

TRADING EDUCATORS

SPREAD TRADING

SPREADS



Introduction

Few traders seem to know how to use spreads in their trading, yet spread trading is possibly the safest way to trade of any other method we have encountered. A mature trader will take spread trading into consideration as at least one, if not the only, method of trading in the futures markets. This is a strong statement and requires explanation.

SPREADS

When the futures markets were first conceived, apart from the fact that the exchanges created them as a way to make money for themselves, the stated purpose of the futures markets was to provide a means for producers and users to hedge against excessive fluctuations in price.

SPREADS

Hedging is both the economic and social justification for the futures markets, and in the eyes of the law, and society, it is the ability to insure stable prices that is the rationale which separates futures trading from outright gambling. A futures hedge is in fact, nothing more than price insurance.

SPREADS

Producers and users can buy most any kind of insurance imaginable. They can insure against weather disasters and natural disasters.

Insurance can be purchased for health, accident, life, liability, crop failure, etc. But there is nowhere that producers and users can insure against price fluctuations, other than by hedging in the futures markets.

SPREADS

Every futures hedge is a spread, and every futures spread is a hedge. When a spread is placed in effect, the risk changes from that of price fluctuation, to that of the differential between the two sides of the spread. A spread tracks the difference between the price of the underlying and the futures or between two futures contracts.

SPREADS

Spreading takes much of the risk out of using the futures markets. Because every spread is a hedge, it serves both a social and economic purpose. Even the US government encourages the use of hedging, and conducts classes for various producers to teach them about the benefits of hedging. Spreading when used properly takes away much of the gamble for both user and producer.

SPREADS

In general, society frowns upon gambling. Nevertheless, there are many traders in the futures market who do gamble – they gamble, perhaps without realizing that's what they are doing. Anyone who trades in futures without the full realization of what is going on, is in fact, gambling. This is regardless of whether that person is a speculator, a producer, or a user of the underlying physical or financial item.

SPREADS

It would seem then, that there are four categories of traders involved in the futures markets.

- Producers
- Users
- Speculators
- Gamblers

SPREADS

We believe there is actually a fifth category of traders. SPREADERS. Let's see why this can be so.

Producers and users employ the futures markets to exchange the risk of price for the risk in the difference between cash prices and futures prices. This risk is much smaller than the risk associated with that of price fluctuations.

SPREADS

The speculator is willing to accept the risk of price fluctuation in return for the greater leverage that comes with that risk in the hopes of earning a greater profit. The true speculator makes his trading decisions based on knowledge gathered from information about the behavior of the underlying, seasonality, historical and current trends, chart analysis, fundamentals, the market dynamics, and knowledge of those who trade it.

SPREADS

The gambler makes his trading decisions on gut feelings, hopes, dreams of getting rich quick, tips from the broker, “inside information” from friends, and from the improper understanding and use of indicators, oscillators, moving averages, and mechanical trading systems. In general, he is looking for a way to shortcut having to truly learn what is going on. Unfortunately, most people who attempt to trade fall into this category.

SPREADS

The spreader is a trader who positions himself between the speculator and the hedger. Rather than take the risk of excessive price fluctuation, he assumes the risk in the difference between two different trading months of the same futures, or the difference between two related futures contracts in different markets.

SPREADS

For example, a spreader might take the risk of the difference in price between March wheat and July wheat, or the difference in price between December Kansas City wheat and December Chicago wheat. Obviously, the risk taken for the difference in price among related contracts is far less than the price risk taken in an outright futures speculation. This is because related futures will tend to move in the same direction.

SPREADS

But there is more, much more accruing to the benefit of the spread trader. The spread trader is able to earn a much greater return relative to posted margin than is available in any other form of futures trading. This is because margins on **intramarket** spread trades are about $1/4^{\text{th}}$ to $1/5^{\text{th}}$ of those for an outright futures trade. Although every spread trade requires two commissions, this slight disadvantage is far outweighed by the lower margin requirements.

SPREADS

To give you an idea of the margin differential, as this is being written, the margin on an outright soybean futures contract is \$1,050. The margin on a January-March soybean spread is only \$250, or 23% of that required to trade an outright soybean futures. Is this important? Yes it is! Why?

Because each point in the spread carries the same value (\$50) as each point in the outright futures (\$50).

SPREADS

That means on 5 point favorable move in soybeans futures and a 5 point favorable move in the spread, the trader would earn \$250. However the difference in return on margin is extraordinary:

Soybean futures - $\$250/\$1050 = 23.8\%$ return

Soybean spread - $\$250/\$250 = 100\%$ return

So what's the catch? There has to be a catch!

SPREADS

Yes! There is a catch. Spreads seem to move less dramatically than futures. It would seem that it is easier to realize a 5 point move in outright soybean futures than it is to realize a 5 point move in a spread between two soybean contracts essentially moving in the same overall direction. But to think that way is to truly distort the picture. That view does not speak the whole truth. There's more to it than meets the eye.

SPREADS

Spreads tend to trend much more dramatically than outright futures contracts. An examination of a variety of spread trades taken at random will more than convince anyone of the beautiful and often steep trends that one can regularly find among spreads. Spreads trend without the interference and noise caused by computerized trading, scalpers, and market movers.

SPREADS

The nemesis of all trading by those not “big” enough to be market movers is that of stop running. While there is nothing negative per se about stop running, this action by market movers is what causes most traders to be taken out of a move with an outright loss on the trade, or with a substantial loss of actual or potential profits.

SPREADS

Intramarket spreads eliminate the problem of stop running. You are long in one futures and short in another. There is no way for the market movers to run the stops. In that respect, spread trading is a more pure form of trading. The lack of stop running is not a guarantee that you will win, but it does provide the trader a more level playing field.

SPREADS

Spreads eliminate the problems associated with lack of liquidity. The surest way to encounter serious stop running and bizarre price movements is to attempt to trade in “thin” (illiquid) markets. However, other than problems with getting filled, spread trading does not suffer from a lack of liquidity, thereby creating many more trading opportunities than does trading in outright futures.

SPREADS

Unfortunately, either by accident or design, the whole truth of spread trading has been lost over the years.

While it is true that an outright futures trade has a better chance of making points than does a spread between two contracts of the same underlying, it is also true that an outright futures trade has a better chance of losing those very same points.

SPREADS

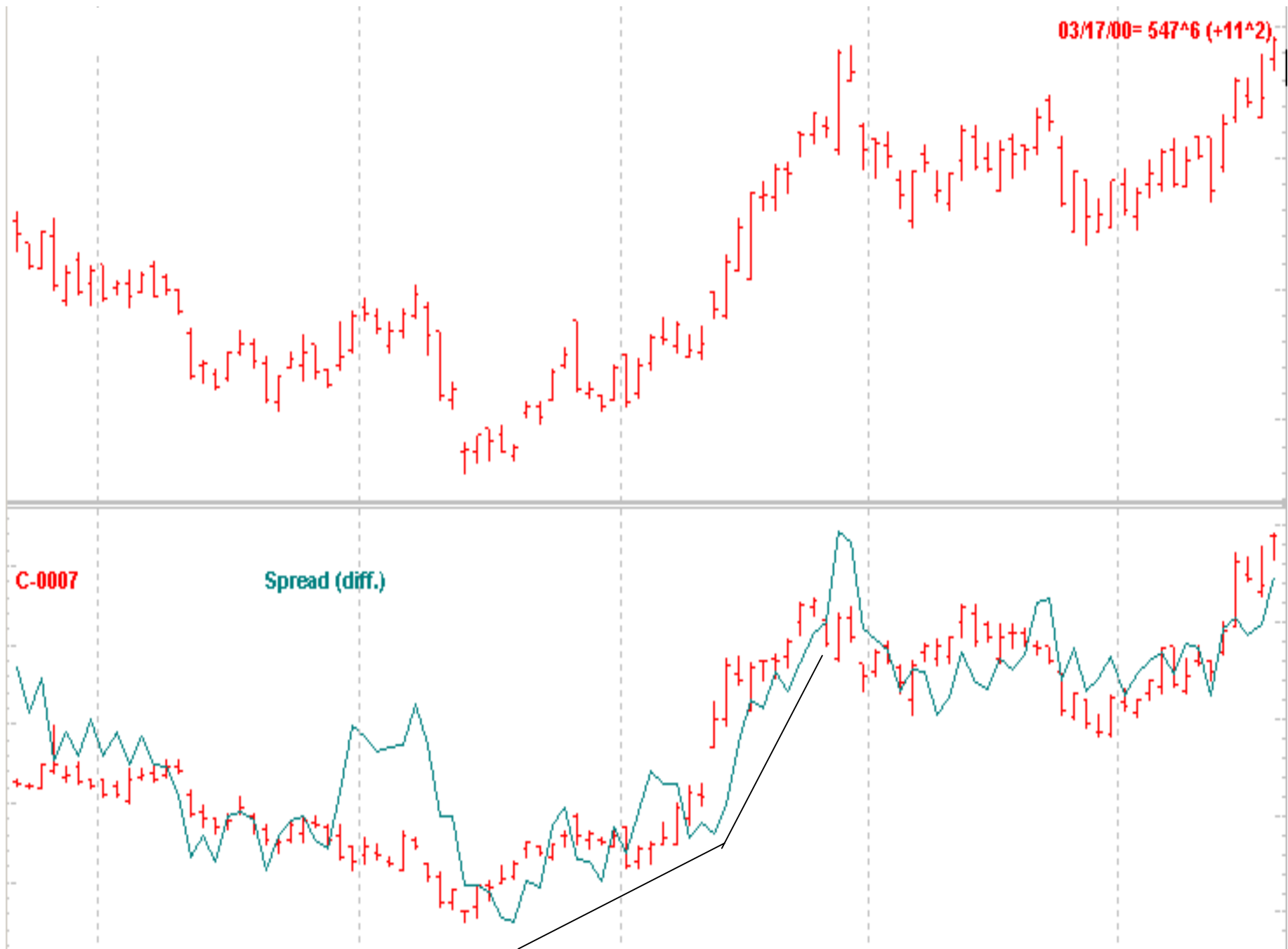
When you enter an outright futures trade, the pure statistical chances of being correct on the direction of the trade are one in two. Some say one in three. Here's why. If you are long futures, the only way you can make considerable profits is if prices rise. If the prices fall, you lose money. If prices go sideways, you could make a little or lose a little. Over time, the sideways moves tend to even out.

SPREADS

If you are short futures, the only way you can make considerable profits is if prices fall. If the prices rise, you lose money. If prices go sideways, you could make a little or lose a little. Over time, the sideways moves tend to even out. In other words, with outright futures trades, the only way you really win is to be correct about which way prices will move.

SPREADS

When you enter a spread trade, you are not primarily concerned with the direction of prices. Your primary concern is with the direction of the spread, i.e., the difference in price between the two sides of the spread. To see what we mean, consider a long July soybean, short July corn spread. As long as July beans rise faster in price than July corn, you will earn a profit.



SPREADS

In that case, the situation is the same as with the outright futures, the odds are one in two of winning. But here's the part no one seems to want to tell you about. If the price of beans suddenly changes direction and falls, as long as the July corn falls more steeply than July beans, you will also win. If we assume that when they both go sideways, those situations will even out, then we have odds of winning being two out of three times that we enter a spread.

SPREADS

What we are saying here is that with outright futures you must be right about the direction of prices in order to win. But with a spread, you can still win even if you were wrong about the direction of prices. You can win when you are wrong, as long as you are not too wrong.

SPREADS

We need to look at other advantages of trading spreads. One of those is seasonality. Whereas seasonality in outright futures trades has shown a dismal record in recent years, seasonality in spread trading has shown an exemplary record. Seasonality works extremely well in spread trading. The percent of wins against losses is outstanding.

SPREADS

Another great advantage seen in spread trading is experienced when a market goes into backwardation. When backwardation first commences, it is almost certain that a spread long the front month and short the next month back will do well. Fortunately, this situation favors entering the spread for as many as several days after a market goes into backwardation.

SPREADS

Backwardation greatly favors spreads over outright futures trades. Why? Because for an outright futures trade to be correct about backwardation, prices must rise. But it is a known fact that backwardation can occur when prices are falling. Due to stronger demand in the front month, price will fall less quickly than will prices in the back month. Therefore, a spread long the front month and short the back month will profit even in a falling market.

SPREADS

We are not denying that when backwardation occurs you can go short the weaker back month, but then you can always go short when prices are falling. In that case, you are losing the advantages of the spread. You are taking outright price risk in a month that is less liquid than the front month.

SPREADS

What about the situation where markets are moving sideways? As long as one trading month of the market is moving up more than another month of the same market, a spread can be profitable, whereas a trade in outright futures has to suffer the whims of the market.

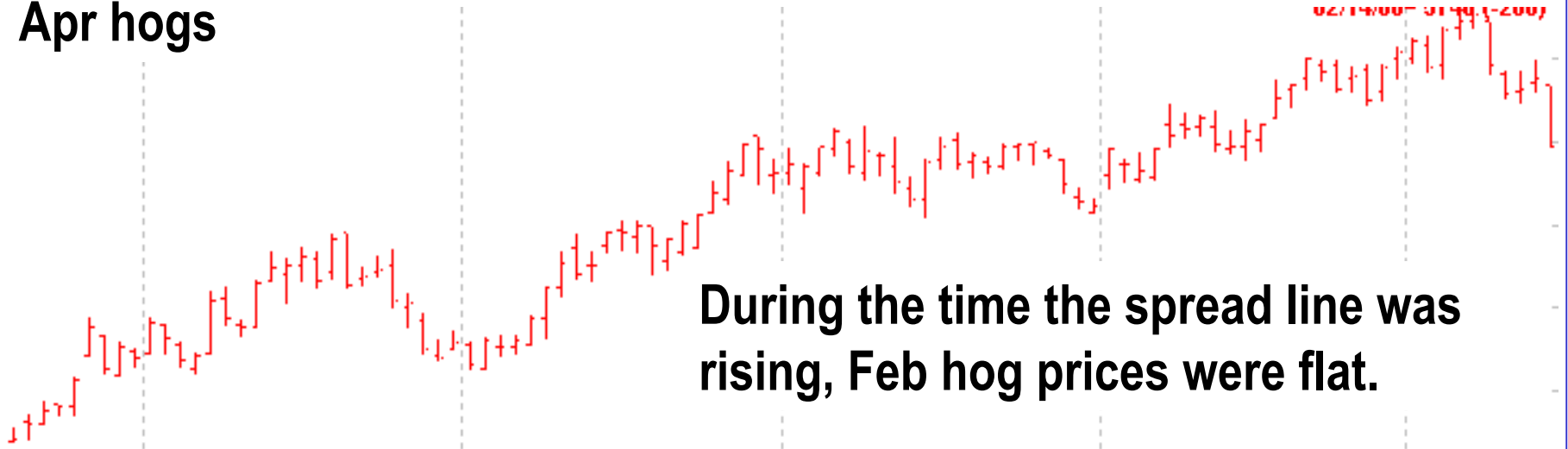
There's more!

SPREADS

In a sideways market, as long as one trading month of the market is moving down more than another month of the same market, a spread can be profitable, whereas a trade in outright futures has to suffer the whims of the market. In other words, if one month of a market is absolutely sideways in price movement, but the other month is either moving up slightly or down slightly, the spread trader can win.

SPREADS

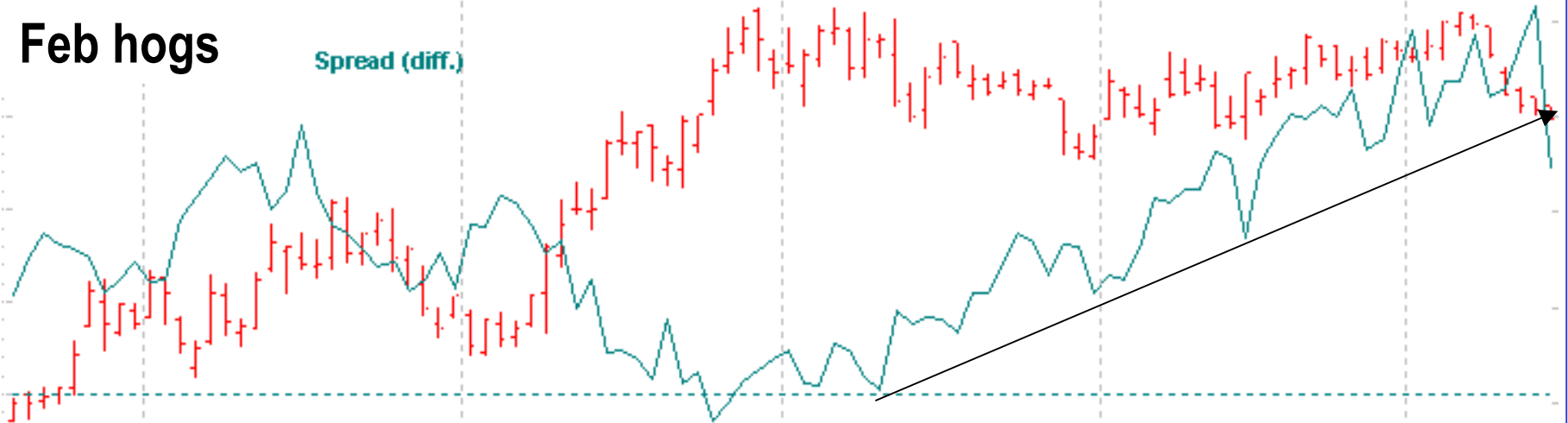
Apr hogs



During the time the spread line was rising, Feb hog prices were flat.

Feb hogs

Spread (diff.)



SPREADS

It is not our intention to reproduce an entire book here in this presentation. “Trading Spreads and Seasonals” is the text book that accompanies this presentation. We can, however, give you a few basics of spread trading so that you can understand the remainder of the presentation and its examples.

SPREADS

A spread tracks the difference in price between two or more futures contracts. They can be contracts for financial instruments, currencies, stock indexes, or physical commodities. There are two multiple contract spreads that are traded. One is called the “Crack,” and the other is called the “Crush.” Most traders are never involved in either of these.

SPREADS

When structuring a spread the contract you want to be long is always expressed first and the contract you want to be short is expressed last. Therefore, a spread between Swiss Francs and Euros is expressed as SF-EC.

SPREADS

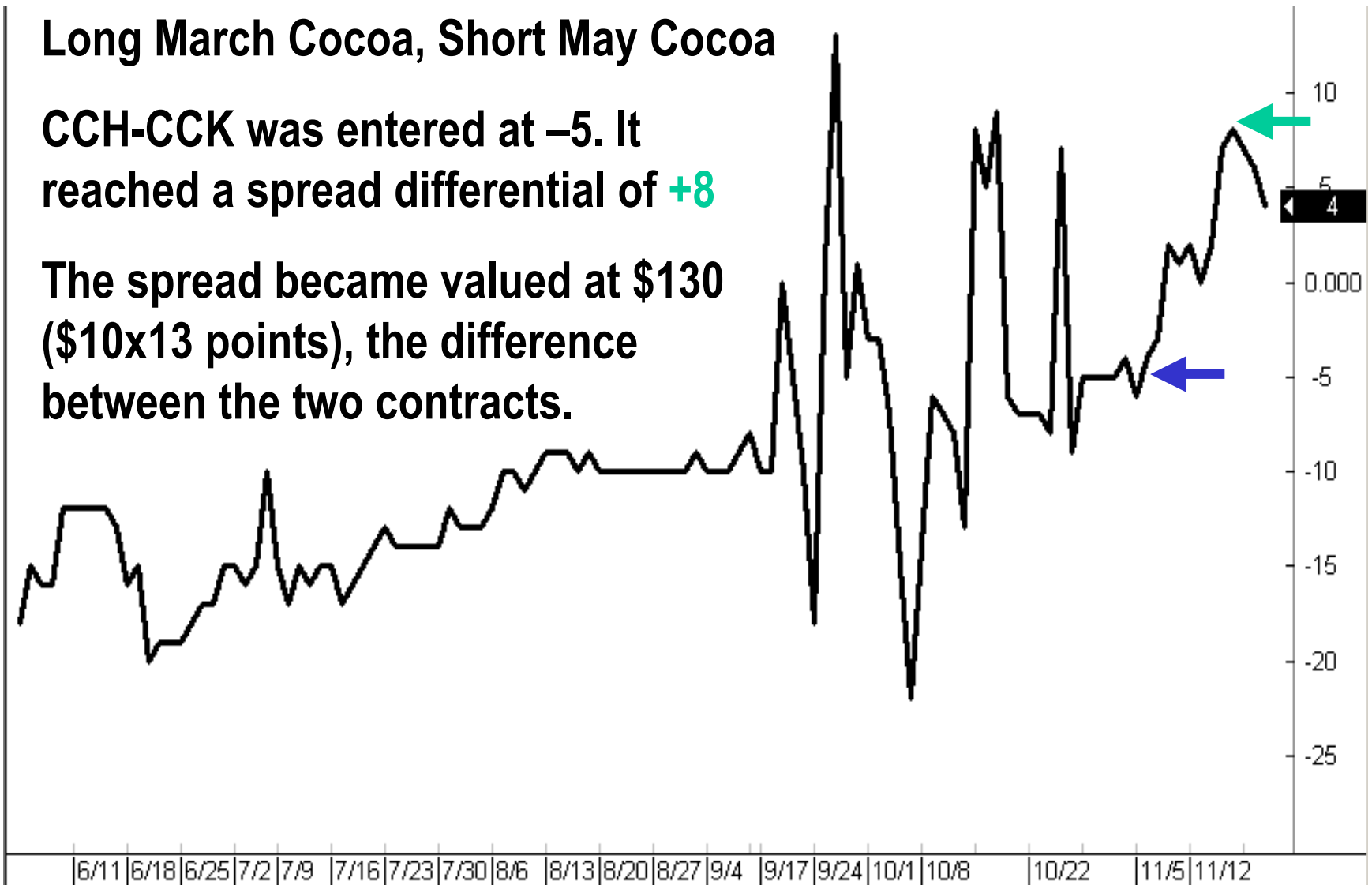
A spread can begin with a negative value. For instance, CCH-CCK for 2002, entered in November of 2001 began at a spread differential of -5 . If a spread begins with a negative value, you want it to become less negative, or even move to where it has become positive. If a spread begins with a positive differential, you want to see it become more positive. Therefore, as you chart a spread you always want to see it moving up.

SPREADS

Long March Cocoa, Short May Cocoa

CCH-CCK was entered at -5. It reached a spread differential of +8

The spread became valued at \$130 (\$10x13 points), the difference between the two contracts.



SPREADS

When ordering a spread always give the long side first, followed by the short side. “I want to buy (# of contracts) March Cocoa and Sell (# of contracts) May Cocoa on a spread of...(give the value of the differential)

At this point, your broker may require one additional piece of information. Brokers differ as to how they want to hear it:

SPREADS

To be certain that he understands what you want, the broker may want you to tell him where the “premium” is, whether or not you are “collecting” or “paying” for the spread, or whether this is a debit or credit spread. You may even encounter some delay in getting your order processed because some brokers have never handled a spread trade. Let’s look at the terms named above.

SPREADS

Premium – is simply which side of the spread has the greater value. E.g. the CCH-CCK spread. Obviously, CCK had the greater price in dollars. That is why the spread had a negative differential. You were subtracting a larger price from a smaller price. Therefore the premium was “to the sell side.” The premium was “to the May,” depending on how your broker wants to hear it.

SPREADS

Since you were paying a lower price for March than you were receiving by selling May, you will be “collecting” for the spread. If March had the higher price, you would be “paying” for the spread. If you are collecting for the spread, you will receive a “credit” in your account, the difference in what you paid to buy March and sell May. If it were the other way around, you would receive a “debit” to your account.

SPREADS

You will have to discuss with your broker, the exact terminology that he wants to hear when ordering a spread. Don't be surprised if the first couple of times you give a spread order, he has to go and ask someone what to do. But after you've issued a couple of spread orders, he should have it down pat and be able to understand what it is you want to do.

SPREADS

Here's the way we gave the order to our broker in accordance with the way he wants to hear it: "Buy (NYBT) March Cocoa and Sell (NYBT) May Cocoa on a spread of 3 to 5 points, premium to the sell side."

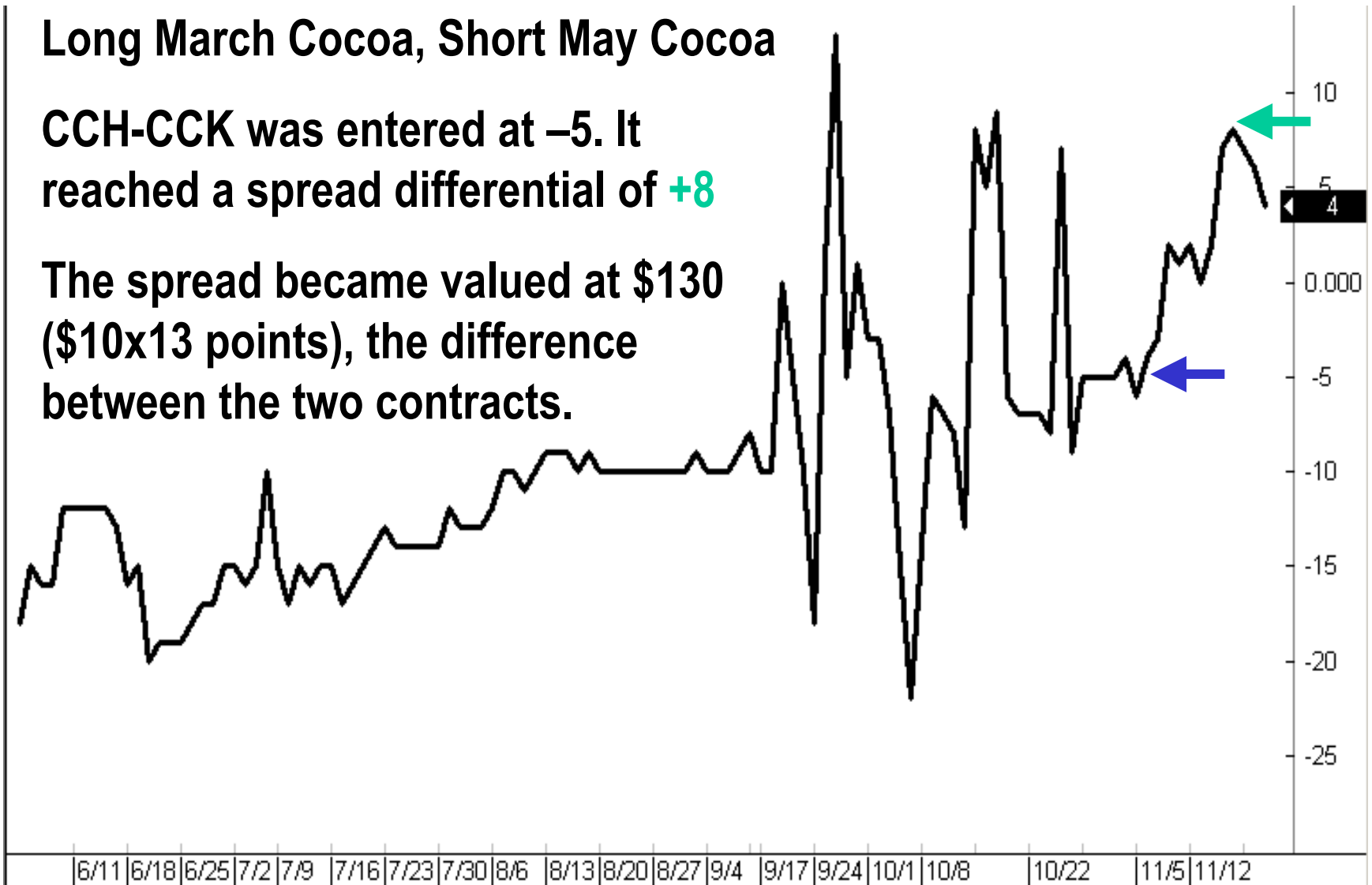
We were filled at -5 , and took profits at $+7$ and also at $+8$. One last thing concerning this and other spread trades. We always have a mental stop loss in mind before we enter a trade.

SPREADS

Long March Cocoa, Short May Cocoa

CCH-CCK was entered at -5. It reached a spread differential of +8

The spread became valued at \$130 (\$10x13 points), the difference between the two contracts.



SPREADS

In the case of CCH-CCK, our stop strategy was to exit on any day following a spread Close of -8 or more negative. We are interested only in where the spread Closes. Spreads can wander all over the place during the trading day. If you try to watch them intraday, you will drive yourself crazy. Apart from trying to optimize your entry and exit, please avoid baby-sitting your spread trades during the day. In the long run it will cause you to make some serious mistakes.

SPREADS

Now, let's look at some spreads. These are all spreads that were traded as given in Traders Notebook our daily trading newsletter. We've already shown you the March-May Cocoa spread. Next we'll show you a long Swiss Frank, short Euro currency spread.

SPREADS

Here's how instructions were given to our readers: "Buy (CME) December Swiss Franks and Sell (CME) December Euros on a spread of 2830 to 2831 premium to the sell side."

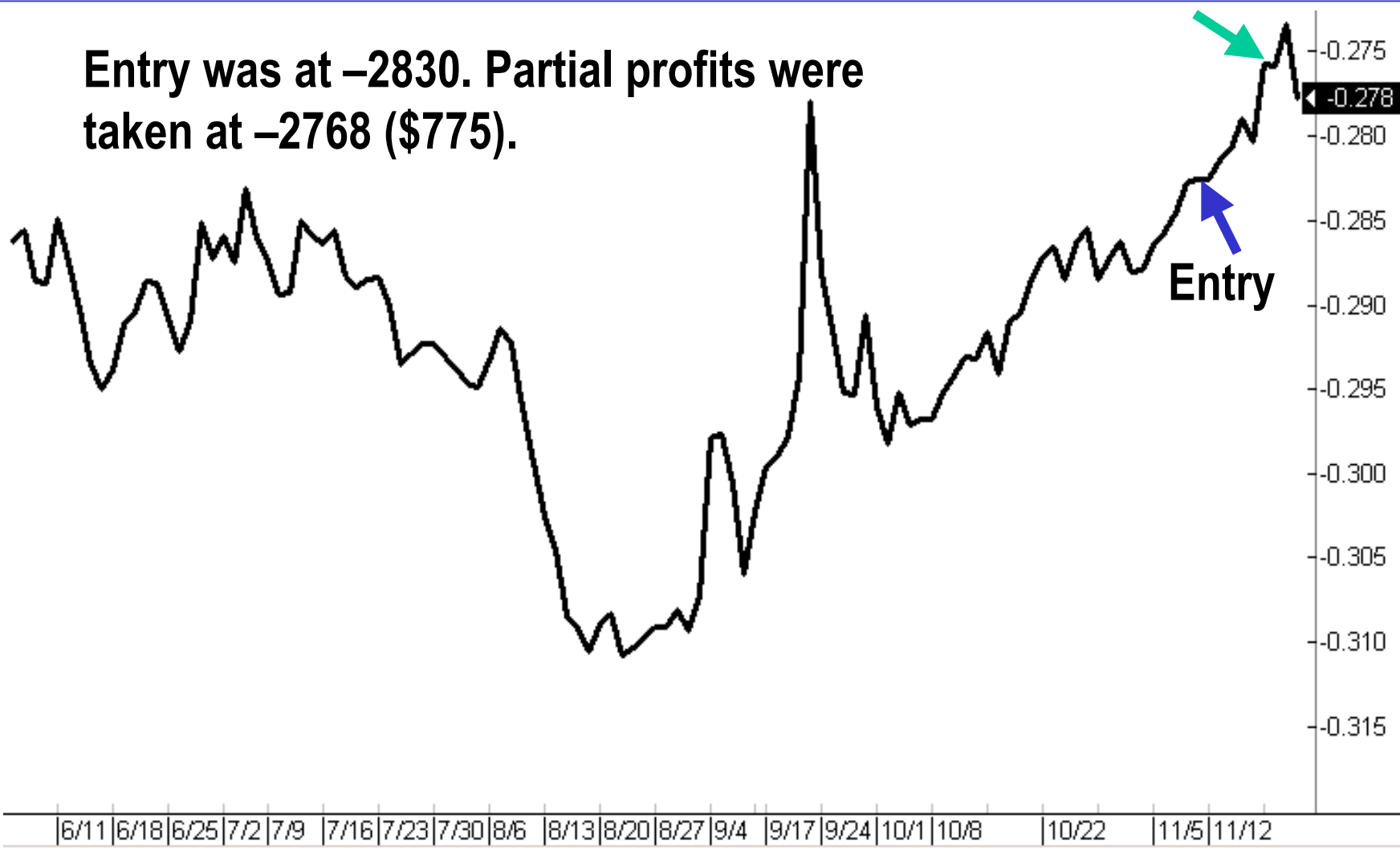
Suggested protection is to exit on any day following a close of -2844 or more negative.

Objective is for the spread to narrow to a less negative number. Objective is -2770 . Basis is fundamental. Premium is to the Euro (EC).

You will collect on the spread."

SPREADS

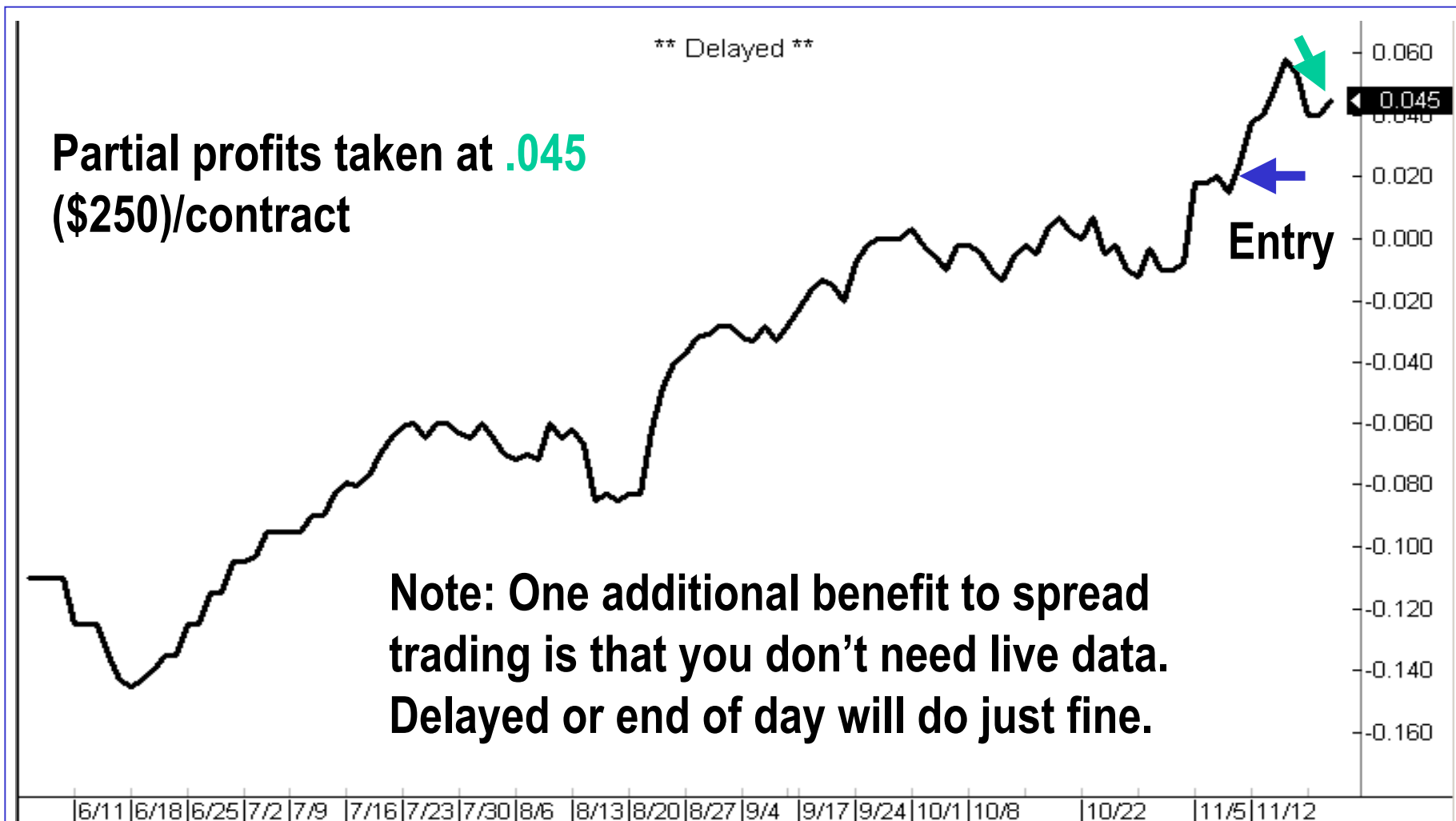
Entry was at -2830. Partial profits were taken at -2768 (\$775).



SPREADS

Here's a Natural Gas spread: Buy (NYM) February Natural Gas and sell (NYM) January Natural Gas on a spread of .020. Protective exit is any day following a Close at or below -.010. Objective is .100. Basis is seasonal. Premium is to February. You are paying for the spread.

SPREADS



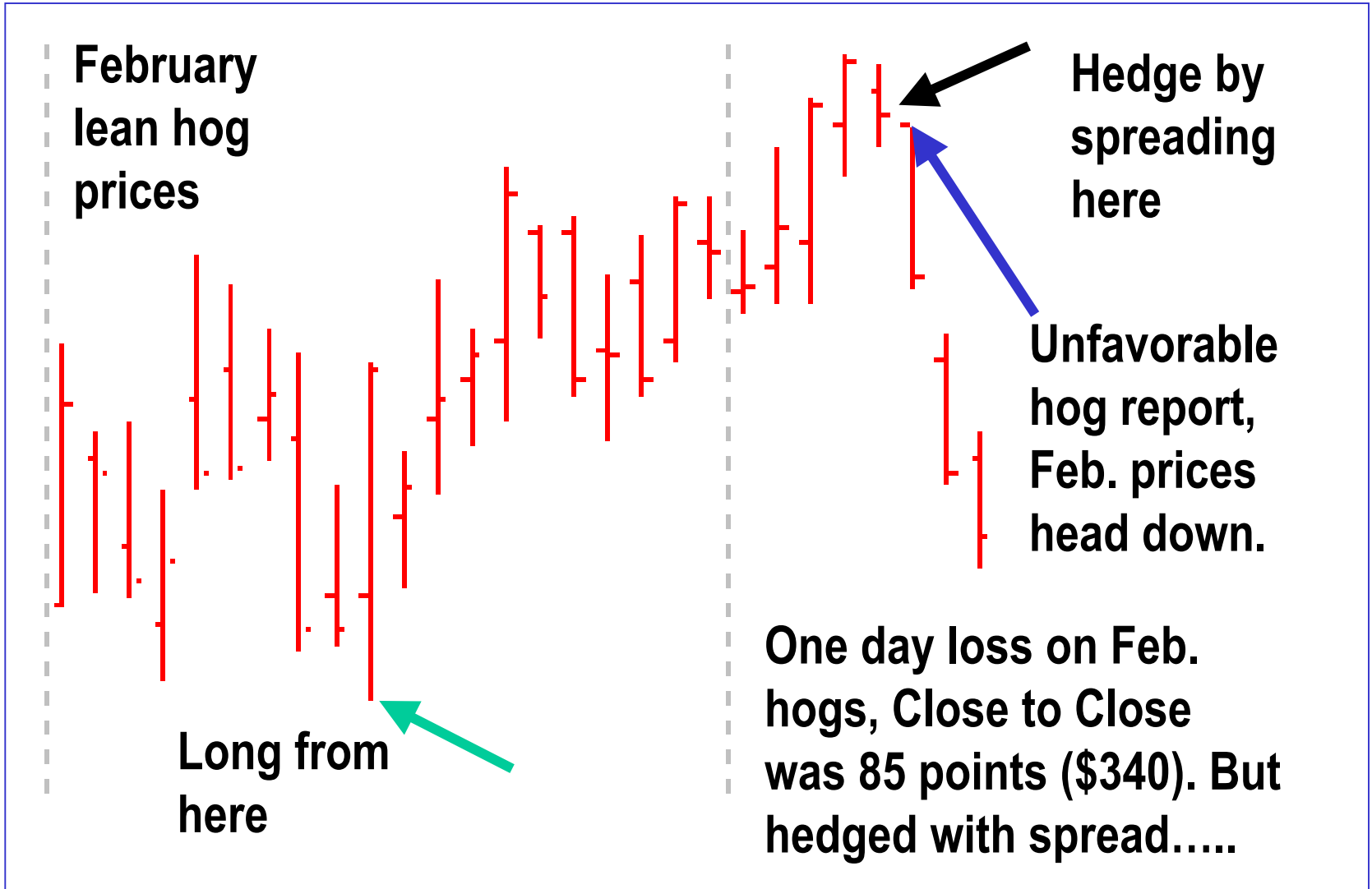
SPREADS

There are some additional things that you should know about spreads. Spreads lend themselves to correlation analysis. You can look to see if the spread currently is tracking the same as it has for the past 15 year, the past 5 years, all the way down to correlation with last year's spread movements. At extreme high and low spread values, the spreads are very often accurate down to the penny.

SPREADS

You can reduce the volatility in an outright futures trade by spreading the contract you are in against another month of the same contract, or even against a month of a related contract. Let's assume that you are long February Lean Hogs at a time when prices suddenly drop ahead of the "Hog Report." You don't want to get killed if hogs are reported to be in great supply, so you enter a spread by selling the back month of April.

SPREADS



SPREADS



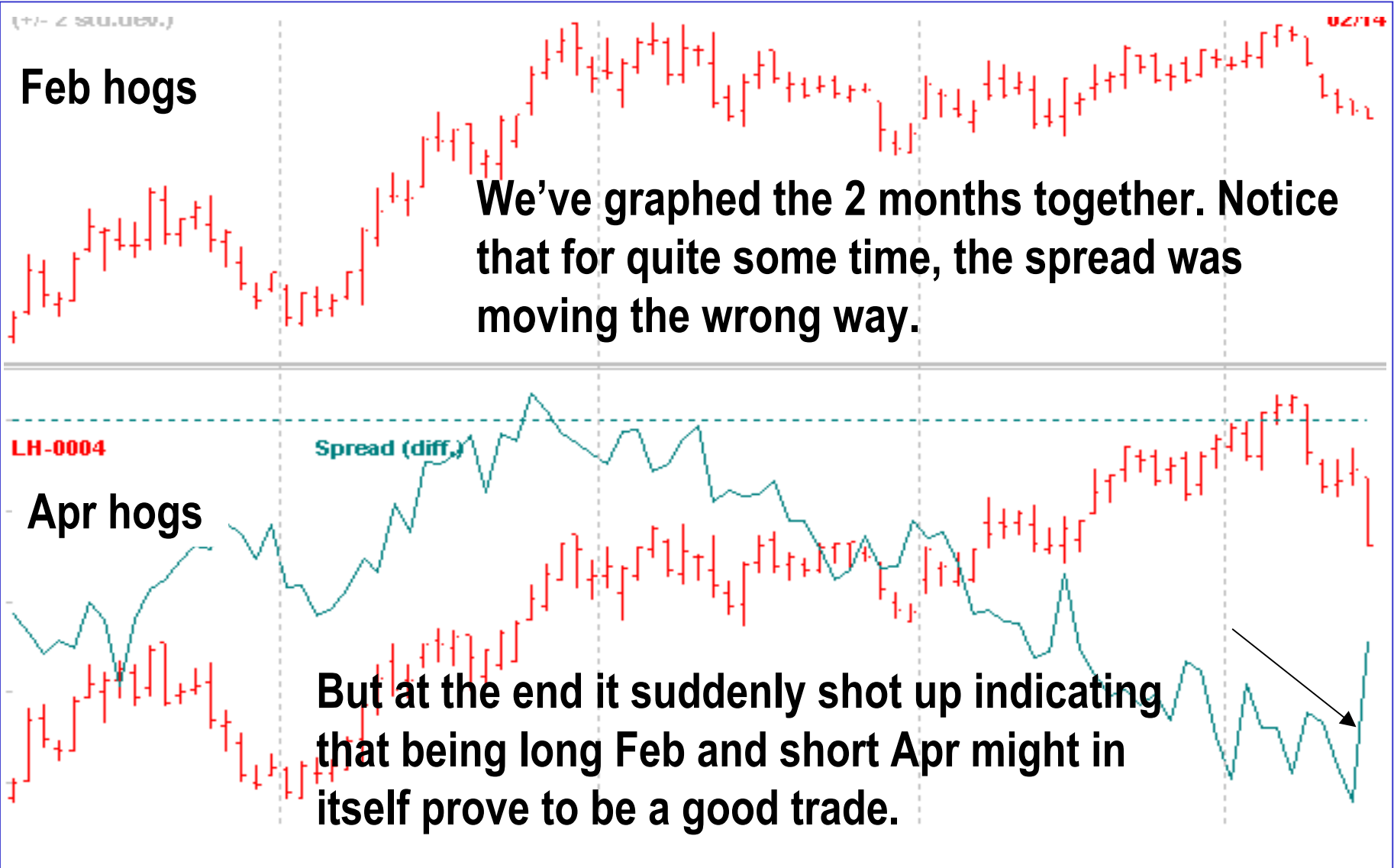
SPREADS

Did you see what happened? Instead of losing \$340 in the long February contract, by selling an April contract there was a gain of \$268 on the trade. Why? Because short April hogs made \$608 on the day the report came out, i.e., one day after having entered the spread. By spreading, we took some of the volatility out of the trade, and made a profit from our attempt.

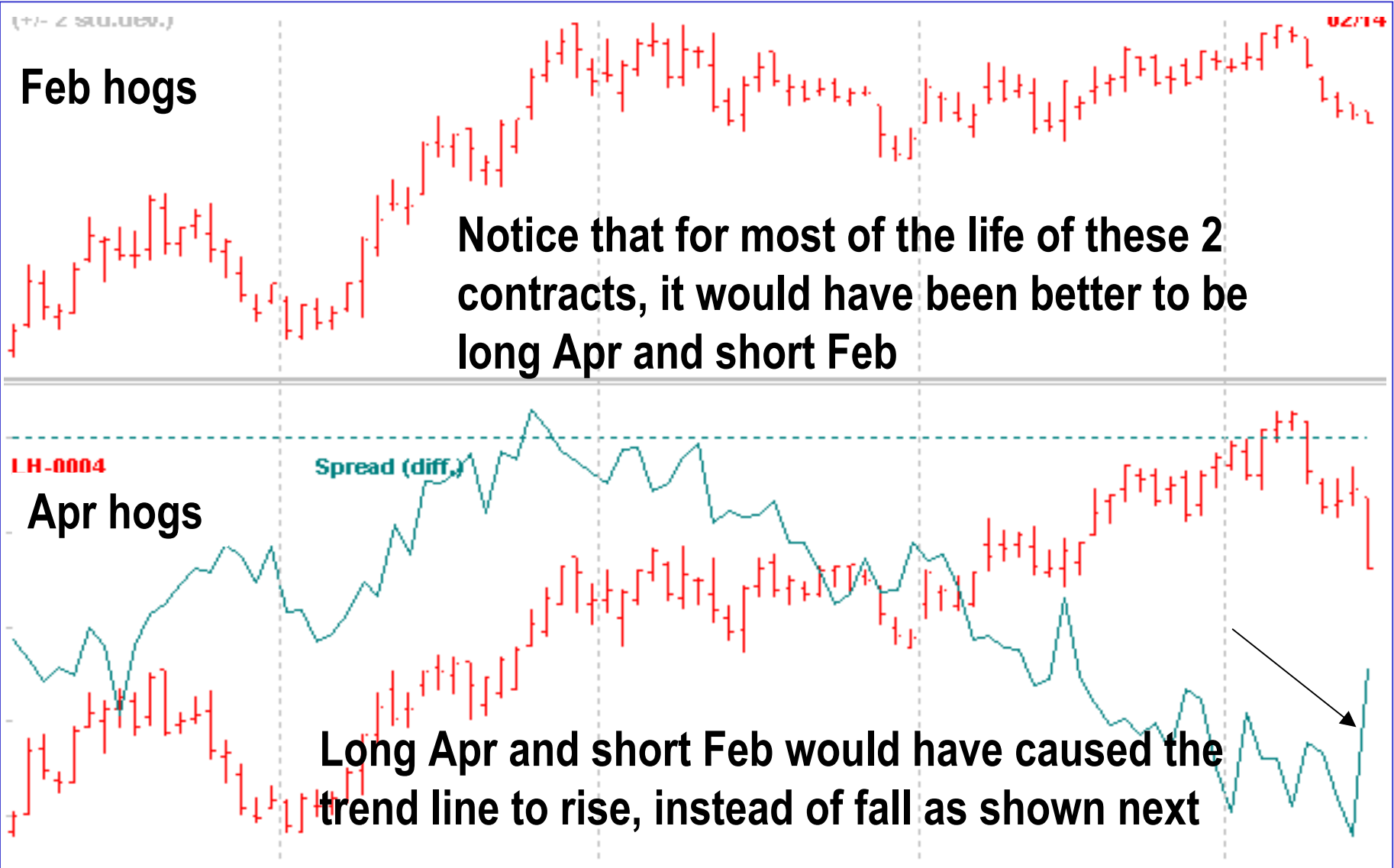
SPREADS

Will we always make a profit by spreading? No! But had the trade gone the other way, with February dropping \$608 and April dropping \$340, we still would have mitigated a loss. We would have reduced the loss from \$340 to \$268, or you might say, lessened it by \$72. There's something else to notice about the spread.

SPREADS

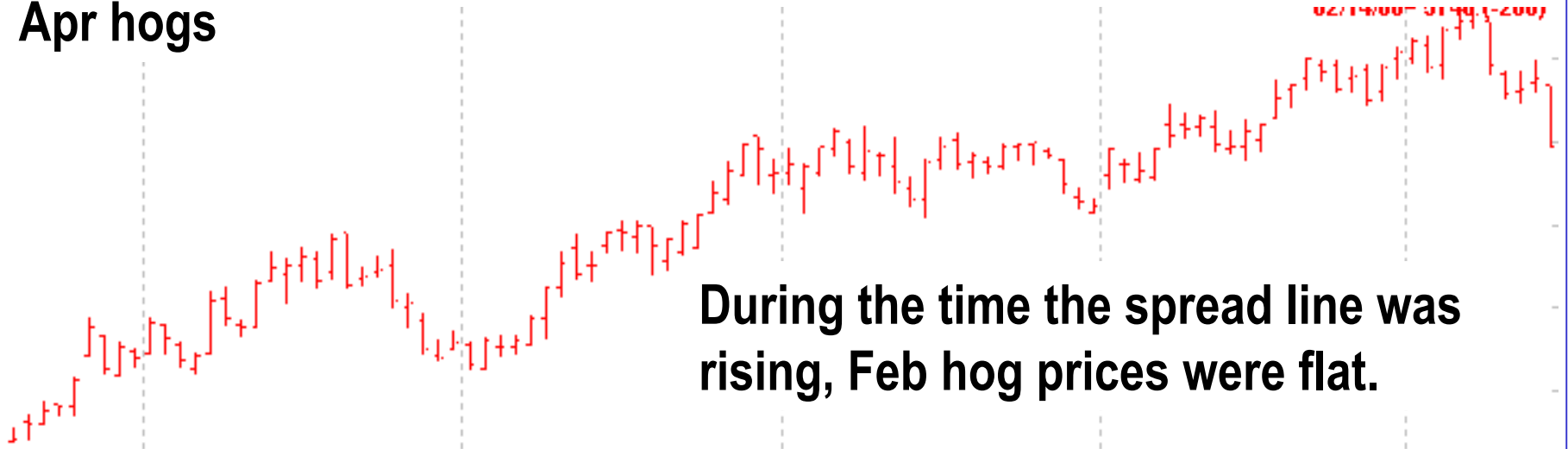


SPREADS



SPREADS

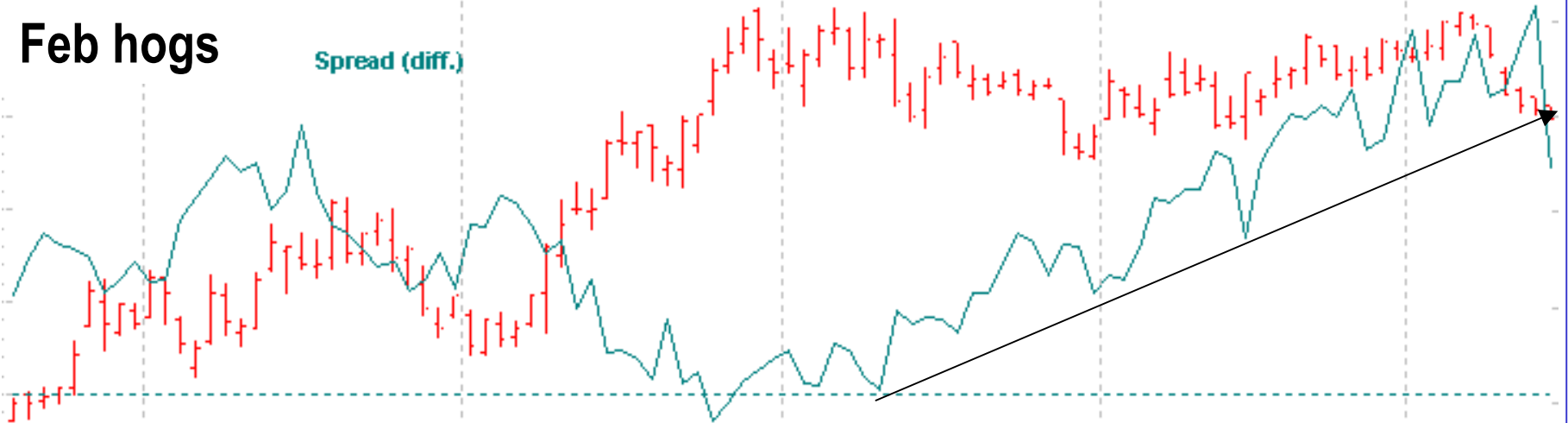
Apr hogs



During the time the spread line was rising, Feb hog prices were flat.

Feb hogs

Spread (diff.)



SPREADS

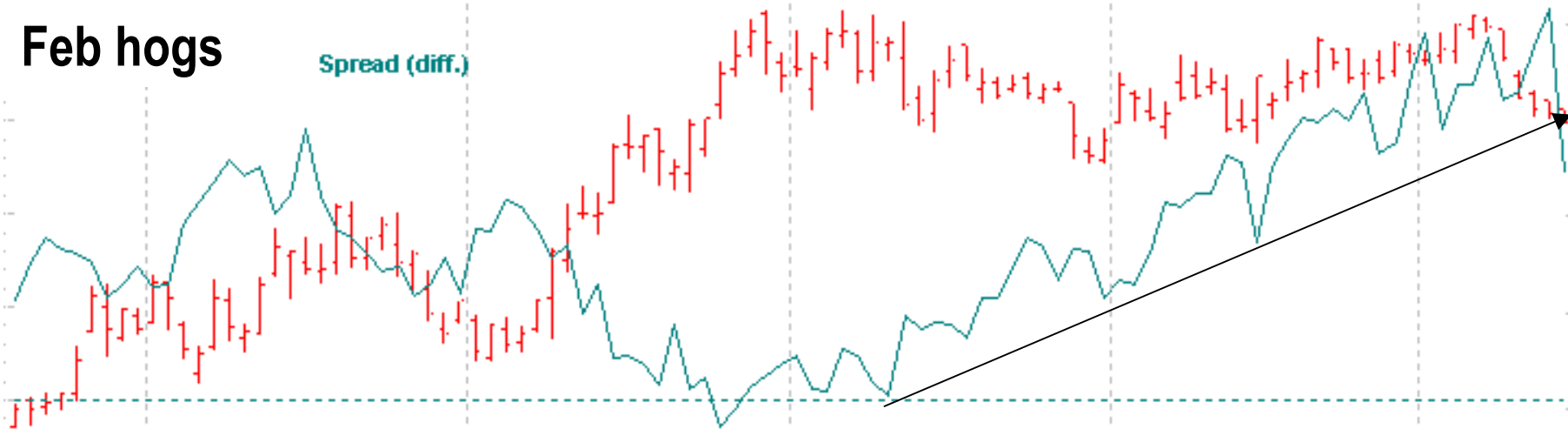
Apr hogs



It was Apr hog prices that were rising, but only slightly.

Feb hogs

Spread (diff.)



SPREADS

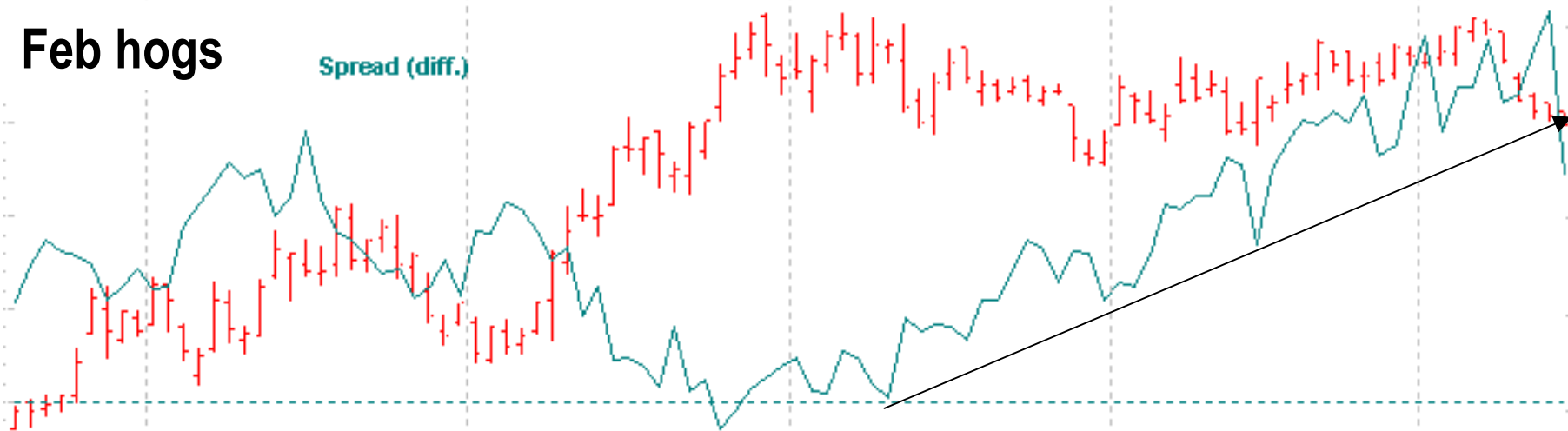
Apr hogs



Can you imagine how hard it would have been to trade Feb in outright futures?

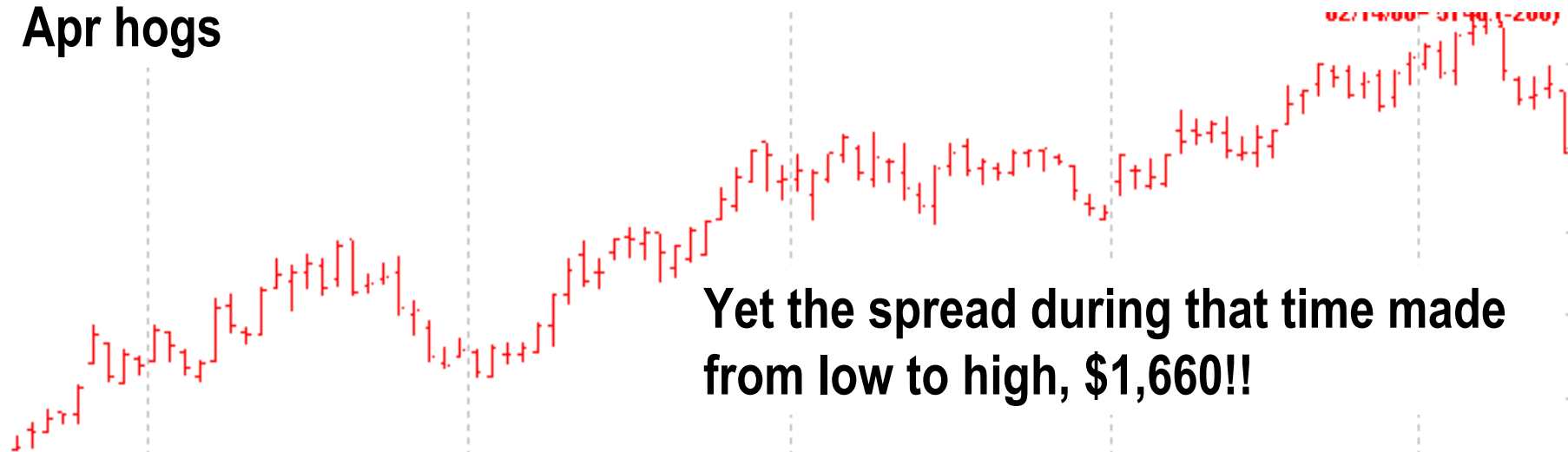
Feb hogs

Spread (diff.)



SPREADS

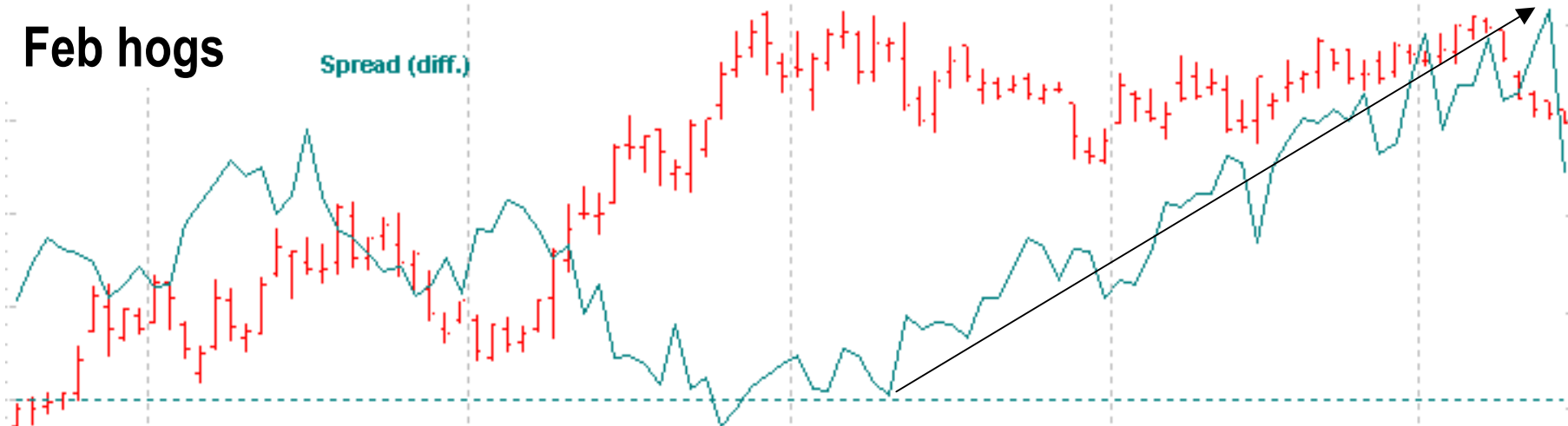
Apr hogs



Yet the spread during that time made from low to high, \$1,660!!

Feb hogs

Spread (diff.)



SPREADS

“All this is very interesting, but I’m a day trader. What good are spreads to me??”

I have news for you my friend, lots of day traders trade spreads. In the stock market people trade the spread between the QQQ Index and Microsoft. You have to use a time frame that will enable you to comfortably put on both sides of the spread, but that is a minor problem. Let’s have a look at this spread.

Long MSFT, short QQQ on a 5 minute chart.



SPREADS

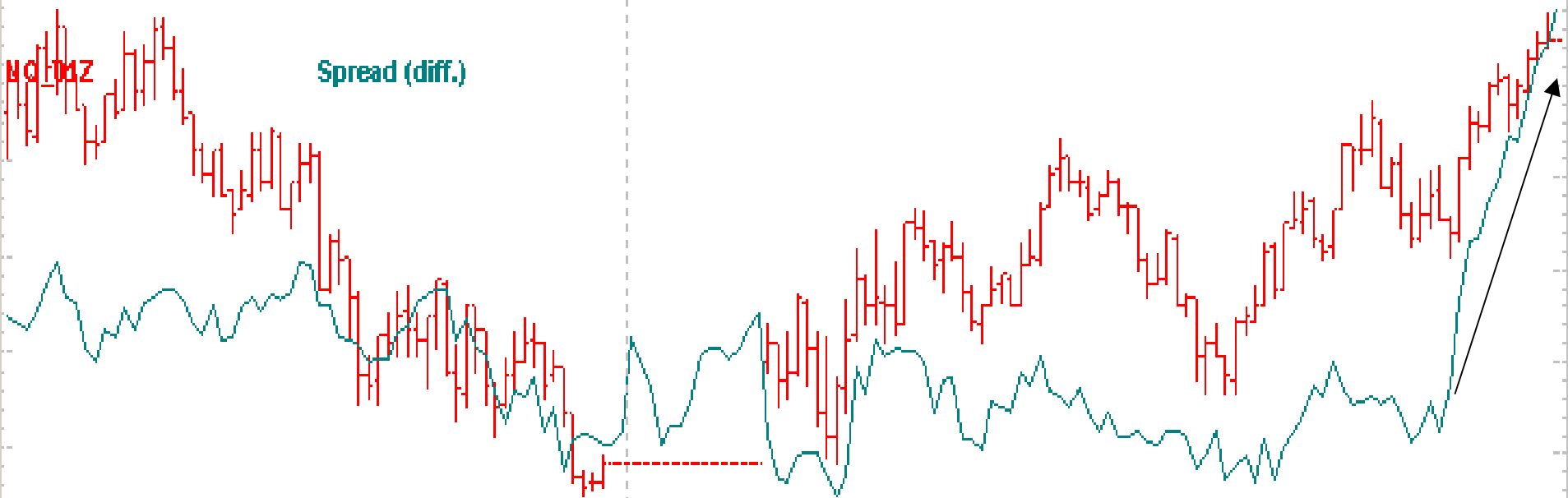
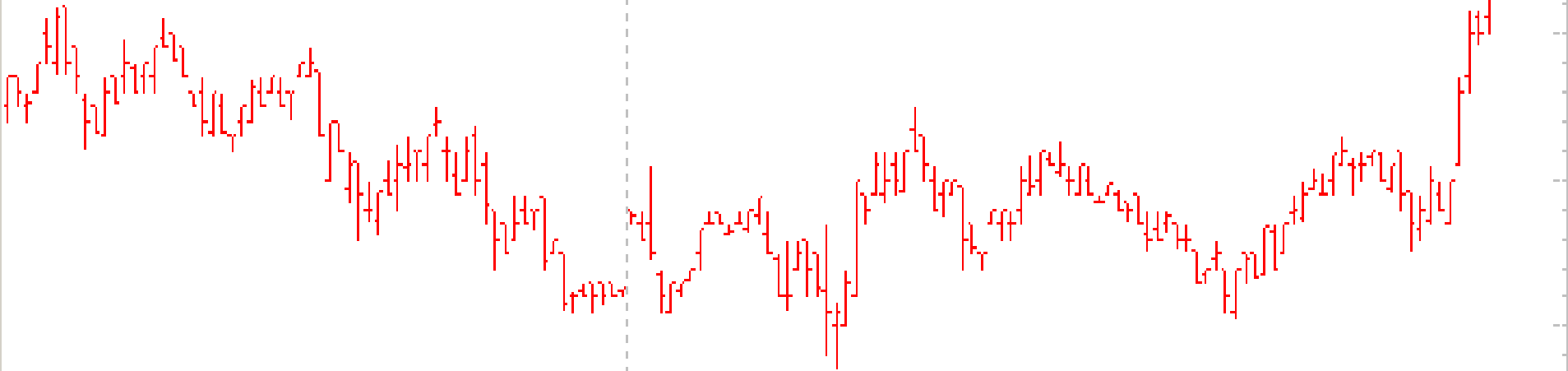
Another intraday spread is done between DJIA futures and Nasdaq e-mini futures, or any two of the e-mini indices. Since, both sides of the spread do not tick at the same dollar value, we create an equitable spread by using multipliers to make them dollar-equal. Just as with physical commodities, you can go long with either one of these indexes, depending on what you see happening.

SPREADS

One of the most exciting things to happen in the world of futures trading are the new “security futures.” These offer some of the easiest and most profitable spread situations in all of trading history. We are already doing them. We would love to teach you this fantastic way to trade. You can spread one stock futures against another; one stock futures against an index; or one index against another index. Wow!!

11/29/01 16:20= 9870 (+157)

NQ*20-DJ*10



NQ*20

Spread (diff.)