Trading Basics

The mechanisms behind futures trading may seem complicated in advance, but they're fairly simple in practice. You can purchase and sell futures through a broker licensed by National Futures Association within the United States. The broker is known as a Futures Commission Merchant, and they will execute orders given by you on an exchange.

In order to obtain an account you will be required to deposit a specific amount of money, this is known as your initial margin. This deposit must occur before you are actually allowed to trade. Your account's current margin must stay above the minimum margin to continue trading. Your account will be marked to market each day based on your investment positions and their current value. Price changes, and their unrealized gain or loss on open contracts are applied. Your current margin will reflect their impact. If your current margin falls too low, you will be issued a margin call. You will be forced to add more money to the account, or rights to open new trading positions will be revoked. If you don't add money, active positions will be liquidated until the account is over the required minimum margin. The exchange may start with losing trade positions, or they may just liquidate all of the financial positions in play.

The actual trading positions are the same as equities: long, or short. If you're buying a future, you are the long position. You are committing to buy commodities on the delivery date. This position is taken if you expect the underlying commodity to rise in the future. Speculators seek the profit from this position. Hedgers purchase the commodity to avoid the risk that the future market price will exceed the delivery price. The future allows them to purchase the good below market cost.

Futures Long Position Profit = Market Price – Contract Price

Payoff can easily be negative for a long position. If the market price is less than the contract price paid at the delivery date, the buyer pays more than the market price. The future's contract must be paid. It is a stated agreement to buy a specific amount of goods at set value, not an option.

If you're selling a future, you are the short position. You are committing to sell commodities on the delivery date. This position is taken if you expect the value of commodities to decline before the contract's delivery date. Speculators profit from receiving more currency from the contract price than the market price at delivery. Hedgers use short positions to sell their commodities at a higher price than they expect from the market price at delivery. If the price falls, they gain profits.

Short Position Profit = Contract Price – Market Price

You don't have to actually own the commodities on the date that you sign into a futures contract. You will provide the exchange with the commodities or enough currency to purchase them at the delivery date.

The short position's loss is equivalent to the long positions gain, minus any fees or commissions encountered by the counterparties. It is essentially a zero-sum transaction. This is also how participants counter a transaction. Since the agreement is a contract that you will pay or sell, you cannot exit your position by selling it to a replacing party. You must acquire an offsetting contract to unwind your position. If you're the short position, enter a long position with the same price and maturity date. If you're the long position, enter into a short with the same price and maturity date.

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