SPREADS – A WHOLE NEW WAY TO TRADE

What Is a Spread?

Spread trading in futures is as old as the hills, yet it is an entirely new concept for most current traders in futures. In this introductory piece, we will show you that spreads can be the most conservative, safest way to trade in the futures markets. But first, what exactly is a spread?

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 to 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.

Furthermore, a spread is defined as the purchase and sale of one or more offsetting futures contracts normally recognized as a spread by the fact that the two sides of the spread are actually related in some way. This explicitly excludes those exotic spreads put forth by some vendors, which are nothing more than computer generated coincidences which are not in any way related. Such exotic spreads as Long Bond futures and Short Bean Oil futures may show up as reliable computer generated spreads, but bean oil and bonds are not really related. Such spreads fall into the same category as believing the annual performance of the U.S. stock market is somehow related to the outcome of the Super Bowl sporting event.

In any case, for tactical reasons in carrying out a particular strategy, you want to end up with:

1. simultaneously long futures of one kind in one month, and short futures of the same kind in another month. (Intramarket Calendar Spread)

2. simultaneously long futures of one kind, and short futures of another kind. (Intermarket spread)

3. long futures at one exchange, and short a related futures at another exchange. (Inter-exchange Spread)

4. long an underlying physical commodity, and short a futures contract. (Hedge)

5. long an underlying equity position, and short a futures contract. (Hedge)

6. long financial instruments, and short financial futures. (Hedge)

The primary ways in which this can be accomplished are:

- Via an Intramarket spread.
- Via an Intermarket spread.
- Via an Inter-exchange spread.
- By ownership of the underlying and offsetting with a futures contract.

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.

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.

Inter-Exchange Spreads

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 of using the same month might be Long December CBOT Wheat and Short December KCBOT Wheat.

Why Spreads?

The rationale behind spread trading is one of the best-kept secrets of the insiders of the futures markets. While spreading is commonly done by the market "insiders," much effort is made to conceal this technique and all of its benefits from "outsiders," **you** and **me.** After all, why would the insiders want to give away their edge? By keeping **us** from knowing about spreading, they retain a distinct advantage.

Spreading is one of the most conservative forms of trading. It is much safer than the trading of outright (naked) futures contracts. Let's take a quick look at some of the benefits of using spreads:

1. Intramarket spreads require considerably less margin, typically around 25% - 75% of the margin needed for outright futures positions.
2. Intramarket spreads offer a far greater return on investment than is possible with outright futures positions. Why? Because you are posting less margin for the same amount of possible return.
3. Spreads, in general, trend more often than outright futures.
4. Spreads are often trending when outright futures are flat.

5. Spreads can be filtered by virtue of seasonality, backwardation, and carrying charge differentials, in addition to any other filters you might be using in your trading.

6. Spreads can be used to create partial futures positions. In fact, virtually anything that can be done with options on futures can be accomplished via spread trading.

7. Spreads allow you to take less risk than is available with outright futures positions. The amount of risk between two Intramarket futures positions is usually less than the risk in an outright futures position. The risk between owning the underlying and holding a futures contract involves the least risk of all. Spreads make it possible to hedge any position you might have in the market. Whether you are hedging between physical ownership and futures, or between two futures positions, the risk is lower than that of outright futures. In that sense, every hedge is a spread.

8. Spread order entry enables you to enter or exit a trade using an actual spread order, or by independently entering each side of the spread (legging in/out).

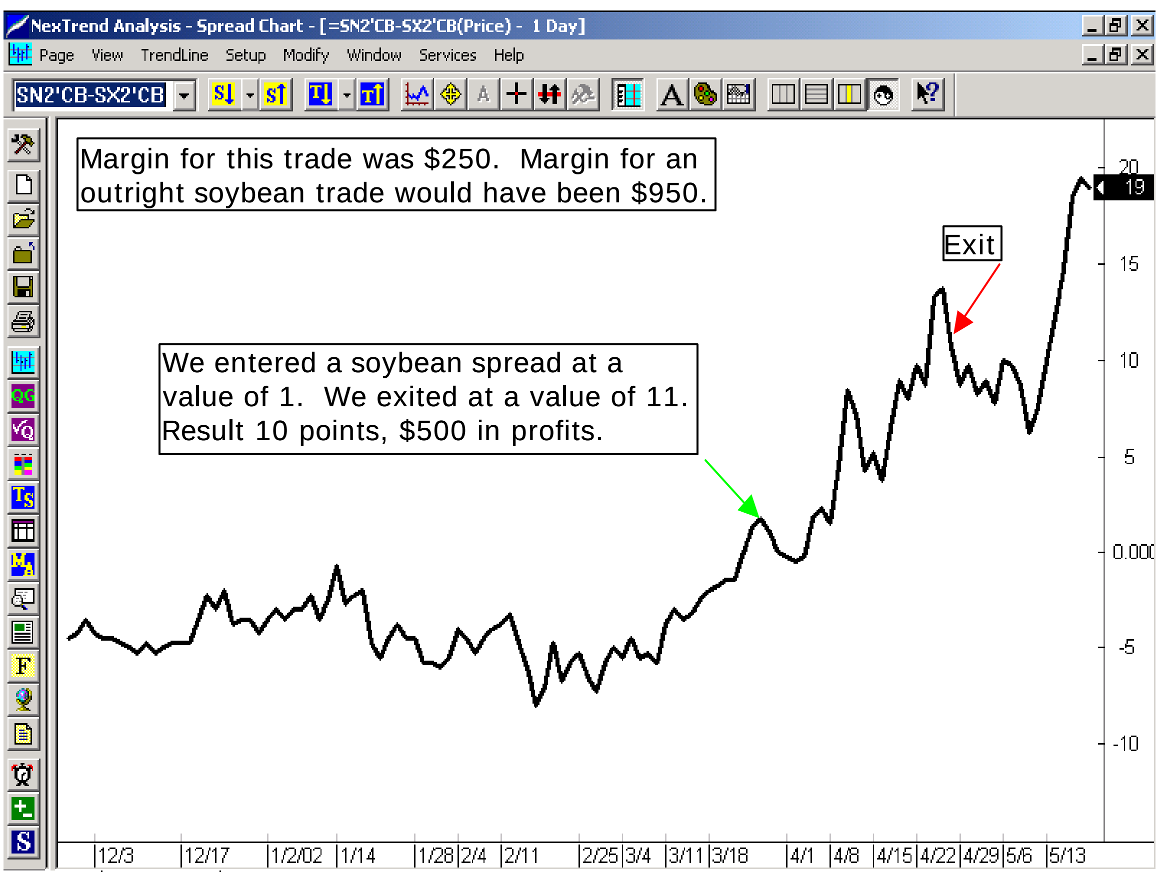
9. Spreads are one of the few ways to obtain decent fills by legging in/out during the market Closing.

10. Live data is not needed for spread trading, saving you $$ in exchange fees.

11. You will not be the victim of stop running when using Intramarket spreads.

What Can You Expect?

Here are some examples of what you can expect from Intramarket spread trading. We think you may be pleasantly surprised!!



Would you want to have been long soybeans during this same period??

Although you would have made money on the trade, you would have suffered from serious whipsaw during the entire length of the trade.

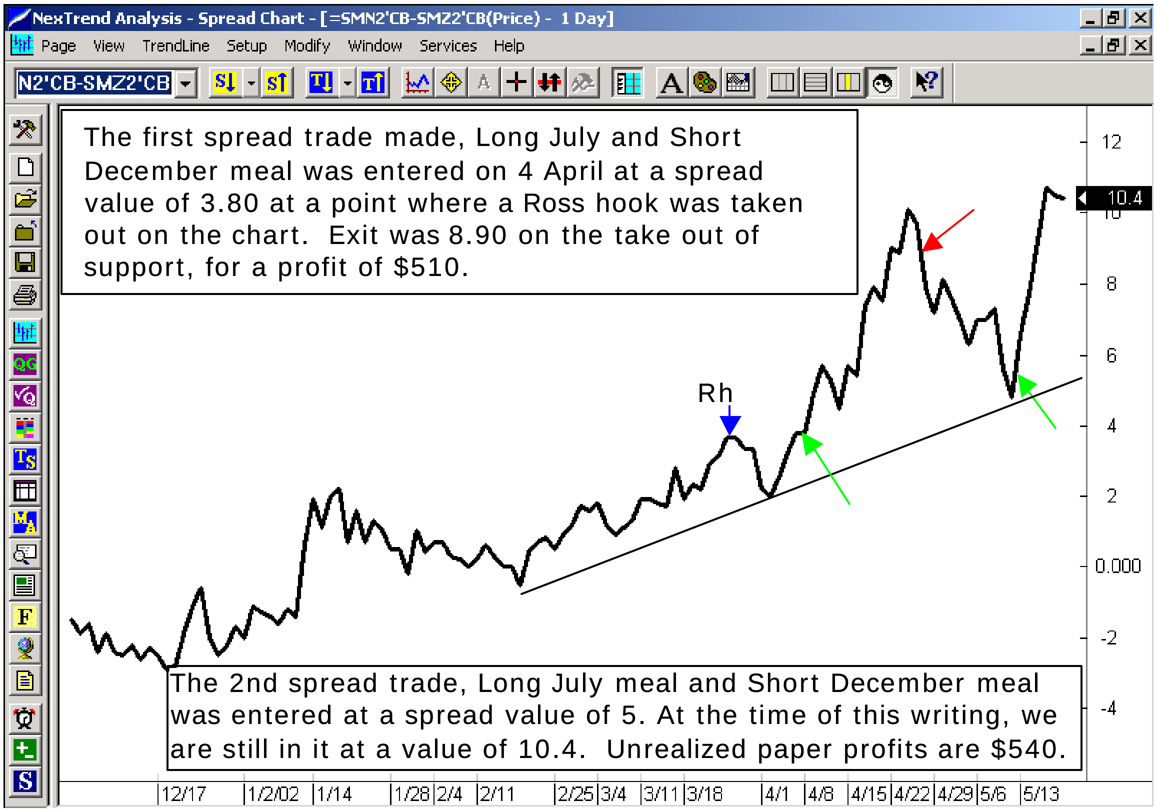
At one point, there was a major draw-down on your margin account as prices plunged below your entry point. Who needs such aggravation? Certainly, we don't look forward to the kind of trading represented by what would have happened on this outright soybean trade. Prices were choppy and sloppy throughout the duration.

Perhaps you think you would have gone in and out while prices were chopping around. However, it is never a good idea to churn your own account. Commissions and fees would have taken a substantial amount from your available capital.

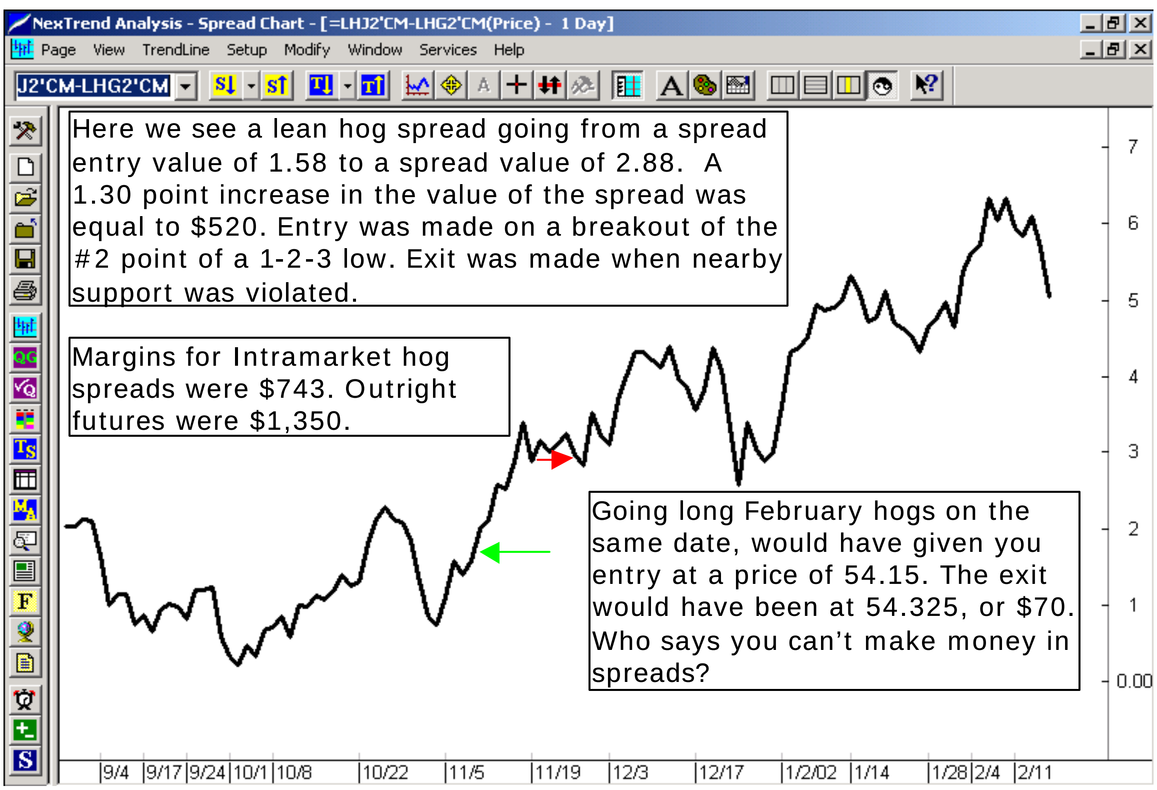
The spread made 11 points. The outright soybean trade made 12.25 points. But to get that extra point and one-quarter you had to put up more than three times the margin, and you had to withstand a huge draw-down.

The following two Intramarket trades in Soybean meal were taken based on seasonality.

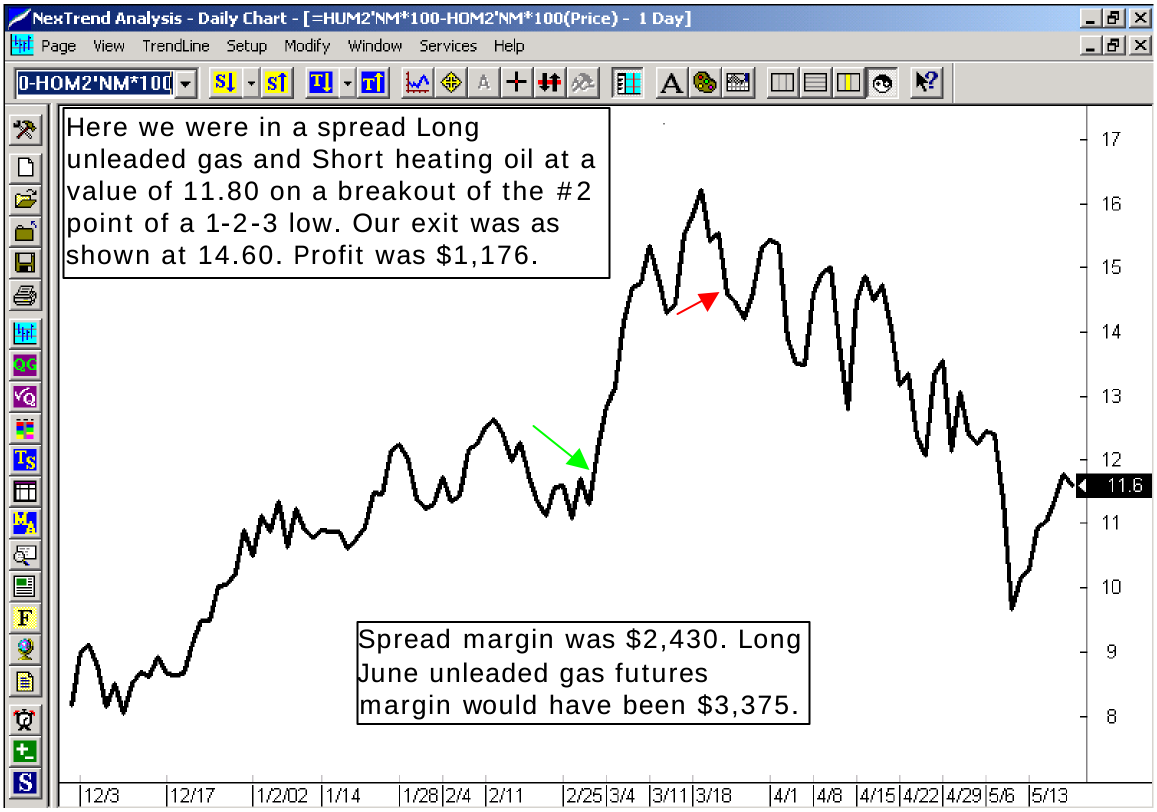
The first of the two was entered not only on the basis of seasonality, but also by virtue of the formation known as a Ross hook (Rh). The second of the two trades was entered because of seasonality and the fact that the spread seemed to be bouncing off an uptrend line.

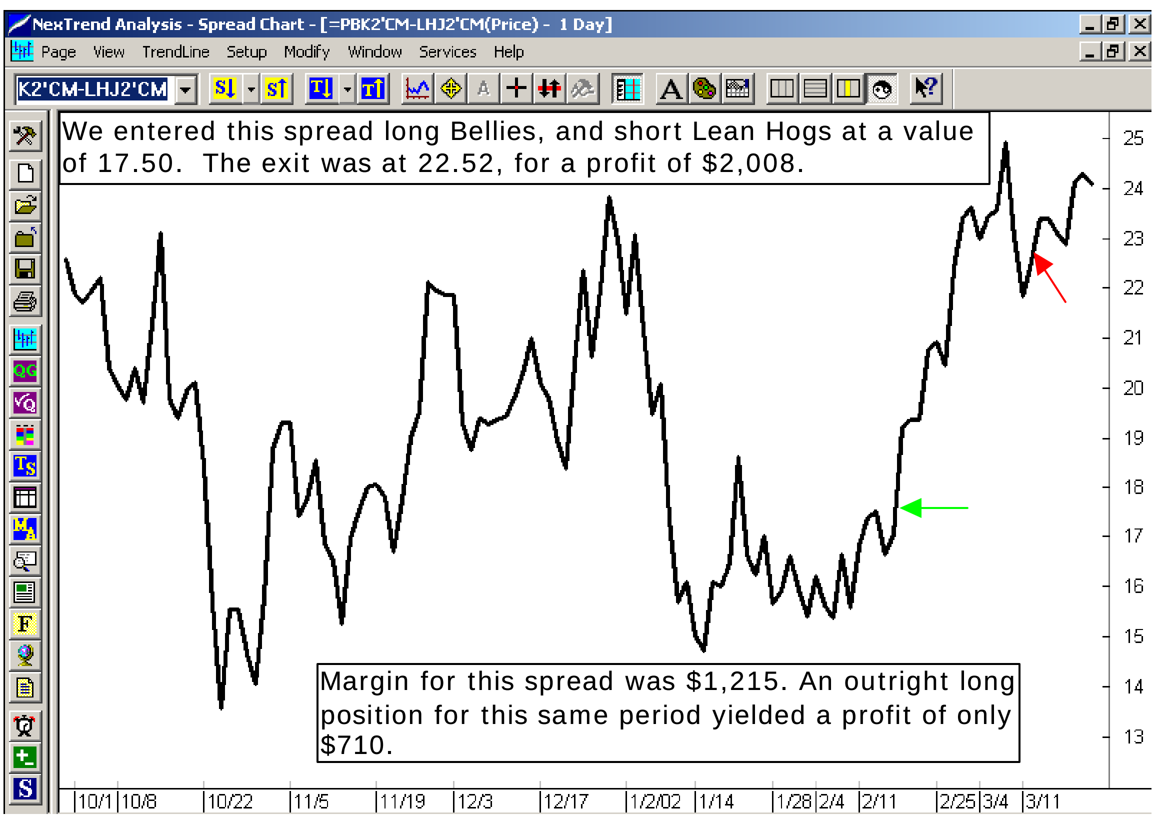


We didn't have to be in the following spread for very long in order to take some fat profits out of lean hogs.



Here are some examples of Intermarket spreads:

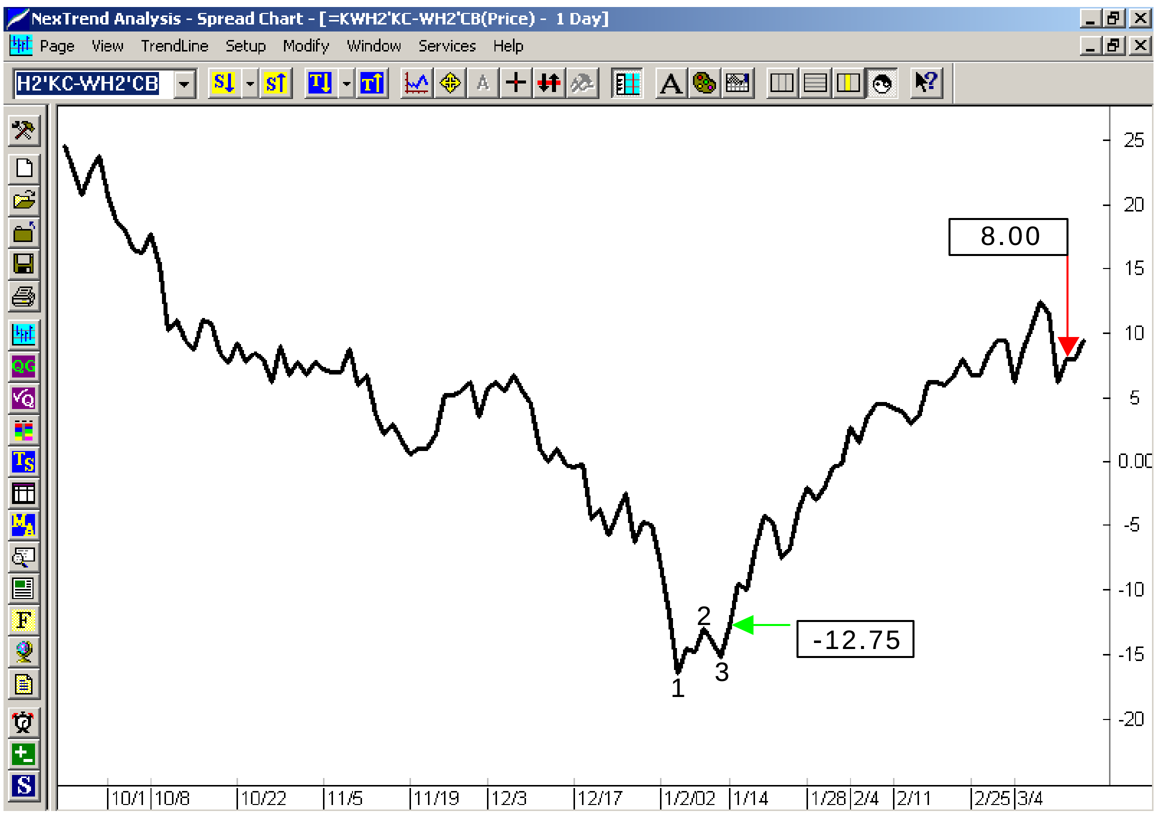




Lastly, we show an inter-exchange spread. This one was made between Kansas City wheat and Chicago wheat.

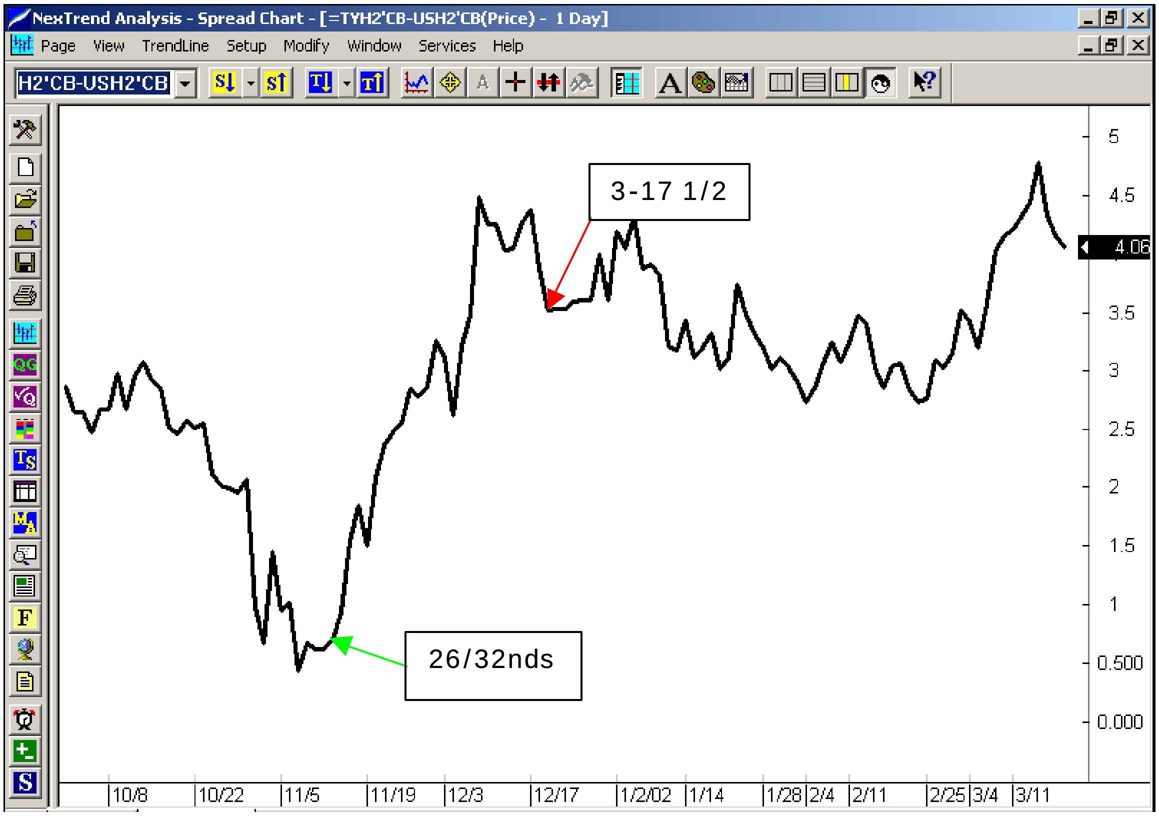
We went Long Kansas City wheat and Short Chicago wheat on a seasonally based trade when prices made a 1-2-3 low and then broke out past the #2 point.

Our entry was at –12.75 (a negative value), and we were looking for the trade to become positive. It far exceeded our expectations by moving to a spread value of 13. We exited at 8. This spread made us 20.75 points, or $1,037.50. The margin required to put on this spread was $1,243.00: $743 for the Chicago wheat leg of the spread, and another $500 for the Kansas City wheat leg of the spread.



Intermarket and Inter-exchange spreads usually, but not always, require the posting of two margin amounts, since the exchanges do not offer the lowered margin requirements that are available for intra-market spreads. Nevertheless, there are many Intermarket and Inter-exchange spreads that can make you considerable amounts of money.

On the next page, we show you an Intermarket spread which does carry lowered exchange markets. It is a spread between the 30-year T-bond and the Ten-year notes. Some people think that interest rate futures hardly ever trend, and that spreads between them are usually flat. We are of a different opinion, as you will soon see.



We entered this spread Long Ten-Year notes and Short T-bonds. The spread value at entry was 26/32nds. Our exit was when the spread value was 3 points + 17-1/2 32nds. Each point in this spread was worth $1,000. 17-1/2 32nds was worth $531.25. Total for the spread was $1,531.25. Margin was $1,148.

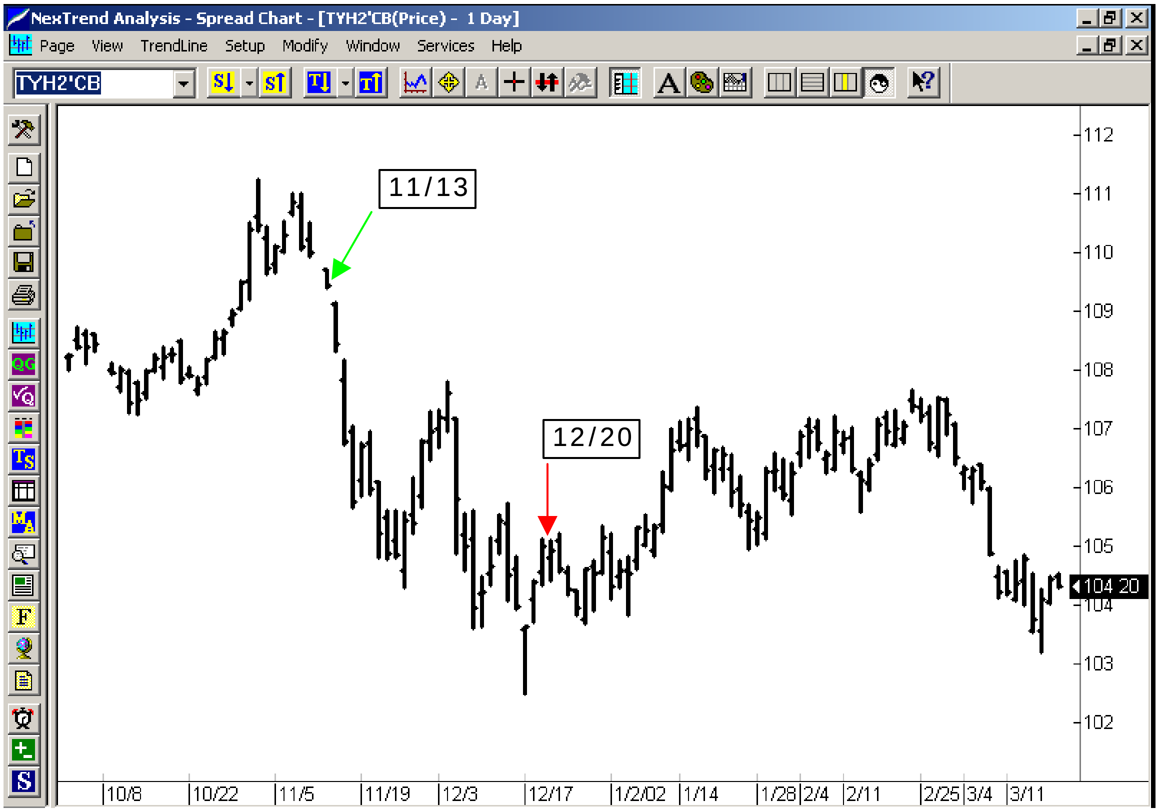
Compare the spread margin of $1,148 with regular T-note margins of $1,890 for an outright futures position.

What would have happened had you been long outright T-Note futures during that same time period? Get set for a shock!!

You would have lost a lot of money in outright futures during the same period that you were making $1,531.25 in the spread.

How can this be? It is because T-bond futures fell much faster than T-note futures. T-note futures plunged. But the melt down in T-bond futures was much more severe. You see, it can happen that even while futures are plummeting, it is possible to make a significant amount of money in a spread, and you can do so without fear that insiders are going to run the stops. This is why the Chicago Board of Trade is willing to offer reduced margins for this Intermarket spread.

Compared with the $1,531.25 we made in the spread, you would have lost about 5 – 1/2 points in an outright T-note futures trade. The loss would have been $5,500.



Does spread trading sound interesting for you?

We invite you to **make profits trading spreads right away:**
In our daily newsletter "Traders Notebook", Joe Ross and the staff of Trading Educators provide specific trades including suggested entry and exit points, stops, objectives, and strategies. We offer you a **free 2-week trial** of "Traders Notebook." Paper trade the trades we are suggesting to see how our concepts work. No risk, no obligation.

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Discover the lost art of trading spreads and gain a powerful advantage.

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