# SECTION 2: COMMODITY TRADING STRATEGY DEVELOPMENT

Most readers are already familiar with the overall concepts discussed in this section, but my goal is to shine some light on the realities of each market approach as well as play devil's advocate with the help of hindsight. Further, I believe my time as a commodity broker has provided me with an insight that other authors, or market participants, might not have.

> "There are so many ways to lose, but so few ways to win. Perhaps the best way to achieve victory is to master all the rules for disaster, and then concentrate on avoiding them." —Victor Niederhoffer

Let's take a look at some of the basic strategies: their characteristics, their advantages, and what's more important, their disadvantages. In this section, I hope to give traders enough objective information on each market approach to enable educated guidance on developing a strategy meeting the needs of each individual. I will also provide insight on what I believe to be favorable strategies based on my observations as a commodity broker, involvements as a trader, and insights I have gained from conversations I've had with other industry participants. This is not to say I haven't been on the blunt end of a market thrashing, nor am I flawless in my analysis. I've witnessed the good, the bad, and the ugly in the markets firsthand, and I hope to share those experiences in hopes of helping you navigate the market profitably.

As we navigate and define each trading style, keep in mind that there may be as many variations in these definitions as there are market participants. This section is intended to give you a sense of these strategies and industry lingo. Hopefully, the tips, tricks, and interpretations offered here will help readers develop, shape, and fine-tune existing and future market ventures.

## CHAPTER 6: POSITION TRADING IN FUTURES

Before we can define position trading in the commodity markets, we must recognize there is a dramatic difference in time frames for stock traders and futures traders. This is because the leverage involved in the commodity markets, combined with the obstacle of expiring futures contracts, tends to speed things up for traders and, therefore, shortens the time horizon. When talking about a stock trader, we can assume position trading is the purchase of a stock to be held for months or even years. However, a futures trader doesn't have the ability nor the capacity (in most cases) to hold indefinitely.

To futures traders, a position trade could be anything held longer than a day or two. The only type of trade excluded from the category of position trading is a day trade which, as I've previously mentioned, involves buying and selling a futures contract in the same trading session. Obviously, this is a widespread net being cast; some position traders are in and out of a few trades a week, while others hold for several months, which typically involves rolling over contracts to avoid expiration and delivery of the underlying asset.

Position traders, whether they are using futures, options, spreads, or some other trading strategy, generally choose between three primary forms of speculation: fundamental trading, swing trading, and trend trading. The latter two styles are derived from technical analysis strategies, while the former is the practice of entering a long-term trade anticipating of a change in market fundamentals that influence pricing. In my opinion, regardless of the charting or fundamental analysis used, traders should always consult some of the other tools we've outlined in this book such as seasonal tendencies, market sentiment, and the *COT Report*.

The primary difference between the two types of technical analysis styles is that swing traders are executing comparatively short-term countertrend positions while trend traders are attempting to trade in the direction of the trend on a relatively longer time horizon. Let's take a look at the advantages and disadvantages of each approach.

## SWING TRADING

Swing trading is a style of trading attempting to profit from countertrend moves that occur in a time horizon of one to four days. A swing trader is buying into fear and selling into greed, or simply buying low and selling high. Of course, this is easier said than done!

> "I believe the very best money is made at the market turns. Everyone says you get killed trying to pick tops and bottoms and you make all your money by playing the trend in the middle. Well, for twelve years I have been missing the meat in the middle but I have made a lot of money at tops and bottoms." —Paul Tudor Jones

Naturally, when it comes to speculation traders are at the mercy of the market; if circumstances call for taking a profit in the same session the trade was initiated, or if it is necessary to stick with the trade beyond the four-day mark, so be it. Nevertheless, the expectation of a swing trader upon entering the trade is for a speculative position in the time horizon.

Swing traders might, or might not, be concerned with the fundamental makeup of the market. Either way, they are using technical analysis to time their entry. By definition they are actively and aggressively buying or selling futures contracts or trading options into predicted areas of support and resistance. Unlike trend traders, swing traders do not wait for solid confirmation of a trend; instead, they try to time market reversals.

> The premise of swing trading is to identify areas of support to be a buyer, and resistance to be a seller.

Clearly, there are an unlimited number of ways a trader could determine entry and exit points of a swing trading strategy, but most involve some sort of technical oscillator falling into oversold or overbought territory in combination with trendlines, trading channels, and other forms of support and resistance.

To reiterate, a swing trader will identify traditional areas of support and resistance and look for countertrend opportunities at, or near, support levels in conjunction with a predetermined mix of technical oscillators intended to identify potential market turns.

In Figure 40, a swing trader in the e-mini S&P 500 using the Williams %R as the *get-set* indicator and the relative strength index as the *go* indicator might have fared relatively well by selling sharp rallies and buying while others were scrambling to sell.

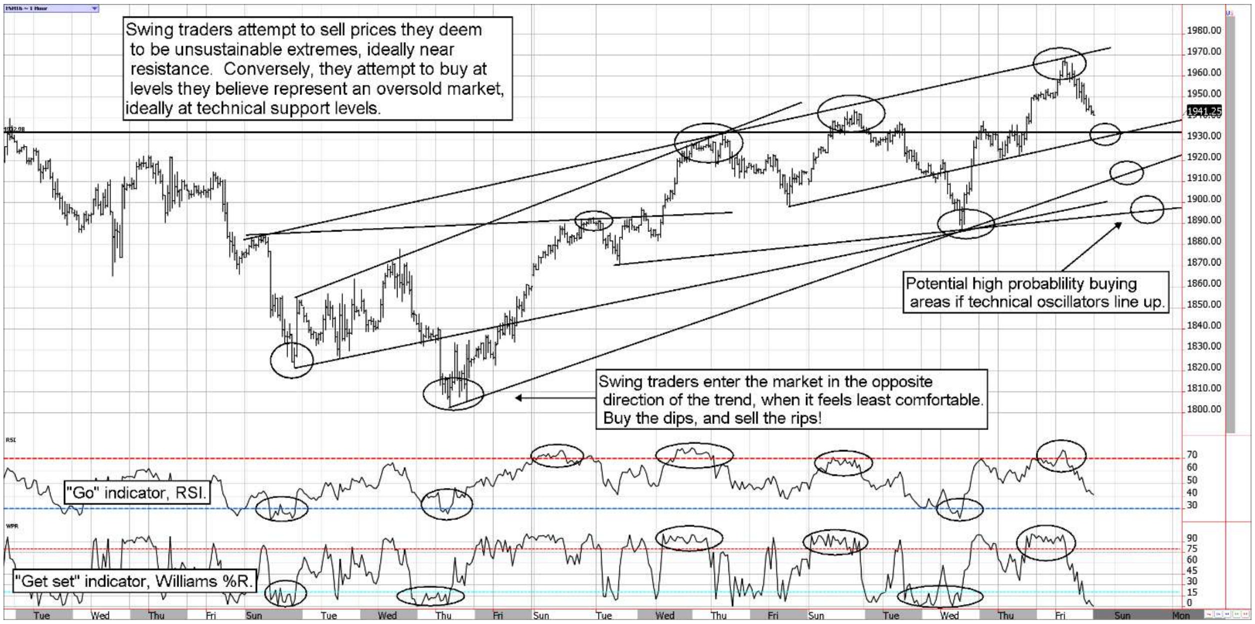


**Figure 40: Swing traders are in the business of doing the exact opposite of what is comfortable—buying when others are selling, and selling when others are buying.**

## ADVANTAGES OF SWING TRADING

> Swing traders look to buy the dips and sell the rips!

Swing trading strategies thrive in range-bound markets because as prices bounce back and forth between support and resistance, a swing trader will be exposed to a plethora of opportunity. This is a big advantage over trend trading or fundamental position trading due to the tendency of commodity markets to trade sideways a majority of the time. Although the stats change with market conditions, it is generally accepted as being true that markets spend 80% of the time trading in a range and only 20% of the time moving directionally to define a new trading range. Similarly, more often than not, confirmation of a trend might also mark the end of it. Once the last buyer (those seeking confirmation) is in, the market has a tendency to reverse.

There are fierce opponents to swing trading. After all, the nature of the strategy calls for entering a trade against the grain. The argument to that point is that most market participants lose money; so doing what is comfortable for most people might not be the best course of action.

In my opinion, swing trading provides traders with a relatively high probability of success on any given venture in comparison to trend traders because a profitable swing trade can occur in a typical market environment. A directionless market with various levels of volatility can result in profitable trading signals. Trend traders, on the other hand, only stand to profit in a market that experiences an abnormally large directional trend. In short, swing traders are seeking more frequent and higher-probability profits, but often give up the prospects of runaway profits should an unusually large price move occur.

## DISADVANTAGES OF SWING TRADING

There is one glaring drawback involved in swing trading—when a trade goes wrong, it can go horribly wrong. Although buying a market at support and selling at resistance will work out more often than not, when it doesn't, the adverse price move could be surprisingly painful. Not only does the market move quickly and swiftly at such technical levels, but it can be difficult to identify a failure of the technical level until it is too late. Accordingly, swing traders must be market savvy and keen on risk management to survive in the long run.

In addition, swing trading is a relatively active method of speculation, and thus, comparatively high transaction costs and time dedication of implementation should be considered.

## SWING TRADING INSTRUMENTS

> "The trick is to make sure you don't die waiting for prosperity to come." —Lee Iacocca

The most common type of swing trading is done with the buying or selling of outright futures contracts. However, swing trading can also be effectively employed using long or short options, option spreads, and even synthetic strategies in which traders combine both futures and options to achieve a common goal. Further, it can be argued that options are better suited for swing traders than they are for trend traders, because they come with finite expiration dates. Although futures contracts also expire, they can easily be rolled into the next contract month without necessarily putting on a fresh trade with additional risk or cash outlay.

A long option trader, on the other hand, will usually have trouble executing a reasonable strategy that works in the time frame necessary for successful trend trading. The concept of swing trading is to buy low and sell high. This is in contrast to the buy high, sell higher approach to trend trading; ideally, swing option traders would be buying calls in a down market at a time in which the call options are undervalued. Swing traders would also be purchasing puts in an inclining market at a time in which put options are undervalued. Trend traders, however, would be attempting to buy calls after a relatively large rally at a time they are overpriced. As you can see, trend trading with options adds another obstacle to profitable trading that swing traders don't have to worry about—buying inflated options.

Because swing traders are relying on "normal" market conditions as opposed to uncharacteristically large trending moves, it is imperative the swing strategy is executed in a market with sufficient liquidity. A rule of thumb would be to avoid, or at least trade sparingly, any commodity market with daily trading volume of less than 20,000. If the chosen trading plan involves options, liquidity becomes an even bigger concern. Judging option liquidity can be tricky; option markets with big commercial and institutional interest, such as RBOB gasoline, might have high daily volume and open interest stats, but offer little liquidity to the average trader attempting to execute smaller lot sizes. Similarly, some option markets such as the currencies, with skimpy volume and open interest, have active market makers willing to display attractive bid/ask spreads that enable traders to enter and exit positions with ease. In essence, liquidity is measured by the ability to seamlessly trade a market, not the volume and open interest.