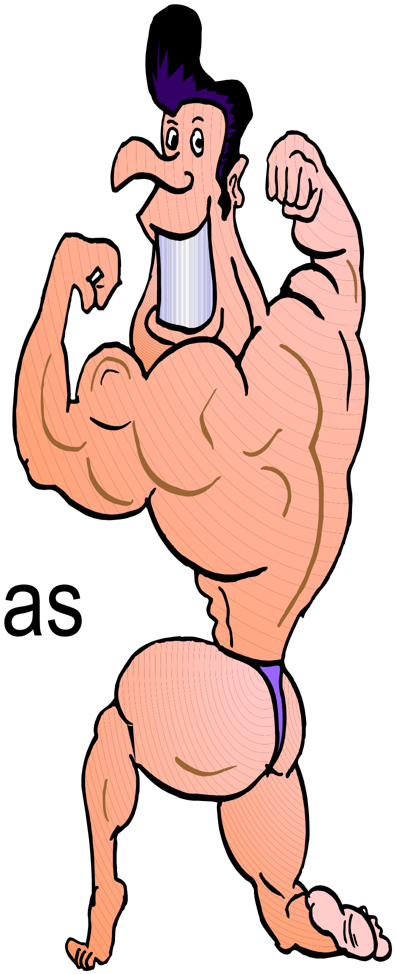
TRADING EDUCATORS
PRESENTS

SPREADS

What you should know!

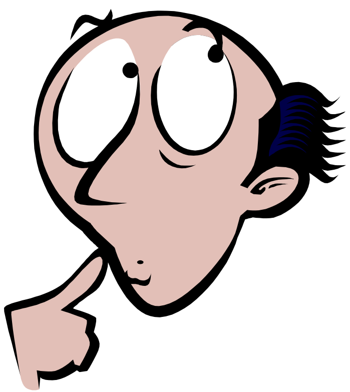
Introduction

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, method of trading in the markets.



Introduction

You may think that spread trading is only for futures traders. But thinking that way is incorrect. You‘ll see as we go along, that there are opportunities for spreading even for stock traders. And of course, these days, stocks can be traded either through the equity markets or through the futures market. Spreading has gone much further than its original intent.



WHY SPREADS EXIST

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.

WHY SPREADS EXIST

Hedging is both the economic and social justification for the futures markets. In the eyes of society and the law, it is the ability to insure stable prices that is the rationale which

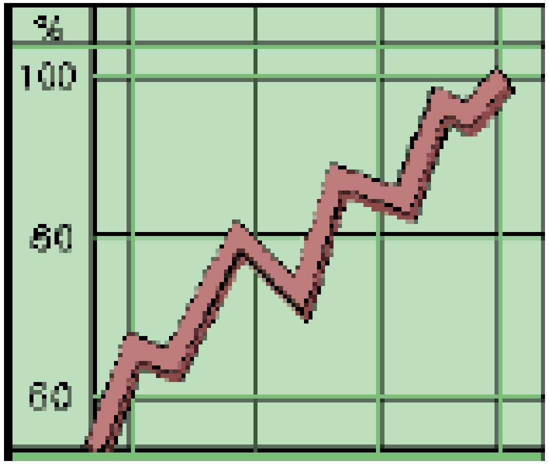
separates futures trading from outright gambling. A futures hedge is, in fact, nothing more than **price insurance**.

WHY SPREADS EXIST

Producers and users can buy almost any kind of insurance imaginable. They can insure against weather and other 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.

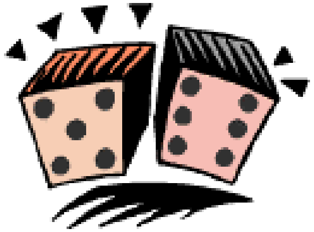
WHAT SPREADS ARE



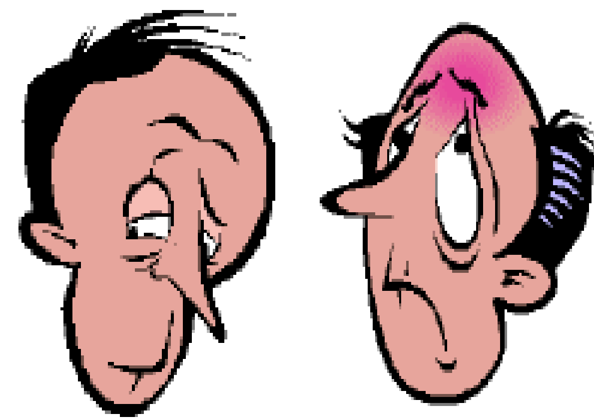
Every futures hedge is a spread, and every futures spread can be a hedge. When a spread is placed in effect, the risk changes from that of price fluctuation to that of the difference between the two sides of the spread. A spread tracks the difference between the price of whatever it is you are long and whatever it is you are short.

WHAT SPREADS DO

Spreading takes much of the risk out of using the futures markets. Even the U.S. 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, and helps to stabilize prices for the consumer.



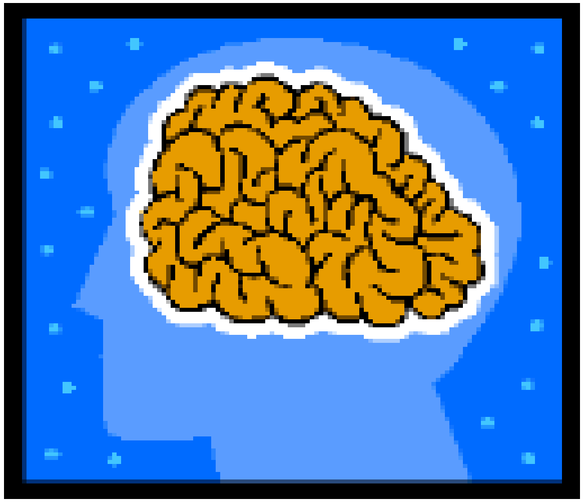
THE RATIONALE FOR SPREADS



In general, society frowns upon gambling. Nevertheless, there are many traders in the market who do gamble – they gamble, perhaps without realizing that's what they are doing. Anyone who trades in markets 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 – ANOTHER WAY TO TRADE

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 – ANOTHER WAY TO TRADE

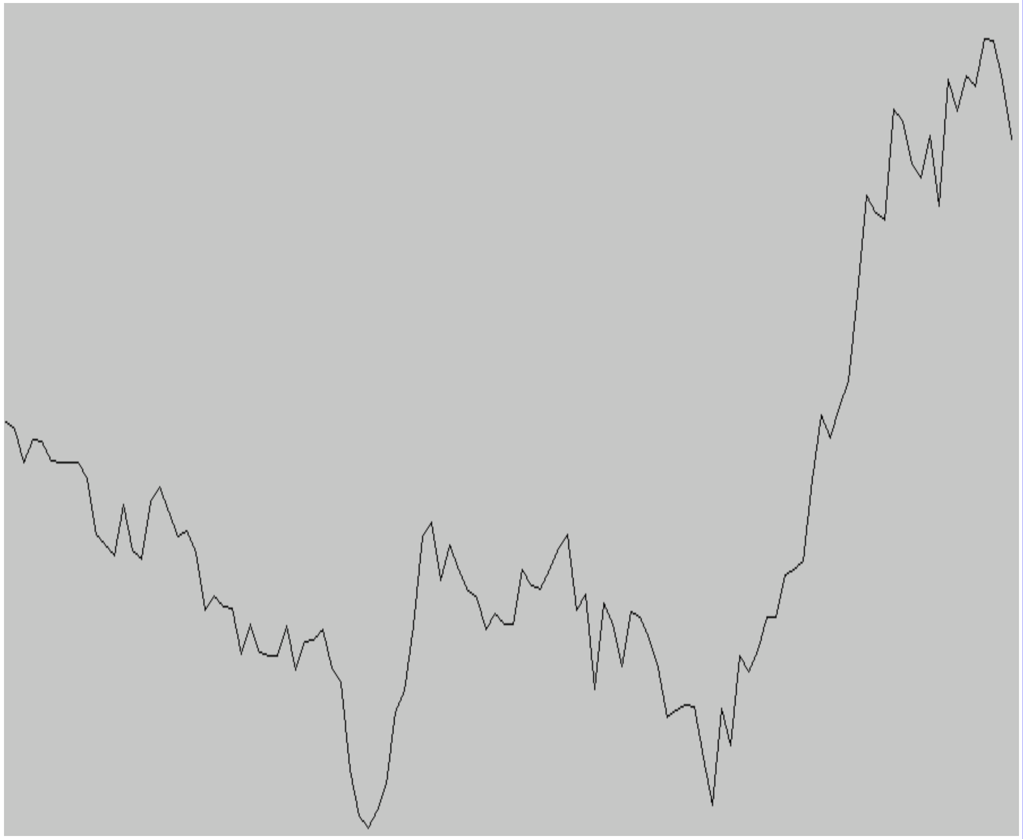
The gambler makes his trading decisions on gut feelings, hopes, dreams of getting rich quick, tips from the broker, "inside information from friends, and from the improper understanding and use of indicators, oscillators, moving averages, and mechanical trading systems. In general, he is looking for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

SPREADS – ANOTHER WAY TO TRADE

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, the difference between two related futures contracts in different markets, between an equity and an index, or between two equities.

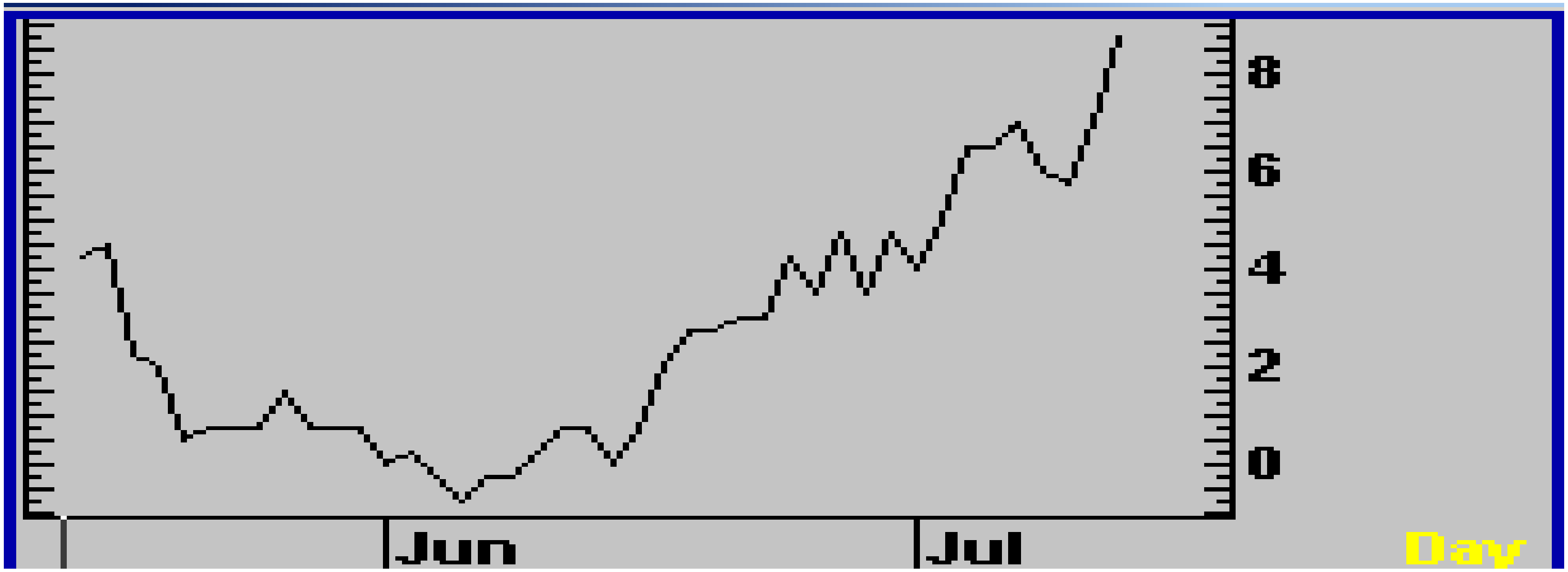
SPREADS – ANOTHER WAY TO TRADE

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.



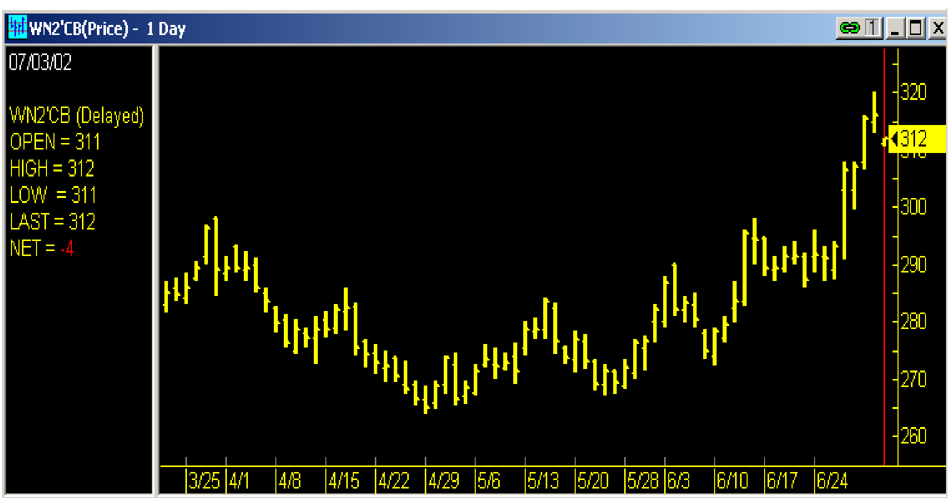
SPREADS – ANOTHER WAY TO TRADE

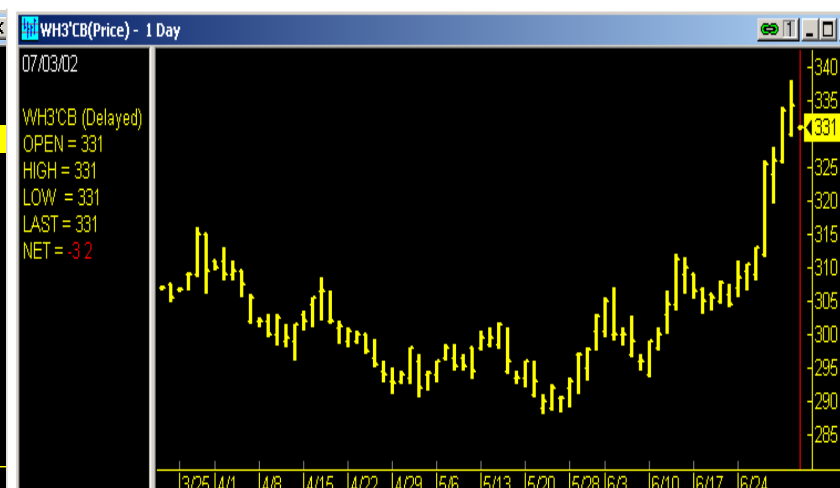
He can just as easily trade the difference between IBM and INTEL. Or he can trade the difference between two Exchange Traded Funds.



SPREADS – ANOTHER WAY TO TRADE

Obviously, the risk taken for the difference in price among related contracts is far less than the price risk taken in an outright speculation. This is because related futures will tend to move in the same direction.





REDUCED MARGIN SPREADS

REDUCED MARGIN SPREADS

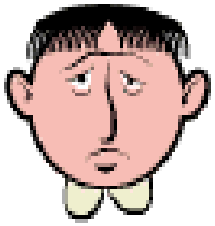
The spreader in those markets that have reduced margins is able to earn a much greater return relative to posted margin than is available in any other form of futures trading. This is because margins on reduced margin spread trades are about 1/4th to 1/5th of those for an outright futures trade.

GREATER LEVERAGE CAN BE A BENEFIT

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).

BENEFITS OF LEVERAGING

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

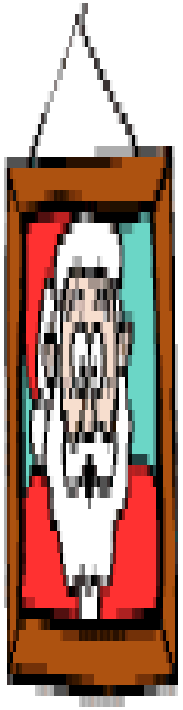


Soybean futures - $250/$1050 = 23.8% return

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

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

Yes, there seems to be a catch. It is said that spreads tend to move less dramatically than futures. It would seem to be easier to realize a 5 point move in outright soybean futures than it would be to realize a 5 point move in a spread between two soybean contracts, which essentially move in the same overall direction. But to think that way **distorts** the picture.

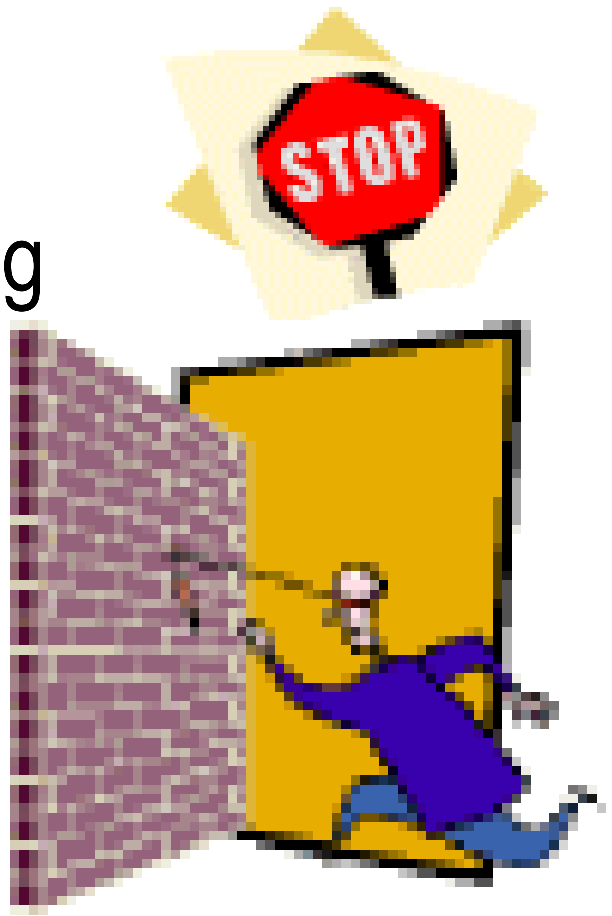


DRAMATIC TRENDING

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

BENEFITS OF TRADING 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.



BENEFITS OF TRADING SPREADS

Spreads eliminate the problem of stop running. You are long on one side and short on the other. There is no way for the market movers to run your 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**.

BENEFITS OF TRADING 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.

BENEFITS OF TRADING SPREADS

When you enter an outright futures or equity trade, the pure statistical chances of being correct on the direction of the trade are one in two. You are either right or wrong about the direction of prices. However, with a spread the picture changes considerably. Let's take a look at that situation.

Direction of prices

When trading an outright, you are either right or wrong about the direction of prices.

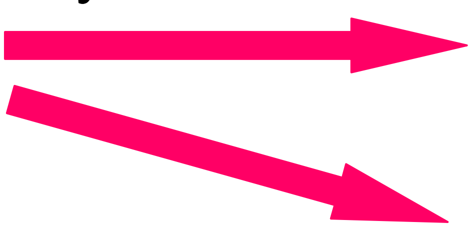
When trading spreads, you can still win even if you were wrong about the direction of prices as long as you were not too wrong.

YOU HAVE MORE CHANCES TO WIN WITH SPREADS!

Direction of prices

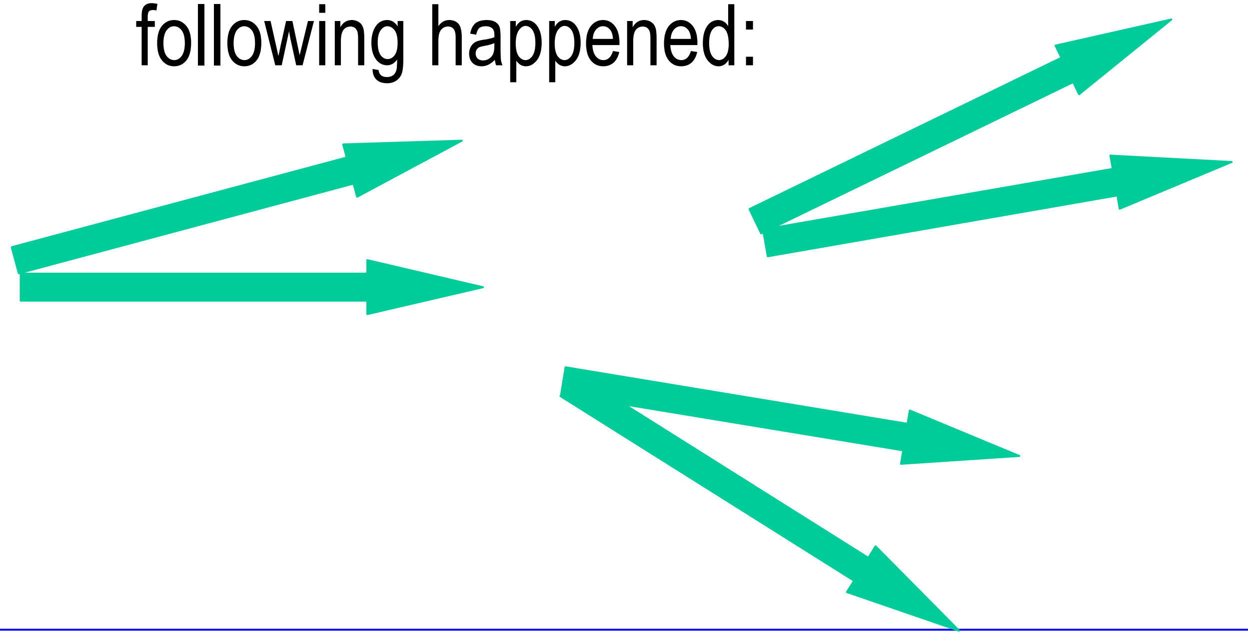
When trading an outright, you are either right or wrong about the direction of prices.

If you are long and prices move sideways or down, you lose.



With a Spread you can win under any of the following conditions.

If you thought prices would rise on one leg and fall on the other, you could win even if any of the following happened:



BENEFITS OF TRADING SPREADS

We need to look at other advantages of trading spreads. One of those is **seasonality**. Seasonality works extremely well in spread trading. The percent of wins against losses is outstanding. For a variety of economic reasons, you can find seasonal trades even in the financial markets.

BENEFITS OF TRADING SPREADS

Highly correlated fundamental spreads are available in many markets.

These are spreads that for some fundamental reason are behaving almost identically as they have in the past. The beauty of these spreads is that you do not have to understand any of the reasons why it is happening. All you have to do is to see that it **is** happening.

BACKWARDATION

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.

BACKWARDATION

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.

BACKWARDATION

When a market comes out of backwardation and returns to a normal relationship between months, you have just as good an opportunity as you did when prices entered into backwardation.

BACKWARDATION

We are not denying that when 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. Usually, you are taking outright price risk in a month that is less liquid than the front month. You are also giving up any available lower spread margins.

REDUCED VOLATILITY

Spreads offer a way to reduce volatility. That‘s why so many of them carry reduced margins. Exchanges set margins based on measured volatility. Obviously, they feel that spreads between a variety of markets are less volatile than trading in the outrights.

VOLATILITY

DAY TRADING SPREADS

"All this is very interesting, but I'm an equity 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.

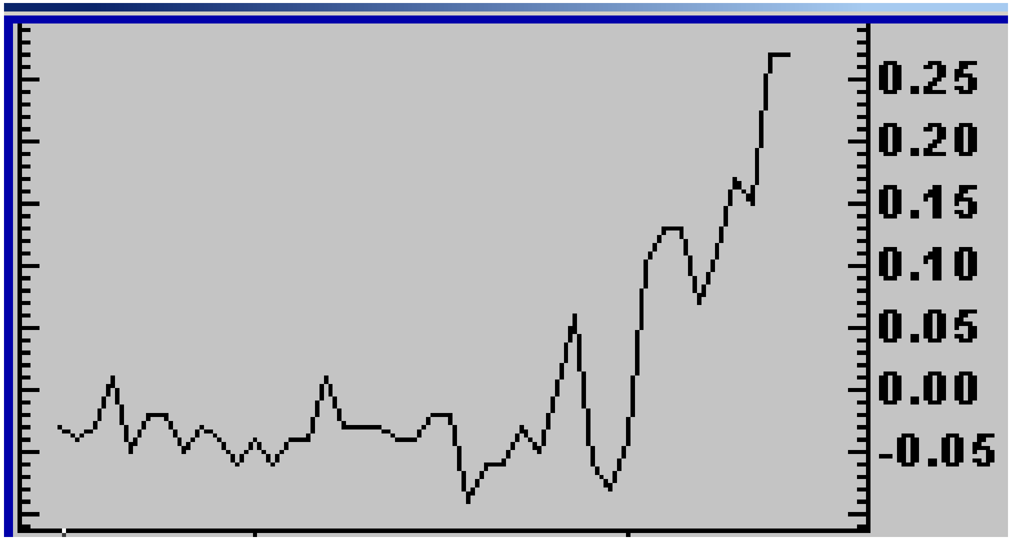
DAY TRADING SPREADS

Another intraday spread is done between 2 DJIA futures and one Nasdaq e-mini futures. Since DJ moves at $10/point and NQ moves at $20/point, we use two DJ futures vs one NQ futures to create an equitable spread. That way, both sides of the spread tick at $20. Just as with physical commodities, you can go long with either one of these indexes, depending on what you see happening.

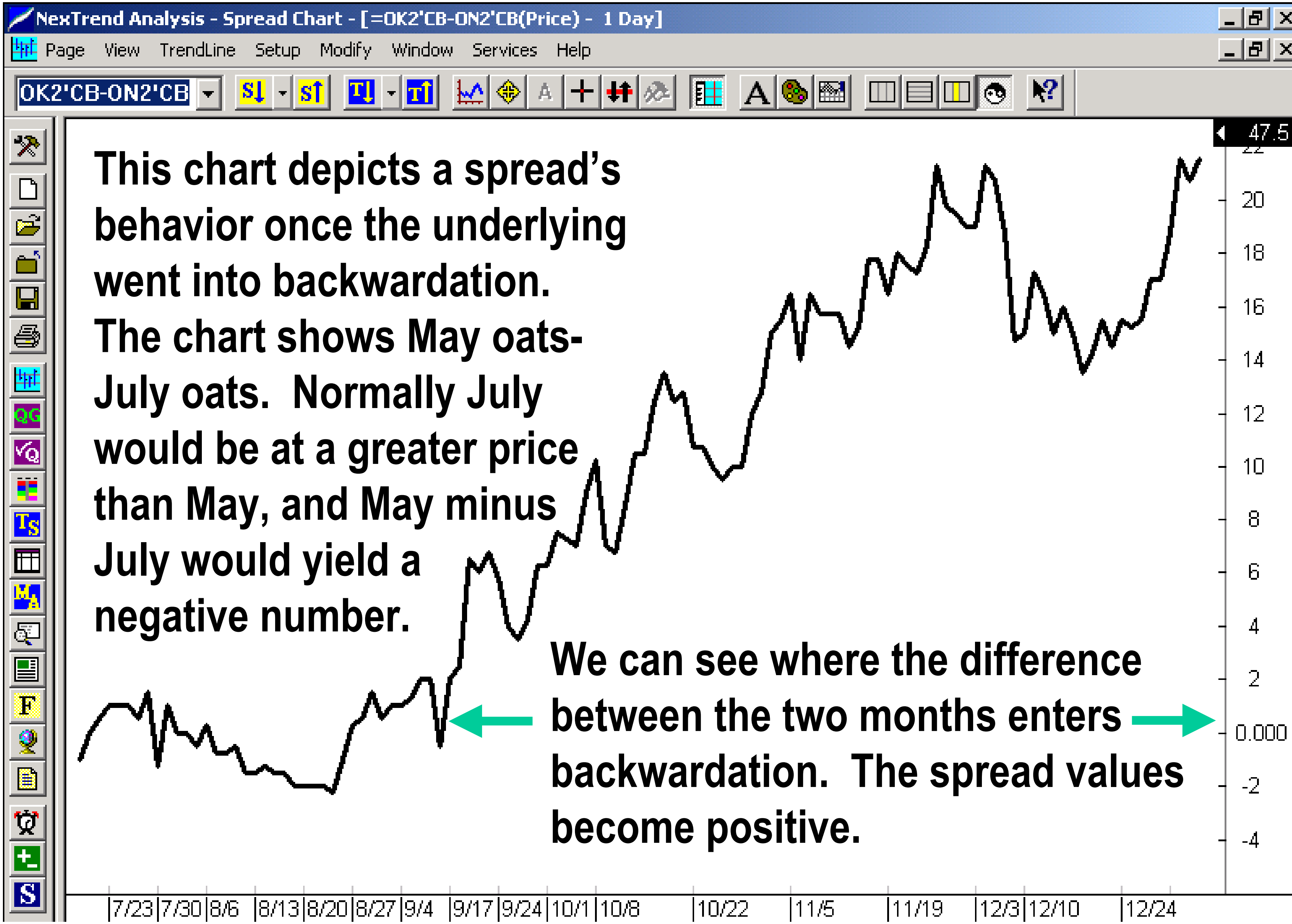

nqp3- = -17229.00
11/ 8/03 9:30
NQP3-DJU3*2
-17000
-17020
-17040
-17060
-17080
-17100
-17120
-17140
-17160
-17180
-17200
-17220
-17240

DAY TRADING SPREADS

You can spread the weakest stock in a sector fund against the strongest stock in the sector. You can spread one sector fund against another sector fund. You can spread the "Qubes" against the "Diamonds," or either one of them against the "Spiders."



BACKWARDATION EXAMPLE



The End

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The staff at Trading Educators

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