SECTION 3: THINKING OUTSIDE OF THE BOX FOR PRODUCT SELECTION, STRATEGY DEVELOPMENT, AND RISK MANAGEMENT

Trading in the commodity markets is more of an art than it is a science. When developing a trading game plan, it is vital to explore all possibilities by viewing the markets as an open canvas of creativity. Too often, traders flock to what is easy and convenient, such as trading outright futures or options, but in doing so they are overlooking opportunities to shift the probability of successful speculation in their favor. In Section 3, we are going to build on the base of information accumulated thus far and, ideally, open minds to the endless possibilities of strategy aggression and risk management.

CHAPTER 12: THE HIDDEN GEMS OF THE COMMODITY MARKETS

Unfortunately, the highly leveraged and volatile nature of the commodity markets has a tendency to lure traders into dreams of windfall profits. Yet the net result of most trading accounts is inevitable losses. In most circumstances, traders are simply overleveraged or undercapitalized. The lack of available margin simply leaves too little room for error to facilitate potential trading rewards. However, an often-overlooked manner of alleviating the disadvantage of being a smaller trader is the use of the CME Group's suite of e-micro futures contracts and the mini grains.

Although there aren't options listed on e-micro and mini grain complexes, the smaller contract size should be sufficient in keeping risk and margin low for nearly all traders. To clarify, some of these products come with margin requirements as low as $200, and point values as low as $1! Let's take a brief look at this group of contracts.

E-MICRO GOLD

Gold is the epitome of a commodity market, but it can be one of the most treacherous futures markets to participate in, making it out of reach for many speculators. The precious metal's price is capable of volatile price swings that can make even the soundest of traders look foolish. Even those trying to mitigate volatility by trading options find the cost and risk to be extremely high. For some traders, the standard-sized gold futures contract of 100 ounces listed on the CME Group's COMEX exchange is simply too big for comfortable speculation. Consequently, many small to moderately sized retail traders have given up on the idea of speculating in the yellow metal. Alternatives such as ETFS, on the other hand, despite being more manageable in regards to risk, are highly inefficient instruments for commodity speculation due to the necessity of fund rebalancing and administrative fees. In spite of all this, most traders venturing into the commodity markets yearn for the excitement of gold.

For those traders with low risk tolerance, or a preference for sound sleep, there is a way to participate in the pure speculation that futures markets offer with manageable risk: e-micro gold futures. The e-micro eliminates many of the challenges the original-sized gold futures pose. For instance, the margin needed to trade a single contract of the original 100-ounce gold futures overnight ranges between a hefty $4,500 to $8,500 (depending on volatility), but the 10-ounce e-micro version of the futures contract can be traded for as little as $400 to $900. Similarly, although a 100-ounce contract produces a profit or loss of $100 per $1 change in the price of gold, an e-micro trader experiences an account value change of only $10. Obviously, due to the reduced contract size, the e-micro gold offers little value to day traders. Yet, for those looking to buy and hold or the opposite, for days, weeks or months, the e-micro is a great option.

E-MICRO CURRENCIES

The e-micro currency suite was introduced by the CME Group as an answer to the popularity of trading in the forex markets. If you are unfamiliar with the term *forex*, it is an acronym for "foreign exchange" and is used to identify the spot currency market. Many beginning traders fail to understand, or even recognize, the differences between trading currencies in the futures market relative to the spot forex market, but they are profound. If you are interested in learning more about this topic, you might find value in my book *Currency Trading in the Forex and Futures Markets*. In summary, forex transactions take place on a synthetic market created either by individual brokerage firms or a group of liquidity providers such as banks and other financial institutions. In my opinion, these synthetic markets are a potential disadvantage to forex traders. I believe currency traders are better off speculating in the futures markets

Prior to the advent of the e-micro currency futures, the sole advantage to trading forex over currency futures was the ability to gain access to small contract sizes and margins. However, the CME recognized they were losing market share in this arena and responded with e-micro futures.

Currency speculators seeking cross-pairs, which is any pair of currencies that doesn't include the US dollar such as the popular British pound vs. Japanese yen (GBP/JPY), won't find what they are looking for in the e-micro futures suite. Nonetheless, for those looking to trade the major currency pairs such as the euro vs. the dollar (EUR/USD), the e-micros are an untapped resource.

The margin required to establish a position in the e-micro futures contracts varies from about $170 to $500, depending on the pair chosen. The most popular EUR/USD e-micro contract generally carries a margin requirement of about $300 to $400 and a point value of $1.25 per tick. Thus, for every penny in price movement, such as from $1.10 to $1.11, a trader makes or loses $125. I think we can all agree that this is an affordable alternative to the full-sized contract, which typically carries a margin requirement of anywhere from $2,500 to $5,000 and a point value of $12.50 per tick, equivalent to $1,250 per penny in price change in the currency pair.

If you've done the math, you probably realize the e-micro is a tenth of the regular contract. The original EUR/USD futures contract represents 125,000 euro, but the e-micro contract size is a mere 1,250 units.

Obviously, you will never get rich trading e-micro currencies, but meager or moderately capitalized traders might find them extremely useful in scale trading strategies, or even less-structured dollar cost averaging strategies.

MINI GRAINS

The mini grain futures complex were among the first of the commodity mini-sized contracts. At the time they were introduced, corn was trading well under $5.00 per bushel, probably closer to $2.00. And soybeans were hovering in the $5.00 to $8.00 range. The thought of “beans in the teens” was more of a pipe dream than a realistic trading idea. Thus, their small contract size and risk reward prospects were almost laughable. Little did we know that in just a few years, mini grain futures would be an attractive alternative to trading larger contracts in a historically volatile grain market.

Similar to the e-micro futures, there are no options listed for the mini grain contracts, but the futures contracts themselves are sized in a manner enabling relatively comfortable speculation for traders of all sizes. There are three mini grain contracts listed by the CME Group: mini corn, mini wheat, and mini soybeans. Even though liquidity in the mini grain complex leaves something to be desired, they can certainly be efficiently traded, thanks to proficient market makers. Market makers are willing to “make a market” in the lightly traded mini complex because they can easily use guidance from the full-sized contract to gauge price and even hedge their risk if necessary. Although due to the small risk involved, I would assume most market makers are willing to execute orders “naked,” at least momentarily.

Each of the mini-sized grains come with a contract size of 1,000 bushels of the underlying commodity, a point multiplier of $10, and an initial margin requirement ranging between $200 and $500. This is exactly one fifth the size of the original contract, offering traders the ability to easily manage a dollar cost averaging trading approach in nearly any account size.

USE SMALL CONTRACT SIZE TO YOUR ADVANTAGE: DOLLAR COST AVERAGE

Too many speculators bypass e-micro and mini contracts as being either boring or a complete waste of time. However, I argue they are an extraordinary step in leveling the playing field for market participants. Simply said, not all traders have the risk capital to establish a long-term scale trade. Nor do they have the wherewithal to ride out normal ebb and flow in the commodity markets. As a result, they are often forced out of trades before their analysis has a chance to prove itself.

Trading smaller contract sizes, which essentially mitigates the leverage involved, creates an opportunity in which there is greater allowance for inaccuracy. Even the best of fundamental or technical analysts will fail to predict prices with any precision. In a perfect world, we would all buy the lows and sell the highs, but anybody who trades will tell you this is nearly impossible. Relatively accurate speculation in the direction of a commodity market might not be enough to avoid drawdowns in a trade before the market finally moves in the desired direction. Thus, it makes sense to enter a position trade with a nibbling strategy as opposed to entering the market all at once. We