THE GREATEST BUSINESS ON EARTH

A Simplified Guide to Trading Commodity Options
The Greatest Business on Earth:
A Simplified Guide to Trading Commodity Options

By Jim Prince
The Greatest Business on Earth™
A Simplified Guide to Trading Commodity Options

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This book features cartoons by artist Frank Quinn.

Important Notice

The risk of loss in trading commodity futures contracts can be substantial. There is a high degree of leverage in futures trading because of the small margin requirements. This leverage can work against you as well as for you and can lead to large losses as well as large gains.

Past performance is not necessarily indicative of future results and examples of historic price moves or extreme market conditions are not meant to imply that such moves or conditions are common occurrences or are likely to occur.

Simulated performance results have certain inherent limitations and do not represent actual trading. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown.

This brief statement cannot disclose all the risks and other significant aspects of the commodity markets. You should carefully study commodity trading and consider whether such trading is suitable for you in light of your circumstances and financial resources before you trade.
**Foreword**

By Jim Prince ("Trader Jim")

If this manual is your first look into commodity trading, I know exactly what you’re going through right now.

You see, it was over twenty years ago that I was exactly where you are today. Perhaps like you, at the time I was hoping to find some way to get a better life for my family and myself. I tried a number of things, and then, one day I saw a gentleman being interviewed on TV about commodity trading. A short time later I received a booklet in the mail (this was before e-mail was even thought of). The booklet caught my attention because of its colorful cover, but it was the amazing story and information inside that kept me reading. I realized that the man who sent me the booklet was the very same man I had seen on TV.

The man was Ken Roberts, the legendary commodity trader and educator, and the booklet offered a course designed to teach ordinary people — like me — how to harness the tremendous profit opportunities that were waiting in the commodity markets.

Back then I didn’t know anything about commodities — I was earning my living as an administrative assistant — but it sounded like it was worth a shot, so I ordered the course, and the rest, as they say, is history. I fell in love with the whole idea of trading commodities using the technical principles that the course taught.

Eventually I wrote to Ken to tell him how much my life had benefited from taking his course. In time the two of us met, we hit it off, and I ended up going to work for Ken. It was both gratifying and fun to help others discover what I had. All these years later I continue to teach commodity trading through The United States Chart Company, the charting service that Ken founded in the early 1990s.

I tell you this so that you can feel confident that my team and I understand your dreams and your needs. We have spent years perfecting both the tools to help you in your trading, and the methods to teach you how to get the most out of them.

This manual is our finest introduction yet to the ins and outs of commodity trading. It provides the principles, techniques, and strategies that we use on a daily basis.

So come along and take this exciting journey with me. Who knows? It may change your life as much as it has mine!

Jim Prince
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• Chapter 1 •

How to Think Like a Millionaire

Many people would like the power and freedom of having more money. Perhaps you’re one of them.

With more money you would feel that you had more control over your life. You would be able to choose what you want to do with your time. You could be your own person because you wouldn’t be dependent on your boss, a banker, or anybody else.

With more money you could have the pleasure of seeing that the ones you love have everything they need to make the most out of their lives and pursue whatever opportunities they want to.

And with more money you could look forward to a future that offers real adventure and fulfillment, where you can enjoy all the comforts you desire, and where you have the means to take advantage of the best that life has to offer.

The wish to have that kind of money has led many people to the point where you are right now — about to discover a money-making technique that has the potential to bring you the wealth to fulfill your dreams. Better yet, this fortune-building method is easy to learn, simple to put into practice, and doesn’t require much in the way of resources to get started. Follow the instructions provided here, and you could soon be running your own version of this business right from your own home, spending as much or as little time at it as you like, and having the satisfaction of knowing that you’re doing something that is more than just fun and interesting — it has potential to make a huge improvement in your life.

This manual is a step-by-step guide to getting started in this great home business. But being good at this requires more than knowledge. It requires having the right attitude. So let’s look at some basic principles that can help you develop the dynamic attitude that underlies success.

Basic Principles of Business Success

People who have the motivation and perseverance to make a lot of money seem to have certain basic perspectives on wealth, and on themselves, that help them fulfill their goals. These are commonsense principles that anyone can master. Examine the following five points and you will soon realize why making them part of your own mental framework will be invaluable in helping you achieve your aims.
1. **Nobody cares as much about your money as you do — or knows better what to do with it!**

Trying to figure out how to invest your money can be daunting. If you pick up a financial publication, you’ll read the opinions of a slew of financial experts, all presenting a different view of what’s going on, all giving conflicting advice, and many of them using terminology that’s hard to understand. You don’t know which one to listen to, and at the same time, if you fall for the act of assurance they put on it could make you afraid to trust your own judgment.

But nothing is as it appears. The fact is that nobody has a crystal ball that can tell what the future will bring. Some people can make educated guesses — and you’ll soon learn how to make some of those yourself — but there are no magic formulas or financial secrets that allow anybody to foresee what will happen. It’s important to realize this, because as long as we believe there are hidden secrets that we’re not privy to, we’ll hesitate to take charge of our own money — and our own lives.

Not only can no one tell you what you should do with your money, but they can’t possibly care about your money the way you do. It’s easy for them to give you advice, but they don’t know about your hopes and dreams, your ability to tolerate risk, your willingness to undertake certain actions. They can’t feel what you will feel if your investments make money or if you suffer a loss.

And that expert you’re trusting in to tell you what to do won’t be there all the time. Markets move quickly. What if the expert you read one day tells you how to act under one set of conditions, but the next day conditions change — and the new issue of that magazine isn’t coming out for another month? How will you know what to do if you’re following the advice of someone else instead of developing your own method and feel for the markets?

It may seem hard at first, but if we want to have the chance for real success, we have to stop listening to the pundits and the talking heads, and start gaining the knowledge and skills we need so that we can rely on ourselves. Once we do, we experience a completely new sense of self-command because we know that we’ve taken our future into our own hands.

2. **Work for yourself**

The legendary millionaire J. Paul Getty said it best. His very first rule for achieving financial success was this:

> “Almost without exception, there is only one way to make a great deal of money in the business world — and that is in one’s own business.”
Earning a salary can bring in a steady income, but the best opportunity for real wealth comes from working for yourself. When it’s your own business, you get to make use of all the profits, not just the share someone else decides to give you. And when it’s your own business you’re more interested in what happens, you’re more dedicated to making it succeed, you’ve got a bigger stake in it. You’ll put more of yourself into it, and so you’ll get more out of it.

And when you work for yourself you have to keep the bigger picture in mind, you have more responsibility, and you have more satisfaction from the outcome. Your self-assurance and self-reliance just have to grow from the experience.

3. **Express your individuality**

   The great American philosopher Henry David Thoreau told us that “the mass of men lead lives of quiet desperation.” They plod through their days, never fulfilling their promise or seeing their dreams come true. Their main goals are to try to fit in, avoid being noticed, and get by.

   In contrast, look at the truly great men and women throughout history, and you’ll find that they all had the courage to stand alone, hold to their own opinions, and act independently. They were all individuals.

   This is especially true in the financial world, where some of the most successful money-makers are the ones who can be characterized as being contrarians. Contrarians take the opposite position of the “mass of men.” This approach is typified by J.P. Morgan, the renowned multi-millionaire. According to a popular story, J.P. Morgan was having his shoes shined one morning when the boot-black gave him a “hot tip” to purchase a certain stock. Morgan already held a large number of shares of stock in that company, but when he returned to his office, he instructed his assistant to immediately sell every share he had. His explanation is still quoted today: “When the man on the street is buying, that’s the time to sell!”

   More recently, noted investor Sir John Templeton said that the way to become wealthy is to buy when the crowd is selling, and sell when the crowd is buying.

   And in a TIME Magazine interview, billionaire financier Carl Icahn said, “When most investors, including the pros, all agree on something, they’re usually wrong.”

   The message is clear: if you don’t want to live the way the average person lives, you don’t want to do what the average person does. Be daring enough to act as an individual — and you don’t need anyone’s permission to do it!

4. **Learn the secret of making your money work for you**

   We all know that putting money under a mattress is no way to become
wealthy. Money under a mattress isn't doing anything. It’s not working for you. And for you to get ahead, you need your money to work as hard as you do to earn it.

Money works for you when it multiplies itself, and one way it does that is by earning interest. It multiplies itself even faster when the interest starts earning interest — a process we call compounding.

There's an easy way to tell how quickly your money is growing when it earns compound interest, and it involves making use of the magic number 72. Divide 72 by the rate of interest, and you know how long it will take for your money to double. For example, if your money is earning 3 per cent interest, you divide 72 by 3 and the result tells you that it will take 24 years to double your money. That’s a long time! But if you’re earning 10 percent interest, it will only take a little over 7 years. That’s better than 24 years, but it’s no way to become wealthy — and that’s assuming you can even find someone to give you 10% interest.

A better way to make your money work hard for you is to make use of the principle of leverage, where a small amount of money is able to control an asset that’s worth much more. People use this principle every day when they get a mortgage on a house. Perhaps a couple buys a house that’s worth $200,000 with a down payment of $20,000 — just 10% of the value of the house. Their small down payment allows them to control something of ten times the value.

And it gets even better. If property values go up, five years later the house might be worth $300,000. If they sell it then, they’ll make $100,000 profit on a $20,000 investment — that’s a 400% return on their money.

Buying a house is a great way to grow your money, but it could be just a once-in-a-lifetime investment. To reach your financial goals, it’s essential that you learn how to multiply your money over and over again. You have to learn how to make your money work hard.

5. **Deal in a product that everyone needs — over and over again!**

Think about breakfast time across America. Millions of people are drinking orange juice, eating cereal, and drinking coffee with sugar and milk in it. And they’re doing this 365 days a year, year in and year out.

When your business involves a product like this, you know that it’s never going to disappear. Prices may rise or fall, but the opportunity will always be there.

Some people think that to make a killing financially they have to come up with some revolutionary new product that will make a big splash — like mood rings or pet rocks. Somebody did make a fortune on those, but the
market is gone now. And how many people can come up with the next fad? Are you going to do it? Who has the time, energy, know-how, or interest?

The best way for the average person to make real money is to get involved in some business that’s been around for centuries and will never go out of style. Something like orange juice, and coffee, and sugar. In fact, something exactly like orange juice, coffee, and sugar! These are products that are sold on international markets and are used by billions of people around the globe every day. And these are products that you can learn how to buy and sell from your own home — just like thousands of other people just like you have learned to do for many, many years.

The Business That Opens a Whole New Future

We’re talking about the business of trading commodities by purchasing options.

Don’t think that this is something too complicated or risky for you to learn how to do. This manual will teach you all the skills you need to be successful. And if you can find as little as $3,000 to $5,000, you have the capital you need to get started in a legitimate money-making opportunity that thousands of others have taken advantage of. And many of them knew less about it when they started than you know right now.

There are many reasons why this opportunity is so great: You can start off slow and completely adapt it to your preferences. You can spend as much or as little time at it as you want. It’s possible to keep track of your business in about half an hour a day. You can do it from your home, on the road, at the beach — wherever you want. You can risk just the amount of money you feel comfortable risking.

You don’t need any special skills. If you can look at a price chart and see if prices are going up or down, you’ve got it made. Thanks to computers and calculators, you don’t need any but the most basic math skills.

And as far as equipment goes, you don’t need anything other than a phone and access to the Internet so you can get all the information you need along with state-of-the-art tools to assist you in your trading. You don’t need to make any investment in inventory, marketing, or employees. There’s no licensing or government regulations you must follow when trading your own money in your own account.

You never have to worry about competition. The more the merrier. And there’s no one way to do it. Everyone you know could have a commodity business going, you could all be doing something completely different, and you could all be making money.

And you’ll enjoy doing it. It’s a challenge to try to figure out how to make money from markets that are always moving. It’s always different — and yet the principles you learn to use here are always the same, so you can get better and better at this as you get more experience. And there’s a way to get the experience you need that costs you nothing and has no risk. It’s called paper trading, where you “place” trades with “pretend money.” You
can learn from your successes and your mistakes and then apply them to your next trades. While paper trading doesn’t guarantee you won’t have losses when you trade real money, it does give you the experience you need without risk. What other business gives you such an opportunity?

**How to Fulfill All the Principles for Business Success**

Earlier we looked at five principles for business success. Starting your own commodity trading business falls in line with all those critical factors, as we’ll see right now.

You should be aware that many experts believe that most people lose money in commodities, and it’s true that trading commodities can be risky. But it still offers a great opportunity to those who learn to trade with discipline, based on some straightforward ground rules. Here you will learn how to identify genuine trades for which you can assess the risk versus the reward ahead of time, and how to use techniques that can help you limit the amount of your risk and keep it at a level where you feel comfortable. We’ll also show you how to practice trading and develop all the necessary skills before you risk any money at all.

So let’s see how your commodity business can fulfill all the principles for success.

1. **Nobody cares as much about your money as you do — or knows better what to do with it!**

   The beauty of the business of commodity trading, as you will learn it here, is that we will teach you how to find trading opportunities on your own, how to develop a trading strategy that suits your own temperament and resources, and how to develop your own overall business plan. Once you master the principles and methods in this manual, you will be able to make your own trading decisions and look after your own money, with the care that only you can give it.

2. **Work for yourself**

   You will be completely in charge of your own trading business, which means you will make the decisions, bear the responsibility, and reap all the profits. You will never have to answer to or explain yourself to anyone else.

3. **Express your individuality**

   You will develop the confidence to run your business and make your trading decisions your own way. You will learn how to recognize the signs of the crowd mentality so that you can avoid being swept up in it — and you will often even be able to take advantage of it by taking the contrarian approach.

4. **Learn the secret of making your money work for you**

   No business in the world gives you the opportunities to use the principles of multiplication and leverage like you’ll find in the commodity markets — and especially when trading the commodity markets by purchasing options, as you’ll
learn to do here. You can control contracts worth tens of thousands of dollars with an investment of just hundreds of dollars. And growth on investment can be in 100s of percent. And we will teach you how to harness these opportunities while using methods that can help protect your investment and keep your risk at a minimum.

5. Deal in a product that everyone needs — over and over again!

The commodity markets are international markets that deal in products that people around the world use every single day. Companies may come and go, fashions may come and go, but the basics of corn, oats, gold, and silver are always going to be traded on the major markets. And you will learn how to take advantage of the profit potential in these staples without ever having to deal with the actual products yourself. You won't have to deal with farmers or manufacturers, and you won't have to worry about a semi-truck pulling up to your house one morning and dumping a load of wheat on your front lawn. You'll just have to place a few instructions with your broker over the phone, or even on the computer, and watch what happens on your charts.

The rest of this manual will give you the basics you need to know in order to run your own commodity trading business. Then you can devote as much or as little time to it as you'd like. You can think of it as a business, an investment program, or just a hobby. Whatever you call it, it's your opportunity to take advantage of the biggest markets in the world, from the comfort of your own desk, couch, or poolside lounge chair.

"It must be working. I'm thinking like a millionaire already!"
Let’s get started on your new venture, where the rewards can be great for learning some very simple ideas. In fact, you probably have spent most of your life mastering some of the basics of commodity trading. You just didn’t know it.

If you’ve ever gone shopping in a grocery store, you’ve already been introduced to some of the classic commodity markets: wheat, oats, coffee, sugar, orange juice, cotton in the specialty t-shirts, lumber in the wooden spoons and toothpicks … we could go on and on.

And your grocery store experience has also taught you a basic fact which makes commodity trading possible as a business opportunity — the continuous change in prices. We all know that the price of orange juice changes from season to season. Lettuce can go from 89 cents a head in early summer, to $2.49 a head in January. Beef and pork prices go up and down. As a consumer, you have no choice but to pay the going price. You’re happy when it’s low, and not so happy when it’s high.

But what if there were some way for you to take advantage of that price differential for your own profit? You can, using the principles you’ll learn here to trade commodities. And you can do it without having to know anything about how any commodity is grown or mined, harvested, packaged, marketed, or anything else.

Basically, it all boils down to one universal principle of making money: buy low, sell high.

Let’s look at a simple example on a very small scale. Suppose you go to your local market one day, and you see that they have beautiful, big avocados selling for 50 cents a piece. What a great price! You’ve seen avocados the same size selling for as much as $2.99 in the off-season. And you love avocados, so you start filling your cart. That’s when it occurs to you that there may be a business opportunity for you here. If you could buy up as many avocados as possible at 50 cents each, put them in cold storage for six months, and then sell them later on for $2.50, that would be a 400 percent return on your money — in just six months. That’s 800 percent annualized — a lot better than the 4 percent you’re getting on your savings account.

If you can see the possibility of making money from buying and selling avocados in this way, you’ve got the basic picture of how commodity trading works. Now it’s just a question of learning the details of how to do it. But maybe you’re thinking the example is a little far-fetched. How could you store all those avocados? And how would you find people to sell them to? And at $2 profit per avocado — less the costs of handling and storing them —
you’d have to sell a ton of them to make enough money to make it worthwhile. That could mean laying out thousands of dollars, with no chance of seeing a profit for six months.

You’re probably right. But now, what if the principle of buying low and selling high was the same, but there were some huge differences in the way you carried it out? What if you never had to handle the physical commodity yourself, and instead:

• You could handle all the transactions over the telephone or on the computer.

• You could deal in huge quantities of the commodity, greatly multiplying your potential to profit.

• You only had to lay out a fraction of the money, and there would be times when the whole deal, from start to finish, could be completed in just a few months, a few weeks, or sometimes even a few days!

This sounds more attractive now, doesn’t it? Now it sounds like something you could do. In fact, the system is set up so that thousands of ordinary people can do it. And it’s set up that way for the benefit of everyone involved in the system. You’ll understand why as you learn more about why the commodity markets were established in the first place, and how they function.

**How the Commodity Markets Came Into Existence**

The large commodity markets — called exchanges — are like giant supermarkets where producers of commodities (like farmers, ranchers, and miners), and users of commodities (like manufacturers and packers) come to buy and sell huge quantities of grains, meats, petroleum products, and so on. For example, Chicago is the seat of the Chicago Board of Trade (CBT), which is a huge hub of grain trading. Cotton traders go to New York City, and the New York Board of Trade (NYBOT).

See the table for a list of the major commodity exchanges, along with their common abbreviations.

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<th>Major Commodity Exchanges</th>
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<td><strong>CBT</strong></td>
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The commodity exchanges, as we now know them, were established in the early to mid-19th century, although the first recorded evidence of such trading comes from 17th century Japan, and there is evidence of commodity contracts for rice in China as far back as 6,000 years ago.

In the United States, exchanges grew up around big cities and provided a centralized location where producers and users of commodities could come to trade. Starting out as small meeting halls, today they’ve grown into huge trading centers (for example, the headquarters of the New York Mercantile Exchange is 16 stories high and features two three-story 25,000-square-foot trading floors!) with international connections.

The utility of the exchanges is obvious. A large company like General Mills needs to purchase millions of bushels of corn to make its cereal. And it has to know that it will receive its corn when it needs it. The General Mills purchasing agent can’t spend hundreds of hours contacting thousands of farmers across the nation — or even the world — to obtain corn. Instead, the agent contacts the commodity exchange that handles corn, and makes arrangements to buy the number of bushels the company needs. On the other hand, the farmer is not a salesman, and is too busy managing his farm to be able to contact different companies to purchase his corn. Instead, he too contacts the exchange that handles corn and sells his crop through it. The exchange serves as the middleman, making it easy for farmers to sell their crops and for manufacturers to get what they need, when they need it.

But there’s another critical function the exchanges serve, by giving producers and users of commodities a way to protect their profits.

Imagine an Iowa corn farmer. It’s summer, and a crop of corn is growing in the field that’s due to be harvested in the fall. He’s got a lot invested in his crop. Not only were there all the costs of planting, fertilizing, and watering it, but he’s had to buy new harvesting equipment. He’s concerned because he knows how corn prices can fluctuate, and he’s figured out that he’s got to make four dollars per bushel to cover expenses and make a decent profit. If he has to sell it for less, he’ll lose money for the year.

Meanwhile, the production manager at General Mills is also making plans for the year. He has to set schedules for processing and packaging his product and he has to determine how much grain he’ll need. He also knows that the advertising department is already planning a sales campaign based on a cut in prices. He’d like to get his corn for as little as possible, but he can’t pay more than $4 per bushel. If he ends up paying a lot more than that, the company’s profit could dry up like corn stalks in a drought.

The farmer and the manager at General Mills are both looking to the future. Is there any way that they can protect themselves?

**Hedging for Protection**

It just so happens that there is. Let’s say that on the day the farmer and the General Mills production manager are thinking about the future, corn is actually selling at $4 a bushel on the corn exchange. It would certainly be to each of their benefit to enter a contract today, at today’s price, for corn that will be delivered on an agreed upon date in the future. And so they
each contact the exchange. The farmer formally agrees to sell his corn at $4 per bushel, and the General Mills production manager formally agrees to purchase corn at $4 per bushel. By doing this they have each entered a contract to be fulfilled in the future — a “futures” contract — and by doing so they have both “locked in” their profit. They are now each protected from possible price fluctuations.

The commodity exchanges were initially developed to afford this kind of protection to producers and users of commodities. Prior to their formation, prices could fluctuate wildly, hurting farmers — who never knew if they’d get enough for their crops to pay expenses; manufacturers — who never knew if they could afford to purchase their basic supplies; and the public — who never knew how much they’d have to pay for a bag of cornmeal, or if any would even be available.

Futures contracts smoothed the flow of business by allowing producers and users of goods to lock in a price that ensured their profits, while stabilizing prices and ensuring a steady flow of goods to the consumer.

A futures contract is an agreement entered into today to buy or sell a commodity at today’s price that is to be paid for and delivered some time in the future. In our example, let’s say the farmer and General Mills entered futures contracts in July for corn to be delivered in September at $4 per bushel. Now they can both go about their business, assured that they will make a profit.

When companies or individuals who actually deal with a physical commodity enter futures contracts as a form of protection, it’s called “hedging.” But hedgers aren’t the only people who trade commodities. There’s another group, called “speculators,” who trade commodities as a form of investment, with no interest in the physical commodity at all. They serve a very important function in the markets, while they also enjoy the potential to profit from futures trading. The purpose of this manual is to prepare you to be a speculator in the commodity markets, so let’s find out more about them.

**Speculating for Profit**

Well into the second half of the 19th century, the way was opened for speculators to trade on the commodity markets, in addition to the hedgers. They were let in for a very important reason — to provide liquidity. Let’s see what this means.

If only producers and users of commodities were able to trade through the exchanges, there wouldn’t be enough contracts on the market at any one time to keep everything moving — and the hedgers would still be at risk. What if at the moment the farmer wanted to enter a futures contract for his corn, there didn’t happen to be a buyer available? Or what if a manufacturer needed to find a seller when there didn’t happen to be one around. They’d both be tied up.

Or what if one of them was in a contract and had to get out quickly? Maybe the manufacturer decided to move his headquarters and would be out of commission at the time delivery
was due. Or perhaps the farmer decided he needed his crop to feed a herd of dairy cows he just bought.

If farmers and manufacturers are to be able to have the protection of futures contracts, along with the freedom to run their businesses with flexibility, they have to be able to get in and out of contracts quickly. And that means the markets have to be liquid; there have to be many contracts being bought and sold all the time. So who's doing all that buying and selling?

Speculators.

Speculators are individuals who trade futures contracts, period. They have nothing to do with the physical commodity itself. Speculators serve farmers and manufacturers by assuming the risk in the futures markets that results from the continuously changing prices. And the reason they do it is because those changing prices also give them the opportunity to make profits.

The aim of speculators is to fulfill the main rule of making money: they hope to buy contracts at a low price and sell them at a high price. The basis of their opportunity lies in the constantly fluctuating prices of commodities. There are so many speculators in the market, that only a tiny number of contracts — perhaps one to three percent — are ever completed with the delivery of a commodity. The remaining 97 to 99% of contracts are entered into and exited well before the delivery date. And every step of trading is recorded only in a broker’s logbook — or more likely today, in a computer. However, the profits made on these transactions are very tangible, indeed.

**How Profits Can Be Made**

Speculators enter the commodity markets in the hope of making a profit. But how much profit is it possible for them to make? We can see by looking at an actual chart that shows the changing prices of a widely used commodity: Corn.

Look at the price chart on page 14 for Corn. It was created by plotting the prices at which Corn was bought and sold each day between April 7, 2006 and March 29, 2007.

Corn is sold on the floor of the Chicago Board of Trade. Like all exchanges, the floor is a huge auction pit where brokers buy and sell commodities by open outcry. You may have seen pictures of an exchange like this in action. People are shouting and signaling wildly with their hands. Paper is flying everywhere. It looks like a madhouse. But underneath all that seeming chaos is a very strict order. And it’s here that the commodity is actually bought and sold. (The truth be told, with the growing importance of computers, a great deal of this action now takes place online, but the image of the trading floor remains a powerful one for most traders.)

As each transaction is completed, a record is made and posted immediately so everyone can see what the current price is for that commodity. At the end of the day, the exchange posts what the price was when trading opened that day, the high price of the day, the low
price of the day, and the closing price. This OHLC data is presented in a tick diagram that looks like this:

Each tick on these charts contains all significant price activity for that trading day:

Each tick, which represents the full day’s price action, is added to an ongoing record of prices for that contract, its daily price chart, like the one we see here for Corn. Looking at the chart, we see that prices rose and fell each day, although prices seem to be rising overall.

Pay special attention to the lowest point of the chart. This low price occurred on September 15, 2006, when Corn sold for as little as $2.73 a bushel. Now let’s find the high price on the chart. It occurred on February 22, 2007, when Corn sold as high as $4.42 a bushel.

Suppose a trader happened to buy Corn on September 15, 2006 for $2.73, hung on to it for a little over six months, and then sold it on February 22, 2007 for $4.42. Now, we’re not saying that any trader would have been likely to buy on the absolute low, and sell on the absolute high, but we’re just looking at this to illustrate what a change in prices — in this case a difference of $1.69 per bushel — could mean.

Let’s figure it out. When we buy commodities on an exchange, we buy them in large lots called “contracts.” Each contract contains a specified quantity of the commodity, which
is set by the exchange. In the case of Corn, each contract contains 5,000 bushels. So, if each bushel increased in value by $1.69, we multiply that by 5,000 bushels per contract, and discover that each contract increased in value by $8,450. That would have been the trader’s profit, less a small broker’s commission and some fees. The trader would have made that money in just a little over six months, and with very little effort. If the trader had bought two contracts, his or her profit would have been double that amount, although the risk of loss would have been increased as well.

But what would have been required of the trader to get into this deal? This is what’s so great about trading commodities. You never have to put up the full value of the contract to get into it. On September 15, 2006, a contract of Corn had a value of $2.73 times 5,000 bushels, which equals $13,650. But traders didn't need $13,650 to enter a contract. They only needed to put down a good faith deposit of about 5 to 10 percent. This good faith deposit is called “margin,” and it’s not even a cost — the margin is returned if the trade makes a profit.

On September 15, 2006, the margin on a Corn contract was $608 — just a fraction of the actual value of the contract. But the potential profit for someone who bought a contract would increase penny for penny with the rising cost of Corn as prices moved up.

And this is why commodity trading is an opportunity that so many people can take advantage of. It doesn’t cost a tremendous amount of money to get started. And the reason is that when you trade commodities you take advantage of a powerful principle — the principle of leverage.

By the way, if you look at the corn chart you may notice that it lists the margin as $1,350. At some point between September 15, 2006 and March 29, 2007, the margin was raised by the exchange. This reflects growing volatility in the market -- a concept we’ll examine later.

Please note the following caveat: Throughout this manual we will make references to trading results based on the past price performance of certain commodity contracts. We don’t want you to think that every trader will have or would have had the same results. The information that is available to us now, would not have been available at the time any trading decisions would have been made, so actual trading results could vary greatly. Also, examples of historic price moves or extreme market conditions are not meant to imply that such moves or conditions are common occurrences or are likely to occur.

**The Powerful Principle of Leverage**

We take advantage of the principle of leverage whenever we use something of less value to control something of more value, just as we can use a physical lever to help us move something easily that otherwise we might not be able to move at all. The greater the difference between what we start with, and what we can control with it, the greater the amount of leverage.

We saw an example of leverage in Chapter 1, where a buyer could use a 10% down payment — just $20,000 — to purchase a house worth $200,000. And then we saw an example of it in Corn, where a margin of $608 controlled a contract worth $13,650. In this case just about 5% of the value enabled someone to control the whole thing.
Margin on commodity contracts is set by the exchange, and is generally around 5 to 10%, although it can be adjusted as market conditions warrant it. Margin varies from commodity to commodity. For example, as of this writing the margin on Canola is $216, while the margin on Oats is $743, and the margin on Wheat is $1,553.

Looking at Corn again, we saw that a $608 deposit could have put a trader in the position to earn $8,450 — a return of over 1300%. And remember, at the end of this successful trade, the trader gets the $608 deposit back. That’s really using the principle of leverage to great advantage.

And it can get even better! Later in this manual you will be introduced to another way of trading commodities — by purchasing options on futures contracts. With options you can often get into trades with even better leverage, with risk that’s completely controlled to your comfort level, and with the opportunity to make unlimited profits.

Leverage is a great tool for commodity traders, but you should be aware that it can work against you. However, we will show you ways to protect your position when trading futures contracts, and how to control your risk completely when trading options on futures contracts.

**Bulls and Bears: Going Long and Going Short**

When traders believe that the price of a commodity is going to rise, they are said to have a bullish outlook on the market. If they enter a trade, they are going to buy, and we say that they are long the market. This way of trading is pretty easy to understand. We already saw an example of it in your little avocado business. You bought them at one price, expecting to be able to sell them later at a higher price. Buy low, sell high — it’s the basic rule of making a profit.

When the time comes for bullish traders to exit their long positions, they do it by “offsetting” the contract they bought earlier by selling it. If the market moved as they hoped, they’ll sell it for a higher price than they bought it for, and the difference is their profit.

Now, let’s look at the other side of the market. When traders believe that the price of a commodity is going to fall, they are said to have a bearish outlook on the market. And the great thing about commodities is that bears can make money too. The way they do it is not so intuitively obvious as with the bulls, but it’s just as real. Bears also buy low and sell high, but the order in which they buy and sell is reversed: first they sell at the higher price, with the intention of buying back their offsetting contract at a lower price. Again, the difference between the two prices is their profit. When bears enter their trade by selling, it’s called going short.

Maybe it will help you understand this better if we look at another avocado example. Imagine that you’re planning to drive to California. It’s winter where you live, and avocados are scarce, and expensive — maybe $2 each at wholesale. But you know that when you get to California they’ll be plentiful and cheap — maybe as low as two for a dollar. So you think to yourself that this might present you with a profit opportunity. You go around to some neighborhood restaurants and offer to sell them fresh California avocados at $2 each, with delivery due in three weeks. A number of restaurants jump at the chance to get
such high quality produce, and you enter futures contracts with them where you sell them avocados for a specified price and with a specified delivery date in the future.

Now, you drive to California and when you arrive there, everything goes according to plan. You find cheap avocados by the caseload. When it’s time to drive home you load up your van with enough avocados to fulfill your contracts, and you pick them up at two for a dollar. When you get home you visit your customers and collect $2 a piece for avocados that you bought for only 50 cents — a profit of $1.50 per avocado.

That’s what selling short is all about. You sell something today for a higher price, with the intention that you’ll be able to pick it up for a lower price by the time you have to make delivery. The difference between what you sell the commodity for, and what you have to pay to offset your contract later, is your profit, less a broker’s commission and fees.

The idea of going short may still seem strange to you. It almost seems wrong to sell something you don’t own. But in the commodity markets this is a standard and necessary way of doing business. For every contract that someone buys, someone else has to sell a contract. The ratio must be one-to-one.

But why would a bear sell you a contract in a commodity that you’re so sure is going up? Or, why would a bull buy a contract that a bear is so sure is going to lose value? The answer is that no one knows for sure if the market is going up or down. As we said in chapter 1, no one has a crystal ball, and there are no experts who know better than anyone else. We all make our best guess; it’s the difference of opinion that makes the commodity markets possible. And because so many thousands and thousands of people are involved in trading, the markets are highly liquid, which means that whatever your opinion is as to which way the market is heading, you’ll likely be able to get in and out of contracts quickly.

Now don’t get worried that the process is completely random. Be assured that the rest of this manual will teach you signals to watch on a chart that can allow you to make educated guesses, and it will show you techniques that will enable you to protect you position in case you happen to choose the wrong direction for a trade. Follow the guidance laid down here and you will have the tools you need and the potential to make a success of your commodity trading business.

A Word of Caution

We’ve looked at several examples where people made trades that developed as planned and left the trader with a nice profit. However, you should realize that a market can move against a trader. If your prediction of future market movement proves to be wrong, you could suffer a loss.

Let’s go back to our avocado example to see how things can go wrong. Suppose you sell avocados short to a number of restaurants in your area, and then you head out to California. When you get there you discover that there’s been an unexpected freeze, and a large proportion of the avocado crop has been ruined. The few avocados you can find are selling for $2.50. Oh, no! You’ve made binding contracts, and now you have no choice. You have
to purchase avocados for $2.50 each that you have agreed to sell for only $2.00. You're
going to lose 50 cents on every avocado you sell.

While it’s always possible that the market can move against you in this way, keep in mind
that every business venture — not just commodity trading — is risky. At least in your
commodity business there are some risks you won’t have to face. For example, there will be:

• No costs for locating and setting up your business
• No outlay of money for inventory
• No insurance or licensing fees
• No certification exams required
• No payroll

And you can open your business with as little as $3,000 to $5,000 — especially if you
trade with options. You’d be hard-pressed to find a comparable business opportunity that
offers so much potential for profit with such a small initial outlay.

Furthermore, we will show you how to reduce your risk by:

• Giving you principles that increase the accuracy of your predictions
• Following the trend — the trend is your friend!
• Teaching you techniques that help you limit and control your risk
• Showing you how to practice running your business so you feel completely
  comfortable with all the techniques before you put even one penny at stake.

By using good common sense, along with the basics that we’ll teach you here, you can
reduce your risk, while still giving yourself the opportunity to make a nice return on your
money — and within a relatively brief period of time.

So let’s go on to learn more about the powerful techniques that you can use to make the
most of your commodity trading business.
How to Choose a Market

The commodity markets are always offering profit opportunities to traders who are alert. As long as prices keep rising and falling, you have the chance to take advantage of the situation to build your trading account.

Learning how to spot one of these profit opportunities is one of the most important skills you’ll develop as a commodity trader. Once you’ve selected your market, you will design your trade using easy-to-follow strategies that help you pinpoint the best moments to enter or exit the trade, and apply techniques to protect your profits and limit your losses. But the entire process, and its ultimate success, depends on first identifying markets that offer the greatest potential to profit.

As we said, these opportunities always present themselves, but they move around from market to market and from time to time. What we’re looking for is a situation that will allow us to buy low and sell high. And because commodity prices are in a constant process of change, profit opportunities abound — but not in every market at every time. One day Corn may present an ideal situation to trade; another day Gold may have an inviting picture. Getting in the right market at the right time can lead to huge profits, but getting in the wrong market at the wrong time can lead to losses.

We want to find a market where prices are rising or falling because it’s the differential in prices that gives us our profit opportunity. But sometimes prices can go for long periods of time just moving sideways, and therefore that market doesn’t offer any opportunity at all. And sometimes prices rise or fall so rapidly that it’s too dangerous to try to hop on to a “moving train.”

What we want to find is a market with the potential to make a significant price change, that clearly signals whether prices are going to rise or fall, and that offers a relatively safe boarding spot. Getting in the right market, in the right direction, at the right time is essential to successful trading. And every commodity trader has a system to analyze the markets and help make these critical calls. While each trader is unique, the systems traders use can usually be placed into one of two categories: fundamental analysis and technical analysis.

Fundamental Analysis

The fundamentals of any commodity market are the basic facts about how it’s produced, who uses it, predictions of upcoming supply and demand, and any other information that
could be used to predict how prices will fare in the future. Fundamental traders primarily use this kind of information to make their trading decisions.

We used fundamental analysis in our avocado examples in the last chapter. First we went to the store and saw avocados selling for a low price. It occurred to us that in six months avocados would be selling for a lot more, and we could take advantage of that rise in prices by purchasing as many as we could now, at today’s price, and then selling them later at a much higher price. Our knowledge of avocado prices, and seasonal changes in how plentiful they are, influenced our analysis of the market. Then, in our second example, knowing how the supply in California compared to the supply where we lived, and understanding local demand, we predicted another profit opportunity, this time by shorting the market.

Commodity traders who follow the fundamental approach use the same kind of information, but on a much broader scale. They will often specialize in just a few market sectors, because it would be too much to become an expert in each of the 52 different commodities that are commonly traded on the major exchanges.

For example, suppose you were a fundamental trader, and you liked to follow the meats — Cattle, Hogs, and Pork Bellies. You would want to learn about ranching practices, supply and demand around the world, weather conditions that could affect feed crops, government subsidies, the effect of low carb diets, the influence of news stories concerned with mad cow disease, medical findings on cholesterol, and scores of other factors that could conceivably affect prices. You would research the opinions of the beef pundits to find out what they thought about the short-term and long-term outlook for beef consumption. And you’d check the news of other countries who might be increasing or decreasing their imports of American beef.

You would end up with a lot of information that you would have to run through your internal computer to come up with an overall picture. It wouldn’t be easy. Some information might be contradictory. An increase of high protein diets would indicate prices could rise, while a reduction in international exports would indicate prices could fall. And one expert could disagree with the analysis of another expert. Which information would you keep in the mix, and which would you drop? How would you weigh the different factors to arrive at an answer?

And even assuming you could reach a conclusion from all this information, then what? How accurate would your predictions be? The fact is that fundamental factors could all point in one direction, and the market could still go the other way!

We saw a perfect example of this in the spring of 1996 when cattle prices dropped to twenty-year lows. Seeing a great opportunity here, many traders who couldn’t imagine that prices could get any lower, loaded up on contracts. But just about then everything went crazy in the beef market. First, according to news reports, the unusually low prices were attributed to price fixing by meat packers. Then it was said that record high prices in the grains would make it impossible for ranchers to feed their herds. The market would be glutted as ranchers sold off their herds to packers. As a result, it was predicted that prices
would remain low for another two years. On top of that, Oprah Winfrey aired a program on mad cow disease, and claimed she would never eat another hamburger. People around the country began looking at their sloppy joes with a suspicious eye.

This was too much for many traders to handle. They sold off their contracts as quickly as they could, and in fact all this selling did cause a further drop in prices. But it wasn’t long before other traders started snatching up these contracts that were sitting on the bargain table, and prices proceeded to rise just as sharply as they fell. Traders who had panicked and sold off at the bottom watched the huge rally that took place without them, and ended up kicking themselves for listening to those misleading news reports.

But, if fundamental information doesn’t help traders make decisions about whether to buy or sell, is there an alternative?

Yes, there is an alternative, and it’s much more straightforward than the fundamental approach. It doesn’t require you to have any information at all about a commodity market except for one thing: the pattern of its previous price activity. People who rely on price patterns as their guide are using something called technical analysis.

**Technical Analysis — the Study of Lines on a Chart**

Prices go up and then they come down. It’s a never-ending process. And, admittedly, many things affect prices. High crop yields mean prices will likely fall. Bad weather that damages crops means prices will likely rise. But there are too many factors to keep track of all of them, and we don’t really know exactly how the effect will express itself in actual prices. But thank goodness we don’t have to know any of that. All we have to know is that prices do change. When they’re rising, they’ll probably keep rising. When they’re falling, they’ll probably keep falling. This seems like common sense. So now the question is, how can we apply this commonsense understanding to actual markets to help us make trading decisions?

The answer is, we can examine a price chart to see the previous price action of a commodity. Then, by learning to recognize recurring patterns in price activity, along with the kind of further price action these formations generally lead to, we can hone our ability to predict future price action.

You already have some intuitive knowledge of how to read a chart. Try it out by looking at the chart on page 22, which records price activity for a particular commodity between late March 2006 and October 9, 2006. You don’t even have to know what the chart is for. What does its shape tell you?

A glance at this chart tell us that prices fell pretty steadily from late July until mid-August, moved sideways for a week, and then started to climb. Prices have gone straight up since mid-September. Don’t prices just look as though, at least for a while to come, they will likely continue to rise? Even though you don’t know what this commodity is, doesn’t the chart seem to present an opportunity to buy?
In fact, except for a small pullback, prices did continue to rise. Look at the chart now, with prices added through November 8.

You can be sure that there were many commodity traders who profited from this big rise in prices. For your information, the charts we just looked at were for Oats. It makes you look at your morning oatmeal in a whole new light, doesn't it?
Basically, that’s the essence of technical trading. It involves recognizing opportunities in price patterns on charts. Let’s look at another one, this time a Sugar chart.

Many traders saw a sweet deal shaping up in the Sugar market in early August 2006. After stalling in a large consolidation pattern for several months, prices broke out of the pattern and looked as though they were heading down, presenting an opportunity to short the market.

Were they correct? Suppose a trader had shorted this market in August, and let’s look at the chart seven months later to see what happened.

As you can see, prices dropped, just as short traders predicted. You’ll learn how to calculate profits later, but just to give you an idea, the value of that drop in Sugar prices between August 3, 2006, and March 2007, was worth $4,256. And all that was required to get into
this market was to put up a margin of $1,400 and pay a broker’s commission and fees. And remember, the margin would have been returned at the conclusion of this successful trade.

This hypothetical trade involves shorting a futures contract. If you were to make this trade with options on a futures contract — as you’ll learn to do in later chapters — the outcome would not have necessarily been the same. Option prices don’t move dollar for dollar with the prices of futures contracts. Sometimes they move more, sometimes less, and sometimes they can move in the opposite direction, depending on factors that you’ll learn about later.

As you look at these trades, you may be thinking that there must have been some fundamental factors that caused these markets to move as they did — and you would be right. Fundamental factors influence supply and demand, and therefore influence prices. But technical analysts believe that all these factors are reflected in the prices on a chart. We don’t have to know why prices change in order to trade. We just need to know that they do change, and that we can recognize certain patterns that give us clues as to how prices will change in the future.

This manual will teach you how to be a technical trader. It’s the most straightforward approach to trading, and it allows you to focus your attention on a set of simple rules, instead of having to study fundamental information on every market you trade.

As a technical trader you don’t need a different set of facts for each market. The chart-reading principles you will learn here are universal and can be used in every market. That’s why thousands of ordinary people have been able to learn the technical approach to trading the commodity markets. And nothing prevents you from learning how to profit from these principles as well.

How to Read a Price Chart

The first requirement of every technical trader is a set of commodity price charts. The charts you see here are created by The United States Chart Company, and were carefully designed to provide not only the prices themselves, but a wealth of additional information to make your trading easier and more convenient. For example, each chart has a ready reference right on it with the information you need to fully analyze your charts and make your trading decisions.

Let’s look at a chart in a little more detail so you can see the information it provides and how you can use it. This time we’ll look at what was happening in the Feeder Cattle market at the end of January 2007.

As you can see, the chart is made up of a grid with little lines — the price ticks — plotted across it. Running across the bottom of the chart is a list of dates, and running up the right side of the chart is a list of prices. To find out more about this chart, we look at the legend box that’s located in the upper left-hand corner. The very top line says “APR 2007 CATTLE (feed) FCJ7.” This means that this chart provides the daily prices for Cattle that are scheduled for delivery in April 2007. As a daily chart, each of the price ticks gives the open, high, low, and close prices for the corresponding day listed at the bottom of the chart.
“FCJ7” is the special short-hand symbol assigned to this particular contract by the exchange. “FC” stands for Feeder Cattle. “J” stands for the delivery month — which refers to April in standard exchange code. “7” represents the year — 2007. Traders and brokers around the world can look at the symbol FCJ7, and they all know it stands for April 2007 Feeder Cattle.

This daily chart is for the April contract, but there are other contract months available to trade, each with its own chart. Commodities are sold in contracts that are named for the month when they are due to be delivered. Only certain contract months are available for each commodity — and these vary across commodities. For example, Feeder Cattle has contracts for January, March, April, May, August, September, October, and November in any year. You can trade contracts for any available month, usually up to about a year out. So, in late February 2007 you can trade Feeder Cattle contracts for March, April, May, August, September, October, and November 2007, and January 2008. The closest contract month to today’s date is called the front month. In February 2007, the front month contract is March 2007.

The next line in the box tells you the hours when the exchange is open for trading. You can place your order with your broker outside of these hours, but it can only be executed during these hours.

The third line in the box tells us how much of a commodity is included in a contract. As we see, one contract of Feeder Cattle contains 50,000 pounds. We also see that the point value for Feeder Cattle is $5. We’ll come back to this, because to understand point value we first have to understand the line in the box that says “Quoted in CTS/LB (1 ct = $500).” This information is important because it tells us how prices are given in this commodity, and how to read the line of prices going up the right side of the chart. For example, on
this Feeder Cattle chart we see numbers ranging from 90 to 112.50. What exactly do these numbers mean? Well, as the legend box tells us, prices are quoted in cents per pound, so a price of 100 is equal to 100 cents per pound (or $1.00). If prices should rise one cent, how would that affect the value of an entire contract? You’d multiply one cent by 50,000 pounds (.01 x 50,000) and your answer would be $500.

In Feeder Cattle, an increase or decrease of one cent is actually quite large. The moment-to-moment price changes on the exchange floor are usually in much smaller price units called “points.” Point size varies from commodity to commodity, so this value is provided in the information box on each chart. For Feeder Cattle we see, “Pt. Value: 1pt=$5.” That means that if prices go up or down 1 point, the value of the full contract will change by $5. As we said, point value varies across commodities. In some of the grains, such as Corn and Wheat for example, a point and a cent are equal, and they are both equal to $50.

Going back to the information box on our Feeder Cattle chart, we see that “Margin/Maint:$1350/$1000.” We talked about margin in an earlier chapter. Margin is the good faith deposit a trader puts down to enter a futures contract. In February 2007, the margin on a Feeder Cattle contract is $1,350. “Maint” stands for maintenance, and it becomes important when traders are in a market that’s moving against them. When traders are in a losing position, at the end of each trading day their brokerage subtracts their losses from their margin account. The broker doesn’t want to be responsible for losses their clients can’t cover, so if the amount of money in a trader’s account falls below a certain minimum for each contract he or she is trading, the trader receives a margin call and has to add money to the account. That minimum amount that must be in the margin account for each contract being traded is called the maintenance. In our sample Feeder Cattle chart, the maintenance is $1,000.

You can find more information in the chart legend, which we’ll discuss as appropriate in later chapters. But for now you have the basic information you need to begin reading a price chart. So let’s go back to our April Feeder Cattle chart.

Commodity traders study current price charts to see if they are now offering an opportunity to profit. So, suppose you were looking at the April Feeder Cattle chart on January 29, 2007. Would we see an opportunity there? We’d see that between the end of May and mid-August, prices moved higher, and then they plunged steadily, hitting a low on November 8. Then they turned on a dime and began moving up and down. On January 29, prices broke out strongly above a previous stalling point. Is this a sign that prices might continue up? If so, it’s a great opportunity. A trader who went long and bought a contract would make $500 each time the price of Feeder Cattle went up one cent.

So, now let’s see what happened a little farther forward in time. Look at the April Feeder Cattle chart on February 26, 2007 — less than a month later (on the next page).

Prices have continued to climb. Just for fun, let’s see how much a contract increased in value between January 29 — when prices were around 96, and February 26 — when
prices were around 104. That difference of 8 cents, at a value of $500 for each cent, was equivalent to $4,000 — in less than a month! Now the trader would have the choice of either liquidating the contract and taking profits, or hanging on for a possible further rise. Is there anything that could help make the decision? Yes, there is, and it has to do with time.
When Time Is of the Essence

As technical traders, we look for recurring patterns in our charts, and the farther back our charts go, the more likely we are to find patterns of significance. So far we’ve looked at daily charts, that provide about a year’s worth of data. But it’s possible to get a much broader view of any market, and we often want to. For example, getting back to our Feeder Cattle trader who has to decide whether to liquidate or hang on, a longer view of the market could be very helpful. According to the daily chart, prices seem to be right in the middle of their range and at the top of a consolidation pattern that fills the lower half of the range of prices. They might be heading up toward the big high, but maybe they’ll just continue consolidating and start heading down. How do today’s prices stand compared to last year? Or the year before that? To find out we can turn to a longer-term price chart — a weekly chart.

Look at the weekly chart for Feeder Cattle.

Weekly charts usually contain price data for about five years, and each price tick (OHLC) represents the open, high, low, and closing prices for a full week. The data it uses are the prices for the front month contract at the time. As each front month changes, the chart starts using the data from the new front month to create the price ticks.

So, what does our weekly price chart tell us? Prices have stalled around the 100 level a number of times in the past three years, and then shot up. Now it looks as though prices have stalled in that neighborhood again and may be beginning a new rise. They would have to turn around and break below the low at around 92.5 before we’d think they could head toward that big low at the end of December 2003. If they continue the recent pattern though, it’s possible they’ll just head back to the range around 120. So, maybe hanging on to that long contract would be a good idea.
You can now see that getting the broader picture on the weekly chart helped us get a clearer view of the current situation. Maybe an even broader picture could help us more. To get that we go to a monthly chart.

A monthly chart usually covers about fifteen to twenty years of price history. Each price tick on a monthly chart summarizes one month’s worth of price information (OHLC) for the front month contract at the time. It provides a very long-term view, which can really affect the way we see current prices. For example, our monthly Feeder Cattle chart shows us that the high at just about 120 that’s been tested now three separate times, is in fact the highest Feeder Cattle has ever been. And today’s price is relatively high in the entire range of prices. However, prices are right in the middle of the trading range of prices that goes back to the year 2000, and spans from around 75 to 120. Judging from this chart, prices could go either way. Now it looks like a wise trader would hang on to his or her long contract, but watch carefully for any signs of a turnaround, and then quickly liquidate and take profits.

Good traders weigh their decisions carefully based on as much information as they can get. They know that getting the long-term picture can be extremely helpful in planning how to respond to changing market conditions.

**Making Better Predictions**

So far we’ve seen that prices rise and fall, and you’ve learned how to read a chart that shows you where prices are now, compared to where they’ve been. You know that traders make a profit by buying when prices are low, and selling when prices are high. But how do we make a reasonable prediction about whether prices are going to move up or down?
We want to be as accurate as possible, especially when our resources are limited. Here’s why. Suppose a trader buys a contract, believing that prices will continue to rise, as they’ve been doing for the last several months. But as it turns out, prices pull back and begin moving lower. As prices decline, the trader’s broker covers the losses by taking money out of the trader’s margin account. If prices continue to decline, and the amount in the margin account falls below maintenance, the trader will have to add more money to the account. If the trader can’t cover the losses, it will be necessary to liquidate the position at a loss. Eventually, prices will likely rise again (prices are always rising and falling). If the trader has enough money to cover those losses while waiting for the turnaround, he or she will get back everything invested, and possibly much more. But traders who are forced out of the market prior to the turnaround will not be able to take advantage of the move, or even make back enough to cover their losses. Traders who do not have the resources to cover their losses in a market that moves against them must be very careful to make market predictions that are as accurate as possible.

This is where the technical approach to trading offers an extra edge, because there are technical signals on a chart that we can learn to recognize. These signals, which we’ll learn about in chapter 4, can be very helpful in analyzing a market so that we can form an opinion of future price activity.

Also, please note that the ability to withstand market moves against you is less of a concern when trading commodities by purchasing options, rather than futures contracts.

Now things really get exciting. You are about to learn how to tease out the secrets hidden in a chart that can help you trade successfully. These are the very signals that many traders have used in their own commodity trading businesses.

**Online Chart Tips**

Before we go on, here are three tips that can help you in reading your online charts.

1. The Internet makes it easy to get exact prices on a chart. With online charts, simply move your cursor to any price bar, and you will see a display with the date; the open, high, low, and close; and the net change from the previous trading session.

2. Your online charts can provide data as far as a year back on a daily contract, or, if the contract hasn’t traded that long, back to the opening of trading. In this manual, we wanted to keep the printed charts legible, so we didn’t go back the full year on most of our charts. However, when you are viewing a chart online, you can select the size of the chart, which determines how much data it will display, and the chart will resize itself automatically.

3. Use all the information available within the charts. For every chart there’s a wealth of useful information, such as exchange symbols, margin/maintenance, point value, and contract size for every market.
“You’ll do better picking a market if you look at US Charts Online!”
If traders knew what the future would bring, there would be no problem buying low and selling high. We’d make money on every trade! However, as we’re all well aware, no one can see the future. But we can use our knowledge of basic market principles to make the best predictions we can, although, as you know, past results are not necessarily indicative of future results.

Fortunately there are repeating patterns in price activity. These patterns are like a secret code, providing signals on a chart that we can learn to decipher to increase our ability to make wise trading decisions. They help us determine whether prices will continue to move up or down, or whether they are about to change direction, and they give us clues concerning the best time to enter or exit a market.

Let’s look at some of the most helpful price predictors.

**Price Predictor #1: Uptrends and Downtrends**

We’ve looked at a number charts so far, and we’ve seen that prices rise and fall from day to day. We’ve also seen that there are more general movements up or down that cover extended periods of time. These larger movements, which are the most obvious aspect of a chart, are called trends. According to the technical definition of a trend, when you see a series of price ticks characterized by higher highs and higher lows, you’re looking at an uptrend. When you see a series of price ticks characterized by lower highs and lower lows, you’re looking at a downtrend.

When a market is in an uptrend, we say that it’s a bull market, and people who expect prices to continue rising are called bulls. They are likely to go long the market by buying contracts. Conversely, when a market is in a downtrend, we say that it’s a bear market, and people who expect prices to continue falling are called bears. They are likely to short the market by selling contracts.

Many traders use uptrends and downtrends to help them make specific trading decisions.

As an example, look at the chart of March Pork Bellies (on the next page).

Judging from the Pork Bellies chart, this market has been on a roller coaster ride since August. But we can begin making sense out of it by drawing some trend lines. There are so many shifting trends on this chart, we won’t draw them all, but let’s draw some, and then you can draw any others you see on your own. We draw a downtrend by connecting the...
high points, and we draw an uptrend by connecting the low points. Pay special attention to the downtrend line we drew from the end of December to the middle of January, and look at the circled area. Notice that on January 17 prices gapped up above the downtrend line. After that prices soared. That break in the downtrend line was a very important signal to traders who were waiting for an opportunity to go long in this market. And in this case it was a very powerful signal indeed.

Another signal was given on March 16, when prices broke below the uptrend line. Some traders might have taken this as a signal to exit their long positions, or short the market, and they would have been wise to do so.

In both cases, the key to entering or exiting the market was the break in the trend line. To summarize how traders read these signals, if a market is in a downtrend, and the trend line is broken and prices begin to rally, traders holding short positions may consider liquidating, and traders who were waiting for an opportunity to go long the market, will consider buying contracts. If the trend line is not broken, and prices continue to fall, traders holding short positions will keep hanging on, while those who were waiting for an opportunity to go long will see that there is no opportunity presently. The converse of all of this would hold in the case of a market in an uptrend.

Trend lines are very helpful, but traders don’t have to rely on them alone. Let’s go on to look at some other price predictors that can be very useful to traders.

**Price Predictor #2: Support and Resistance**

Look at the Pork Bellies chart once more. Notice that as prices rise and fall, they reach a number of points that they cannot seem to get past. They may even test these points
several times, approaching or hitting them, and then turning around. When rising prices reach a ceiling they can’t seem to break above, we call it resistance, and when falling prices reach a floor they can’t seem to break below, we call it support. We marked several areas of support and resistance on the Pork Bellies chart. See if you can find some more on your own.

As prices bounce off areas of support and resistance, they build up momentum. If they finally do break through, all the momentum they’ve gathered often carries them all the way to the next level of resistance or support. This is very important for traders to keep track of, because it suggests whether it’s time to enter a position, or if they’re already in the market, whether to consider exiting. If rising prices hit resistance (the ceiling holds), or falling prices hit support (the floor holds), it means that buying or selling is weakening and the trend doesn’t have the oomph to keep going. But, if prices have the strength to break through, the momentum that took them through the barrier may carry them all the way to the next level of support or resistance.

Watching what happens around points of support and resistance is critical for technical traders. Traders who are looking for an opportunity to go long a market, will take a break above resistance as their signal to buy. On the other hand, a failure of prices to break through resistance could indicate that the uptrend is weakening, and traders already holding long positions might consider exiting. From the other side, traders planning to short the market would take a break below support as their signal to sell. Failure of prices to break support would indicate that the downtrend is losing steam, and traders already holding short positions might consider exiting.

Our Pork Bellies chart provides a classic example of what can happen when prices break above a strong area of resistance. For the second half of 2006, prices kept bouncing off resistance at around 95, until they finally broke through with a vengeance on January 17, 2007, and shot straight up.

**Price Predictor #3: The Narrow Sideways Channel**

A narrow sideways channel is a consolidation pattern that is very much related to support and resistance. Prices are in a channel when they move up and down within a narrow range defined by parallel lines of support and resistance. Look at the May 2007 Soybeans chart on the next page for several nice examples of channels.

While a market is in a channel, traders must be patient because there are no profits to be made while prices move up and down within such a narrow range. However, a channel can set up a very valuable trading opportunity because when prices break out of a channel, their momentum can carry them to new highs or lows.

Theoretically, prices can break out either above or below a channel. We don’t know which way they will go until they make their move, but we can prepare ourselves for either outcome. Some traders plan ahead of time — and even place orders with their broker — to go long the market if prices break above the top of the channel, or short the market if prices break below the bottom of the channel. The break is their signal to enter the market. Other traders will only enter the market on a breakout in the direction of the prevailing trend.
Looking at the Soybeans chart, we see two types of channels. Channels #1 and #2 precede a change in trend. But many channels are periods of consolidation that appear within a trend. For example, in May Soybeans, Channel #3 developed within the middle of an uptrend. It’s as though prices rallied strongly off the September lows, took a rest while they slowly built up steam in early winter, and then shot up again in mid-January. When a channel like this occurs in the middle of a trend, traders who are already holding positions must learn to be patient during these periods of consolidation. For traders who had missed the earlier entry, the breakout of a channel in the direction of the larger trend provides a new opportunity to get on board a major move.

Besides narrow sideways channels, there are a number of additional consolidation patterns that appear within uptrends and downtrends. All these patterns represent resting places within the larger trend, and with all of them, a breakout of the formation is the signal for a trader to enter the market. Pennants, Flat-top and Flat-bottom Triangles, Wedges, and Flags are all examples of consolidation patterns.

**Price Predictor # 4: Pennants**

Pennants develop where there is a series of higher lows and lower highs. The top of the pennant (sometimes called a triangle) is drawn with a line that connects the high points, and the bottom of the pennant is drawn with a line that connects the low points. The two lines converge as the range of prices gets smaller and smaller.
Pennants can be very powerful signals because as prices coil tighter and tighter they build more force, giving greater momentum to the eventual breakout. Our market entry signal occurs when prices break out in the direction of the prevailing trend.

**Price Predictor # 5: Flat-Top and Flat-Bottom Triangles**

Two variations of triangles, the flat-top and flat-bottom triangles, have even more predictive potential than pennants. What makes these formations so powerful is that one of the lines that forms them is a very strong level of resistance or support.

Flat-top triangles are defined by a series of higher lows which form the bottom of the triangle, and a resistance line across the top of the consolidation pattern. They are a very bullish signal because when prices finally build up enough steam to break through the resistance at the top, their momentum can carry them far.

We often see large flat-top triangles in the early part of the rise, lasting from several weeks to several months. Flat-top triangles that develop during the latter part of the rise are often shorter in duration. Our buy signal is a breakout and close above the horizontal resistance line that forms the top of the formation.

Flat-bottom triangles are the inverse of flat-top triangles. They are defined by a series of lower highs that form the top of the triangle, and a line of support that forms the bottom of the consolidation pattern. They are a bearish pattern, and when prices finally break below support, their downward momentum can be quite strong.

We tend to see shorter flat-bottom triangles at the beginning of a downtrend, and flat-bottom triangles of longer duration as the trend continues. Our sell signal is a breakout and close below the horizontal support line that forms the bottom of the formation.

**Price Predictor # 6: Wedges**

A wedge is an upward or downward pointing triangle, with the point in the direction of the prevailing trend. It is generally considered a reversal chart pattern signifying the onset of a change in trend.

Wedges that develop during an uptrend are formed by a series of higher lows and slightly higher highs. Wedges that develop during a downtrend are formed by a series of lower

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highs and slightly lower lows. In an uptrend, unlike a pennant where the highs drift lower, in the wedge the highs continue to move gradually higher. Similarly, in a downtrend, unlike a pennant where the lows continue to gradually rise, in the wedge, the lows drift lower. A rising wedge is generally considered to be a bearish pattern. A falling wedge is generally considered to be a bullish pattern.

**Price Predictor # 7: Flags**

Our final consolidation pattern is the flag. The flag is similar to the sideways channel in that the lines that define the pattern are parallel. However, while the lines forming a sideways channel are parallel to the bottom of the chart, the lines forming a flag both angle up or both angle down, or even sideways. The flag has a pole, which is the price action that leads up to the consolidation.
You can see examples of all these consolidation patterns in the accompanying charts and illustrations.

**Technology Gives Traders the Edge!**

Technical traders down through the years have looked for signs in the price data that would tell them the direction and strength of a trend. They’ve also used formations on the chart to help them determine favorable entry and exit points during a trend. But judging these matters by eye is not always easy or precise.

But now, thanks to technological advances, traders have help in deciphering chart patterns. For example, US Charts Online makes it easier than ever to spot a trend, know its strength, and more effectively use the signals provided by formations through its online tool called Trend Seeker.

You’ll learn more about this remarkable tool and how to use it when we go through a series of sample trades later in this manual.

**50 Percent Retracements**

We’re now familiar with the major chart formations that help us determine whether prices are likely to continue in a certain direction. But our next question is, how far will they tend to go? This is important to help traders determine if the potential reward of a trade is worth the risk. It also helps traders determine exit points for positions they may be holding.

You already know the answer to the question of how far prices are likely to go. Areas of support and resistance give us important clues. As prices approach these critical levels, they either pause and turn around, or they break through. In the short term, we can predict how far prices could go by identifying the most recent area of support or resistance on the chart. And if prices reach that area and break through, we can predict where they could go next by identifying the farther-out area of support and resistance.

But there’s one more very specific rule that many traders use. It’s a general rule of price action that after prices move in one direction for a while, they have a strong tendency to retrace that move in the opposite direction by 50 percent. Prices will move back and forth in 50% retracements until they finally break through and head toward a new level of support or resistance.

On the broader scale, if you take any chart, and calculate and draw a line where the 50% level is between the high and low points on the chart, you will generally find very interesting action occurring around that point. Here’s a diagram that shows an idealized example:
Now let’s apply the 50% rule to a real commodity. Look at the chart for May 2007 Wheat.

We begin our 50% analysis by determining the range of prices on this chart. Prices range from a low of 456, which was made on September 14, 2006, to a high of 552, which was made on November 30, 2006. Add the high and low together and divide by two to determine the 50% level for the entire chart. The result is 504. Now you can draw a line across the chart at the price of 504.

The Wheat chart with the 50% line drawn on it shows us all kinds of important activity happening around this line. There are areas of support and resistance right at the line. Notice, for example, that prices tested support at the 50% line several times in December, then broke through in early January and made a nice move down. As this illustrates, prices often bounce off of 50% levels for a while. A breakthrough often heralds a continuation of the prevailing trend.

As an example, suppose a trader was short Wheat in December 2006. Having drawn a 50% line on the chart that trader would have been expecting something interesting to happen as prices approached 504. Prices might hesitate and begin consolidating, or they could break right through which could indicate the beginning of a big move. Sure enough, prices bounced for a while on the Wheat chart. If the trader recognized this as a likely pattern, and patiently held on, he or she might have still been on board when prices broke through the 50% level and then moved down.

Traders who want a broader picture of a market can calculate 50% levels on weekly and monthly charts too. These can be very helpful in determining profit targets and exit points for trades.
As you become more familiar with charting and setting up trades, you will become very appreciative of the 50% level. For many traders, calculating the 50% level is the first step they take when they look at a chart.

**How to Protect Profits While You Limit Losses**

While traders have many tools to help them make decisions about when and how to enter markets, no trading system is infallible. Markets make twists and turns and they can surprise traders by suddenly changing direction. If you've entered a trade, and then a sudden market move puts you on the wrong side of the market, you want to liquidate your position before your losses get out of hand. Or, if you're in the middle of a profitable trade, you want some way to protect your gains so they won't be drained away in a trend change.

Traders of futures contracts use a very simple technique to help them limit their losses on losing trades, and protect their profits on winning trades. It's called a “stop loss.”

A stop loss is an order placed with a broker in advance that says when prices reach a certain point, you want to liquidate your position. Let’s first see how this works to limit losses. When you first enter your position, you decide how much you’re willing to risk on the trade. You know that prices rise and fall, even in the middle of a trend, so you expect that at some point prices will move against you, and then, hopefully they’ll resume the direction you want. But sometimes prices don’t turn back in your direction, and if you let the market move too far against you before you get out, you could end up with a greater loss than you feel comfortable with. To avoid this happening, you place a stop loss at the price beyond which you don’t want to suffer any more losses. Your broker knows that when prices hit your stop loss, it’s time to get you out of your contract. You’ll still have a loss, but hopefully it will be a loss you can handle, and you’ll have the resources to trade another day.

Now, let’s say you entered a trade on the right side of the market, and you’re making a profit with each tick that prices move. As your profits add up, you don’t want to keep your stop loss where you originally placed it to protect you from a loss. You want to use it to protect your profits, so you move your stop loss past your entry price and get it closer to the current price. For example, if you’re long in a rallying market, you would move your stop loss up as futures prices rise. If you’re short in a falling market you would move your stop down as prices drop. One of the beauties of a stop loss is that it can be changed at any time with a call to your broker. Moving your stop up to protect profits from your long position in a rising market, or moving it down to protect profits from your short position in a falling market, is known as trailing your stop.

Getting full value from a stop loss requires that you place it properly. With prices fluctuating as they do, keeping a stop too close means you could be stopped out on a small move against you, which is nothing more than a small pullback before prices continue on in your direction. On the other hand, if your stop loss is set too far away, you could suffer a big loss before your stop is hit.
So, where do you place your stop? The first, most obvious rule is that you place your stop below your initial entry point when you go long a contract, which protects you by getting you out of the market if prices fall too far; you place your stop above your entry point when you’re short a market, to protect you by getting you out of the market in case prices begin to rally too quickly. The diagrams illustrate how to use this rule.

Once you’ve determined whether to place your stop above or below the current price, you have to decide how far away to place it. You want it far enough away to give the market a little room to rise or fall without stopping you out, but you want it close enough to keep you from losing too much in an adverse market move. Basically, you don’t want to be taken out of the market on a minor move against you, but you want to be protected from a significant adverse move. Many traders find it helpful to place their stops at areas of support and resistance. Alternatively, they may decide upon the amount of money they’re willing to risk, and place their stop at the appropriate price.

Let’s look at a chart of March 2007 Soybeans for an example of how to use stops.
Let’s say we went long this market on October 9 when prices popped above the channel. With channel trades, traders often place their initial stop at the bottom of the channel, so we might have placed our initial stop at around 572. Over the next couple of days prices fell back a little, but came nowhere near our stop, so we were able to hang on. Then, with prices rising steeply, there was no clear place to move up our stop, so we’d have to move it to brief areas of support. Then, in mid-November prices entered a period of consolidation. If we kept our stop just a tad below developing support, maybe around 670, we’d be kept in the trade through the entire period of consolidation and would then be in on the next big rally. If we kept our stop too tight however, and moved it up to 666-1/2 on December 6, we would have been stopped out on December 18. We’d still have a profit, but not as much as we could have had.

In placing our stop we have to make the best decision we can, and then not go into regret if we get stopped out too soon. No one can see the future and no one can make the perfect trade. We try to make wise business decisions, and we should be satisfied with our profits and learn what we can from our experience.

This is a good time to introduce you to a new concept: slippage. You should be aware that just because you have a stop loss in place, that doesn’t mean your order to liquidate will be filled at exactly that price. Markets can move quickly, and a lot can happen between the time your broker places your order and it’s actually filled on the floor. Your order could be filled higher or lower than you hoped, and you could end up losing more than you anticipated.

We have been looking at how to use stop losses when trading futures contracts. Option traders also use a form of stop that works a little differently than stops on a futures contract. We’ll talk about this later when we examine exit strategies for option trades.

**Summary**

In this chapter we’ve seen that learning how to read a commodity price chart enables us to benefit from the wealth of information these charts contain. By deciphering the signals that a chart offers, traders can make informed and reasonable trading decisions.

We’ve covered a great deal of territory in the last several chapters. Look at all we’ve learned so far about the basics of trading strategy and reading price charts:

We’ve looked at the basic trading rule, buy low and sell high, and we saw how traders can use this rule to go long a market or sell short. We’ve discussed the fundamental and technical approaches to making trading decisions, and saw the many advantages the technical approach offers.

Learning how to read commodity price charts is essential for technical traders, and we looked at the basics of chart reading in detail. We also learned about the basic formations that price data develops into, and how to use these formations as signals that tell us when to enter and exit a trade. Finally, we learned how to use a stop loss to attempt to protect our position in a futures trade.
Here are just a few more important points to keep in mind before we move on: Always have your entire strategy planned out before you enter your trade. And always be willing to learn from your trades, whether you win or lose. You may find that you learn your most important lessons from your mistakes!

"Now that #6 broke through resistance, I predict he’ll make it all the way to the 20-yard line."
• Chapter 5 •

More Market Facts

You’re now well on your way to starting your own commodity trading business. Just master a few more facts and techniques, and you will know how to recognize the many opportunities that are available every day — just as so many other traders are doing right now.

In this chapter we’ll continue your education by looking at some additional aspects of market activity that you need to learn so that you can properly develop your own commodity trading business.

Commodity Contracts

As you now know, we buy and sell commodities by the contract. The specifics of these contracts, such as their size and margin requirements, vary for each commodity and are determined by the exchange that handles it. US Charts Online provides a convenient summary of contract specifications in a box on every chart. You need this information to place your orders and calculate such things as risk and reward on a trade. Having this information right there whenever you need it is a feature you’ll find very helpful. We’ll look at a sample chart to review some of what you’ve already learned, and to introduce some new information. Look at the chart for May 2007 Coffee, paying special attention to the information box.
We can see from the first line that this is the daily chart for May 2007 Coffee — this is coffee due for delivery in May 2007 — and the exchange symbol is KCK7. As you’ll recall, commodities are sold in contracts, and different contract months are available. In Coffee you can trade contracts for delivery in March, May, July, September, and December.

Suppose you noticed a nice formation shaping up in Coffee that you’d like to trade. You can trade any available contract, so which one would be best? There are a number of factors to keep in mind. First of all, you want to make sure that the contract you trade has the formation you may have spotted on the front-month chart. In general, prices in all the different contract months trade similarly, but they’re not exactly alike. You may be noticing a 12-month low forming on the front-month chart, but prices may be approaching, but not hitting, the 12-month low on a farther-out contract month chart.

Another factor to consider is timing. You want to make sure that the contract you trade gives you plenty of time for the move you’re looking for to develop. Remember, contracts come with an expiration date. If the move you want hasn’t occurred by the time the contract expires, you will have to either liquidate your position, or if you want to stay with the trade, you’ll have to “roll over” into another contract, which will cost you another commission. So, you don’t want to trade a contract that’s due for expiration soon. You want to trade a contract that gives you time.

However, you don’t want to get into a contract that’s too far out in time. The reason has to do with two new concepts — open interest and volume.

Open Interest and Volume

When we talked about the history of commodity trading, we mentioned that speculators are important because they add liquidity to the markets. By raising the number of contracts available to be bought and sold, they make it possible for hedgers and other traders to get in and out of contracts quickly. Liquidity is a very important factor for many traders, and they keep track of it by noting two figures that indicate the level of trading activity for a contract: open interest and volume. If you’ll look at the bottom of the Coffee price chart you’ll see two graphs — a line graph and a bar graph — that run the length of the chart. The line graph represents open interest, and the bar graph represents volume.

The open interest represents the total number of contracts that are open on any given day. It includes every contract opened since the contract started trading that has not yet been liquidated. Generally we see open interest rising gradually from the day the contract begins trading and more traders begin entering long and short positions. Open interest will peak, and then, as expiration day nears, all traders will begin liquidating their positions, and open interest will drop. We can see the gradual rise in open interest on the Coffee chart. But with several months left before expiration, we don’t see the decline in open interest on this chart that we’ll see toward the end of April.

If you were looking at this Coffee chart online, you could run your mouse over the dates running along the bottom of the chart, and you would see the open interest and volume.
for each day. On June 5, for example, you would learn that open interest was only 986. By January 2, it was up to 29,284; and by March 5 it was 86,022. Since each contract requires one trader who bought long, and one trader who sold short, this means that more than 172,000 May Coffee trades were in effect on March 5.

Volume, which is represented by the bar graph at the bottom of the Coffee chart, indicates daily trading activity. Each bar represents the total number of trades in that contract on that day. Volume is much choppier than open interest. While open interest starts low, increases steadily to a peak, and then declines as expiration day nears, volume rises and falls throughout the contract’s duration. It also begins low, and moves generally higher, but it fluctuates from day to day, often representing increased and then decreased activity as trends develop, become better established, and then end. On our Coffee chart, on January 26, when prices were in a narrow channel, the volume for that day was 2,901. On February 22, the day prices showed a huge rise, volume was 21,273.

It’s interesting to see how liquidity, as reflected in open interest and volume, is related to the pattern of prices on a chart. Notice on the Coffee chart that in June, July, and August, when open interest and volume are both low, there are few contracts being traded, and the price action on the chart is spotty, with gaps. During this time, traders may have to wait hours, or even days to find a buyer or seller to complete a trade. In December, January, and February, open interest and volume are both high, and even though we still see some days of volatile price swings, there are few gaps and prices transition smoothly from day to day. Entering and exiting trades can happen within minutes.

Now, let’s relate this to our initial question of what is the best contract month to trade. Generally, the farther-out in time a contract is, the lower its open interest and volume. This means it will be more difficult for your broker to fill your orders at your desired price. You’ll be more likely to have your instructions carried out quickly and closer to your specifications if you trade a closer-in contract that is showing more trading activity.

So, selecting the right contract month is a matter of balance. You want a month close-enough in to offer good liquidity, but far enough out to give the move you’re looking for time to develop.

**Limit Moves**

Looking back at the information box on the Coffee chart, look at the area that says “Daily Limit.” The Daily Limit is a form of protection that many exchanges have adopted to prevent huge price swings that could create havoc in the commodity markets. This is very important in volatile markets.

In a volatile market we see wild changes in prices within a short time period. This can be very dangerous for people who make their living handling a physical commodity — the manufacturers and the farmers the markets were set up to protect in the first place. When prices are volatile, there’s no way to know how much you can sell your crops for, or how much you’ll have to pay to get the raw materials you need. And once prices start falling
or rising, they can really take off, like a snowball rolling down a hill, picking up momentum and size as it goes. And of course, this can also be bad for speculators who find themselves on the wrong side of the market.

Many exchanges have introduced a daily limit to provide some price stability. Once a daily limit has been put in place, if a price swing in one direction occurs that exceeds the daily limit, all further trading in that direction is stopped until the next day. Looking at our Coffee chart, we see that the daily limit is “NONE”! This is why Coffee is often considered one of the more risky markets to trade. It has no daily limit! But let’s look back at the Wheat chart we looked at in the previous chapter. Its daily limit is 25 cts = $1,250. If prices rise or fall more than 25 cents in one day, trading will be closed in that direction. However, if someone is willing to make a trade in the other direction, for a lower price let’s say, that trade can be made. If no one is willing to trade at a lower price, all trading is frozen for the day. This is called a state of “lock limit.”

Very rarely, and only in extremely volatile markets, the difference between the closing price of one day, and the opening price of the next day, is so great, that the limit is reached at the opening bell. If the market continues in lock limit all day, there will be no price activity at all. That day will be represented on the price chart with a dot instead of a price tick showing the range of prices.

Exchanges set the daily limit, and they can change it when necessary. For example, if a market remains in lock limit for a number of days, the exchange may increase the daily limit so that trading can open up again.

You may have heard stories of people caught in limit moves. Although they are not a common occurrence, it is necessary to be aware of the risk when trading futures contracts. How might limit moves affect futures traders? It depends on the position they’re holding, or hope to enter.

If you’re long a market that’s limit up, or short a market that’s limit down, clearly you’ll be happy. You’re making large profits every day. If you had been planning to enter a market — let’s say you wanted to go long in a market that’s now limit up — you would be locked out of purchasing a contract, and you could easily miss the move altogether. By the time trading reopened, the market could be so extremely high it wouldn’t be worth it to buy a contract anymore. On the other side, if you’d been waiting to short a market that went limit down, you might miss out on that opportunity.

The worst position to be in would be if you were long in a market that’s limit down, or short in a market that’s limit up. You’re losing money and you can’t liquidate your position. This is called being caught in a limit move. One way you can attempt to protect yourself from getting caught this way is to place a stop loss with every trade. Also, stay away from markets that are too volatile for you to afford.

While high volatility does offer a good opportunity to profit, it also puts traders at greater risk. If a huge price swing against their position occurs, and they can’t get out of their position quickly enough, and they don’t have the resources to hang on until the market
turns back in their favor, they could suffer a major loss. All traders must decide how comfortable they are with risk and select markets that best fit their style and resources.

You can tell how volatile a market is just by looking at its chart. A chart with long price ticks and lots of gaps is a volatile market. You can also get a clue from the margin. A market like Coffee, that tends to be volatile, and with no daily limit, has a margin of $2,500, more than three times the margin of the notoriously tame Oats market, with a margin of $743. But even a tame market can turn into a tiger — and exchanges can increase and decrease margin as necessary. For example, in early 2002, when Oats — usually the grandmother of the grains — kicked up her heels and became highly volatile, the margin was $1,013.

Whenever you think about trading a market, check on its volatility to determine whether it’s right for you. Also be aware that when you trade markets by purchasing options rather than futures contracts, your risk is limited to the cost of your option plus commissions and fees, and volatility is generally your friend.

**Dates to Remember**

Every commodity contract expires as its delivery date approaches. The only traders who hold on to their contracts until this date are the ones who are actually selling the physical commodity (such as citrus grove owners) or who are actually buying the commodity and intend to take delivery (such as orange juice packers). All the speculators, who are trading commodities as an investment only and have no intention of handling the commodity itself, want to liquidate all their positions well before the contract expires. Exchanges set specific dates for each contract by when positions must be liquidated. You can see these dates in the box on the Coffee chart.

FND is the First Notice Day and it is the day by which everyone holding long positions (those who have bought contracts) must liquidate their positions. Long traders liquidate by selling contracts to offset the ones they bought.

LTD stands for Last Trading Day, and it’s the day by which everyone holding short positions (those who have sold contracts) must liquidate their positions. Positions that are not liquidated will take delivery. Short traders liquidate by buying contracts to offset the ones they sold. Traders are responsible for keeping track of these dates. Brokers may inform their clients if these dates are coming dangerously close, but it’s not wise to rely on brokers as a warning system. If traders miss the deadline they may have to pay extra fees to stop the process leading to delivery.

It’s not advisable for traders to wait until the last minute to liquidate their contracts. They’ll get caught up in the rush of other traders who are also trying to liquidate. This could make it difficult for them to get their orders filled quickly, and they may not get the price they were hoping for. Traders should be alert and liquidate their futures contracts about one or two weeks before FND or LTD, depending on whether they’re long or short.
How to Compute Profits and Losses on Futures Contracts

When determining how much you’ve gained or lost on a trade, you’ll find it very helpful to check the information box on your chart. Commodities list prices in different ways, and until you’re familiar with how the commodity you’re trading works, it’s best to consult the box. For example, checking the box on the Coffee chart we see that prices are quoted in cents per pound, where 1 cent = $375. That means that each time the price of Coffee goes up or down by 1 cent, it affects the value of the entire contract by increasing or decreasing it by $375. (Another way to figure this is to see that the contract size is 37,500 pounds. A 1 cent increase would mean .01 x 37,500 = $375.) We also know that the prices listed along the side of the chart are in cents, where 100 = 100 cents = $1; 105 = 105 cents = $1.05, etc.

Looking back at our Coffee chart, suppose a trader bought a contract on the break above the wide channel that formed in September and October, getting in on October 30, at around 115. After that prices rose, and perhaps the trader moved his or her stop up to around 121, the low on November 13. The stop would have been hit when prices dropped on November 17, and let’s say the trader got out at 120. The exit price was 5 cents above the entry price (120 — 115) for a profit of $1,875 (5 x $375) — less fees and commissions. And it would have happened in just about two weeks.

Now, you may be thinking, if it weren’t for that stop loss, the trader would have been able to hang on and make even more profit. That’s true; and it’s also true that hindsight is always 20/20. No one can see the future. When you’re in a trade, you make your best efforts to have a profitable trade, while protecting your position. Placing a stop at 121 would have been a reasonable move at the time, and an $1,800 profit in less than two weeks is nothing to be ashamed of. Making consistent profits like this is the bread and butter of your commodity business. Trying to make the “big killing” is what gets traders into trouble. As the old commodity traders’ saying goes: “Bulls make money. Bears make money. Pigs get slaughtered.”

A loss is calculated the same way we calculate a profit. Determine the difference between the entry and exit points, and multiply by the value of each unit. When calculating profits or losses, all the information you need is in the chart legend.

In the old days traders had to do these calculations by hand, but nowadays online services do all the work for you. All you need is the entry price, quantity, whether you’re buying or selling, and the program will automatically display your portfolio and current profit and loss for every market.

Expand Your Trading Options

There’s one more entry in the information box on the Coffee chart that we haven’t mentioned yet. It says Opt Exp: 04/12/2007. This is the date on which options on this contract expire.

Trading futures contracts with options provides many advantages to commodity traders. You can generally enter option trades with a lower outlay of money. And when you buy
options your potential loss is limited to what you paid for the option, while your potential to profit can be unlimited; sometimes it even surpasses the move in the futures market. And because of your limited and known risk your option gives you staying power. You can wait out contrary moves in the futures market, knowing the limits of your risk. This means you can still be holding your position should prices ultimately turn in your favor.

In the next chapter we'll begin our study of this powerful trading technique — trading futures with options.

"He just checked prices on US Charts, and lumber is up."
Trading commodities with futures contracts is appealing to many because of the great profit potential it affords. However, as we've seen, there are risks involved as well.

Fortunately, there's another way to trade commodities that provides significant advantages, especially to the new trader, traders on limited budgets, or traders who simply prefer a “calmer” approach to trading. This other method lets you get started trading with much less initial outlay of money and you can maintain a smaller margin account with your broker. For each trade, you can generally enter the market for much less money than with futures contracts, and there are no surprises — you know exactly what the extent of your risk is ahead of time. There's never any concern about limit moves or getting stopped out of a trade. This method gives traders tremendous leverage, and tremendous profit potential. And, when you trade using this method, you have staying power. Even if the market moves against you, your known, limited risk allows you to hang on to your position — so that if the market does turn around before expiration day, you can still be on board.

This powerful method for taking advantage of the profit potential in the commodity markets with limited risk is to buy options on futures contracts. This trading alternative first became available on a limited basis in the early 1980s, and since then it has grown in popularity so that today hundreds of millions of options are sold annually.

**Why Staying Power Is Essential**

Traders who were able to always get in at the absolute bottom of a market, and get out at the absolute top, would make the most money. And that’s what some traders try to do — they try to pick tops and bottoms. But that can be a very tricky proposition. An old bit of trading wisdom tells us that markets will always go farther than you think. So, even though you may believe you’re buying at the bottom, the market could surprise you and go lower still.

However, we also know that every market eventually turns around. So, if traders can withstand the drawdown while the market moves against them, and they’re still holding their position when the market finally turns in their favor, it doesn’t matter how much
they temporarily “lost” while the market was moving in the wrong direction. Once the market starts coming back, and if they hang on long enough, ultimately they will collect a profit.

Theoretically that sounds great, but practically it’s impossible for the vast majority of traders. Huge financial resources are required to trade that way. Unless traders can meet margin calls, they are forced to liquidate their losing positions, and with no money to enter new contracts, they are stuck with the loss. This is why staying power is so important when trading commodities. Traders must have the ability to withstand the troughs of the roller coaster, or they’ll be off the ride long before the car hits the peaks.

Actually, staying power has two components. There’s a psychological component — the ability to mentally handle drawdown during adverse price movement. And there’s the financial component — having the money to hold your position even while the market moves against you. And traders of futures contracts need lots of both.

When trading futures contracts by purchasing options, however, you can be more relaxed. You need less of both components of staying power. The controlled risk means you don’t need the mental stamina or the financial resources that trading with futures contracts requires. And, with the strategies we will cover here, you won’t feel the need to pick a top or bottom, because you’ll learn how to profit from a market while it’s trending, which means there’s less waiting involved. And finally, with less capital required than when trading futures contracts, it’s easier to take advantage of the opportunities the commodity markets offer.

Now, let’s look at the abc’s of option trading.

**Options Defined**

The option process is not complicated. In one form or another, people use options every day. Any time you secure the right to do something, without being obligated to do it, you’re using an option. Some simple examples are making a reservation at a restaurant, or asking the salesperson in a store to hold an item for you. The restaurant will hold your seat, and the store will hold your item, for a limited amount of time. It’s up to you whether you will take advantage of your option by claiming your seat or the item you were going to purchase, or you let your option “expire” by not showing up at all.

Sometimes an option costs nothing, as in the example of making a reservation at a restaurant. This is because the restaurant owner has little at risk. If one party doesn’t show up, there will likely be walk-in business. But if granting you an option has the potential to put the grantor at risk, a fee will be involved. For example, most hotels now require a credit card to hold a room after a certain time, such as 6 pm. If someone reserves a room, and then fails to show, the hotel will be less likely to be able to sell that room once it gets too late, so it protects itself by demanding payment whether the customer uses the room or not. Another example of this kind of option is purchasing a ticket to an event. The ticket gives the purchaser the right to attend, but the purchaser is not obligated to attend. And once the ticket is sold it makes no difference to the theater or the producer of the event whether you come or not.
With room reservations and tickets, the amount paid for the privilege of having something held is the actual cost of the item itself. In some option situations only a part of the total value is required to hold the item. For example, a furniture store may require a deposit on special order items. And depending on the circumstances, that deposit may or may not be refundable.

The grantor of an option is always at some risk. He or she gives up all rights to do anything with an asset until the option holder makes a decision. The greater the chance the grantor could profit from the asset had the option not been granted, and the greater the grantor’s risk of loss, the more expensive the option agreement will be. In a sense, the potential risk of the option grantor is unlimited. But the risk to the person who requests the option is limited to the fee, deposit, or whatever else is required in the option agreement.

Another form of option transaction occurs in the insurance business. Here the option purchaser pays a fee — called the premium — in exchange for the insurance company’s promise to take certain actions if certain events occur. If the events never happen, the company is under no obligation to return the premium. And the higher the probability that the event could happen, the higher the premium. That’s why teenagers pay more for car insurance than 40-year-olds do, and why the closer people live to a body of water, the more they pay for flood insurance.

Let’s summarize all that we now know about options: Every option transaction involves two parties: the grantor and the requestor. Most options give the requestor control over some asset for a limited period of time. The requestor has the right to use the asset within that time period, but is not obligated to do so. At the end of the agreed-upon time the option expires. If the option agreement requires some payment to be made, the size of the payment will reflect the level of risk faced by the option grantor.

**Option Terminology**

With everything you now know about the option process, it will be easy to apply that knowledge to the use of options in trading the futures markets. To begin, let’s look at some standard option terminology. Many of these terms will already be familiar to you.

**Option:** An option is a contract that gives the purchaser the right, but not the obligation, to enter a specific futures contract at a specified price before the option’s expiration date.

**Call:** A call option gives the purchaser the right to buy (go long) a specific futures contract at a specified price within a specified period of time. The purchaser of a call option intends to profit from an increase in the price of the underlying futures contract.

**Put:** A put option gives the purchaser the right to sell (go short) a specific futures contract at a specified price within a specified period of time. The purchaser of a put option intends to profit from a decrease in the price of the underlying futures contract.
Option Purchaser: Also referred to as the buyer or holder. The purchaser pays a premium for the right (but not the obligation) to enter a futures contract long (call) or short (put) from a specified price within the time specified by the option’s expiration date.

Option Seller: Also referred to as the writer or grantor. The seller collects a premium and in exchange guarantees the purchaser’s right to enter a specific futures contract at a specified price within the time specified by the option’s expiration date.

Underlying Futures Contract: The specific futures contract that the option purchaser now has the right to buy or sell. The option’s value at any time is largely based on the current price of the underlying futures contract and the length of time remaining before the option expires.

Strike Price: The price at which the option purchaser may buy or sell the commodity futures contract regardless of its current price. The strike price is part of the initial option contract.

Premium: The cost of an option. Note: Option premiums are quoted in point value. To calculate the cost in dollars, multiply the premium by the contract’s point value.

Liquidate: Also called offsetting or liquidating. The action of the purchaser to sell back the option prior to its expiration date.

Exercise: The process by which the option holder (purchaser) acts on his or her right to enter a futures contract at the option’s strike price.

Expiration: The termination date of the option contract.

Now, let’s see how this terminology is used.

A True-to-Life Example

The way options are used in the real estate business is very similar to the way they are used in the futures markets. And because real estate is so tangible, it’s a little easier to explain the process using real property before moving on to futures. So we’ll start with an example that involves the purchase of a piece of land.

Imagine you live in a rural area near a small city. You’ve noticed that houses are beginning to be built in your neighborhood as more families from the city are looking for homes with a little land. It occurs to you that property values could rise, and it might be a profitable venture to purchase a piece of land and build a spec house. You drive around the area and notice that one of your neighbors has a one-acre parcel for sale. It would be the ideal location for the house you’re thinking of building.

Your neighbor is considering selling his land for $10,000. That seems like a fair price,
especially since you think the property will increase in value, and if you waited several more months before finding a property, you’d have to pay quite a bit more. But you don’t want to rush into anything either. First you want to find out if you can get the permits you need to build a house. And then you must arrange for financing to build on spec, and that will mean getting the land appraised. You might even have to look into rezoning. All of this could take time. You don’t want your neighbor to sell the land to someone else while you’re doing your investigating, and you’d like to lock in a good price. But you don’t want to take on the burden of purchasing the property in case you can’t get the permits or the financing, or you just change your mind about the whole project.

So you go to your neighbor with a little proposition: You will give your neighbor $500 to hold the land for you for four months while you look into the feasibility of your project. He gets to keep the $500 whether or not you decide to go ahead and purchase the land. Your neighbor is interested, but he also knows that the property could increase in value during the time he’s holding it for you, so he says he’ll enter the deal providing you agree that if you decide to buy the lot, you’ll pay him $11,000 for it.

Applying option terminology to this transaction, you are the buyer of an option, and your neighbor is the seller. Since your option gives you the right to buy the land, you are purchasing a call option. The option premium is the $500 you agreed to pay for the right (but not the obligation) to purchase the land within the agreed upon time (four months). The price at which you agreed to purchase the land ($11,000) is the strike price of your call option. Four months from the day you enter your agreement is the expiration date.

As the option buyer, your total risk is the $500 premium, while your potential gain is unlimited. As the option seller, your neighbor’s only gain for granting this option is the $500 premium. However, his potential for loss is unlimited. Let’s see why.

First, let’s look at the situation from the perspective of the option buyer. Your $500 gives you the right, but not the obligation, to purchase the property for $11,000. The option seller keeps that $500 no matter what you do from this point on. But your risk is limited, because if you decide not to buy the property, and you want to end the deal, you will not owe any more money. The $500 premium is the most you can lose.

At the same time, your potential gain is unlimited. No matter how much the value of the property may increase while you hold the option, you still have the right to purchase it for only $11,000. If a developer comes in who wants to put up a shopping mall, and he offers $20,000 dollars for the property, you still have the right to purchase it for $11,000 and make an immediate profit of $9,000. Even if an oil well suddenly gushes forth on the property and raises its value to a million dollars, your neighbor still must honor the $11,000 price.

And there’s even one more way you can make money on your option. If during the four months your option is in effect, the property goes up in value, but you decide you don’t want to buy it after all, you might be able to sell your option to someone else. For example, if the property goes up in value to $15,000, your option to purchase the property for $11,000 is worth at least $4,000 ($15,000 value - $11,000 purchase price). Another buyer
might be very happy to pay you $2,000 for an option that’s worth $4,000 (and maybe more if prices continue to rise before the expiration date). If you sell your $500 option for $2,000, you make an easy $1,500 profit with very little work.

Now let’s look at the situation from the perspective of the option seller. Even if nothing happens to change the value of the property, and you decide not to buy after all, he gets to keep the $500. On the other hand, the most he can gain from granting you the option is the $500 premium. Even if you go ahead and purchase the property he’s not really gaining, because he’s getting no more for it than he likely could have sold it for to another buyer. That’s why his potential profit is limited. But he has the potential to lose much more.

If the property increases in value to $15,000, $25,000, even a million dollars, he is still obligated to sell it to you for $11,000. By granting you an option for four months, he’s given up all the increase in value his property might experience during that time. The option prevents him from finding another buyer who might pay him the new actual value of the lot. And what if the property decreases in value to $5,000? Again, the option cost him the ability to sell the property earlier, at a better price, while he still had the chance.

This real estate example illustrates many important features of how options work in the futures markets. To draw the parallel, we’ll look at how you might use an option to trade a commodity like Silver. Let’s say you look at your Silver chart and you see a formation that suggests that Silver prices are about to rise. Checking the price quotes, you see that Silver is currently selling for $5 an ounce. You could simply go ahead and purchase a contract of Silver, but is it mathematically feasible? As of this writing, the margin in Silver is $4,725. To control a contract of Silver you would have to tie up almost $5,000 in your margin account, and although you could trade with a stop loss in place, theoretically there’s no limit on how much of that you could lose if the market turns against you. So, while on the upside your Silver contract would give you the potential for unlimited gains, it also poses the risk of unlimited losses.

As we saw in our real estate example, you may not be ready to expose yourself to the risk of a futures contract. After all, you don’t know for sure when the market will make the move you’re looking for. Your money could be tied up for a long time. And you don’t want to be faced with a margin call if the market moves against you. At the same time, you don’t want to miss the opportunity to profit from what you think could be a great move in the Silver market. So you decide to purchase a call option in Silver that gives you the opportunity to profit from rising Silver prices without exposing you to the unlimited risk of a futures contract.

The premium you pay for your option secures for you all the following benefits:

- You are not required to put up or maintain margin.
- Your potential loss is completely limited to the premium you paid plus your broker’s commission and fees.
- You can terminate the agreement at any time without any further obligation.
- You have unlimited profit potential.
Before moving on, here’s a quick summary of how options on futures contracts work. The cost of a commodity option purchases a right — not an obligation. The buyer pays the option seller (grantor, writer) a premium for the right, but not the obligation to either buy or sell a specified futures contract at a specified price within a specified period of time. Option buyers who believe the price of a commodity is going to rise purchase a call option. Option buyers who believe the price of a commodity is going to fall purchase a put option. The price paid for the option is its premium. The price at which the option gives its purchaser the right to buy — or sell — the specified futures contract is its strike price. The option contract remains in force until the specified option expiration date.

At any time during the term of the option the purchaser can either:

- Exercise it and take a position in a futures contract
- Liquidate it by selling it for its current premium
- Do nothing and let the option expire worthless

**More Option Basics**

We have a few more basics to learn about option trading, so let’s return to our easy-to-understand real estate example.

As you recall, in our example you are thinking of purchasing a $500 option on a piece of property that is worth $10,000. Your option would give you the right to purchase the property in 4 months for $11,000. As the option purchaser, the most you can lose on this deal is the $500 premium. But, if the value of the property increases the way you predict it will, your potential for profit is unlimited. Thinking that this seems like a good business arrangement, let’s say you purchase the option and then sit back to see how things develop.

On the day you purchase your option, the property is worth $10,000. Your option gives you the right to buy the property for $11,000. If you exercise your option now, you will have to pay more for the property than it’s worth. But that’s okay. You’re not concerned with the situation today. You’re looking to the future when you think the value of the property will be higher. In fact, you won’t even exercise your option unless the property does increase in value. In option language there’s an expression we use to describe the situation where the strike price of our call option is higher than the property’s actual value. We say that the option is “out-of-the-money.”

Now, let’s check back a month later. As you hoped, property values have increased, and the property you’re holding the option on is now worth $11,000 — exactly what your option gives you the right to buy the property for. The current value is equal to the strike price, and we say that your option is “at-the-money.” This is great, and you still have three more months on your option. There’s no telling what could happen in that amount of time. So you wait patiently.
Another month passes, and now the property has increased in value to $12,000! With your option to purchase the property for $11,000, if you bought it today you would have an immediate $1,000 profit on your asset. We say that your option is “in-the-money.”

There’s more to come on this exciting story, but let’s step back a minute and draw the parallels between our real estate example and commodities. We’ll look again at a possible Silver trade, and see how we use the terms we just learned. Suppose that Silver is selling for $14 an ounce, and you believe the price is going to rise, so you purchase a call option with a strike price of $15. Your option is out-of-the-money on the day you purchase it. Time passes and your prediction proves correct. Silver prices rise, and on the day they reach $15, your option is at-the-money. More time passes, and to your delight Silver prices rise to $16! Your option is in-the-money, and if you entered the market now at your strike price, you would have an immediate profit.

Let’s get back to our real estate example. When we last checked, your option was in-the-money. But what is its actual value? To put it bluntly, your option is worth whatever someone else is willing to pay you for it. But what determines how much that will be? There are a number of factors that determine an option’s value.

First, your option gives you the right to purchase a $12,000 asset for $11,000. Your option is worth at least the difference between your option’s strike price, and the actual value of the asset. In this case the amount is $1,000, which is the “intrinsic value” of your option. Every option that’s in-the-money is worth at least its intrinsic value.

What else might affect how much your option is worth? How about time? Your option gave you four months for something to happen. Now only two months have passed, and the price of the property has increased by $2,000. Your option still has another two months before it expires, and a lot could happen in that time. So in addition to its intrinsic value, your option has “time value.” But time value changes. Your option already has less time value than when you bought it. In another month it will have less time — which means it offers less opportunity for something to happen that could increase the value of the asset. As time runs out, the time value keeps decreasing — we say that it “decays” — until one day the option expires. When the option expires, the contract you entered four months ago is terminated. If no one has done anything with the option before that time, it’s not worth anything to anyone. It has expired worthless.

But time value is an interesting factor because the rate at which it decays is affected by other conditions. If there is no change in the situation, time value will decay at a steady rate, but suppose one day there’s a report in the newspaper that a big company is planning to build a factory on the outskirts of town, and it’s expected that there will be a lot of new housing starts to accommodate all the factory workers who will be moving out to be close to their jobs. Over the next couple of days rumors spread wildly, and even though some contradict each other, all the interest being shown in the area causes property values to seesaw wildly. The market is showing increased volatility — another major factor that affects the value of an asset. Perhaps a few days earlier the two months remaining on your option didn’t seem that attractive — after all, how much could happen in two months?
But now, in this volatile market, a lot could happen in two months. And the value of your option rises accordingly. If you wanted to liquidate your option now by finding someone else to buy it from you, you could get a higher premium for it now than you could a couple of weeks ago.

All these factors that affect the value of real estate options hold for commodity options as well. Commodity options earn intrinsic value as the price of the underlying futures contract moves beyond your strike price in the correct direction (up for a call option, and down for a put option). Looking at our Silver example, you bought a Silver call option with a strike price of $15, and we saw the price of Silver increase to $16. Your option has intrinsic value. To determine how much, take the difference between the current futures prices and your strike price ($16 — $15 = $1). Silver is quoted in cents /ounce, so we’re looking at a difference of 100 cents, multiplied by the value of one cent, which equals $50, and we get an intrinsic value of 100 x 50 = $5,000.

But that’s only the option’s intrinsic value, and we know that the factors of time and volatility also affect the premium. The more time an option has before its expiration day, the higher its premium will likely be. So, if it’s March, and you’re selecting an option to purchase, the farther-out the contract month you consider, the more expensive the premium will be. Options for the May futures contract will be cheaper than those for the July contract, which will be cheaper than those for the September contract, and so on. You pay for time value.

But as we’ve seen, time value is also affected by volatility. If the underlying futures contract is exhibiting high volatility, it’s likely that option premiums will increase. Generally, if futures prices are in a narrow sideways channel, a situation with low volatility, option premiums will be lower than if futures prices are on the move.

The bottom line is, there are a number of factors that affect an option’s premium: its degree of intrinsic value, time, and volatility. And these factors interact in ways that are unpredictable and cannot be precisely calculated. This means that knowing when an option is at the right price to buy — or liquidate — is not a clear-cut matter. Fortunately, US Charts Online offers option history. With option history you can see where today’s premium for an option compares to its premiums for every day since it began trading. This gives you a much better idea of whether today’s price is a bargain, or if the option is overpriced.

Even so, new option traders are not always comfortable with the ambiguity of option values compared to futures contracts. With contracts, you have a pretty good way to estimate potential profits and losses. To calculate your potential risk you determine the difference between your entry point and your stop loss. To calculate your potential profit you determine the difference between your entry point and your profit target — either a 50% level, or any other point on a chart, such as an area of support or resistance. But with options, there’s no way to know how premiums will be affected by time and volatility, or even a move in the futures market. Futures prices could jump, and option premiums could respond forcefully, or not at all. Or futures prices could make a small move, and send option premiums skyrocketing.
This uncertainty about how option premiums will vary over time is not that important compared to the benefits of trading options. When buying an option, your place in a market is assured — and your risk is completely known in advance. The amount you pay for the option is the most you can lose, no matter what happens. At the same time, your option gives you the potential to make unlimited gains. Also, remember that all the variables that make option trading seem confusing, are the very variables that give it so much potential to profit. For example, volatility, which is so difficult to put into a calculation, is the very factor that can cause an option to surge in value, far beyond its intrinsic value.

All of this will become clearer to you as we look more closely at how an option's value changes over time, and how we can use this information to set up trades. Once you see the profit potential in trading options, you will realize why we call it a premium approach to making money!

“Our Crude Oil call options sure ease the pain at the pump.”
Now you will see why so many people engage in option trading. It’s because of the many benefits for making money that they offer.

The basic rule of making money — buy low, sell high — applies to option trading as well. With options, it’s the premium that’s key. Our aim is to buy while the premium is low, and liquidate when the premium is high.

Please notice that we said “liquidate” rather than “sell.” In option trading “sell” is reserved for the act of writing an option. When you liquidate an option you find another buyer for it, and this is the preferred way of completing an option trade, although there are other ways a trade could end. For example, if your option is in-the-money, you could decide to exercise your option and enter the underlying futures contract. You would be unlikely to do this, however, as it’s rarely, if ever, to your advantage to exercise an option. We’ll explain why later in this chapter.

Another way the trade could end is for your option to expire worthless. This happens when you continue to hold your option, and it’s still out-of-the-money when expiration day comes. When that happens, you’re out the cost of the option, which includes the premium you paid, plus fees and commissions. You might do this if you believed the move you wanted could still happen and it was worth more to you to maintain the opportunity than to recoup anything on the option by liquidating it. However, remember that at any time you see your option is losing value, you can decide to liquidate it for whatever the going price is at the time, and use the part of the premium you get back to enter another trade.

The premium is the market price of an option — whatever someone is willing to pay for it. Premiums can rise and fall throughout each trading day, reflecting the influence of intrinsic value, time value, and volatility. These factors come into play as prospective buyers and sellers (or their representatives) haggle over prices. The final price is a measure of how much option buyers are willing to pay for an opportunity, and how much option sellers want to receive for taking on the risk.

Just to review, of the three factors that affect premiums, intrinsic value is the one that is easiest to quantify. If an option has acquired intrinsic value, its premium will be at least equal to that amount. An option that is out-of-the-money has no intrinsic value, and its value will be based on how much time is left before it expires and how likely it is that the futures price will surpass the strike price within that time. This, of course, is a factor of the distance between the strike price and the current futures price. The farther the strike price is from the current futures price, the less likely it is that it will be hit, and therefore the lower that option’s premium will likely be.
The time value of an option is related to the number of days left before it expires. As the expiration day approaches, it becomes less and less likely that any out-of-the-money strike price will be hit, and premiums decrease rapidly, especially in the last 30 to 60 days of the option contract. By the way, option traders should pay special attention as expiration day nears. Some in-the-money options are automatically exercised on their expiration date if traders haven’t left instructions with their broker to liquidate them.

The picture gets more complicated as volatility enters the picture and affects the interaction of time and strike price. As volatility increases, so does the chance that an out-of-the-money strike price will be hit — which means there may be an increase in the premium. In fact, high volatility can so influence traders’ valuation of options, that it may raise a premium far beyond an option’s intrinsic value. This points out an important aspect of volatility — it reflects a psychological condition: traders’ interest in a commodity. This is why it can't be measured precisely. But even though we can't exactly predict how all the various factors will affect an option's premium, we can still take advantage of all these factors to make profitable option trades. Let’s use a real commodity as an example to see how option premiums can change over time, and how we can profit as a result.

For our example we’ll look at the Corn market, and we’ll start our investigation with a chart. It's the middle of September 2006, and prices have been in a narrow sideways channel for weeks. Judging from this chart we don't really know which direction this market will go. However, looking at the monthly chart we see that prices are in an uptrend.

We expect that if prices break above the top of the channel, that could mark the continuation of the uptrend. So we decide to look into call options for the May 2007 contract. These options expire on April 20, which would give us seven months for the move we want to occur. We’ll wait for the breakout, and then get prices on available call options by looking them up online or contacting a broker.
The breakout above the top of the channel occurs on September 21 so we check prices on that day. The table shows call option premiums on a number of call options with different strike prices in the May 2007 Corn market. With futures prices around 277 we look at strike prices starting at 280.

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Premium (cents)</th>
<th>Premium ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>420</td>
<td>1.875</td>
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<td>—</td>
<td>—</td>
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<td>$456.25</td>
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<tr>
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<td>$662.50</td>
</tr>
<tr>
<td>290</td>
<td>16.00</td>
<td>$800</td>
</tr>
<tr>
<td>280</td>
<td>19.25</td>
<td>$962.50</td>
</tr>
<tr>
<td>270</td>
<td>23.125</td>
<td>$1,156.25</td>
</tr>
</tbody>
</table>

* Option prices courtesy of US Charts Online. www.uscharts.com
Many more call options are available than are listed in this table, but we’re only listing the ones a trader would most likely buy. Notice that a range of options is available, and they fall in 10-cent intervals. This is typical of Corn options. Each commodity offers options at pre-set intervals, although in very active markets sometimes additional options that fall between the standard ones may become available. Option prices are generally quoted in points or cents. To determine the value of the premium in dollars, simply multiply the price quote by the point value for the commodity, which is listed in each chart’s legend.

Looking at the table you can see that the premiums for these options vary widely from a low of $93.75 to a high of $1,156.25, with option prices decreasing as the strike price moves farther away from the money — the current futures price of 277. It seems unlikely that prices could jump all the way to 420, so options with strike prices in that range don’t pose much of a threat to option sellers. They’re willing to give a buyer the opportunity for only $93.75. In fact, it’s so unlikely that prices will reach that high, that a number of options in this range aren’t even trading on September 21. They don’t start trading until weeks later.

It’s more likely that futures prices could jump three cents and reach 280, so sellers are charging $962.50 to provide this opportunity. Only one of the options listed — the 270 call — has intrinsic value. The remainder are all out-of-the-money. And all these options, regardless of the strike price, will expire on the same day.

After making its breakout on September 21, Corn prices take off like a rocket. Look at the chart a little more than two months later.

Look at the table of updated prices to see how Corn call options fared during this time.
May 2007 Corn Call Option Premiums  
Opt. Exp: 4/20/07

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Premium (cents)</th>
<th>Premium ($)</th>
<th>Strike Price</th>
<th>Premium (cents)</th>
<th>Premium ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>420</td>
<td>1.875</td>
<td>$93.75</td>
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<td>390</td>
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<td>7.625</td>
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<td>$900</td>
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<tr>
<td>320</td>
<td>9.125</td>
<td>$456.25</td>
<td>300</td>
<td>19.25</td>
<td>$962.50</td>
</tr>
<tr>
<td>310</td>
<td>11.00</td>
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<td>290</td>
<td>23.125</td>
<td>$1,156.25</td>
</tr>
<tr>
<td>300</td>
<td>13.25</td>
<td>$662.50</td>
<td>280</td>
<td>26.25</td>
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<tr>
<td>290</td>
<td>16.00</td>
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<tr>
<td>270</td>
<td>23.125</td>
<td>$1,156.25</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Option prices courtesy of US Charts Online. www.uscharts.com

This table is a perfect example of how options make money. All of the options have increased in value. Do keep in mind that options do not always rise in value dollar-for-dollar with the futures price. But clearly these options did rise in value as the futures price rallied. With the futures price now at 394, all the options with strike prices of 390 or below are in-the-money. However even the options that are out-of-the-money jumped in value over ten times, even though these options have no intrinsic value. Even taking intrinsic value into account, the 390 call has only $200 in intrinsic value (394 – 390 = 4 cents; 4 x $50 = $200), and yet the premium for that option is almost $1,600.

How do we explain these increases? The options haven’t been granted any more time, so time value of itself is not an issue. There is a lot more interest in these options, which has raised the volatility, and that accounts for part of the increase. In addition, the value of the strike price has changed. The options that originally seemed so out of reach, are now just a heartbeat away from being in-the-money, making them much more attractive to buyers. This table of Corn options provides a very nice illustration of how volatility can affect option premiums.

This table also reveals why it’s generally more profitable for traders to liquidate their options rather than exercise them. As an example, suppose a trader had purchased the 290 call for $800 on September 21. On November 27, that option is worth $5,225. Liquidating the option would yield a profit of $5,225 – $800 = $4,425 less fees and commissions. On the other hand, exercising the option would involve purchasing a contract at 290. With futures prices at 394, the contract would have an immediate profit of 394 – 290 = 104 cents x $50/cent = $5,200. Subtract the $800 paid for the premium, and you have a profit of $4,400 less fees and commissions. This is comparable to the profit earned from liquidating the option, however now, having exercised the option, the trader must pay additional fees and...
a commission for entering the futures contract, put up over $1,000 in margin, and then wait anxiously to see if the market continues to rally. In this case, liquidating provided the quicker, easier, and equally profitable way to go.

Just to finish off this example, there was no reason why a trader would liquidate or exercise on November 27. There was no signal on the chart to prompt such an action. As it turned out, prices continued to rally. And, on February 22, 2007, when corn closed above 447, the 270 call sold for $8,875, and the 420 call sold for $1,850.

Our look at May Corn provided an excellent demonstration of the profit potential in trading options on futures contracts. And all option traders had to do was spot the opportunity, risk a limited amount of money, and then watch what happened. This is exactly what you’re learning to do here. So let’s move on to our next important topic: how we make our most important option trading decisions.

**Another Word of Caution**

The above examples are hypothetical trades and are illustrations made with the benefit of 20/20 hindsight. In regard to hypothetical trades, please keep in mind the following:

Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or to adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

“The corn is as high as an elephant’s eye...”
• Chapter 8 •

Decisions, Decisions

At any one time, thousands of different commodity options are available for you to buy. How do you sort through all those possibilities to select the one you want to purchase — the one that offers the opportunity you've been waiting for? And once you've identified your option, how will you plan your trade? You just need to determine a few basic parameters.

Each time you purchase an option, you must decide:

• Which market
• Which contract month
• When to buy
• Which strike price
• How much to pay
• When to exit your position

Let's tackle each of these in turn, starting with your first decision.

Which Market?

We always begin our search for a promising trade with our charts. We're looking for a formation that signals the possibility of a market move from which we can profit. As an example, let's say we look through our charts in March 2007, and we notice a pennant formation shaping up in the Gold market. We decide to keep watching this market to see if the opportunity presents itself for us to head for a Gold rush.

Which Month?

While we wait for the breakout, we think about which contract month to trade. We're looking at this market at the end of March. Gold options tend to be expensive, so we can't buy too much time. But options in the August market should be affordable, and they give us four months of time before options expire at the end of July, so we decide to trade options in the August contract. Now we're waiting for the right time to buy.
When to Buy?

The question of when to buy is tied up with our strategy for planning a trade. When planning our strategy we like to keep in mind that many veteran traders tell us that the “the trend is your friend.” This is because our best chances for profit come when we get the signal to enter a market that is already in a strong trend. All we have to do is hop on board and take the ride up or down. But as great as charts are, you can’t always tell by looking at one how strong a trend is, or even its direction. For example, the daily chart may show prices rallying, but the longer-term weekly or monthly chart may reveal that prices are in a strong downtrend, and going short the market provides a much better opportunity than going long.

If charts don’t give us the answer, where can we turn for help? Fortunately, US Charts Online provides you with one of the most powerful tools available that technical traders can use to determine trend strength and direction. This remarkable tool is called Trend Seeker, and it analyzes huge quantities of data using complicated mathematical formulas to arrive at a comprehensive description of the trend in any market. Finally, it presents its findings on all the major markets in an easy-to-read online table.

Look at a brief excerpt from the Trend Seeker table to see all that it contains.
Column 1 lists all the markets in alphabetical order. Column 2 lists the front month – the contract month whose data Trend Seeker is entering into its formulas.

Column 3 indicates whether the trend is up, down, or neutral. For our trading, this is the signal we use the most. It serves as a “filter” to indicate whether a breakout on a chart may be worth trading. We look for a breakout of a chart formation that’s in the same direction as the Trend Seeker Trend Rating. Column 4 lists the number of days the market has been in this trend.

Column 5 indicates the entry price. This is the price at which the current trend began. Column 6 is the Trend Signal Ranking. It tells you if the trend is weak, strong, or neutral. Some neutral trends that are beginning to show a slight tendency in one direction are labeled as bullish or bearish.

As we mentioned earlier, the large Trend Seeker table uses data from the front month contract. However it’s easy to get Trend Seeker ratings for any contract month. Each US Charts Online chart has the basic information listed in a box below the chart.

Now, let’s see how we use this information to determine “when to buy.”

Let’s look at the chart for August 2006 Gold and our example of a trade off a pennant formation.

Gold had been in an uptrend since the beginning of the chart, and then entered a large pennant formation, beginning at the end of December 2005 and early January 2006. Now, suppose we followed this market for a while. We sat up and took notice on March 29 when prices broke out of the pennant to the upside, and closed outside of the formation. It looked like this was a good opportunity to purchase call options, but we wanted to get confirmation from Trend Seeker.

Look at the excerpt on the next page on Gold from the Trend Seeker table on March 29, 2006.
The Trend Seeker Trend Rating was up, so we had the perfect setup to enter the market on the following day, provided futures prices were still near the breakout point. Now we knew when to buy. But which option should we buy, and how much should we pay?

### Which Strike and How Much to Pay?

The key to selecting a strike price is to choose an option that’s close-to-the-money but still affordable. Options that are closer-to-the-money will cost more than options that are out-of-the-money.

On March 30, the first day we could have bought options in our Gold trade, we would have shopped for calls. On that date futures prices in the August 2006 Gold contract were around 590. By that date Gold had made a pretty large move up and call option premiums jumped 30% from the previous day. However we could not have bought options on the previous day because we were waiting for the end-of-day price to get our signal. On March 30 we could have purchased an August 2006 call option with a strike price of 610 for a premium of 2010 points ($2,010); the 620 call went for 1680 points ($1,680); and the 630 call went for 1400 points ($1,400).

The strike price we’d choose would depend on our budget — or how much we could afford to pay. The $600 difference between the 610 call and the 630 call is pretty hefty. The 620 calls falls pretty much in the middle. Each trader must decide how much risk to take on, which in turn determines how close he or she will get to-the-money.

Whenever possible, and if you can afford it and are willing to take the risk, it’s best to purchase two or more options in a market. That way if the market moves in your favor you can liquidate one option when its premium has doubled, thereby paying for your trade — and hanging on to the second option until some exit point is hit, such as support or resistance or a 50% level.

### When to Exit

In trading, entering a market is “science,” but exiting your position may not be so clear — it may be closer to “art.” When entering a position you have more time to analyze price action, shop for your options, and then wait for the buy signal. The procedure is methodical. Based on your charts and the valuable information provided by Trend Seeker you identify your market and the direction of the trend. Then, once a breakout is confirmed by Trend Seeker you’re ready to enter the market. You’re dealing with known factors, and the psychology of the situation is relaxed. You don’t have anything at risk yet, the market is quiet, and you’re not under pressure to make a decision. Your plan to enter is clear and you’re the one in the driver’s seat.

When liquidating your position, however, the situation is not as clear. Since you’re following
the trend, you’re no longer the driver. And with money at stake, you feel more pressured to act quickly. This is why it’s so important to have an exit plan in place before you enter the trade. Several possibilities are open to you. One popular method is to choose a dollar amount that you will look for your option to increase in value (or lose value). For example, you could decide that if your option doubles in value, you’ll exit the market with your profit (or if your option loses half its value, you’ll exit the market with your limited loss). Another possibility is to select a point of support or resistance on the chart, and decide that when futures prices hit those levels, you’ll liquidate your option.

As we’ve seen in previous examples, sticking with an exit strategy may result in less profit than you would have made if you stayed with the trade. However, any profit is a good one. Since no one can see the future, we make our best business decisions, learn from them, and move on. Perhaps staying on with the trade would have yielded a better return in
one situation, but in another situation sticking with a trade could have put you right up against a market turnaround, leading to a loss. It’s always best to stick with your plan.

Now, returning to our Gold trade, after March 30, prices continued to rally strongly. Look at the Gold chart on May 11, 2006 to see what a Gold Rush this was.

Also, look at the monthly chart for Gold on the previous page to see how we might have planned our exit strategy.

If we had purchased two options, we could have liquidated the first on April 19, when the value of the premium had doubled. We could have hung on to the second option until May 11, when futures prices hit the previous high on the monthly chart, which was made back in 1980.

Let’s see how premiums rose from our entry date to our exit.

<table>
<thead>
<tr>
<th>Strike</th>
<th>Entry (3/30/06)</th>
<th>1st Liquidation Point (4/19/06)</th>
<th>2nd Liquidation Point (5/11/06)</th>
</tr>
</thead>
<tbody>
<tr>
<td>610</td>
<td>$2,010</td>
<td>$4,510</td>
<td>$12,130</td>
</tr>
<tr>
<td>620</td>
<td>$1,680</td>
<td>$3,910</td>
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<tr>
<td>630</td>
<td>$1,400</td>
<td>$3,360</td>
<td>$10,350</td>
</tr>
</tbody>
</table>

Please note that while you’re waiting for the Trend Rating to come into agreement with the direction of the breakout, prices may dip back into the formation a number of times. That is not a problem. In fact, the pullback may mean you can get your options at a better price.

As a final comment, knowing how to choose the right option and plan strategy is the art and science of trading. There are a number of factors involved, but once you learn how to analyze a trade as we just did with the Gold market, you’ll see that it’s just a step-by-step process. Practice working with the numbers, and everything will fall into place. In the next chapter we’ll look at some more sample trades that should make the whole process even clearer.
More Trading Strategies

Are you getting excited now about the great possibilities in trading commodity options? Then let’s go on to look at some sample trades, concentrating more on strategy. Remember, the examples below represent hypothetical trades with the limitations mentioned at the end of chapter 7.

Trading a Channel in Cotton

Let’s look at how we would trade a channel formation with the assistance of Trend Seeker. When you look at a channel formation with the naked eye, you often can’t tell whether to expect a breakout above or below the channel. But, when you consult Trend Seeker, you can see what the overall trend of the market is, and then you will only look for a breakout in the right direction.

For example, look at the chart for the July 2007 Cotton market.

On March 26, 2007, Cotton prices had been in a narrow channel for several weeks. Looking at this chart it would have been impossible to predict the direction that a breakout would take. However, looking at Trend Seeker we would have seen that the Trend Rating was down. That would have told us that the only breakout worth trading would have been to the downside.

The breakout and the close below the channel occurred on April 9. Checking back to Trend Seeker, the Trend Rating was still down, so this provided a perfect opportunity to purchase put options on the next trading day, which was April 12.
On April 12, July Cotton futures prices were around 53. Looking at available put options on that date we could have purchased the 55 put for 285 points ($1,425), the 54 put for 216 points ($1,080), or the 53 put for 157 points ($785).

After this date prices continued to drop. Look at the chart as the trade developed. Our first target, doubling our premium, was hit on April 26.

As of this date, Cotton put options had increased nicely in value, as the table indicates.

### July 2007 Cotton Put Option Premiums

<table>
<thead>
<tr>
<th>Strike</th>
<th>Entry (4/12/07)</th>
<th>1st Liquidation Point (4/26/07)</th>
<th>2nd Liquidation Point (5/16/07)</th>
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<tr>
<td>55</td>
<td>$1,425</td>
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<td>54</td>
<td>$1,080</td>
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</tr>
<tr>
<td>53</td>
<td>$785</td>
<td>$1,690</td>
<td>$2,060</td>
</tr>
</tbody>
</table>

* Option prices courtesy of US Charts Online. www.uscharts.com

From that point on it was too difficult to set a target off the monthly chart, so we might have trailed a mental stop, and we would have exited the market when prices proved a change in trend by breaking above resistance on May 16.

Here’s what option premiums looked like on that date.
Feeder Cattle Makes a Bull Flag

Now we’ll look at a trade based on a flag formation — in this case a bull flag.

In February 2007 Feeder Cattle prices were in a consolidation pattern during an uptrend. Looking at the chart on February 23, a bull flag was clearly visible. As you will recall a bull flag formation is basically a channel that’s pointing down. Its flag pole, which as always precedes the flag, rises up to the bull flag. We’ve marked the flag and the pole on the chart.

Checking Trend Seeker, we see that on February 23 the trend was up, so our signal to purchase call options would have been the breakout above the upper trend line of the flag.

The breakout occurred on February 26, and Trend Seeker confirmed that the trend was still up. Shopping for Feeder Cattle call options on February 27, when futures prices were around 106, we would have found a 108 for $1,850, a 110 for $1,400, and a 112 for $925. Let’s say we purchased the 112, which was the most affordable option.

After that prices continued to rally. If we had bought two options, we could have liquidated the first on April 9 when the premium had more than tripled in value to $4012.50. Anything we would have made from this point forward would be profit.

Looking at the weekly chart, on the next page we might have set our profit target at resistance around 120. If prices continued to rise, we would liquidate when that price was hit. However, as with any trade, we also have an exit strategy. In this case, if futures prices began to drop we would liquidate when prices fell below a level of support.

After our first liquidation, we would have seen that Feeder Cattle prices began to fall. We might have liquidated our second option on April 13 when futures prices dropped below
the support made on March 8, and again on April 4 and 5. On that day the premium for the 112 call was $2,075.

**Flat-Top Triangle Trade**

Now we're going to look at setting up an option trade off a flat-top triangle formation. As our example we'll use the March 2007 Soybeans market.
Looking at the March Soybeans chart on February 1, we see that prices rallied from lows made in October 2006, then moved sideways for several months, broke above the top of the consolidation pattern, and finally formed a classic flat-top triangle. We would be waiting for the breakout above the top of the triangle to purchase call options.

The breakout occurred on February 2, when futures prices closed at 721-1/2. Shopping for options on the next trading day, which was February 5, we would have found the 720 call for 26 cents ($1,300), the 730 for 19-1/2 cents ($975), and the 740 for 14 cents ($700).

Our first profit target, assuming we had bought two options, would be when the premium doubled, which occurred on February 20. Our second profit was based on resistance on the weekly chart at 801.
By February 22, prices still had not hit our target, but it was one day before expiration, so we would have liquidated on that date. The table shows how option premiums fared at both exit points.

**March 2007 Soybeans Call Option Premiums**

<table>
<thead>
<tr>
<th>Strike</th>
<th>Entry (2/5/07)</th>
<th>1st Liquidation Point (2/20/07)</th>
<th>2nd Liquidation Point (2/22/07)</th>
</tr>
</thead>
<tbody>
<tr>
<td>740</td>
<td>$700</td>
<td>$1,562.50</td>
<td>$2,193.75</td>
</tr>
<tr>
<td>730</td>
<td>$975</td>
<td>$2,056.25</td>
<td>$2,687.50</td>
</tr>
<tr>
<td>720</td>
<td>$1,300</td>
<td>$2,556.25 (doubled 2/21/07)</td>
<td>$3,187.50</td>
</tr>
</tbody>
</table>

* Option prices courtesy of US Charts Online. [www.uscharts.com](http://www.uscharts.com)

"Can I buy an option on that corn?"
Chapter 10

Exit Strategy —
How to Garner Your Profits and Minimize Losses

As we keep saying, one of the most important aspects of planning a trade is determining when you will exit the market. If you have this part of the trade planned out ahead of time, you will be less likely to fall victim to emotions that may try to influence your thinking when you’re in the heat of a trade.

Your exit strategy should include steps for protecting and collecting your profits in a winning trade, and minimizing your losses should the market move against you. In the sample trades in previous chapters we looked at how we implemented an exit strategy, but in this chapter we want to more clearly discuss how you would make your plans going into the trade, and especially how you would plan to exit a losing trade.

Setting Up Your Plan

While you are in the process of setting up any trade you will plan in advance for an exit strategy to protect and collect your profits if the market moves in your favor, and an exit strategy to minimize your losses should the market turn against you.

One way to select a spot to exit a trade is to decide on a certain amount of money you would like to make on your option, or the amount that you feel comfortable losing if the option begins to lose value. For example, you may decide to take profits if your option doubles in value, and you may decide to exit the trade if your option loses a certain percentage of what you paid for it — for example 50%.

Another exit strategy is to use points of support and resistance on the chart or a 50% level as profit targets. If the market moves in your favor and hits your target you will exit the trade. This may seem difficult to follow if the market looks to you like it’s going to go in your direction forever. However, once a major target is hit, prices could turn at any moment, and it’s usually better to stick with your plan and enjoy your profit, than to hang on and watch your profits slip away in a major market turnaround.

At any time prices can surprise you and turn on a dime. If you’re in a winning trade you want to protect your accumulating profits by using a mental stop. You can’t set an actual stop in an option trade in the same way that you can in a trade with futures contracts, but you can trail a mental stop at points of support and resistance. This means you keep...
an eye on the chart at least once a day, and if you see that futures prices are beginning to move against you, even though your profit target hasn’t been hit, you can preserve the profits you’ve already made by exiting the market when your mental stop is hit.

Now let’s look at how you would plan ahead for a trade that turns out to move against you. Here again, you would plan ahead of time for points of support, resistance, or a 50% level that you would use to exit a losing trade. These would be points below the futures price on the day you entered the trade if you are holding a call option, or above the futures price on the day you entered the trade if you are holding a put option.

**More About Exiting a Market That’s Moving in Your Favor**

Selecting exit points is a highly individual process. Traders may use daily, weekly, or monthly charts to find exit points, and they may read their charts differently. The best way to determine the approach you prefer is to paper trade as many trades as possible.

When trailing your mental stop to protect accumulating profits, use points of support and resistance as they naturally develop, and/or a break in the trend line on the daily, weekly, or monthly chart.

Watch your charts each day. In the case of a call option in a rising market, each day prices will rise and possibly fall, but overall the direction will be up, with falling prices hitting a floor that they can’t seem to break below. This floor is support. When this support level is broken by a price that does fall below it, exit the trade. In the case of a put option, futures prices generally fall, and even when they rise, seem unable to rise above a ceiling, which is resistance. When this resistance level is broken by prices rising above it, exit the trade.

A trend line is really a graphic representation of areas of strong resistance or support. When it is broken it indicates a possible turnaround (and change in trend) of that market. Consider exiting the trade when the trend line is broken.

**More About Exiting a Market That’s Moving Against You**

As we said previously, an easy exit strategy to implement is to simply decide upon a dollar amount that you’re willing to risk, and if the premium of your option falls by that amount, liquidate it.

Another strategy to consider is to exit the option if futures prices break a level of support or resistance on the daily, weekly, or monthly chart. For example, let’s say you buy a call option but the market moves down. You’d exit the position if a predetermined level of support on the price chart is broken. On the other hand, if you buy a put option and the market then moves up, you’d exit the position if a predetermined level of resistance on the price chart is broken. The idea is to preserve some of your premium so that you can use it to go on to trade another day.

Some traders purchase an option with the mindset that they’re willing to risk the entire premium and they will hold on until the option expires worthless just in case there’s a last
minute turnaround in prices. This is fine as long as it’s part of the original plan for the trade. However, if you select an exit point, and then, in the middle of a losing trade you decide you want to keep hanging on, this is not a good policy, and it will build bad trading habits. Always plan your trade and trade your plan.

**An Example of Saving Your Hide in a Feeder Cattle Trade**

We’ll now look at an example of exiting a losing trade while conserving some of the premium.

In April 2007, August Feeder Cattle prices were in a pennant formation that developed during an uptrend. When prices broke out of the pennant on April 30, it looked like a perfect opportunity to buy a call option in this market. With futures prices at around 113, let’s say we purchased an August 116 call for $1,112.50 on May 1.

Unfortunately, as sometimes happens, the market then turned on a dime and moved limit down on May 3. For holders of futures contracts this would have meant a loss of $1,500. For holders of the 116 call option, the effect was not as extreme. On May 3 the premium for that option fell to $575, meaning a loss of only $537.50. On this occasion the market gave us two reasons to liquidate. First, if our trading plan had been to exit when our option lost 50% of its value, we would have exited on May 4. Second, if our plan had been to exit when a level of support was broken, again, we would have exited on May 4. In either case we would have salvaged a nice portion of our premium to use in another trade.

**Win From Your Defeats**

It is realistic for traders to expect losses. The plan is to profit well from winning trades, and protect our capital by salvaging as much as possible from losing trades, so that overall a profit is made.
You can win from your defeats by limiting the amount you lose, and learning necessary lessons that will help you better plan for future trades.

Always plan for a possible loss when setting up your trade. If you only plan for a win, you are essentially gambling, and you will suffer more losses than necessary. Have your exit strategy in place in case the market moves against you, and don’t be afraid to follow it. Learn from your mistakes, and then let them go.

"It’s elementary, my dear Watson. The clues are all in the chart."
Chapter 11

Your Broker and You

Using the principles you are learning here, you are equipped to run every aspect of your commodity trading business yourself — except for one thing: you cannot place orders with a commodity exchange yourself. You must place your orders to enter and exit positions through a licensed professional called a broker. Your broker is an integral part of your commodity business, and you’ll probably want to shop around until you find one you like. Once you’ve established a relationship with a broker, you’ll likely do all your buying and selling through that one individual, although if you’re not happy with your broker’s performance you can switch at any time.

It’s only natural to want a friendly, comfortable relationship with your broker, and there may be times when you want to discuss a trade you’re planning. And of course your broker should answer all your questions without making you feel weird about asking them. However, always remember that you are learning how to make informed trading decisions on your own. Once you feel more sure of what you’re doing — which will come as you gain more experience, beginning with paper trading — you will want to see your broker more as a colleague than an advisor.

Online vs. Full-Service Brokers

The kind of broker you choose to work with will largely reflect your own personality, your level of confidence as a trader, and how much you’re willing to pay for having your trades executed. These days, traders have the choice of performing their transactions online, or working personally with a full-service broker. Many brokerages offer both types of service. The kinds of services traders receive and the commission structure are quite different depending on whether they trade online or use a full-service broker.

Full-service brokers will give you their time and attention, will be willing to discuss your trades with you and answer your questions, and most important, will check your orders and make sure that the instructions you give in fact represent your wishes. This means they will be likely to catch, and correct, potentially costly errors. Full-service brokers also keep an eye on your orders to help you get better fills, and by keeping track of the markets they are better able to respond to changing conditions and fulfill your instructions for liquidating options in a timely manner. Your full-service broker may also keep track of approaching expiration dates and give a warning call, or may even contact you if there’s a sudden market movement that you should respond to. Of course, you will pay for this kind of service with higher commissions, but even many veteran traders prefer to work with a broker like this. They feel more confident when placing orders knowing that another
pair of eyes is checking for them. They may also appreciate the opportunity to discuss the markets with another knowledgeable person.

These days, however, especially with the widespread use of computers, many traders would rather work on their own, place their orders online, and save some money. This approach does offer some conveniences. You can place your orders outside of business hours, and you never have to talk to anyone if you don’t want to. On the other hand, whatever you type into the computer is what you will get, and no one is going to check it to see if you made a mistake. You will have to keep a close eye on the markets yourself, because no one will inform you of things it might be to your advantage to know. And you won’t get the insight of another person who has more experience than you do and may be able to give you helpful and valuable information.

If your budget is very limited, and saving money is important to you, an online brokerage may be your best choice. But do shop around. Sometimes the difference in cost between online and full-service brokerages is not that great, and one catch by a full-service broker of a potentially costly error could well make up the difference.

Never forget, however, that even if you do use a full-service broker, you are the one who is ultimately responsible for all your trading decisions. Your full-service broker is a useful backup, but you should still check all your own orders, stay on top of the markets you’re trading, and follow up with your broker to ensure that all your instructions for entering and liquidating your positions are being fulfilled the way you want.

**Opening Your Brokerage Account**

You can’t start trading with real money until you have a brokerage account opened. And it may take a while for all the paper work to be completed. So, even while you’re still paper trading, you may want to begin shopping around for a broker.

If you know other traders, you might get recommendations from them. If not, call around to a few places, and check their Web sites. Ask to talk to one or two brokers, and make sure you find someone you would like to work with before making a commitment.

After selecting a broker, the next step is to open an account at the brokerage where he or she works. You will be given a packet of forms requesting credit information; the brokerage wants to make sure that you don’t get in over your head financially. Once everything is approved, you can deposit money into your account. By getting all of this put into place ahead of time, you’ll be all set to act the moment you spot your opportunity and are ready to enter the market with real money. Some brokerages will actually pay you interest on the money you keep in your account.

The type of trading you intend to do will determine how much money a brokerage will require for you to open your account. If you only plan to trade options, you should be able to get started with perhaps $3,000 to $5,000. That’s an extremely reasonable outlay of money to get started in a business that offers so much potential for profit!
Once your account is open, you may begin feeling some pressure to trade. You may become impatient to get started, dreaming of all the profits you’re going to make. But you should never trade because you feel pressured. Only trade when you have spotted a real opportunity, you have a plan in place, and the time is right.

On the other hand, there are some people who get everything set up, and then they never act on it! They just keep studying their charts and preparing themselves, but they never actually trade. If you decide that you don’t want to trade after all, that’s fine. But, if you really do want to see what the possibilities are in trading, don’t let fear keep you from even trying. Begin with a small, simple trade in a market that doesn’t cost too much to enter, and see what happens. Your full-service broker will help you, and you will gain the confidence that only experience can provide.

**Managing Your Margin Account**

Your margin account is the life-blood of your business, so keep it healthy.

First of all, don’t put all your resources into one trade. If you have $2,000 to trade, you’re better off buying $1,000 options in two different markets, than buying one option for the full $2,000. This spreads your risk and increases your chances that one of your options will yield a profit. If the market you’re looking at only offers $2,000 options, then that market may be too expensive for you, and you should look for another one.

Now, suppose one of your options makes a huge profit. Great! Put some of your earnings aside and enter a new trade with an amount similar to your first trade. Let small, consistent profits build your trading account. With time you can buy more expensive options, or buy more than one of the same option, but at the beginning stay within your means.

Some people get so carried away with their first successes, that greed kicks in. They tell themselves, “Well, I turned $1,000 into $2,000. Now it should be no problem to turn $2,000 into $5,000, and then I’ll turn $5,000 into $15,000…” This kind of thinking leads to risky trading decisions, and more likely than not, losses.

Start over fresh with each trade, using a reasonable amount of money, and let your margin account grow. Whatever you do, don’t ever place so large a portion of your resources into one trade that you could be completely wiped out if the market moves against you.

Finally, here’s a note on a special way to manage your margin account if you trade futures contracts. If you have bought or sold a futures contract, and the market moves in your favor, the profits that build in your margin account each day are immediately available for you to use. That means that if you want to add to your position by entering another contract, you can use the profits accrued from the first contract to pay the margin on the second one. This is not possible when trading options. With options, the profits from your winning positions only become available to you after they have been liquidated.
How to Place Your Order

Brokers and traders use standard language when communicating with one another so there will be no confusion. When you’re ready to place your order to enter a position in the commodity markets your instructions will have two elements: the time element and the price element.

The time element lets your broker know how long you want your order to be in effect. Your order will not necessarily be filled right away. This is especially true if the market is not liquid, or you are very specific about the price (see the section on “Limit Orders” below). How long are you willing to wait for your order to be filled before you want to reconsider it? You have two choices for instructing your broker:

**Day Order** — This order is only good until the end of trading on the day it’s been placed. It is automatically canceled if it isn’t filled by the end of the trading session. If you want your broker to try again the following day, you must place the order again.

**Good ’Til Canceled Order** — Also known as a GTC order or an open order, it remains in effect until it is either filled, or you cancel it. These orders are convenient, but do keep track of them, or you could end up in a trade that you lost interest in a while back.

The other element of your orders to your broker concerns price:

**Market Order** — This simple order tells your broker to get you in (or out) of a trade “at the Market,” which is whatever the price is at the moment your order reaches the trading pit. You use this kind of order when getting into the market is more important to you than getting the best price.

**Limit Order** — With this type of order you tell your broker to get you in or out of the market at your specified price or better. You use a limit order when getting the price you want is more important to you than the time it takes to fulfill your order. With this type of order you will generally get a better price, but you run the risk of not having your order filled at all.

You will likely use limit orders for most of your trading. Market orders can be too dangerous in a fast-moving market. At the same time, with the strategies you’ll be learning here, getting in the market when you want can be more important than saving a bit on the premium. One way to fulfill all your aims is to offer a little more premium when buying an option, and to accept a little less premium when liquidating. The $20 to $50 more you pay (or less you receive) may be worth it to lock in a profit or limit a further loss.

The ordering process can seem confusing at first. That’s why, especially at the beginning, using a full-service broker can be a good idea and well worth the higher commissions you pay. He or she will be happy to explain the different order types, and when to use them.
A Final Word About Brokers

For many people, the thought of dealing with a broker is the most intimidating part of becoming a commodity trader. But as with anything else, once you become familiar with your broker and develop a working relationship you’ll realize there was never any reason to be nervous about it.

Your broker should be willing to help you even while you’re paper trading. If your broker refuses to give you prices and other information you need for your paper trades, find another broker. At the same time, be thoughtful of your broker’s time. If you’re paper trading, don’t call during trading hours, when your broker is placing orders for real-money trades. And even when you’re in real-money trades, it might be best to call with questions on issues like strategy after the markets are closed.

You’ll feel much more comfortable talking with your broker if you’ve studied your market carefully, you have a very clear trading plan in place, and you have a pretty good idea about how to place your order. The more practice you have with paper trading, the more confident you’ll feel when discussing your real-money trades. In chapter 13 we’ll look at how to set up paper trades so you can get all the practice you need. But first, let’s look at some of the things you need to know about the most important aspect of your commodity trading business — you!

“I’m a little absent-minded today. I have this piece of rope in my hand, and I don’t remember if I just found the rope, or I lost a horse. It’s a good thing I have a full-service broker!”
What makes someone a champion at anything? It could be a sport, some form of art, a business, the game of poker — whatever it is — given the same opportunities, and even the same basic skills, what makes some people excel while others get nowhere?

To a large extent, an individual’s psychology plays a big part in determining success or failure. This is especially true in an area like commodity trading, where the basic skills are easy to develop, and the markets offer the same opportunities to all. Qualities like patience, perseverance in the face of discouragement, the willingness to take a risk along with the level-headedness to avoid too big a risk, objectivity, not being overly emotional, possessing self-understanding — these are all psychological qualities that help traders succeed. And they can be developed. So let’s look at some of the important principles whose understanding can give your trading a psychological edge.

Begin to Question the Things Your Mind Tells You

To a large extent we live in the world our minds create. It is not events that affect us so much as it is our interpretation of events that makes us happy or sad, worried or confident. This is why the Seven Sages urged individuals to “Know thyself.” Unless we understand the way our minds influence us, we are bound to make mistakes. And because our minds tend to justify those mistakes, we will keep repeating them.

One powerful tendency of the human mind is to divide everything up into opposites. There’s always me vs. you, friend vs. foe, right vs. wrong, good vs. bad. And once we’ve defined a situation according to one of these opposites we persist with our one-sided view, and miss the big picture altogether. The consequences are that we see everything as a fight instead of a process, we become rigid in our decisions, and we miss important information that could change our decisions.

All of these consequences make us approach trading from a perspective that is contrary to the way the markets actually operate. First, the market is never a fight. The way prices move is impersonal. There’s no point to struggle and argue with the way the market goes. Our goal is simply to learn to recognize price action and go with it — not debate it! If we
made a wrong prediction, and the market proves us wrong, we can learn a lesson. But there’s no need to get emotional over it.

Next, the market is fluid, and our responses should be nimble and adaptive. Rigidity in the market is not going to lead to success in trading. The market is always right, and if it proves you wrong there’s no need to blame yourself. Just change yourself.

And finally, the market is always providing new information. A developing formation could present a warning that a change in direction is imminent. But if all you want to see is confirmation that the market will continue in your favor, you could miss the opportunity to get out of a market before the turnaround. Don’t let what you want to see keep you from seeing what’s actually there.

Your mind will play tricks on you. That’s why you have to understand how your mind works. Always question your view of the market and be alert to anything that could prove you wrong. This will give you the openness and adaptability that every successful commodity trader needs.

**Develop Your Own Trading Style**

We’ve been teaching commodity courses for over twenty years. This manual contains a combination of our knowledge and experience. We developed US Charts Online to work with the techniques and strategies you’ve learned in this manual so that you can make the best choices possible.

There are great principles of trading, but there are no formulas. New traders are always asking questions like “How do I know which is the best option to purchase?” “How do I determine whether I’m paying the right price for an option?” “When is the best time to liquidate my position?” and, “Is this the right trade for me?”

No one can answer these questions for you. Only you know your resources, your tolerance for risk, the markets you have a feel for, and your style of trading. And if you don’t know these things, it would serve you better to do the inner work to find out for yourself, than to keep searching for some “super trader” who will make all your decisions for you.

This is why it’s so critical for you to paper trade as long as you have to so you become confident in your decisions. This will give you the hands-on experience you need to not only understand the trading process, but to understand yourself as a trader. And then, after you do start trading with real money, you should start slowly so you can see how you react in different situations. This will help you with your future trading decisions.

You will likely find that your entire trading career is one big, continuous learning process. You will continue to learn about the markets and about yourself every time you make a trade. And with time you will develop your own trading style. Then you will enjoy conferring with fellow traders, but you’ll never ask the wrong questions again.
Online Tools Help You Avoid Problems of Emotional Trading

As we've seen, misdirected emotions can take a toll on traders’ energy and on their trading accounts. This is why US Charts Online continues to develop tools that use the amazing power of computers and the Internet to assist traders in making their most important market decisions.

These tools have been specifically designed to help US Charts subscribers put into practice the principles taught in this manual. Here's a quick summary of just some of these tools and the advantages they offer:

**Trend Seeker**

When looking at a chart, no one’s vision is completely objective. We often see what we want to see. And it’s easy to misread the subtle signals on a commodity chart when we’re trying to identify the direction of a trend or recognize when a breakout has occurred. Prices rise and fall continually, and it’s often difficult to tell whether we’re looking at a genuine change in trend, or if we’re simply looking at a temporary pullback before prices resume their original course.

The naked eye can be fooled. But sophisticated mathematical formulas have the ability to make determinations that most human beings can’t make on their own. The US Charts development team spent years formulating a program that could calculate the direction of a trend, measure its strength, and identify the point at which the direction of the trend changes. The product of these efforts is a unique proprietary tool called Trend Seeker.

Trend Seeker is a computerized trend analysis system that uses a combination of wave theory, market momentum, and volatility to arrive at its conclusions. Trend Seeker attempts to help you cut your losing trades early, while it gives you the confidence to let your winners run. US Charts subscribers can access all of this mathematical power simply by referring to an online table that is updated regularly.

**Interactive Charts**

Each time you return to a chart that you looked at earlier, you may see it a little differently. Unless you make careful markings on the chart and jot down notes about your entry and exit points, profit targets, and other aspects of your trading plan, you may feel like you’re starting from scratch each time you view your chart. And this is where uncertainty can creep in. Plus, who wants to spend time rethinking a trade when it’s not necessary? Or risk missing an important element you’d seen before but failed to notice the second time around?

US Charts developed Interactive Charts to help you maintain a consistent view of the markets, and keep your trading plan on track. This online feature makes charting techniques come alive for you as you turn your electronic charts into your own personal trading notebook. You can make notes, highlight formations, calculate 50% levels and risk/reward ratios, and more. And everything you put on your charts is there for you to refer to again and again, as long as the contract has not yet expired.
Interactive Charts serve an important function by helping you keep track of your thinking processes, as each time you return to a chart you’ve marked you see all the comments, calculations, and notes you’ve already made.

**Trade Tracker**

Calculating profits and losses on several contracts can be tedious, and it’s possible for mistakes to slip in. And when you’re paper trading, it may be tempting to stretch the facts a little bit to exaggerate a win or minimize a loss, which can keep you from learning all the important lessons from a trade. And if you’re busy and have a number of trades going, you may even find that some of them “slip through the cracks.”

But with US Charts Online’s Trade Tracker, this is never a problem. Trade Tracker keeps a record of all the critical information you need in order to follow your trades, and it performs all your calculations for you. Once you enter the basic information on your trades in your Trade Tracker portfolio, your profits and losses on every position are automatically recalculated throughout the trading day. You never lose track of a trade, and you always know at a glance how your account is doing.

**Ken’s Chart Book**

An excellent way to learn anything is to follow the example of an expert. And that’s what you can do when you refer to Ken’s Chart Book, a collection of personal charts maintained by me, Jim Prince (a.k.a. Trader Jim). I worked for over twelve years under the world’s leading commodity educator and founder of US Charts, Ken Roberts.

Ken’s Chart Book comes complete with my notes on exactly which markets I’m personally watching now. This gives traders the opportunity to see how an experienced commodity trader charts the markets and chooses which options to buy. Traders can build their knowledge and confidence as they follow my thinking while I find and point out which markets are in trends, explain my trading plan, and identify the options I’m looking at myself.

**Training Videos**

Ken’s Chart Book has been such a success with subscribers, that US Charts Online has gone even a step further to inaugurate weekly online Training Videos. Every Friday evening, I record a free video training lesson. These lessons are delivered right to your online account, where you can view them at your leisure.

The Weekly Training Video is an opportunity to literally look over my shoulder as I analyze charts and use the US Charts Online tools. I speak in plain English about trading strategies and explain everything in detail using current, real-life examples.

US Charts knows that even experienced traders can benefit from seeing how like-minded traders view the markets. And for traders who are new to commodities, and are unsure of their ability to correctly interpret a chart, it’s extremely helpful to watch an expert in action. My
objective approach serves as an encouraging model to traders who are trying to develop their own feel for the markets, and helps them build their charting sense and confidence.

**A Trader’s Dozen**

Now let’s look at some very practical ways to understand and use your trading psychology in making trading decisions. The more you know about why you make the choices you do, and how you can make better choices, the greater your potential for success.

Here are a dozen principles that will help you become the best trader you can be:

1. Traders who lack confidence are easily scared by unexpected market moves, and easily swayed by other people’s opinions. The way to gain confidence is to use solid principles, have a complete plan in place — including entry and exit points — before entering a trade, and getting hands-on experience with trading. Build your confidence in this way, and when people offer unsolicited advice you can listen and judge its merit for yourself, but you won’t get conflicted or feel intimidated into taking some action that you don’t really want to.

2. Stick to your plan — the plan you made in the calm before you entered the trade. It’s been said that most traders lose money trying to avoid losses. For example, they get out too soon on a temporary setback in prices. When you’re in the middle of a trade, emotions can get the better of you, causing you to bail out too soon when prices are moving against you, or hang on too long in a market that’s moving in your favor. If you’re not staying aware of yourself, your carefully thought-out exit strategy can go out the window when you fear a big loss, or greed kicks in and you decide to hold on a little longer and squeeze a little more profit out of a trade. Treat your trading as a business and stick to your plan. If you have a loss, learn from it so you’ll know better for next time. If you make a profit, be glad for it and don’t chastise yourself for not making more. Steady gains — not the big kill — are the bread and butter of your commodity business. Changing plans in mid-trade and in the heat of emotion is never a good policy.

3. Don’t get overconfident. Of course it’s a thrill to receive your first profit statement. But having one or two successful trades doesn’t make you an invincible market expert. Stick with your principles, make trades you can afford, and never stop learning. Approach the markets with humility, and you are less likely to be humiliated by them.

4. Don’t overtrade. Some traders become so anxious not to miss a move that they get into too many trades, and they get in too early for fear of missing out on the move altogether. Be patient and watch your charts for the solid formations that lead to bigger moves, and bigger profits. You can lose money unnecessarily by trying to catch too many little moves. And some traders who see they missed an entry into a potentially profitable move make the
mistake of “chasing a market” — they just jump on without waiting for the right signals. Wait for all the signs to line up before entering the market.

5. Don’t trust the naked eye. It’s not always easy to recognize a change in trend. Rising prices off a low could just be a temporary rally before the downtrend continues; falling prices off a high could just be a temporary setback before the uptrend continues. When we’re eager to get in on the ground floor of a new major move, we can convince ourselves that we see a turnaround that isn’t really there. And if we want to stay in a profitable trade, we can see a minor setback where there really is a change in trend. So always check what you think you see with US Charts’ Trend Seeker. Let it tell you the direction of the trend and go by that. A pilot learns to trust his instruments, and so should you.

6. Many traders have learned from hard experience that prices can always go higher (or lower) than you think. When traders are scared, they’ll buy or sell at any price, pushing the market farther than they thought possible. So don’t ever feel confident that you’ve found a bottom or a top, and then rush into a trade for fear of missing it. Only trade on solid formations.

7. Always get the bigger picture. Looking at the daily chart doesn’t give you enough information to know where a market may be headed. Check the weekly and monthly charts before setting up your trading plan. That’s where you’ll find your biggest opportunities shaping up — the trades with the greatest profit potential long term. With this information, you can set reasonable profit targets which can help you choose the best market to trade if more than one is looking attractive to you.

8. Your hardest trading decision is not when to enter the market (Trend Seeker can help you with that), but when to liquidate your position, especially when you’re in a profitable trade. Knowing when to take profits is a problem for many traders. It feels bad to sell too soon, and then watch prices take off without you, and equally bad to sell too late, and end up watching profits that you’d made drain away, maybe even leaving you with a loss (as when a profitable option that you failed to liquidate in time becomes worthless on expiration day). We keep harping on it, but it’s an important point: have your exit plan in place before you enter the market!

9. Keep a record of your trades — paper and real money. At the end of each trade, print out the chart and mark on it where you entered and where you exited. Keep all your charts together in a trade log, and refer to it when you need to. Price patterns repeat themselves again and again. Comparing one of your old trades with a current market can help you set up your trading plan.

10. US Charts Counselors often hear from subscribers who want to know if there’s a template they can lay over their charts that will tell them exactly when to buy and sell. But this would be impossible. Trading is really more of an art than a science, and every trader is different. And while similar patterns
appear on charts, every chart is unique. To master the principles of technical trading you have to do your own work. Your experience will show you the intricacies of price movement that you can use to make your own trading decisions.

11. Be patient, and don't get discouraged. Everyone makes mistakes, and big profits don't happen overnight. Just keep working at it, studying your charts, paper trading, and then beginning with small trades that you can afford.

12. Be prepared to work, and take advantage of all the help available to you through US Charts Online, including the weekly updates, training videos, and more. Trading commodities is not rocket science. Put in a reasonable amount of effort, and you will see results.

Understanding all these points will help you keep the right perspective on commodity trading. But there's one more thing to keep in mind: Always remember to have fun. You're learning how to trade commodities to improve your life — not only financially, but in terms of taking on a new challenge that is interesting and satisfying. With the right attitude toward trading, you will experience many rewards.

Now that we've looked at the psychology of trading, we're ready to move on to the business of running your own commodity business.

"Interpreting dreams is okay. But interpreting commodity charts — now that's a challenge I can sink my teeth into."
• Chapter 13 •

The Business of Running Your Own Commodity Trading Business

If you’ve learned all the information we looked at so far, you have all the basic knowledge you need to run your own commodity trading business. You know how to examine your charts and use the tools on US Charts Online to help you select markets and make trading decisions. And you know how to plan strategy, place orders with your broker, and enter and exit your positions. In no time at all you will be ready to get started trading the markets and pursuing all the opportunities they offer.

There are just a few more practical matters we need to discuss about running your business. And, most important, we’ll give you some instructions on paper trading — a method that enables you to practice everything you’ve learned so far and perfect your technique before risking even one dime of real money.

How to Get to Carnegie Hall

Knowledge and action are two different things. You can talk about strategy all night, but until you plan a trade in a real market, and watch what happens as time passes and the market actually unfolds, you haven’t really mastered anything.

The old story tells us that if you want to know how to get to Carnegie Hall, the answer is very simple: practice! It’s the same with commodity trading. If you want to become a commodity virtuoso, you have to practice, and fortunately there’s a very simple way to do it. It’s called paper trading.

When you paper trade you examine the markets, choose one to trade, plan your entry and exit strategy, record the price on the day you “enter” your position, follow prices as they develop after that, record the price on the day you “exit,” and calculate your profit and loss — all on paper. You never actually place the order or risk any money at all.

Paper trading isn’t an exact replica of a real trade. Because of slippage in real markets, you can’t know for sure what your entry or exit price would have been in an actual trade. And emotions play a bigger factor in real-money trades as compared to paper trades. Even so, there’s no better or safer way to learn this business. And you’d be surprised how emotions can affect you even when you have no money at stake — a good foretaste of what will happen in a real-money trade.
It’s advisable to paper trade for as long as you have to until you feel completely comfortable with all aspects of trading and you consistently make profits on your practice trades. Even after you begin to make real-money trades, you may want to continue paper trading. Many veteran traders continue paper trading when they want to try out a new method of trading, or they want to learn the characteristics of a new market. Every trader occasionally hits a slump, and when that happens, paper trading is a great way to get back on track. It’s an opportunity to review techniques and principles that may have been forgotten.

Paper trading gives you the opportunity to learn many valuable lessons. It gives you the chance to see how accurate you are in making market predictions, and gives you practice with the different tools that US Charts Online provides. If you’re having problems, paper trading can help you pinpoint what you’re doing wrong and develop techniques that can improve your success. Through paper trading you can get a feel for how quickly markets move and what you need to do to adapt yourself to surprising price action. You can see how you handle losses, and whether you have the money and the discipline to hold your position in a market that’s temporarily moving against you. And if the market is moving your way, you can see whether you have the willpower to stick with your initial exit plan, or if you’re tempted to hang on so you can squeeze the last penny out of the trade. And if you do, it shows you whether you were able to make more profit, or if you lost as a result.

Follow through on all your paper trades until their conclusion, which is the point at which you exit your position. Then calculate your profits and losses (Trade Tracker will do this for you if you enter the trade into your portfolio). While you’re paper trading, you may feel tempted to cheat so it looks like your trade came out better than it did — but don’t yield to the temptation. The only one you’re cheating is yourself. It’s often said that we learn more from our errors than from our successes, and it’s true. So don’t hide your mistakes; analyze them. After all, you won’t have the luxury of changing your decisions after the fact when you’re trading with real money. Learn the lessons from your practice trades. That’s why you’re doing them. You want to learn from your paper trading losses so you can minimize your real-money losses in the future.

No one has to see your paper trading records but you, so there’s no one you have to impress. Just keep an honest record and learn everything you can. And once again, do not begin trading with real money until you are making consistent profits on paper. However, also always keep in mind that being a successful paper trader during one time period does not guarantee that you will make money when you actually invest during a later time period. Market conditions constantly change.

**One for the Records**

Every trader needs to keep accurate records, and paper trading gives you the opportunity to try out several different methods and find the one that works best for you. Some people like to keep highly detailed records, and they refer to them often. They keep track of their thinking and why they made the decisions they did. Others are satisfied with just the basic facts of a trade. You have to learn for yourself what kind of records fit your style.
And be sure to take some help from US Charts Online’s Trade Tracker. This easy-to-use online portfolio keeps a record of all the critical information you need to follow your trades. It even performs all your calculations for you. Just print out the page at the end of a trade to keep a permanent record.

Also, you can use US Charts Online’s Interactive Charts to mark the formations and make your notes on strategy, entry and exit points, and profit/loss, all in one place. Print out the marked-up chart and put it in your Trade Log and you’ll have a quick and easy way to maintain a history of all your trades.

**Only Trade Markets You Can Afford**

When you start up a new business, you have to consider your resources and determine what kind of inventory you can afford to carry. For example, if you’re opening a wine shop, you may have to start with some moderately priced vintages, and a few more expensive ones, but you would have to wait to build your business before you could afford to carry bottles worth several hundred dollars. It’s the same with your new commodity business. Some markets are just more expensive than others. For example, you would have to be backed by huge resources to trade the S&P 500. On the other hand, Oats is generally one of the least expensive markets to trade. You have to take this into consideration and only trade markets that you can afford.

One factor that can affect the affordability of markets is volatility. The more volatile a market is, the more expensive it will be to trade. So look at your budget before selecting your market, especially if your strategy is to purchase more than one option so that you can liquidate them at different profit targets.

If you want to learn about more expensive markets, paper trade them as much as you like. But for your real-money trades, keep to the markets that you can comfortably afford. As you gain more experience, and hopefully start making profitable trades, you can afford more expensive markets. But always stay within your comfort zone.

**Have a Plan, From Start to Finish**

As we keep saying — and it bears repeating — you should always have a trade completely mapped out before you enter the market. Your plan should involve at least the following steps:

1. Using a set of charts, and the technical principles you’re learning here, select a market that’s offering a good profit opportunity. Confirm your analysis with Trend Seeker.

2. Plan on the signals you will look for to tell you it’s time to enter the market, and determine how you will trade it (e.g., with put or call options — and at what price; with futures contracts, etc.).

3. Decide what kind of order you will place (e.g., market order or limit order), and place your order with your broker.
4. Plan ahead of time the signals you will look for to tell when to add to your position or exit your trade. Always have an exit strategy to preserve your profits or get out of a losing trade.

Once you’ve decided on a plan, stick to it. You’re making these plans with a calm head, before entering the trade, because these decisions will be much more sensible than those you would make once you’re in a trade and your emotions kick in. When you’re in a market that’s going your way and looks like it will never stop, it’s hard to see a good exit point. And when you’re in a trade that’s moving against you, it’s easy to just want to get out, without realizing this could be a minor setback that will soon right itself. Your original plan should have taken all these possibilities into account, and it’s best to stick with it. If it turns out that your original plan was faulty, that’s an important lesson to learn and remember for next time, but you’ll never know if it was faulty or not unless you stick with it.

Also, your plan will help you keep on course in the face of news reports based on fundamental factors that you may find disturbing, or the comments of your friends (“You’re going to trade what???”). Unless you trust your plan, it’s easy to be swayed. That’s where experience — even paper-trading experience — can help give you stick-to-it-iveness. Once you see for yourself that the technical principles you’re learning here really work, you’re less likely to be confused by your own emotions, or anyone else’s opinion.

Some Final Words

Many people have run their own successful commodity trading businesses from their homes, just as you have learned to do here. They have seen for themselves the many advantages it offers:

- It’s interesting, fun, and challenging
- It only takes about half an hour a day to run
- You can go at your own pace, starting out as slowly or fast as feels comfortable, and devoting as much or as little time to it as you want
- You can start with limited resources
- Using the principles of technical trading, you have the potential to make large profits

As with any business, running your own commodity trading business requires an initial outlay of money, along with learning basic principles, and practicing what you learn. But compared to most other businesses that people try, the outlay of money is relatively small, the training doesn’t take long, and practicing is simple, interesting, and doesn’t require you to put any money at risk.

Before you start trading with real money, put in the time to master all the information in this manual, and be sure to practice paper trading until your hypothetical trades are yielding consistent profits.
When you’re ready, start with small trades. And keep in mind that no one makes a profit on every trade. You are bound to have losses, but you can learn from all of them and become a better trader. Handle your resources with care, and you will be able to weather your losses. You will find that the gains on your profitable trades can return your money many times over. Keep track of your wins and losses, and if you’re not making a profit overall, rethink your strategy and start paper trading again.

If you’ve gone over the sample trades we’ve presented, and paper traded on your own, you should now be aware of the amazing profit potential in commodity trading. And you’ve also received invaluable information on running your own commodity trading business and understanding the psychology of trading. Right now you’re probably filled with enthusiasm, so don’t waste all that good energy. Keep following the markets and get ready to go out and do this on your own.

But of course, you won’t be completely alone. When trading commodity options, information is key. To help you we provide the following great tools to get you started:

- Weekly e-mailed Alerts that keep you up on the latest market developments
- Weekly online training videos
- Ken’s Chart Book, which shows you the chart formations we’re watching, marked with our own notes and trading plans
- Our Online Help features that show you how to get the most out of all the great trading tools on the Web site
- Premium Alert Service™. Look over my shoulder as I analyze the markets for trading opportunities on a daily basis.
- Our hand-picked team of US Charts Counselors, ready to give you help and encouragement when you need it. Call with your questions any trading day from 8:30am to 5pm Pacific Time

As a final reminder, throughout this manual we presented sample trades that were chosen to demonstrate the successful use of the principles you learned here. But in actual trading, not all trades end up with a profit. In some cases, the best you can do is minimize your losses. This is why you have to stay on top of your trades and know how they’re going so you can take appropriate action when necessary. There’s no substitute for practicing with all the techniques you’ve learned here to build your skills and develop trading confidence. Your experiences with paper trading will show you the importance of developing a sound plan, and sticking with it. Always use your resources wisely, don’t get ahead of yourself, pay attention to what you’re doing, use your common sense, and start slowly while you build your trading muscles.

Wonderful opportunities are awaiting you in the futures markets. And you now have the knowledge and techniques that you can use to begin taking advantage of them. Put everything you’ve learned here into practice to start your own commodity trading
business, and one day you may know for yourself the satisfaction that comes from having taken your future into your own hands.

“Ah yes, another hard day at the office.”