

Jake Bernstein's Online Trading Courses

Course #1 Basic Training/ Getting Started

Lesson #1 Background of Futures Trading

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Course #1

Basic Training/Getting Started

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Background of Futures Trading

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Jake Bernstein's Course #1 -- Basic Training/Getting Started

Lesson #1 -- Background of Futures Trading

Introductory Comments

For many years futures trading has been considered either too risky or too sophisticated for the average investor.

Most myths are born of ignorance, and the futures myth is no exception. For all too long, futures trading was either ignored or shunned in economics texts and, as a consequence, the general public was not educated in the basics of futures. No informed choice could, therefore, be made.

Investments in securities, stocks, bonds and even stock options, however, received considerable attention. It is generally believed that trading in stocks has more historical justification and, therefore, more value in an economic education.

There are, in addition, a number of other reasons for the historically diminutive role of futures trading, few of which are valid.

Generally, objections to futures trading are based on either partial or distorted facts. So, before launching into an explanation of precisely what futures trading is, it may be necessary to clear the decks of any misconceptions you may hold.

First, let's examine some of the standard objections to futures trading, so that we may have a relatively clean slate upon which to write the new learning.

Let's take a look at a few of these misconceptions.

1. "You Can Lose All You've Invested, or More, if You Trade in Futures."

This is true. However, the key word is invested. Trading futures should in no way, shape or form be considered an investment. As a speculation, however, the rules of the game become distinctly different -- high risk is necessary for high reward.

Nevertheless, even 'high risk' does not mean that the common sense rules of good trading and money management (to be taught in this course) should be ignored.

It has been demonstrated clearly that a balanced investment portfolio consisting both of stocks and futures performs better, on average, than a portfolio consisting exclusively of stocks.

2. "Trading in Futures is a Gamble."

This is another misconception. In fact, trading in futures is, technically and fundamentally, no different from trading in stocks.

The odds of being right or wrong are essentially similar. However, due to lower margins, the odds of making money in futures are probably lower than those of making money in stocks.

Ultimately, though, the possible percentage return in futures trading is considerably greater than the potential return in stocks. Futures trading is, therefore, no more of a gamble than trading in stocks.

Carefully and closely following the rules of successful futures trading will help reduce the risk and gamble.

**3. “Futures Trading is for Insiders. It’s a Rigged Game.”
(Markets are Manipulated.)**

These two misconceptions go hand in hand

There is probably less inside information available in futures than there is in the stock market. The United States Department of Agriculture, the Commodity Futures Trading Commission and the National Futures Association have all imposed very stringent limits on the total number of positions a trader may hold.

They monitor the brokerage industry and large trader transactions very closely. Important government information is guarded and kept strictly secret until the scheduled release date and time.

In this way, the markets can function freely and with minimal effects of insider information. In fact, most markets cannot be manipulated for other than perhaps very brief periods of time. This is because they are too complex and diverse for any one individual or group to affect prices over the long run.

Unavoidably, some traders will always have an edge based on inside information, but success in the futures market is very possible without access to such information.

**4. “Trading in Futures Serves No Economic Purpose.
It’s a Gamble, Pure Speculation.”**

This popular misconception couldn’t be farther from the truth. The futures markets serve to stabilize prices. In fact, we often forget that futures markets in the U.S. were originally created to protect the farmer from volatile price moves.

In today’s markets this same price protection is needed by farmers, food companies, banks and many other large institutions, often referred to as ‘hedgers.’ The speculators provide liquidity and are often willing to take market positions when prices are fluctuating significantly due to news, weather, crop conditions, etc. This stabilizes prices by providing additional buyers and sellers to buffer extreme moves.

Were it not for the speculator, prices would move more viciously, and the hedgers could not enter and exit the market as efficiently. And, were it not for speculators buying and selling regardless of price levels, the markets would be subject to great volatility.

Supplies would stand a good chance of being disrupted and unstable. One probable reason for the Soviet Union’s demise was its lack of a delivery and exchange system for its commodities. A functional futures market would have contributed considerable stability to its economic system while also reducing producer and consumer dissatisfaction.

5. “Futures Trading is Only for the Short Term.”

This is also incorrect. Futures trading can be either long term, intermediate term, and/or short term depending upon the orientation of the trader.

In fact, some of the most successful futures traders -- referred to as 'position traders' hold their positions for an intermediate- to long-term period of time. The particular time horizon or time frame that a trader adopts is an individual choice, which does not necessarily have to be short term to be prosperous.

Many other misconceptions and misunderstandings plague futures trading -- all bred out of either partial information or ignorance.

One-by-one, these myths will be unveiled and corrected as your understanding of futures markets and futures trading increases. Now that a few of the major myths have been revealed, we can move on to the basics of futures trading.

Evolution of the Futures Markets

Trading in futures had its origin in the development of grain trading in the United States in the mid-1800s.

The Japanese futures exchange began over a hundred years earlier than it did in the U.S. Their methods of trading in the silk and rice markets, as well as the English methods of trading iron warrants, were precedents to the United States futures markets.

The practice of futures trading in the United States evolved naturally from the need to protect against volatile price moves in physical grain products. Chicago took the leading role as the center of grain futures trading.

The Midwest is the heart of a rich and vast agricultural region and, since Chicago is strategically situated as a shipping center, it was a natural site for grain trading. The Mississippi River and its tributaries were available to move grain and later, in conjunction with the railroads, commerce in the grain markets flourished.

The Chicago Board of Trade was organized in 1848 and actually began trading about 1859. It was formed to meet the needs of producers (farmers) and exporters in order to systematically manage their risk and exposure to unknown elements such as weather, political events and economic uncertainty.

The concept of hedging, upon which the futures markets are based, became widely used and continues today to serve as a valuable tool for risk management.

What Is Hedging?

The concept of hedging is based upon the assumption that movement in cash and futures prices will parallel each other in movement after due allowance has been made for any seasonal or other trend in the cash market.

In essence, the goal of the hedger is to lock in an approximate future price in order to eliminate his risk of exposure to interim price fluctuations. The best way to understand hedging and the futures market is by example. I will assume that you have no understanding of the futures market.

Suppose You are a Grain Farmer

It becomes hot and dry. Rain is scarce in most parts of the country, and some of the large grain-processing firms become concerned about what will happen to corn prices several months in the future as the heat and drought damage take their toll on the crop.

In your area however, weather is fine. You grow corn. Your crop has been planted and the summer has not been too bad and moisture has been sufficient. Your crops are quite good, in fact.

The grain-processing concerns such as large baking companies, animal feed manufacturers, food processors, vegetable oil producers and other related concerns begin to buy corn from farmers and grain firms who have it in storage from previous years. Their buying is considerable due to their immense needs. Simple economics tells us that the price of corn will rise as the supply falls.

Prices begin to rise dramatically in what is called the **'cash market.'** This is the immediate or day-to-day market. Another term for the cash market is the **'spot market.'** It is so termed because it refers to transactions made on the spot, that is, for immediate delivery, not for delivery at some point in the future.

Assume that you know the cost of production for your corn. In other words, you've taken into consideration your fertilizer, fuel, land, labor and additional costs. You conclude that it costs you \$1.85 to produce each bushel of corn.

Your call to the local grain terminal -- where cash corn is bought and sold -- tells you that today cash corn is selling for \$3.25 per bushel. You know that only two weeks ago it was at \$3.00 per bushel and three months ago it was going for \$2.75.

You know you will be producing over 50,000 bushels of corn this year and, as a consequence, the price difference between what the market was several months ago and today's price is considerable. In fact, it runs into thousands of dollars.

What are Your Options?

You know that by the time your crop has been harvested, prices may be back down again.

What could force prices back down?

Many things could happen. The government could release grain from its reserves to drive prices down; foreign production could be larger than expected making the U.S. crop reduction less important or weather could improve significantly, lessening the impact of the problem. Demand could decline and the grain companies might sell from some of the supplies they've accumulated.

Regardless of what actually happens, you've decided that you want to sell your crop at the current price.

You Can Do Either of Two Things

- **You can enter into a forward contract with a grain firm.**

This contract is made between you and a grain processor or elevator. (These firms are known as 'commercials'.)

They will quote you a price for your crop to be delivered to them at some point in the future, usually shortly after harvest. Often, their price is not as high as the market's current trading level. Or,

- **As an alternative, you could sell your crop on the futures market.**

The futures markets are organized exchanges or marketplaces where many individuals congregate for the purpose of buying and selling contracts in given markets for future delivery and/or for speculation.

Prices there will be relatively free of manipulation by large commercial interests, which may have almost complete control over what you will be paid in your hometown area for your crop. Provided your corn meets the proper exchange specifications, you can sell it in advance on the futures exchange.

You will not get your money until the crop is delivered to the buyer, but the price you get will be locked in. Regardless of where the price goes thereafter you will be guaranteed the price at which you sold your crop.

You Could Win or Lose

If the cash market is higher by the time the crop is ready, you will not make as much as you might have.

If the price is lower, then you are fortunate to have sold prior to the decline.

Of course, you have the option of doing nothing, hoping that corn will be much higher at some point in the future.

The essence of the futures market vehicle is, its use as a tool by which the producer and end-user can hedge or protect profits.

Futures are ideal hedges against rising or falling prices.

What's in it for the Players?

Who takes the other side of the futures transaction and why? In other words:

- **Who will buy the grain from you?**
- **Why will they buy it?**
- **What will they do with it?**
- **How will they sell it if they change their mind?**

The Three Categories of “Players” in the Futures Game and their Roles

Producers

These individuals and/or firms actually produce or process the commodity that is being traded.

Whether it be silver, gold, petroleum, corn, live cattle, lumber, sugar or currencies, these are the people who make the goods available either by mining them, harvesting them, raising them, growing them or lending them.

They need to lock in costs. In other words, they have a product they want to sell at a determined price. They may do this in order to guarantee a profit on an actual commodity they have on hand or have produced, or they may want to lock in a price on an item in order to avoid losing more money on it if it is already declining.

Finally, they may not have the goods at all. Rather they may be protecting themselves from a possible side effect of declining or rising prices.

For example, a jewelry store with considerable gold and silver jewelry on hand may fear a decline in the price of precious metals. They stand to lose money on their inventory as prices decline. Therefore, they may choose to sell futures contracts of silver and/or gold in expectation of the decline. Thus, they have profited from the futures sale.

End-Users

These are the people who will use the stuff that's sold by producers. They need to lock in the cost of their production by advance purchase of raw goods.

Therefore, they will buy either on the futures market or they may make a forward contract (previously defined). At times, the end-user may become a seller as opposed to a buyer.

Assume, for example, that too much has been purchased or that the final product is not selling well. In such an event, the end-user may switch to the sell side.

The producer may, at times, switch sides as well.

Assume the producer does not have enough production to meet obligations to others. The producer may then become a buyer as opposed to a seller. As you can see, roles in futures trading can change.

Speculators

This is the largest group of futures traders. These people are sandwiched between the end-user and the producer, providing a market buffer.

Perhaps no more than one to three percent of all futures contracts is actually completed by delivery. The balance is closed out before any actual exchange of goods occurs.

Suffice it to say that speculators are often willing to take risks in markets at times and at prices that may not be attractive to the other two groups.

Speculators do this in expectation of large percentage profit returns on price fluctuations.

The chart below shows the general relationship between the three basic groups of market participants. More details will be given as your understanding of basic concepts increases.

Players in the Futures Markets & their Usual Roles		
■ Producers	Sell to lock in profits.	<ul style="list-style-type: none">• Can buy at times.• Are usually farmers, banks, mining firms, manufacturers, etc.• Often called 'hedgers.'
■ Speculators	Buy or sell to make a profit, but not to use the actual goods or products.	<ul style="list-style-type: none">• Often called 'traders' (among other things).• Do not take delivery of the goods.• Often trade for short-term swings.
■ End-Users	Buy in order to use the product in their processing or business concern.	<ul style="list-style-type: none">• Can be sellers at times.• May not actually use the goods they buy.

For now, I'll spare you specifics of **how** futures contracts work. These mechanical things will be learned later. What I want you to learn now are **the concepts of futures trading**.

The basic issue is, of course, **why trade?**

Summary

The futures markets operate on very specific factors which, when, understood, can allow you to trade profitably. To understand the markets, you must learn the underlying structure and functions of commodity trading.

Why Traders Trade

At first glance, the answer to this question is obvious. The simple fact of the matter is that traders trade, or participate in markets, in order to make profits. But there are many aspects to this simple answer.

Let's look at a few of the most significant reasons for trading futures:

1. Futures Trading Requires Relatively Small Start-Up Capital

Typically, one can get started in futures trading for as little as \$10,000. In some cases less capital is required. Many professionally managed trading pools require from \$2,500 to \$5,000 for participation. While most traders are not successful when starting with limited capital, this is one way to get your foot in the door.

Futures options trading requires even less capital. Therefore, it is possible for the individual to begin with an even smaller amount of capital. In most other areas, considerably greater capital is required.

The small amount of capital can work for or against you -- most often against you.

2. Leverage is Immense

The typical futures contract can be bought or sold for one to three percent of its total value. For example, a 100-troy-ounce gold contract at \$400 per ounce (\$40,000 cash value) can be bought for about \$1,500-\$2,000.

The balance of the money will, of course, be due if and when the contract is completed (i.e., when you take delivery).

In the meantime, about \$2,000 is controlling \$40,000. In Treasury Bill futures, the contract size is \$1 million and the margin is about \$2,500. In other words, you have immense potential using small amounts of money.

This can work for or against you. It is the goal of the futures trader to make leverage work in his or her favor.

3. Futures Markets Make Big Moves

Prices fluctuate dramatically almost every day. There is considerable opportunity to win or lose daily in futures trading. Many markets will permit potential returns of 100% or more per day on the required margin money (i.e., money required to buy or sell a contract).

This, too, can work for or against you. Where there is great opportunity, there is often great risk as well.

4. Futures Markets are Very Liquid

By this I mean that it is possible to get into or out of a market very quickly. This is not so with many stock and real estate investments. Some speculative stocks rarely trade, and real estate is often hard to dispose of quickly.

With futures transactions, as with active stock transactions, one can enter and exit within minutes, or even seconds. This makes the market 'ideal' for the speculator with limited capital.

It is possible for the individual to begin with an even smaller amount of capital. In most other areas considerably greater capital is required. The small amount of capital can work for or against you -- most often against you.

5. There are not Many Secrets to Successful Trading

In some areas of investment, you need to know either the right people or the right inside information. While correct inside information can be very helpful in trading futures, success does not depend on such information. There are few secrets to successful trading.

Good trading is a skill that can be learned and, in fact, be taught very specifically, objectively and successfully to those willing and able to learn. Virtually any individual with speculative capital, self-discipline and the motivation to succeed has an opportunity to do so in the futures markets -- but it's not easy.

6. There are Many Futures Vehicles

In addition to the traditional buy and sell short positions, there are many vehicles in futures trading. These include options, spreads, option spreads, futures versus options positions and combinations of the above.

Summary

The bottom line of all futures trading is to either make money or to keep from losing it. The futures markets provide an excellent vehicle for doing this.

Additional Uses of the Futures Markets

This course has, to this point, briefly outlined preliminary concepts and applications of futures trading. Naturally, as a vehicle for speculating, hedging, or spreading risk, futures trading has significant importance. As a vehicle for stabilizing costs to producers and end-users, futures trading is a vital tool.

On a more pervasive level, however, an understanding of futures trading can prove very valuable to the investor not interested in actually trading futures.

This course gives considerable attention to the hypothesis that a knowledge of futures price trends and futures market behavior can assist one in understanding economic trends as well as in forecasting the short-term to intermediate-term direction of prices. There may also be long-range implications for investors.

Conclusions

- **Futures trading is a technique whereby one can buy and/or sell a variety of raw and processed commodity items, including financial instruments and stock indices, for anticipated delivery at some point in the future.**
- **There are three major categories of participants in the futures markets, each with their own expectations, goals and market methods.**
- **Futures trading allows producers and end-users to lock in costs of production, improving economic stability as well as the stability of their particular business.**
- **Speculators, by far the largest category of traders, have no interest in making or taking delivery. Rather, their interest is in playing market swings for dollar profits.**
- **There are many common objections to futures trading. Some have merit, others are not well-founded.**
- **There are specific methods, systems and procedures used in futures trading designed to reduce its inherent risk, a majority of which have been time-tested.**
- **Futures trading involves considerable risk. However, this risk can be greatly reduced by consistent application of various principles.**
- **Futures trading can be an excellent vehicle for immense profit, or it can be a dangerous tool for financial ruin. Those who win often attribute their success to an attitude, which reflects self-discipline, courage, consistency, persistence, specific trading techniques and a willingness to learn from mistakes.**

Dealing with Basic Issues First

The goal of profits in futures trading can be achieved through many ways -- long-term trading, short-term trading, speculating on an intraday basis, spreading, options trading, option spreads, floor trading, as a broker or by a combination of these strategies. In addition, there are many vehicles which can lead you toward, or away from your goals.

How Will You Achieve Your Goal?

You must make some important decisions as to how you will achieve your goals. Some of these decisions can be made based on your present knowledge. Others, however, cannot be made until you have a broader understanding of the field.

I would suggest that even if you feel you already know the answers to these issues, you come back and reread this section after you have finished reading the entire text in this course. In future sections, I will revive some of these pressing issues, providing you with some suggestions as to their resolution.

The Vehicle

Many vehicles can take you to your goal. Some will lead you in the right direction, whereas others will take you in the wrong direction. These vehicles are the systems and methods of futures trading.

I can't tell you which system is best for you. All I can do is to acquaint you with the various methods and with the guidelines for deciding which techniques are best for you.

The performance of trading systems is not static. Systems go through good times as well as bad. Traders go through good times as well as bad. Traders and systems interact in a complex combination.

I can't give you the ultimate answers, but I can acquaint you with the tools. I can give you the knowledge to help you make your own decisions based upon the facts. As you read the remainder of this course, keep your mind tuned to the issues I have just raised, looking for answers as you go. Assuming that you have already had some experience in this area, you will recognize the answers more easily.

The Fuel

The energy that drives the wheel of successful speculation is good old-fashioned money.

To make it, you have to have it, and to multiply it you have to use it wisely. You know the risk is immense and that the odds are stacked against you. Your chances of making it in the competitive world of futures trading are probably five or ten in 100, but they are reduced to zero by starting with nothing.

Successful speculation is not a get-rich-quick scheme, a no-money-down real estate venture or a 15-million-to-one odds lottery ticket. The facts of futures trading dictate very clearly that the more you start with, the greater your chance of success and the less you start with, the greater your chance of failure.

“How much is enough?” you ask.

I can give you some guidelines. Based on current conditions in the futures market, the beginner should have sufficient capital to meet liberal margin requirements on at least five contracts in the futures market.

If we assume, for example, that the average margin on a futures contract is \$2,500, then we are looking at approximately \$12,500 in speculative capital. I don't think it is realistic for you to expect success if you begin with less.

Don't be fooled!

Some individuals will tell you that you need virtually nothing in the way of starting capital, whereas others will tell you need much, much more. I won't argue the fact that the more you have to start with the better your odds of success, however, there is a limit on the downside.

Certainly you must consider the fact that you don't want to risk everything. When someone asks me how much he or she should risk in futures trading, I answer the question with a question. I ask, “How much can you afford to lose?” One answer might be \$10,000. I respond, “Take this slip of paper on which I have written \$10,000. Rip it into shreds. Flush it down the toilet. How do you feel?”

This small test represents a little experiment that may help you determine how much you can afford to lose in the futures market without too serious an emotional reaction to the consequences.

Financially, the answer is different. How much can you afford to lose from this standpoint? I would suggest that as a rule of thumb, you risk not more than 25 % of your total liquid risk capital!

Don't Borrow Your Starting Capital

Let me caution you against a practice I have witnessed on a number of occasions during my years in the futures market. It has become more and more common for individuals to borrow money in order

to speculate in futures. Specifically, second mortgages or home equity loans are often used for this purpose.

I recommend you do not consider this foolish behavior. There is no sound judgment in such behavior and the results of such actions can be disastrous.

The individual not only places him or herself at financial risk, but jeopardizes his or her trading by using funds that should not and cannot be placed at risk.

Certainly it takes no great insight to see that the trading decisions of the speculator will be based on fear and this will seriously affect his or her judgment.

Another pitfall to avoid is the following mental trap: "I'll put more money into my account than I intend to lose, but the rest will draw interest and, of course, I will watch the money closely." As I explained, this is a rationalization based on unrealistic thinking.

Even with the best intentions, when "extra" money is in the account, chances are it will be used for trading. Put into your account only what you can afford to lose in its entirety.

Don't be fooled by the lure of interest rate earnings on the unused funds, especially low-risk trading programs, fail-safe programs, "no risk" option strategies, minimal risk spreading programs and a host of other seemingly simple "minimal risk" programs.

I've seen them come and I've seen them go. There are some big winners, but there are many, many more big losers. Do not accept the claims of any trading system, your own or that of someone else, as the basis for deciding how much of your money you will place at risk.

Reach Your Goal by Stages

The most fruitful and consistent means to achieve a goal is through stages or steps. Unfortunately, or perhaps fortunately, our dimension in time and space does not permit thoughts to become actions instantaneously and, therefore, goals must be attained slowly.

Whether you decide to trade for the short, intermediate or long term, it is advisable that you regularly withdraw profits from your account once you have reached a certain level of successful performance.

Generally, I recommend 10 to 25% of profits be removed from every winning trade in your account. This need not be done on a trade-by-trade basis. You can do it weekly or perhaps bimonthly, but remember to do it!

More speculators would be successful if they approached futures trading as though it were a business. After a period of teaming and initial cost, a business that reaches the point of profitable operation will generate income for its operators. The profits are then taken and employed in some other fashion not directly connected with the business itself. Some of the other profits are turned back into the business in order to expand its base.

It is the same with futures trading. On occasion, speculators have achieved tremendous initial growth in their accounts. Lured by greed and the promise of even greater profits, they have plowed every penny, if not more, back into the market, only to lose it all. When all is said and done, they have nothing to show for their great efforts.

This is why you must formulate and institute a specific program for systematically removing a percentage of your profits from your, trading account. This rule is applicable whether you are speculating for the long-, short- or an intermediate-term time frame.

Other Important Issues

In addition to the points just raised, a number of important issues warrant attention from all aspiring futures traders, regardless of their eventual orientation, system, or trading methodology.

Trade Alone or With a Partner?

There are pros and cons to each alternative. If you trade alone, there will be no one to help you with your work (unless you hire employees) and there will be no one who can trade for you in your absence. Furthermore, there will be no one with whom you can discuss various markets, indicators, techniques and trades.

To those individuals who need this type of assistance, a partner or well-trained assistant might be desirable. However, before you make such decisions consider the potential negatives of having a partner.

Too Many Cooks Spoil the Broth

Futures trading is a 'loner's game'. Sometimes a partner or partners will get in your way. You may be influenced to avoid some trades you should have made and to make some trades you should have avoided.

Who's Responsible?

It is always good to know that you alone have the responsibility for profits and losses. If you have a partner or partners, it may be difficult to know who is responsible for each decision. Lacking such knowledge will slow the teaming process and may, in fact, stall it entirely.

Sharing the Profits

Do you really want to share your profits with partners? Granted, they may also share in your losses, but since you may end up with more losses if you have partners, the benefits may prove nil.

Do you Want to Share Your Research?

Many of us consider our research proprietary. We work long, hard hours to develop trading systems and methods and we may not want to share these with a partner regardless of what he or she may bring into the relationship.

Slower Decision Time

As you know, decisions in the futures markets must be made quickly. Many times the presence of a trading partner may slow down the decision-making process and, hence, severely limit the speed with which you can execute orders. This, as you can well imagine, can frequently have negative results.

Trade for the Short Term, Long Term or Immediate Term?

I could teach several courses just addressing this subject. There are so many variables to consider, not the least of which are your personality and temperament.

Factors You Should Consider in Making this Decision

- **Trading System**

While some trading systems are more ideally suited to short-term trading, others are better suited to long-term trading.

- **Time Availability**

Only you know how much time you have available. To trade for the short term or intraday you will need to make a major time commitment.

If you have another job and you can't make this commitment, don't even try! Be realistic and determine what you can do with the time you have available. This may automatically make your decision for you.

- **Commissions**

Are you paying sufficiently low commission's to permit short-term trading with a positive bottom line?

- **Personality**

Can you take the pressure of short-term trading? Are you more in tune with long-term trading, its less demanding pace and the patience required?

- **Health**

Believe it or not, health is a consideration. If your health is at stake, then by all means don't push your luck. Trade with that period of time in mind, which will best be suited to any health concerns. Answering this question honestly will help make many decisions for you without considering any of the other aspects.

- **Data**

Many individuals are under the false impression that they can day trade the market without a steady source of tick-by-tick data. Don't fool yourself.

To day trade you need up-to-date, tick-by-tick, accurate and reliable data. If you can't afford it, if you don't know how to use it, then don't kid yourself. Day trading is not for you.

In addition to the above, there are other factors which are specific to your individual situation that must be considered before a final decision is made about the type of trading you wish to do.

This is an important decision. Do not take it lightly.

Fundamental or Technical

Another important decision which ideally should be made prior to the start of your trading is whether your approach will focus primarily on trading signals from technical indicators or from trading ideas based upon fundamentals.

I distinguish here between ideas and signals because they are two distinctly different types of approaches generated by two distinctly different understandings of the futures markets.

Later on I will provide a very thorough discussion of the two approaches, outlining their strengths, assets, liabilities, differences and methods of implementation. For now, suffice it to say that a

decision will need to be made, preferably sooner than later, about the approach you wish to employ in your trading.

Some individuals may seek to implement a hybrid approach, incorporating what they feel are the best aspects of each technique. I also will discuss the merits of this approach, or the lack thereof.

How Much Risk do You Want to Take on Each Trade?

A significant question, one that is perhaps best answered prior to the start of trading is, “how much do you want to risk on each trade?” Many factors enter into this decision, and there are many different opinions regarding the best answer.

On opposite ends of the continuum, we find the two most extreme approaches.

Those who belong to the “money management school” will tell you that the best approach to take is a per-trade risk based strictly on money management. In other words, you decide ahead the maximum risk you want to take, in dollars. When a trade goes against you by the predetermined amount, you close it out.

On the other end of the spectrum is the “systems approach.” Proponents of this approach claim that each trade is unique. Every trade has specific levels of support and resistance and, therefore, it is not possible to determine a prior rule for dollar risk.

My approach to this aspect of futures trading is essentially similar to my approach in other areas. I prefer not to be in the middle of the road. Rather, I would align myself with either of the extremes.

As you continue to read this course, you will understand more clearly why my preference is usually to be found on one end of the spectrum or the other, but rarely in the middle.

It’s been said that you can walk on the left side of the road or the right side of the road, but if you walk in the middle of the road you will get squashed. There are merits to each approach and there is no right or wrong answer to the question. There is, however, an answer that is your answer. My job is to help you find it.

Hopefully, by the time you have finished this course, you will have found the answer falling naturally into place. For the time being, however, I will tell you that each approach has its strong and weak points and you can be successful by following either of the extremes.

Summary

This section reviewed some basic principles and distinctions. You must learn them before you can continue.

Lesson #1 Quiz (Course 1)

- 1. The concept of hedging is based upon the assumption that movement in cash and futures do what with each other?**
 - a. They move in opposite directions.
 - b. They lead one another.
 - c. They parallel each other.
 - d. They follow 3 points behind.

- 2. When you begin trading, what is the minimum amount of completely disposal, speculative capital that I feel you need to being with?**
 - a. \$12,500
 - b. \$5,000
 - c. \$25,000
 - d. \$2,000

- 3. Another name for a cash market is a spot market. Why is this?**
 - a. Because the market is often spotty and uneven.
 - b. Because transactions are made on the spot.
 - c. Because they help you spot moves.
 - d. Because it makes a spot for you in the market.

- 4. The following is a list of four things that speculators do. Only three are true. Which one is false?**
 - a. They do not take delivery of the goods.
 - b. They often trade for short-term swings.
 - c. They are buyers and sellers of cash commodities.
 - d. They are often called traders.

- 5. What do producers do?**
 - a. They produce or process the commodity that is being traded.
 - b. They produce the final manufacturing of the commodity.
 - c. They produce the contracts to be traded.
 - d. They oversee the production market deliveries.

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- 6. How should you get your starting capital to begin trading?**
- a. Borrow it from the bank or from a member of your family.
 - b. Take a second mortgage on your house.
 - c. Borrow it from your children's college fund.
 - d. Use only extra money that you have on hand and will not miss if you lose it.
- 7. When deciding how much you risk on each trade I told you that those who belong to the "money management school" will tell you to take a per-trade risk based strictly on money management while those who believe in the "systems approach" claim that each trade is unique and that it is not possible to determine a prior rule for dollar risk. What position did I suggest you follow?**
- a. The middle-of-the-road approach is usually safest.
 - b. Align yourself with one or the other extreme but be consistent.
 - c. Ask a friend or associate what they do and do the same.
 - d. Take a percentage of what you feel the profit potential could be and use that.
- 8. What is the amount of profits I feel you should remove from your account for every winning trade that you make?**
- a. 50 to 75%
 - b. None
 - c. 10 to 25%
 - d. 2 to 3%
- 9. If you decide to become a day trader what kind of data should you have?**
- a. Information that you can glean from reading the daily papers.
 - b. Up-to-date, tick-by-tick, accurate and reliable data.
 - c. A friend or associate who trades also that you can compare notes with.
 - d. Only the history of past trades is needed.
- 10. When you use leverage, what is the typical percentage of the total value that a contract can be bought or sold for?**
- a. 10 to 15%
 - b. 5 to 7%
 - c. 1 to 3%
 - d. 20 to 25%

When you have completed the questions in this quiz, email your answers to: jake@trade-futures.com