

Chapter 1

What Is a “Spread?”

If you already know what a spread is, you may be tempted to skip this initial chapter. However, I advise against it. Besides being presented for those who know, it is presented here for those who are not sure, and also for those who know that they know that they don't know.

I have been amazed at the number of traders who show up at my seminars who do not know what a spread is. Additionally, they do not know its numerous purposes or its many uses.

A Spread is...

For purposes of this book, a spread is defined as the sale of one or more futures contracts and the purchase of one or more offsetting futures contracts. You can turn that around and state that a spread is the purchase of one or more futures contracts and the sale of one or more offsetting futures contracts. A spread is also created when a trader owns (is long) the physical vehicle and offsets by selling (going short) futures. However, this course will not cover the long physicals, short futures types of spreads.

Furthermore, for purposes of this course, a spread is defined as the purchase and sale of one or more offsetting futures contracts normally recognized as a spread by the futures exchanges.

This explicitly excludes those exotic spreads that are put forth by some vendors but are nothing more than computer generated coincidences which will not be treated as spreads by the exchanges. Such exotic spreads as long

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Bond futures and short Bean Oil futures may show up as reliable computer generated spreads, but they are not recognized as such by the exchanges, and are in the same category with believing the annual performance of the US stock market is somehow related to the outcome of a sporting event.

Either way, for tactical reasons in carrying out a particular strategy, you want to end up with simultaneous long futures and short futures positions or, if you prefer, simultaneously short futures and long futures positions.

The primary ways in which this can be accomplished are:

1. Via an intermarket spread.
2. Via an intramarket spread.
3. Via an inter-exchange spread.

Intermarket Spreads

An intermarket spread can be accomplished by going long futures in one market and short futures of the same month in another market. For example: Short May Wheat and Long May Soybeans.

Intermarket spreads can become calendar spreads by using long and short futures in different markets and in different months. These spreads are specialized and uncommon, but it may be profitable for you know they are available.

Intramarket Spreads

Officially, intramarket spreads are created only as calendar spreads. You are long and short futures in the same market but in different months. An example of an intramarket spread is that you are long July Corn and simultaneously short December Corn. Other unofficial methods for creating intramarket spreads are beyond the scope of this course.

Inter-Exchange Spreads

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A less commonly known method of creating spreads is via the use of contracts in similar markets but on different exchanges. These spreads can be calendar spreads using different months, or they can be spreads in which the same month is used. Although the markets are similar, because the contracts occur on different exchanges they are able to be spread. An example of an inter-exchange calendar spread would be simultaneously long July Chicago Board of Trade (CBOT) Wheat, and short an equal amount of May Kansas City Board of Trade (KCBOT) Wheat. An example where the same month is used might be long December CBOT Wheat and Short December KCBOT Wheat.

Offsetting Contracts

Although both the long and the short futures may be entered simultaneously through a “spread broker,” it is often advantageous to enter a spread one “leg” at a time. However, until both the long and short futures are in place, there is no offset and consequently no spread exists. Offsetting merely defines the difference between the futures contracts, i.e., simultaneously both long and short futures. A spread consists of two “legs.” Each side of the trade constitutes one leg. Long futures is one leg and short futures is the other leg.

There are times when offsetting may be accomplished by using inter-exchange spreads employing differing numbers of contracts. Let’s say, for instance, you are short 5,000 ounces of July Comex (CMX) Silver and would like to offset with an equal amount of June Silver. You could create the necessary inter-exchange calendar spread by purchasing five Mid-America Exchange (Mid-Am) June, 1,000 ounce Silver contracts. Currency positions at the Chicago Mercantile Exchange (CME) can be similarly offset by contracts at the Mid-Am. I can offset a long CME D-Mark contract with two Mid-Am D-Mark contracts.

Sources of Spread Information

All the major US exchanges publish materials on seasonal spreads. Generally this material can be had free or, at most, for a nominal charge.

For example, the CBOT and the CME are happy to send you lovely color brochures showing charts of their exchange-recognized intermarket and intramarket spreads dating back over a period of 12 years. If you call and

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ask, they will send them at little or no charge. Don't forget to ask for both their commodity and financial futures material.

Years ago, before the advent of computerized data bases, I used to obtain the CBOT's "Year Book." I am not aware if they still publish it, but it was chock full of tables giving actual prices for every contract for an entire year. It provided me with a complete data base of prices that at the time was incomparable. I used that data as a historical base for creating a history of which spreads worked best seasonally. It was laborious and tedious work, but I manually entered much of the data into my old Epson QX-10 computer so I could produce an historical graph. The public library where I lived carried the Year Book on its reference shelf and I made an arrangement with the head librarian to pick up last year's volume as soon as they received the latest, newest volume. Seasonal tendencies in futures change little, if any, over the years. I still trade the same seasonal spreads today as I did decades ago.

There are more seasonal spreads today than there were then because there are more markets in which to trade, and because computers are able to spot very short term trends in spreads that would have been difficult and impractical, if not impossible, to detect by manual methods. Today, you can trade not only agricultural spreads, but also exchange-recognized spreads in the currency, financial, energy, and metals futures.

There is also an abundance of non-seasonal, intermarket and intramarket exchange-recognized spreads. Many of these non-seasonal spreads do have some seasonal tendencies and can be traded as seasonal spreads as well as outright spreads based on an event, fundamental knowledge, or some observable chart pattern.

In addition to the material provided by the exchanges, there are also private sources of information on spreads. Some of these sources, with a brief description of each, are listed in the Appendix B of this course.

Markets Suitable for Spreads

When trading spreads, I am careful to trade in liquid markets and generally reject spreads in very thin markets. However, because there is essentially no such thing as "stop running" when trading spreads, I can afford to take them in markets that are a bit more illiquid than what I normally would consider

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appropriate for trading. I consider the following markets suitable for trading spreads:

Currency:

British Pound, D-Mark, Swiss Franc, Japanese Yen. Any of these, one versus the other, on an intermarket basis.

Energy:

Crude Oil, Heating Oil, Unleaded Gas, Natural Gas. Any of these on an intermarket or intramarket basis, along with the "Crack Spread."

Grain:

Corn, Chicago Wheat, Soybeans, Chicago Oats on an intermarket or intramarket basis.

Chicago Wheat and Kansas City Wheat on an intermarket or intramarket basis.

Soy Oil and Soy Meal on an intermarket or intramarket basis, and the Soybean "Crush" spread.

Financial:

US Treasury Bonds, Treasury Ten Year Notes, Treasury Five Year Notes, and Municipal Bonds on an intramarket basis and on an intermarket basis. (MOB spread, NOB spread, etc.)

Two year notes on an intramarket basis.

Eurodollars on an intramarket basis.

T-Bills and Eurodollars on an intermarket basis. (TED Spread)

Meat:

Live Cattle and Live Hogs on an intramarket basis. Feeder Cattle on an intermarket basis with Live Cattle entered only as a spread.

Metal:

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Gold, Silver, Copper on an intramarket basis, and Gold, Silver on an intermarket basis.

Softs:

Cocoa, Coffee, Cotton, Orange Juice on an intramarket basis. (Caution: Coffee, Cotton, and Orange Juice in particular are among the world's most treacherous markets and I never trade outright futures positions in any of them. In this writer's opinion, trades in Cotton and Orange Juice should be avoided by non-commercial interests.)

Of the above named markets, I will not take any trade that involves legging into a spread in any of the following markets: Orange Juice, Heating Oil, Unleaded Gas, Copper, Coffee, Cotton, Live Hogs, T-Bills, and Feeder Cattle. I will leg out of any of these only in dire emergencies, preferring to liquidate the trade intact, as a spread, both legs at the same time at a specified spread differential. "Legging in" refers to a situation in which both sides of the spread are not put on simultaneously. "Legging out" refers to exiting the spread one side at a time and not exiting both legs simultaneously.

I will not take any trades that involve Lumber, Value Line, Canadian Dollar, or Pork Bellies. I tend to reject spreads in very thin markets or delivery months.

As a rule, I will not take any trades that involve spreads that are not recognized by the exchange as being a spread. However, I may take a non-recognized spread if it occurs in related markets such as Soybean Oil and Soybean Meal.

Indices:

S&P 500 Stock Index, Dow Jones Industrial Average Stock Index, NASDAQ 100 Stock Index, New York Stock Exchange Index

Chapter 2

Why Use Spreads?

There are certain advantages to using spreads. Stop for a moment and think about what they might be. I'll list them here and you will also see them discussed as appropriate throughout the course.

Advantages of Spreads

Spreads can be insensitive to the trend or lack thereof in the outright futures. Of course, there are exceptions. In a bull market, the front months usually outperform the back months, and in a bear market, the back months usually outperform the front months. Generally, the absolute direction of the underlying futures is of little concern. The important thing is whether or not the trend of the spread differential moves favorably in the direction you would prefer.

Exchange-recognized spreads carry lower initial and lower maintenance margin requirements. This is because spreads involve lower volatility. Most of the time true spreads do not move as frantically as do the underlying futures. A spread position is automatically a hedged position most of the time and therefore usually involves less risk. Some cases of "old crop" vs. "new crop" can refute this. They sometimes look like different animals.

Spreads serve to reduce the volatility impact of the underlying futures. In an intramarket spread, if the front month of a contract suddenly comes crashing down, it is highly likely that all the remaining months will also crash down.

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The only thing the spread trader is interested in is whether or not a change in the spread differential has helped or hurt his position.

Spreads allow a trader to take a fractional approach when putting on a futures position. Did you think you could do that only with options? Let's say you want to get long Treasury Bond (T-Bond) futures. After speaking with your broker, you realize that the margin for a single T-Bond trade is greater than you feel you can handle in your account. You notice that on most days, Treasury Note (T-Note) futures generally move some fraction of the amount of T-Bond futures. You also notice that the long T-Bonds, short T-Notes spread is widening.

By going long T-Bond futures and short T-Note futures, you have created a fractional position in the interest rate futures. If T-Notes are moving 80% as much as T-Bonds, then your spread renders a move that is 20% of a long position in T-Bond futures. For example, if T-Bonds move up 10 points (\$312.50), and at the same time T-Notes move up 8 points (\$250), then the spread, T-Bonds/T-notes will have widened by 2 points (\$62.50) i.e., 20% ($\$62.50 / \312.50).

Spreads have yet another advantage: they are convertible. It is possible to "leg out" of a spread, leaving yourself with an outright futures position. Conversion can work both ways, outright futures may be convertible to spread positions, and spreads are convertible to outright futures positions. Convertibility adds a great amount of flexibility to your futures trading. Don't tell them, but options traders think they're the only ones who can do this.

Spread trading helps the trader to avoid a lot of the noise created during the intraday market trading. Much of the intraday noise is that of stop running by the locals on the floor. There are no stops in the traditional sense with spread trades. There is no stop running available when there is no stop order in the market. Why is there no stop running in spreads? Because the stop exists in the spread differential, and can be obtained by a combination of any number of futures prices. This leads to another feature of spread trading, confidentiality.

When you are in a spread, and both long and short at the same time, you have no exit order in either market. If you are long Corn and short Beans, there is no exit order in place other than to exit at a certain difference

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between the contracts. Your trade is confidential. The locals have no idea of your true position or intent. They can't see both of your positions and have no reason to look.

Spreads, by their very nature, constitute a hedge. The economic rationale for the futures markets is to provide an arena in which risk may be hedged. A futures speculator can also hedge. His hedge is created by using an offsetting position. He creates the offset by putting on a spread. Have you ever wanted to hedge your position but didn't know how? Spreading can, at least temporarily, stop or lessen the pain of a bad trade.

There is one further, somewhat obscure advantage of spreads. It is possible in some markets to use far distant back months for the offsetting position. In other instances, where you might be involved in a back month, you can use closer-in months for the offsetting position. In a later chapter, I will show you an example of how this advantage could have been utilized to save what would have otherwise resulted in a disastrous situation in the Coffee futures.

Uses of Spreads

There are numerous reasons to use spreads. You might want to pause a moment to think about what they might be. Spreads are usually, but not always, used by speculators to reduce the risk of holding a position overnight or, indeed, to lower risk at any time at all. Spreads are used by traders to take advantage of historical seasonal tendencies.

Spreads are used by traders to trade sideways markets where the futures spread is trending at the same time outright futures prices are seemingly moving sideways within Trading Ranges. Spreads are also used to convert an outright futures position to a combination futures position where the trader feels for any number of reasons that it is better to carry the offsetting positions available by spreading.

Spreads are also used as outright intermarket and intramarket speculations. Spreads are used when there is a desire to remove the effects of futures directionality or trending from a trade. Spreads can be employed to reduce the amount of initial margin and maintenance margin required to trade a particular contract. Finally, spreads can be used to reduce and greatly eliminate the effects of volatility and the resulting uncertainty from a trade.

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Let's briefly look at each of the above situations in order to gain an overview and somewhat deeper insight into the reasoning behind each.

In later chapters, when I show how I trade the various spreads, I will probe the depths of the reasons for taking spread trades. In conjunction with the reasons, I will also show you my strategies and the tactics by which I carry them out. **Keep in mind, it is entirely possible to lose on both sides of a spread.**

Reducing the Risk of Holding a Position

It is not uncommon in liquid or illiquid markets for a floor trader to hedge his position by "spreading off" against the same market in another month, or against a related market in the same month. I have seen this kind of floor trading tactic in such illiquid markets as the Value Line, and even in more liquid markets such as Soybeans, Eurodollars, and Bonds. In fact, arbitraging through spreads in distant back months by financial traders is commonly done while greatly reducing risk. If floor traders think it's important to "spread off," don't you think it's important for you to do the same thing?

Value Line floor traders, in an effort to make a market, will take the opposite side of an entry order coming in from off the floor. Then, because volume and liquidity are so terribly low in this market, the Value Line floor trader will offset his position by taking an opposite position in the S&P 500. By doing so, he has hedged his risk. It is not uncommon for a floor trader in the Soybean pit to offset and hedge his risk by taking an opposite equity position in Soybean Oil or Soybean Meal.

Financial floor traders will hedge risk by spreading intermarket contracts and intramarket back month contracts. Often these are not perfect spreads and often they are not spreads recognized by the exchange as such. Nevertheless, they are regularly used by floor traders and are illustrative of the use of spreading off as a means to reduce risk and thereby create a hedge.

Off-the-floor traders can also hedge risk by use of offsetting positions to be held overnight. Both daytraders and position traders can create spreads that considerably minimize the risk of a position that might be held overnight. Day trades can be converted to position trades by spreading. Position trades can be held considerably longer at less risk by spreading.

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Taking Advantage of Historical Seasonal Tendencies

Probably the most common use of outright spread trading is for the purpose of taking advantage of the seasonal tendencies that occur in various futures markets. Trades with a high probability of being profitable can be entered this way. Trades with success probabilities in the 80th and 90th percentiles are quite common among seasonal spread trades.

Seasonal spreads are not exclusive to consumable commodity futures. They occur in the currency and financial futures markets as well. The proof of the reliability of seasonal trading is extensive. In fact, not that many years ago it was the mainstay of many a successful trader. Knowing when the markets are following their normal seasonal behavior and taking advantage of the fact is one of the safest and surest ways to trade the futures markets. One has to be patient and restrained from greed when trading seasonals. The reward is well worth the effort.

Trading in Sideways Futures Markets

It is not unusual for a particular futures market to be moving sideways. Experts have stated that markets spend approximately 85% of their time with their prices moving sideways and not trending. Whereas overall markets may be moving sideways, there is often a trend occurring between different months of the same underlying futures or the same or various months of related futures. Markets that tend to incur long periods of congestion may very well be trending when a front month is offset against a back month. One month may be moving sideways with an upward bias while another month is moving sideways with a downward bias. The difference gives rise to a spread trend and an opportunity to profit from the spread differential.

Converting an Outright Futures Position to a Spread

Quite often an outright futures position can be converted to a spread position. The result can be less risk and will require less margin. I have entered such conversions in my trading and have witnessed what would have been a loss, had I held outright futures, turn into a profit by way of conversion to a spread. Trades of this sort will be illustrated later in this course. Ending up in a spread has usually been the result of a need or willingness to hedge. The resulting profit has often been greater from the

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spread than it would have been had an outright futures position been maintained. Have you used this privilege in your trading?

Outright Inter-Exchange, Intermarket, and Intramarket Speculations

A spread trade is often entered without the benefit of seasonality as an outright spread position. This may be done as a counter-seasonal trade due to backwardation in a market. Any news event, rumor, fundamental fact, or technical formation can cause a trader to enter a spread based on the merits of his ascertaining that a spread trade would be in his best interests. Outright spread trades may be entered when it is unknown which way a market will break from congestion. Once the break has occurred, the losing side of the spread is dropped and the winning side is maintained. Entire strategies and the resulting tactics needed to carry them out can be built around outright spread trades.

Any time a spread is trending, sufficient reason exists to consider entry via the spread method of trading futures. Should it become advantageous, any spread position can at any time be converted to an outright futures trade by simply dropping the losing side of the spread.

Removing the Effects of Directionality

Spread trades are not fully dependent upon the trend or lack thereof of the individual futures of which they are comprised. Rather, they are dependent upon the trend of the spread differential itself. This is why, even when markets are not trending, a spread trade can make money from the trend in the spread differential. However, spreads can also make profits in trending markets. If the long side of a spread trade trends higher and faster than the short side of that same trade, profits will be acquired by virtue of the upward trend in the spread differential.

In like manner, if the short side of a spread trends lower and faster than the long side of that same trade, profits will be acquired by virtue of the upward trend in the spread differential. This may seem confusing, but it points out the fact that the trend of a spread can be up even while the two legs of the spread contract are plunging down.

Both Sides of a Spread Can Win or Lose

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While on the subject of directionality, keep in mind that directionality of profit or loss is another matter. It is entirely possible to be profitable on both sides of a spread as well as to be unprofitable and actually lose on both sides of a spread.

Reducing the Amount of Initial and Maintenance Margin

Exchanges recognize the reduced risk of spread trades and the corresponding reduction in the effects of volatility by making the margin requirements necessary to carry spread trades much lower than those for outright futures trades. Spreads are generally fractionally less volatile than outright futures positions.

Every spread trade carries in it the elements of hedging, and the elements of risk. Hedgers require less margin to trade because they are both long and short the same or a related commodity. That is one reason why, with a few exceptions involving related markets, we do not advocate exotic, exchange-non-recognized spreads for purposes of this course. Lowered margin requirements are a major positive reason for entering spread trades. Lower margins can mean more opportunities to enter or add to positions in the same market or to diversify through additional positions in other markets. If you are trading a small account, are you aware that spread trading may offer a way to obtain more trading opportunities?

Reduce and Greatly Eliminate the Effects of Volatility and Uncertainty

As stated above, it is the hedging nature of spreads that can reduce risk and margin. This reduction is directly related to the lessened exposure to volatility that may be carried by spread trades. If you are both long and short the Japanese Yen and it explodes into a 500 point price rise in a single day, you may profit if the long side of the trade moves up more than the short side. If the opposite is true, you will lose only fractionally the amount you would have lost if you were holding an outright short futures position. The long futures will always mitigate the effects of any loss you might be taking on the short side of the spread trade.

Disadvantages of Spreads

Since I've been listing the advantages of spreads, it is only fair that I list the disadvantages of spreads. Nothing in life is perfect. Spread trading is not totally without some drawbacks. You wouldn't want me to pretend there are none, would you?

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Probably the greatest disadvantage in the minds of some traders is that trading spreads limits profit potential. Of course, this is true. When you limit the risk in a trade, you usually end up limiting the amount of profit available in that trade. Limited profit potential must be weighed against the benefits and advantages that accrue to a trader who utilizes spreads.

Another disadvantage in spread trading is the limited amount of written information about spreads. There are few books indeed that cover the subject. One of the reasons for my preparing this course is to provide an in-depth treatment of the subject of spread trading.

Ordering of spread trades is another draw-back for many traders. It takes a greater effort to place a spread order than other types of orders. Although the ordering of a spread trade involves no more than a few additional words, this seems to be an insurmountable obstacle for those not willing to make the effort. I believe this degree of reluctance derives from the fact that traders are not sure of themselves when it comes to placing spread trades. This lack of certainty revolves around not understanding the mechanics of ordering, and also a lack of understanding of how spread trades work.

Ignorance in this area is not solely in the realm of the trader. It also involves the broker. This leads to another disadvantage of spread trading, broker uncertainty.

I've been amazed at how few brokers know anything about how to place a spread order. Therefore they are sometimes of little help to the trader seeking such information. That's too bad, isn't it?

Perhaps the final disadvantage of spread trading is found at the spread desk itself. For spreads that involve the existence of an actual spread desk, i.e., spreads like the TED spread which involves a spread across two markets, and therefore trades at an official TED spread desk of the International Money Market, there is a loss of the confidentiality that is available were the trader to avoid the spread desk and simply leg into the spread trade.

I feel that it is often better to leg into spreads, especially where the trader has the time and resources to observe the market and enter at a more propitious differential. The back office computer is oblivious to legging in. It cannot tell whether the spread was entered as a spread or was entered by legging-in.