FUTURES MARKETS

03 SERIES

Futures Market Players-

The Hedgers & The Speculators

In the last segment, we covered the fundamentals of how the futures markets worked. This then brings us to the two primary types of players in the futures market; the hedgers and the speculators.

Hedgers are the people, mostly farmers, manufacturers, importers and exporters, who wish to secure a future price for a commodity in order to protect themselves against the volatility of the commodity price. In other words, hedgers use futures contracts to protect themselves against price risks.

The speculators on the other hand, are the direct opposite of hedgers. Hedgers use futures to mitigate risk, whereas speculators use futures to benefit from the risk itself. Speculators are individuals who prefer to profit from the risk that the hedgers are protecting themselves against.

Example:

Take for example, in June; a palm oil producer expects to harvest at least 25,000 tons of Palm Oil in September. Say that the Crude Palm Oil Futures contract for September trades in June for RM3500 per metric ton. By selling the September CPO contract at RM3500 in June, he can secure a price for his palm oil price and protect himself against the possibility of falling prices of palm oil in September. Even if crude palm oil prices were to drop to RM2800 in September, the produce had effectively locked the price of RM3500 by hedging it with CPO Futures.

In this example: Suppose that Company JL knows that in 6 months it will have to buy 5,000 ounces of a certain raw metal to fulfil an order. Let's say the price for silver is $39.5 an ounce in June and the futures price for October Contract is $40 an ounce. By buying the silver futures contract, Company JL can secure a price of $40 an ounce that reduces the company's exposure to price risks. Even if Silver prices shot up to $60 an ounce, Company JL will be able to close its futures position and have effectively bought 5,000 ounces of Silver at $40 an ounce.

Since higher risks provide higher returns, the speculators enjoy such volatility as it brings them substantial benefits.

Thus, speculators do not intend to own the underlying asset of their futures contract. Rather, a speculator would enter a market to seek profit and take the profit by offsetting their position in the market (buy what is sold, sell what is bought) after benefiting from the rise and fall of prices.

There are many types of speculators. They all have different trading methodologies and their style varies from one to another.

For private speculators, they may specialize in a certain commodity and only trade that particular commodity day after day.

Example:

Joy may trade the gold futures only, and she only specializes in that particular commodity and trades it every day. This will make her a private speculator.

There are also traders who buy or sell contracts at the slightest move of the price; for example, fraction of a cent. These traders are called scalpers and they are very active in the market, hoping to secure a profit through small movements of the price.

There are also day traders who buy and sell contracts throughout the day and then close their position before the session ends. There are also position traders who will hold their position for days, weeks or months.

It is obvious that there are different speculators that embody different styles and preferences. There are no better styles or approaches. All approaches are unique to each speculator and if one can find a profitable trading strategy in a particular method, they will almost usually stick to what works for them. However, what works for one may not work for others.

In part 4, we will explore the advantages of Futures, as well as how to get started in trading Futures.

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