

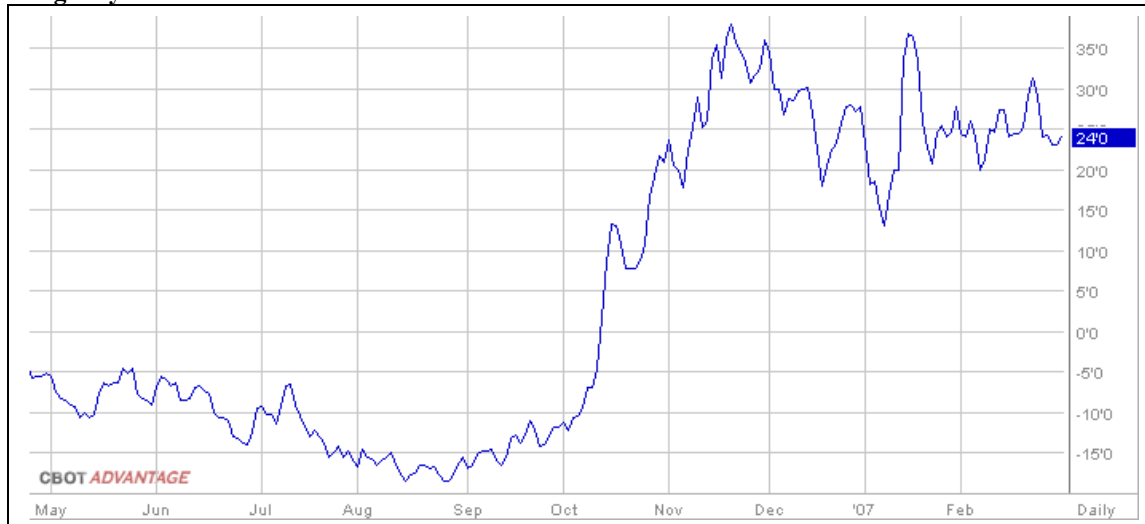
## **Futures Spreads 101**

A futures spread position involves the simultaneous buying and selling of two different futures contract months within the same commodity. A futures spread position may also combine the buying and selling of futures contracts that are different but related. Futures spreads may be used to reduce the amount of required margin to trade in a commodity. In a futures spread, you are usually trading a closer futures contract month against a further-out futures contract month in a particular commodity. This strategy is also known as a calendar spread.

The graph below is an example of a futures spread in which the trader entered into a Long July 2007 Corn vs. Short December 2007 Corn futures spread position during the Summer of 2006. The graph plots the difference in price between the two corn contracts over several months. In this strategy, the trader is buying July 'old-crop' Corn and selling December 'new-crop' Corn. In utilizing this bullish futures spread strategy, the trader is projecting that the Corn market is going to increase in value and enters into the July-December 'bull futures spread' in Corn. The July Corn futures contract is the last contract each year to trade the old-crop Corn and the December Corn futures contract is the first contract representing the new-crop Corn that comes with harvest time in the fall. 'Carry-over' is a term for un-used old-crop Corn 'carried over' and added to the supply of the most recently harvested new-crop Corn.

Again, referring to the graph below, we see that near the end of August in 2006, the July 2007 Corn futures contract was trading as much as 20 Cents under the Dec. 2007 Corn futures contract. This is termed a 'normal carry-charge' market where futures contracts get more expensive as you move outward in time. Under normal conditions, this 'carry charge' reflects the cost of storage, insurance and other fixed costs associated with farming Corn. A normal carry-charge market reflects that there is adequate supply of old-crop Corn available in the market and that there is no anticipated threat to the supply of Corn that would drive prices higher.

Beginning in September, 2006, we saw the July 2007 Corn contract begin to increase in price at a much faster pace than with the 2007 December Corn contract. About mid-October in 2006, the July '07 and Dec. '07 Corn futures contracts were priced about evenly. By mid November, the July 2007 Corn contract was trading at about 40 cents over the December 2007 Corn contract. With this 'bull futures spread' in Corn, the trader made a profit as the long July Corn contract increased in price faster than that of the short December Corn contract. The trader that would have taken the opposite 'bearish' view, going long on December Corn and selling the July Corn, would be in a losing position. We can see that from September '06 up to November of '06, there was a profit potential of more than 50 cents per futures spread depending upon when you entered and exited your spread position. Traders taking the opposite position in Corn could have potentially lost more than 50 cents per spread. This example is a snapshot of what happened in the Corn market starting in the summer of 2006 and does not necessarily guarantee the same results in the future. (Each one-cent gain in a Corn futures contract or one-cent net gain on a Corn futures spread position, equates to \$50). The example above is purely hypothetical and is not suggesting that any account has or will obtain these stated profits or losses.

**Long July '07 Corn – Short Dec. '07****03/05/2007**

You may be wondering what happened in 2006 that caused Corn prices to have a dramatic increase in value. In looking at the futures spread chart above, we can see the Corn market's reaction to a projected heavy increase in Corn demand. Prices rose dramatically due to the fear that Corn supplies would be inadequate. This Corn futures spread chart shows the price impact in the Corn market with the onset of the new Corn-for-ethanol fuel program. The huge run-up in the price of Corn, especially with the nearer contract months, was the market's reaction to fears that the old-crop Corn supply would not be able to meet the new demand for Corn ethanol on top of the traditional Corn demand for feeding livestock. Combining the sudden increase in Corn demand with depleted ending stocks from the previous harvest, Corn prices exploded. Corn, suddenly had a dual purpose...a food and a fuel and supplies were tight. Since Corn was now considered a fuel, the price of Corn was also sympathetic to the price of Crude Oil which was rising.

To better understand the utilization of futures spreads, remember that you are always short a futures contract and long another futures contract in a spread position. As a 'rule of thumb', the futures contract closest to the cash market or front futures contract month determines whether you are bullish or bearish in that commodity. If you are long the closer futures contract month in your futures spread, you are in a 'bull futures spread' meaning you are bullish. To recap, if you are bullish, you buy the front month futures contract and sell the outer month futures contract. In a bear futures spread, you would sell the closer futures month contract and buy the outer futures month contract. In the Corn futures spread example above, you are buying July Corn and selling the farther out Corn position in the following December...this is an example of a 'bull futures spread'. You are bullish on Corn in a Corn futures spread. If a trader had thought the opposite about Corn and perceived that prices would begin moving back down, then he would have entered into a 'bear futures spread' where he is short the (closer month) July '07 Corn and simultaneously long new crop December '07 Corn (outer month). A holder of a bearish Corn futures spread during the Summer-Fall time-frame would have lost money in this bullish Corn market.

In the beginning, it may be helpful to think of a futures spread position as combining two individual trade positions where you are either long or short a market in the near-by futures

contract and enter an opposite futures position in a contract that is farther out. Your farther out contract could be deemed as your hedge portion of your futures spread. Another 'rule of thumb' in trading the futures markets, is that you will usually experience a bigger price move in the front month futures contracts and usually a lesser price move in the outer futures contracts. Near-by futures contracts closest to the cash market are usually more reactionary to current supply/demand situations.

Remember that your 'long' or 'short' near-by futures contract in your futures spread specifies whether you are 'long' or 'short' in that futures market. Your outer month (contrary) futures position serves as your hedge. There is an exception to this 'rule of thumb' and it is in the Eurodollar market. When placing a futures spread position on the Eurodollar market, your outer month position is usually your prediction of the move in that market and your closer month position is your hedge.

Another example of a futures spread strategy is an inter-commodity spread. This is a futures spread comprised of two different but related commodities markets. An example of an inter-market spread is where the trader is long July Soybean Meal and short July Soybean Oil. This seasonal strategy has potential to make a move in favor of the Long Bean Meal into summer as the market anticipates continued strong demand for Bean Meal while anticipating yearly demand for Soybean Oil to peak in May. Always remember that unknown events and market conditions in the future may cause this spread to move against investors as well. Each spring, traders may want to look for a setup in this particular futures spread strategy. This has often been a historical seasonal tendency but does not guarantee results in the future.

Many futures markets do have the potential to repeat yearly price patterns based upon planting, growth cycles, weather cycles, harvest, rearing, and slaughter along with yearly seasonal supply and demand fluctuations. Agricultural prices can make seasonal highs as consumption uses up supply before the new crop harvest is available. Even in the financial and stock markets there can also be seasonal price tendencies based on institutional and government buying and selling. Historical studies of stock market price fluctuations have shown that the stock market has fared much better during the November through April time-frame rather than the other six months of the year. Again, past performance, however, does not guarantee future results and there is risk of loss in trading.

Disclaimer: The risk of loss in trading futures contracts and futures spreads can be substantial. Each investor must consider whether futures trading is a suitable investment. Past performance is not indicative of future results.
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## Three Basic Futures Spread Types

### **Intra-market Spread**

(Most common futures spread where both the long and short are on the same commodity market...a.k.a. the inter-delivery or calendar spread. Example: July Corn vs. Dec Corn)

### **Inter-commodity Spread**

(Buying a commodity market and selling a related commodity market as in the Long Soy Meal vs. Short Bean Oil spread)

### **Inter-market Spread**

(Involves buying a commodity product on one exchange and selling a commodity product on another exchange. Example: Long Kansas Wheat vs. Short Chicago Corn)

## Reasons to Consider Using Futures Spreads

- Futures Spreads have sometimes provided a better trend-following system than trading the outright 'long' or 'short' futures contract. It has been said that 'futures spreads can sometimes move like big ships...once they get going, it is hard to turn them around in the other direction.' This can also mean that if you maintain a losing futures spread position, losses can mount.
- Futures spreads can possibly provide less market risk as you speculate with your front month position while hedging with your outer month position. Futures spreading is not without risk, however, and there is potential for losses.
- Futures Spreads have lower margin requirements which allows for trading in larger positions.
- Lower futures spread margin requirements also allow a futures spread trader to diversify into other unrelated markets.
- It may be easier to predict a trend in a futures spread rather than predicting a trend in a 'long' or 'short' futures contract.
- Grains, Fibers, Livestock and Energies markets often exhibit well-defined seasonal tendencies and can follow seasonal price behavior setting up futures spread opportunities. However, past seasonal market behavior is not guaranteed to be repeated in the same manner.
- Seasonal divergence between futures contracts of a given commodity can sometimes create arbitrage opportunities.
- Futures Spread behavior tied closely to seasonal planting, growing, harvesting, slaughter and weather cycles may provide similar futures spreading opportunities each year.
- Seasonal futures spreads may have the potential of providing better risk-to-reward ratios.
- Futures spreading may provide traders with more protection against wild price and volatility swings, too often associated with margin calls and panic liquidation.

Experienced futures spread traders can have greater peace of mind while holding a position.

- In many cases, futures spreads can serve as a surrogate for the outright contract, especially when the timing of a market move is uncertain.
- Floor traders cannot run (protective) stops in futures spreads.
- In a 'locked limit' up or down market, futures spreads can still sometimes be exited and entered.
- A futures spread may be an alternative to an outright futures contract which may initially require a wide protective stop. Once the anticipated market move is confirmed, the trader can then liquidate the outer (hedge) contract in the futures spread position and remain with the desired long or short position to try and follow the trend.
- Tracking futures spreads have been known to help indicate turning points in a given market trend.

## Five Objectives in Using Futures Spreads

(Suggestion: To begin to grasp these concepts, try thinking of a futures spread as two individual futures position)

1. The long leg of the Futures Spread moves up; the short leg moves down. (Ideal!)
2. Long leg of the Futures Spread goes up; the short leg doesn't change much.
3. Long leg of the futures Spread doesn't change much; short leg moves down.
4. Long leg of the futures spread moves up faster than the short leg.
5. Short leg of the futures spread moves down faster than the long leg.

While these five outcomes listed above are your anticipated goal, futures spreads can also work against your investment portfolio, causing a loss greater than your original margin requirement. It is important to develop a trading plan when investing in futures spreads and futures markets. Always work closely with your broker and abide by your stop-loss parameters. A final suggestion is to abide by a predetermined profit target and a stop-loss plan after entering any market position. Good luck in your trading.

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