The interaction of hedgers and speculators, each pursuing their own goals, helps to provide active, liquid, and competitive markets. For those individuals who fully understand and can afford the risks that are involved, the allocation of some portion of their investment capital; the portion that is truly risk capital; to futures speculation can provide a means of achieving greater portfolio diversification and a potentially higher overall rate of return on their investments. There are also a number of ways futures and options on futures can be used in combination with other investments to pursue larger profits or to limit risks.

Speculation in futures contracts, however, is clearly not appropriate for everyone. Just as it is possible to realize substantial profits in a short period of time, it is also possible to incur substantial losses in a short period of time. The possibility of large profits or losses in relation to the initial commitment of capital stems principally from the fact that futures trading is a highly leveraged form of speculation. Only a relatively small amount of money is required to participate in the price movements of assets having a much greater value. As one will illustrate, the leverage of futures trading can work for you when prices move the direction you anticipate or against you when prices move in the opposite direction. The purpose of this study will not be to recommend either that you should or shouldn't participate in futures trading; that definitely, will be a decision that one would make only after consultation with a reliable broker or financial advisor and in light of one's own financial situation and objectives.

Introduction

A future contract (more colloquially, futures) is a standardized forward contract, a legal agreement to buy or sell something at a predetermined price at a specified time in the future, between parties not known to each other. The asset transacted is usually a commodity or financial

instrument. The predetermined price the parties agree to buy and sell the asset for is known as the forward price. The specified time in the future (which is when delivery and payment occur) is known as the delivery date. Because it is a function of an underlying asset, a futures contract is a derivative product.

Contracts are negotiated at futures exchanges, which act as a marketplace between buyers and sellers. The buyer of a contract is said to be long position holder, and the selling party is said to be short position holder. As both parties risk their counter-party walking away if the price goes against them, the contract may involve both parties lodging a margin of the value of the contract with a mutually trusted third party. For example, in gold futures trading, the margin varies between 2% and 20% depending on the volatility of the spot market.

The first futures contracts were negotiated for agricultural commodities and later futures contracts were negotiated for natural resources such as oil. Financial futures were introduced in 1972, and in recent decades, currency futures, interest rate futures and stock market index futures have played an increasingly large role in the overall futures markets.

Futures markets have been used by traders in commodities for hundreds of years. Trading in rice futures was being conducted in Osaka, Japan as early as the18th century. The New York Mercantile Exchange (NYMEX), the world's largest regulated energy futures exchange, started life in 1872 as the Butter and Cheese Exchange of New York, before being renamed ten years later. Exchange-traded futures and options provide several important economic benefits, including the ability to shift or otherwise manage the price risk of cash and physical market positions. As open markets where large numbers of potential buyers and sellers compete for the best prices, futures markets like the TOCOM in Tokyo, SGX in Singapore, IPE in London, EEX in Germany, Nord Pool in Scandinavia, NYMEX in New York, and Intercontinental Exchange out of the USA allow trading companies to discover and establish competitive prices. Partly because these markets provide the opportunity for leveraged investments, they attract large pools of risk capital. As a result, futures markets are among the most liquid of all global financial markets, providing low transaction costs and ease of entry and exit. This, in turn, fosters their use by a wide range of businesses and investors who want to manage price risks. Today's futures industry functions with a number of time-tested institutional arrangements, as well offer opportunities for speculation in that a trader who predicts that the price of an asset will move in a particular direction can contract to buy or sell it in the future at a price which (if the prediction is correct) will yield a profit.

Early future contracts & today's contracts

The frantic shouting and signaling of bids and offer on the trading floor of an open-outcry futures exchange undeniably convey an impression of chaos. The reality, however, is that chaos is what futures markets replaced. Prior to the establishment of central grain markets in the mid-nineteenth century, the nation's farmers carted their newly harvested crops over plank or dirt roads to major population and transportation centers each fall in search of buyers. This seasonal supply glut drove prices downward to giveaway levels and even to throwaway levels as corn, wheat and other crops often rotted in the streets or was dumped in rivers and lakes for lack of storage. Come spring, shortages frequently developed, and foods made from corn and wheat became barely affordable luxuries. Throughout the year, it was each buyer and seller for himself, with neither a place nor a mechanism for organized, competitive bidding. The first central markets were formed to meet that need. Eventually, contracts were entered into for forward as well as for spot (immediate) delivery. So-called forwards were the forerunners of present-day futures contracts.

Spurred by the need to manage the price and interest rate risks that exist in every type of modern business, today's futures markets have also become major financial centers, without the existence of which even the U.S. Treasury or Federal Reserve System would be hard pressed to carry out their fiscal responsibilities. Current market participants are just as likely to be mortgage lenders, investment bankers and multinational corporations as farmers, grain merchants and exporters.

Wherever there are hedgers who need to transfer price risks, there are speculators willing to selectively accept the risks in the pursuit of profit. Futures prices, whether arrived at either through open outcry or by electronic matching of bids and offers, are immediately and continuously relayed around the world**.** A farmer in Texas, a merchant in Dublin, an importer in Seoul and a speculator in New Jersey have simultaneous and equal access to the latest market derived price quotations. Should they go ahead and choose/decide, they can set up a price level for future delivery (or for speculative purposes) simply by instructing their broker to buy or sell the appropriate contracts?

What's a futures contract?

There are two types of futures contracts: those that provide for physical delivery of a particular commodity and those that call for an eventual cash settlement. The commodity itself is specifically defined, as is the month when delivery or settlement is to occur. It should be noted that even in the case of delivery-type futures contracts; very few actually result in delivery. Selling a contract that was previously purchased liquidates a futures position in exactly the same way that selling 100 shares of IBM stock liquidates an earlier purchase of 100 shares of IBM stock. Similarly, a futures contract that was initially sold can be liquidated by making an offsetting purchase. Cash settlement futures contracts are precisely that, contracts that are settled in cash rather than by delivery at the time the contract expires. Stock index futures contracts, for example, are settled in cash on the basis of the index number at the close of the final day of trading. Delivery of the actual shares of stock that comprise the index would obviously be impractical.

Furthermore, it is prudent to know the losses and gains on futures contracts. Gains and losses on futures contracts are not only calculated on a daily basis, they are also credited or debited to each market participant's brokerage account on a daily basis. Thus, if a speculator were to have $800 profit as the result of a day's price changes, that amount would immediately be credited to his or her account and, unless required for other purposes, could be withdrawn. On the other hand, if the day's price changes resulted in a $800 loss, the account would be debited for that amount. The process just described is known as daily cash settlement and it's an important feature of futures trading.

Key facts about futures contracts

A futures contract is a standardized agreement between two parties that:

*Commits one party to sell and the other party to buy a stipulated quantity and grade of oil, gas, power, coal, or other specified item at a set price on or before a given date in the future.

*Requires the daily settlement of all gains and losses as long as the contract remains open.

*For futures contracts remaining open until trading terminates, the expiry of the contract provides either for delivery of the underlying physical energy product or a final cash payment (cash settlement).

Main global oil, gas, coal and power futures exchanges

IPE London: http://www.ipe.uk.com/
EEX: http://www.eex.de/
UKPX: http://www.ukpx.com/
NYMEX New York: http://www.nymex.com/
TOCOM Tokyo/SGX: http://www.tocom.or.jp/
SGX Singapore: http://www.sgx.com/
Nord Pool: http://www.nordpool.com/

Futures contracts have several key features:

*The buyer of a futures contract, the 'long', agrees to receive delivery.

*The seller of a futures contract, the 'short', agrees to make delivery.

*The contracts are traded on regulated exchanges either by open outcry in specified trading areas (called pits or rings) or electronically via a computerized network.

* Futures contracts are marked-to-market each day at their end-of-day settlement prices, and the resulting daily gains and losses are passed through to the gaining or losing futures accounts held by brokers for their customers.
*Futures contracts can be terminated by an offsetting transaction (i.e.an equal and opposite transaction to the one that opened the position) executed at any time prior to the contract's expiration. The vast majority of futures contracts are terminated by offset or a final cash payment rather than by delivery. For example, on the IPE and NYMEX less than 2% of the open interest (total contracts open) in their energy futures contracts go to physical delivery each month.

The process of price discovery & market participants

Futures prices increase or decrease largely because of the myriad factors that influence buyers' and sellers' expectations about what a particular commodity will be worth at a given time in the future (anywhere from less than a month to more than two years). As new supply and demand developments occur and as more current information becomes available, these judgments are reassessed, and the price of a particular futures contract may be bid upward or downward. This process of reassessment of price discovery is continuous. Moreover, competitive price discovery is a major economic function (and, indeed, a major economic benefit) of futures trading. Through this competition all available information about the future value of a commodity is continuously translated into the language of price, providing a dynamic barometer of supply and demand. Price "transparency" assures that everyone has access to the same information at the same time.

Furthermore, the market participants should have in mind a priori this question; should you decide to trade in futures contracts or options, either for speculation or price risk management, your orders to buy or sell will be communicated through your brokerage firm to the trading floor for execution by a floor broker. If you are a buyer, the broker will seek a seller at the lowest available price. If you are a seller, the broker will seek a buyer at the highest available price. More again, it's very important to know about the *Hedgers* in this situation. The details of hedging can be somewhat complex, but the principle is simple. By buying or selling in the futures market now, individuals and firms are able to establish a known price level for something they intend to buy or sell later in the cash market. Buyers are thus able to protect themselves against higher prices and sellers are able to hedge against lower prices.

More again, *speculators*, Were you to speculate in futures contracts by buying to profit from a price increase or selling to profit from a price decrease, the party taking the opposite side of your trade on any given occasion could possibly be a hedger or it might be another speculator, someone whose opinion about the probable direction and timing of prices differs from your own.

Buying futures contracts with the hope of later being able to sell them at a higher price is known as "*going long*" Conversely, selling futures contracts with the hope of being able to buy back identical and offsetting futures contracts at a lower price is known as "*going short*" An attraction of futures trading is that it is equally as easy to profit from declining prices (by selling) as it is to profit from rising prices (by buying).

	Reasons for BUYING futures contracts	**Reasons for SELLING futures contracts**
Hedgers	To lock in a price and thereby obtain protection against rising prices	To lock in a price and thereby obtain protection against declining prices
Speculators	To profit from rising prices	To profit from declining prices

Basic trading & the participation in future trading

To say that gains and losses in futures trading are the result of price changes is an accurate explanation but by no means a complete explanation. Perhaps more so than in any other form of speculation or investment, price changes in futures trading are highly leveraged. An understanding of this leverage is absolutely essential to an understanding of futures trading. If you speculate in futures contracts and the price moves in the direction you anticipated, high leverage can yield large profits in relation to your initial margin deposit. But if prices move in the opposite direction, high leverage can produce large losses in relation to your initial margin deposit. Leverage is a two-edged sword.

Futures trading thus require not only the necessary financial resources but also the necessary financial and emotional temperament. It can be one thing to have the value of your common stock portfolio decline by five percent but quite another, at least emotionally, to have that same five percent stock price decline wipe out 100 percent of your investment in futures contracts. An absolute requisite for anyone considering trading in futures contracts is to clearly understand the concept of leverage. Calculate precisely the gain or loss that would result from any given change in the futures price of the contract you would be trading. If you can't afford the risk, or even if you're uncomfortable with the risk, the only sound advice is don't trade.

The basic trading strategies

Even if you should decide to participate in futures trading in a way that doesn't involve having to make day-to-day trading decisions about what and when to buy or sell (such as having a managed account or investing in a commodity pool), it is nonetheless useful to understand the dollars and cents of how futures trading gains and losses are realized. If you intend to trade your own account, such an understanding is essential. Here are brief descriptions and illustrations of the most basic strategies:

Buying (Going Long) to Profit from an Expected Price Increase

		Price per barrel	**Value of $1,000-barrel contract**
February	Buy 1 August crude oil futures contract	$17.00	$17,000
May	Sell 1 August crude oil futures contract	$16.00	$16,000
	Loss	$1.00	$1,000

Note that if at any time the loss on the open position had reduced funds in your margin account to below the maintenance margin level, you would have received a margin call for whatever sum was needed to restore your account to the amount of the initial margin requirement.

Selling (Going Short) to Profit from an Expected Price Decrease

The only way going short to profit from an expected price decrease differs from going long to profit from an expected price increase is the sequence of the trades. Instead of first buying a futures contract, you first sell a futures contract. If, as you expect, the price does decline, a profit can be realized by later purchasing an offsetting futures contract at the lower price. The gain per unit will be the amount by which the purchase price is below the earlier selling price. Margin requirements for selling a futures contract are the same as for buying a futures contract, and daily profits or losses are credited or debited to the account in the same way.

Participating in future trading

Now that you have an overview of what futures markets are, why they exist and how they work, the next step is to consider various ways in which you may be able to participate in futures trading. There are a number of alternatives and the only best alternative is whichever one is best for

you. In addition to describing several possibilities, the pages that follow suggest questions you should ask and information you should obtain before deciding. Also discussed is the opening of futures trading account, the regulatory safeguards provided participants in futures markets, and methods for resolving disputes, should they arise?

Deciding How to Participate

At the risk of oversimplification, choosing a method of participation is largely a matter of deciding how directly and extensively you, personally, want to be involved in making trading decisions and managing your account. Many futures traders prefer to do their own research and analysis and make their own decisions about what and when to buy and sell. That is, they manage their own futures trades in much the same way they may manage their own stock portfolios. Others choose to rely on or at least consider the recommendations of a brokerage firm or account executive. Some purchase independent trading advice. Others would rather have someone else be responsible for trading their account and therefore delegate trading authority to their broker or a trading advisor. Still others purchase an interest in a commodity trading pool.

There's no formula for deciding. Your decision should, however, consider such things as your knowledge of and any previous experience in futures trading, how much time and attention you are able to devote to trading, the amount of capital you can afford to commit to futures and your individual temperament and tolerance for risk. The importance of the latter cannot be overemphasized. Some recognize and accept the fact that futures trading all but inevitably involve having some losing trades. Many experienced traders thus suggest that, of all the things you need to know before trading in futures contracts, *one of the fundamental significances in this process is to know yourself*. This can help you make the right decision about whether to participate at all and, if so, in what way. Thus, *in no case should you participate in futures trading unless the capital you would commit is risk capital*. That is, capital which, in pursuit of larger profits, you can afford to lose.

Trade Your Own Account

This involves opening your individual trading account and making your own trading decisions. You will also be responsible for assuring that adequate funds are on deposit with the brokerage firm for margin purposes, and that additional funds are promptly provided as needed.

Moreover, most major brokerage firms have departments or even separate divisions to serve clients who want to allocate some portion of their investment capital to futures trading. Some firms specialize exclusively in futures trading. All brokerage firms conducting futures business with the public must be registered as Futures Commission Merchants or Introducing Brokers with the Commodity Futures Trading Commission (CFTC), the independent regulatory agency of the federal government that administers the Commodity Exchange Act and must be Members of National Futures Association (NFA), the industry wide self-regulatory organization.

Have Someone Manage Your Account

A managed account is also your individual account. The major difference is that you give someone else written power of attorney to make and execute decisions about what and when to trade. He or she will have discretionary authority to buy or sell for your account. You, of course, remain fully responsible for any losses that may be incurred. Although an account manager is likely to be managing the accounts of other persons at the same time, there is no sharing of gains or losses of other customers. Trading gains or losses in your account will result solely from trades that were made for your account. Different firms and account managers, however, have different requirements and the range can be quite wide. Be certain to read and understand the agreements from the broker.

In addition to commissions on trades made for your account, it is not uncommon for account managers to charge a management fee, and/or there may be some arrangement for the manager to participate in the net profits that his management produces. These charges are required to be fully disclosed in advance. Make sure you know about every charge to be made to your account and what

each charge is for. Account managers associated with a Futures Commission Merchant or Introducing Broker must meet certain experience requirements if the account is to be traded on a discretionary basis.

Participate in a Commodity Pool

Another alternative method of participating in futures trading is through a commodity pool, which is similar in concept to a common stock mutual fund. It is the only method of participation in which you will not have your own individual trading account. Instead, your money will be combined with that of other pool participants and traded as a single account. You share in the profits or losses of the pool in proportion to your investment in the pool. One potential advantage is greater diversification among commodities than you might obtain if you were to establish your own trading account. Another is that your risk of loss is generally limited to your investment in the pool, because most pools are formed as limited partnerships. And you won't be subject to margin calls. Bear in mind, however, that the risks a pool incurs in any given futures transaction are no different than the risks incurred by an individual trader.

Regulation of Futures Trading

Firms and individuals that conduct futures trading business with the public are subject to regulation by the CFTC and by NFA. NFA is a congressionally authorized self-regulatory organization subject to CFTC oversight. It exercises regulatory authority over Futures Commission Merchants, Introducing Brokers, Commodity Trading Advisors, Commodity Pool Operators and Associated Persons (salespersons) of all of the foregoing. NFA staff includes nearly 150 field auditors and investigators. In addition, NFA is responsible for registering persons and firms required to be registered with the CFTC, including exchange floor brokers and traders. Violations of exchange rules can result in substantial fines, suspension or expulsion from exchange membership.

Analyzing (& managing) the risk of future trading

Anyone buying or selling futures contracts should clearly understand that any given transaction may result in a loss. The loss may exceed not only the amount of the initial margin but also the entire amount deposited in the account or more. Moreover, while there are a number of steps that can be taken in an effort to limit the size of possible losses, there can be no guarantees these steps will prove effective.

Well-informed futures traders should be familiar with available risk management possibilities. Imagine an oil producer plans to produce 1million barrels of oil over the next year (which will be ready in 12months). Assuming the price is set at $75 per barrel; the producer could produce and sell the oil at the current market price one year from now. Given the volatility of oil, the market price at that time could be very different.

Now, if the producer thinks the price may go up in a year's time, the latter may opt not to lock up a price immediately, the latter can rather lock-in a guaranteed sale price by entering into futures. A mathematical model used for futures takes into consideration the current spot price, the risk-free rate of return, time to maturity, storage costs, dividends, dividend yields, and convenience yields. Assuming the one-year oil futures contracts are priced $88 per barrel. By entering into this contract, the producer is obliged to deliver 1million barrels of oil and is guaranteed to receive $88million, regardless of where spot market prices are at that time.

Retail traders and portfolio managers are not interested in delivering or receiving the underlying asset. Futures contracts can be traded purely for profit, as long as the trade is closed before expiration. Many futures expire on the third Friday of the month, but contracts do vary; sp you got to check the details of your contract and it's specifications of any trading item/asset. For example, it is January and April contracts are trading $55. If the trader believes that the price of oil will rise before the contract expires in April, they could buy the contracts at $55. This gives the latter control of 1.000 barrels of oil. Therefore, $55 x 10000 = $55.000 barrels for this privilege though.

The profit or loss of the position fluctuates in the account as the price of the futures contracts moves. If the loss gets too high, the broker will ask the trader to deposit more money to cover the loss, and this is called maintenance margin. The final profit or loss of the trade is realized when the trade is closed. In this case, the buyer sells the contract at $60, they make $55.000 ($60-$55) x 1000. Alternatively, if the price drops to $50 and they close out the position there, they lose $ 5000.

Choosing a Futures Contract

Just as different common stocks or different bonds may involve different degrees of probable risk and reward at a particular time, so may be different futures contracts. The market for one commodity may, at present, be highly volatile, perhaps because of supply-demand uncertainties which could suddenly propel prices sharply higher or sharply lower. The market for some other commodity may currently be less volatile, with greater likelihood that prices will fluctuate in a narrower range. You should be able to evaluate and choose the futures contracts that appear most likely to meet your objectives, your willingness to accept risk and your expectations as to when the anticipated price change will occur. Keep in mind, however, that neither past nor present price behavior provides assurance of what will occur in the future.

Liquidity

There can be no ironclad assurance that, at all times, a liquid market will exist for offsetting a futures contract that you have previously bought or sold. This could be the case, if a futures price has increased or decreased by the maximum allowable daily limit and there is no one presently willing to buy the futures contract you want to sell or sell the futures contract you want to buy.

Even on a day-to-day basis, some contracts and some delivery months tend to be more actively traded and liquid than others. Two useful indicators of liquidity are the volume of trading and the open interest (the number of open futures positions still remaining to be liquidated by an offsetting trade or satisfied by delivery). These figures are usually reported in newspapers that carry futures quotations. The information is also available from your broker or advisor and from online market reporting services and exchange web sites.

Options on Futures Contracts

The most the buyer of an option can lose is the cost of purchasing the option (known as the option "premium") plus transaction costs. Options can be most easily understood when call options and put options are considered separately, because they are totally separate and distinct

Buying Call Options

The buyer of a call option acquires the right, but not the obligation, to purchase (go along) a particular futures contract at a specified price at any time during the life of the option. Each option specifies the futures contract which may be purchased (known as the "underlying" futures contract) and the price at which it can be purchased (known as the "exercise" or "strike" price). Although an option buyer cannot lose more than the premium paid for the option, he can lose the entire amount of the premium. This will be the case if an option held until expiration is not worthwhile to exercise.

How Option Premiums are Determined

Option premiums are determined the same way futures prices are determined, through active competition between buyers and sellers. Three major variables influence the premium for a given option:

The length of time remaining until expiration. All else being equal, an option with a long period of time remaining until expiration commands a higher premium than an option with a short period of time remaining until expiration because it has more time in which to become profitable. Said another way, an option is an eroding asset; its time value declines as it approaches expiration. The volatility of the underlying futures contract. All else being equal, the greater the volatility the

higher the option premium. In a volatile market, the option stands a greater chance of becoming profitable.

Selling Options

At this point, you might well ask, who sells the options that option buyers purchase? The answer is that options are sold by other market participants known as option writers, or grantors. Their sole reason for writing options is to earn the premium paid by the option buyer. If the option expires without being exercised, the writer retains the full amount of the premium. It should be emphasized and clearly recognized, however, that unlike an option buyer who has a limited risk, the writer of an option has unlimited risk.

Recommendations & conclusion

Recommendations

Rather, the pages that follow are intended to help provide the kinds of information you should always obtain first about any investment you are considering. In sum, obtain the kinds of information you need to be an informed investor. Such as; Information about the investment itself and the risks involved.

How readily your investment or position can be liquidated when such action is necessary or desired.

Who the other market participants are.

Alternative methods of investing.

How prices are arrived at.

The costs of trading, including commission charges.

How gains and losses are realized.

What forms of regulation and investor protection exist?

Thus, be extremely cautious if approached by someone attempting to sell you a commodity-related investment unless you are able to verify that these requirements are met. Be at least equally cautious of anyone soliciting the retail public for investments in non-exchange traded, foreign exchange (Forex) contracts. Again, other sales pitches that should raise warning flags include: Investments in illegal off exchange futures contracts that may be called by different names such as "deferred delivery," "forward" or "partial payment" contracts in an attempt to avoid the strict laws applicable to regulated futures trading.

At the time you apply to establish a futures trading account, you can expect to be asked for certain information beyond simply your name, address and phone number. The requested information will generally include (but not necessarily be limited to) your income, net worth, what previous investment or futures trading experience you have had, and any other information needed in order to advise you of the risks involved in trading futures contracts. Opening a futures account is a serious decision and should obviously be approached as such. It is in your interest and the firm's interest that you clearly know your rights and obligations as well as the rights and obligations of the firm with which you are dealing before you enter into any futures transaction. Nor should you be hesitant to ask, in advance, what services you will be getting for the trading commissions the firm charges

If a Dispute Should Arise

All but a small percentage of transactions involving regulated futures contracts take place without problems or misunderstandings. However, in any business in which millions of contracts are traded each year, occasional disagreements are inevitable. Obviously, the best way to resolve a disagreement is through direct discussions by the parties involved. Failing this, however, participants in futures markets have several alternatives (unless some particular method has been agreed to in advance).

What to Look for in a Futures Contract

The more you know in advance, the less likely you will be surprised later on. Specifically, be certain you comprehend and have insight of important things as:

The Contract Unit

Futures contracts specify such things as the unit of trading and contract size (such as 5,000 bushels of grain, 40,000 pounds of livestock, or 100 troy ounces of gold). Foreign currency futures specify the number of marks, francs or pesos. U.S. Treasury obligation futures are in terms of instruments having a stated face value (such as $100,000 or $1 million) at maturity. Stock index futures contracts that call for cash settlement rather than delivery are based on a given index number times a specified dollar multiple. Whatever the yardstick, it's important to know precisely what it is you would be buying or selling, and the quantity you would be buying or selling.

Order Placement

Nothing is more important in futures trading than clearly communicating with your brokerage firm about what you want to buy or sell, when you want to buy or sell, and any other conditions or limitations you may want to attach to your order. For example, if you want to buy or sell immediately at the best available price, whatever that happens to be, this is known simply as a "market" order. However, there are many other types of orders that give the broker specific instructions about when and/ or at what price to execute a purchase or sale. Your order instructions can specify not only when and at what price you are willing to establish a futures position but also include instructions about when and at what price, if possible, you want to liquidate the position.

Daily Price Limits & Position Limits

Exchanges establish daily price limits for trading in futures contracts. The limits are stated in terms of the previous day's closing price plus or minus so many cents or dollars per trading unit. Once a futures price has increased by its daily limit, there can be no trading at any higher price until the next day of trading. Conversely, once a futures price has declined by its daily limit, there can be no trading at any lower price until the next day of trading. Daily price limits set by the exchanges are subject to change. They can be either increased or decreased. Because of daily price limits, there may be occasions when it is not possible to liquidate an existing futures position at will. In this event, possible alternative strategies should be discussed with a broker.

Position limits are stated in number of contracts or total units of the commodity. The easiest way to obtain the types of information just discussed is from your broker or from the exchange where the contract is traded.

Conclusion

This piece of work ends where it began; with the statement that it is not the writer's intention to advocate either that you should or should not participate in futures markets. Low margins, high leverage, frequently volatile prices, and the continuing needs of hedgers to manage the price uncertainties inherent in their business creating opportunities to grasp potentially substantial profits. But for each of such opportunity, there is proportionate risk. Futures trading, as stated at the outset, are not for everyone's reckon; but they are mostly for those who can tolerate the pressure of increase and decrease of prices (index) of their commodities placed in the markets.

One should therefore have a clear understanding of the opportunities and the risks involved, as well as have a clear picture of what futures markets are; how they operate, who operates them, unconventional methods of participation especially in the buying and selling of assets, and also, knowing the vital economic function that futures markets perform as a whole.

In anyway should it be emphasized that all the information written in this paper qualifies you into the futures contracts game or acting out as your financial or trading adviser. No, such ample information should be provided by your broker or advisor. That been said and done, your broker or advisor is your best sources for additional and more detailed index about futures trading of the

commodities, but the latter isn't God to stop you completely from making a huge investment that might plunge you into debts/ruin or that can boost you at the top. The final decision is yours to make, nobody else.

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