

TRADING COMMODITIES AND FINANCIAL FUTURES

FOURTH EDITION

**A Step by Step Guide to
Mastering the Markets**

George Kleinman



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Financial Futures, Third Edition**

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Trading Commodities and Financial Futures

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A Step-by-Step Guide to Mastering the Markets

George Kleinman

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To Sherri

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Important Risk Disclosures

Before you trade with real money, familiarize yourself with the risks.

Commodity futures trading is speculative and involves substantial risks, and you should only invest risk capital.

You can lose a substantial amount or all your investment, and you should carefully consider whether such trading is suitable for you in light of your financial condition.

The high degree of leverage that is obtainable in commodity trading can work against you as well as for you, and the use of leverage can lead to large losses as well as large gains.

If the market moves against your position, to maintain your position, you may on short notice be called upon by your broker to deposit additional margin money. If funds are requested, and you do not provide them within the prescribed time, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account. Under certain market conditions, you may find it difficult or impossible to liquidate a position. This can occur, for example, when the market makes a "limit move." The placement of contingent orders, such as a "stop-loss" or "stop-limit" order, will not necessarily limit your losses to the intended amount.

There is no guarantee that the concepts presented in this book will generate profits or avoid losses.

Past results are not necessarily indicative of future results.

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About the Author

George Kleinman is the president of Commodity Resource Corp., a futures advisory and trading firm that assists individual traders and corporate hedgers. George has a track record of success in the commodity futures business that spans more than 30 years.

A graduate of Ohio State, with an MBA from Hofstra University, George entered the commodity trading business with Merrill Lynch Commodities in 1979. When he left Merrill to start his own trading firm, George was a member of "The Golden Circle" (the top 10 commodity brokers internationally).

From 1983 to 1995, Commodity Resource was located on the trading floor of the Minneapolis Grain Exchange, where George held multiple memberships and served on the MGE board of directors. George was also a member of the COMEX Exchange for over a decade.

George has been featured for his trading in national publications and has lectured at major financial conferences regarding his trading techniques. He is the author of four previous books on commodities and futures trading and is an active trader for clients as well as his own account. George has developed his own proprietary trading techniques, some of which are highlighted in this edition. He can be reached via email at gkleinman1@mac.com.

In 1995, George and his family moved to northern Nevada, and he now trades from an office overlooking beautiful Lake Tahoe.

Introduction

“It is not the strongest of the species that survives, nor the most intelligent. It is the one that is the most adaptable to change.”

—Charles Darwin

New York’s oldest commodity exchange, the New York Cotton Exchange, was established in 1870. For over a century, traders packed the cotton trading pit. They would discuss weather and crop reports, and they would make and lose fortunes. On a rainy Friday, October 19, 2012, the floor traders in cotton (as well as in coffee, cocoa, sugar, and orange juice) donned their trading jackets and yelled out their bids and offers for the last time. You see, this was the final day of “open-outcry” trading. The following Monday, for the first time since 1870, every trade in these markets was matched by computers.

I found this passing of an era sad. The best stories in this book emanate from the days of the floor traders. Human stories make for more entertaining reading than rogue computer algorithms (which is why I kept them in this edition).

Critics of electronic trading tell us that the old days of the pits added order to the markets. A professional market maker standing in the pit would observe the order flow in terms of the news, and he or she would take the other side of excessive speculative order flow. This made for a more orderly market environment. Many of the computer programs don’t even look at the news but monitor the order book in milliseconds to hop on for a ride. Liquidation works in a similar manner, as the computers scramble to exit. Stops are hit, generating margin calls, causing more liquidation as it all feeds on itself. Having no professional market maker leads to vacuums and overextended moves because fewer players are available to take the other side of momentum. When the vacuum is finally filled, the move back in the opposite direction is just as frenzied.

I admit I’m sentimental for the days of the pit traders. I dealt with them most of my trading life, but we have no choice other than to move forward and adapt to change in order to survive. In the words of Ayn Rand, “You can ignore the reality but you cannot ignore the consequences of an ignored reality.”

Today's electronic markets are like a battlefield. In the words of Napoleon Bonaparte, "The battlefield is a scene of constant chaos. The winner will be the one who controls that chaos, both his own and the enemy's."

Today, there is more chaos than ever before. Speed and volume have combined to make the markets more volatile than they've ever been in the past. This chaos is cleverly programmed—not by traders but by engineers. I've always been good in math, but introductory calculus was the extent of my academic math training. Today's programmers code formulas similar to the one shown in Figure I.1—only much more complicated. (The example shown in Figure I.1 is a relatively simple trading formula, now 10 years obsolete.)

$$E[S_i | t] = P_n(t)S_i^* + P_b(t)\underline{S}_i + P_g(t)\overline{S}_i$$

$$B(t) = E[S_i | t] - \frac{\mu P_b(t)}{\varepsilon + \mu P_b(t)} [E[S_i | t] - \underline{S}_i]$$

$$A(t) = E[S_i | t] + \frac{\mu P_g(t)}{\varepsilon + \mu P_g(t)} [\overline{S}_i - E[S_i | t]]$$

$$\Sigma(t) = \frac{\mu P_g(t)}{\varepsilon + \mu P_g(t)} [\overline{S}_i - E[S_i | t]] + \frac{\mu P_b(t)}{\varepsilon + \mu P_b(t)} [E[S_i | t] - \underline{S}_i]$$

Figure I.1 A "simple" trading formula

After the formulas are constructed and coded, they're fed into sophisticated trading computers that cost millions of dollars. Many of these computers are actually located in the Exchange building for a speed advantage proximity that you and I will never have. With technology evolving seemingly at the speed of light, how will we ever compete with these folks? The simple answer is that we won't (nor do I want to), nor do we have to. That's not to say adjustments from the days of the pits are unnecessary. As traders, we have all had to adjust our methods to the new market realities in stocks and commodity futures. In this book, I've used the KISS ("keep it simple, stupid") method. I know I'm nowhere near as smart as the computer wizards, but in the words of the great Homer Simpson: "Stupidity got us into this mess, and stupidity will get us out!"

I'm not going to blame today's heightened volatility totally on computerized trading. It also has to do with central banks, government policies, global uncertainty, and instant dissemination of information. The newest variable, however, is the computers replacing the pit traders. Previously, "news days" were volatile, but now we see volatility just about every day. We now receive instant fills, which is a good thing, but in the process, the Internet has created a dog-eat-dog trading world. We need to get used to this because it's not going away. The good news is that the more extreme the moves, the better it is for the trend-following methods I present to you

in the following pages. In this book, one of my goals is to provide you with strategies designed to help you capture your share of the profit pool.

As an old-time trader once told me, the key to success in trading is “Slow and steady wins the race.” This requires calmness at all times, which is not always easy to obtain, but a systematic approach will help. With that said, I can almost guarantee that you’ll stray from your original plan at times because you’re human.

So, the pit trader has gone the way of the dodo bird, the eight-track tape, and the VCR. Still, despite all the changes, much has remained the same. The markets have dramatically changed in certain respects, and I’ve addressed these changes in this revised edition. In my first 30 years in this business, there was nothing I can recall akin to “banging the beehive” (a strategy in which high-speed traders send a flood of orders just prior to the release of a major report, milliseconds before the data is released, in an effort to trigger huge price swings). Yet, the markets have remained the same in the respect that human beings, with their emotions (particularly fear and greed), are ultimately behind all the transactions. Today, there are what can be termed “synthetic” as opposed to “real” moves. While there may be chaos in the millisecond, in the longer run, the basic fundamentals of supply and demand affect commodity prices in the same ways they did for hundreds of years. And there are times that computers get stung “banging the beehive;” they whack each other. You and I don’t have to participate right before major reports are released; we have the ability to wait for that fat pitch, that fastball into our sweet spot.

In 1951, the legendary trader W.D. Gann said, “The tape moves in mysterious ways, the multitude to deceive.” And in 1923, Jesse Livermore said, “It is literally true millions come easier to a trader after he knows how to trade, than hundreds did in the days of his ignorance.”

My primary goal in this new edition is to help you navigate the shark-infested trading waters to avoid the sharks.

George Kleinman
Lake Tahoe, Nevada

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The Four Essentials

**“It’s tough to make predictions...especially about the future.”
—Yogi Berra**

A floor broker once told me the following story, and he swears it’s true:

In the 1960s, there was a corn speculator who traded in the pit at the Chicago Board of Trade. He was known for plunging: taking big positions.

Early one summer, he put on a large *short* corn position for his own account. (Short positions make money if prices fall but lose if prices rise.)

Within days, the weather began to heat up in the midwestern United States, where the corn is grown. The corn crop needed rain, and prices began to rise. Day after day, the sun shone, the temps rose, not a cloud in the sky—the corn crop was burning up. The market continued to rally against this guy, and he knew if this continued, he’d go broke.

Late one trading session, the big trader started a rumor in the corn pit. His rumor was that it was going to start raining the next morning sometime around 10:30 a.m. The other traders laughed at this prediction.

The following morning, the sun was shining without a cloud in the sky, and the market opened higher once again. Then, almost miraculously, at precisely 10:30 a.m., rain started pouring down the windows that surrounded the grain trading room. (The old grain room, located on the fourth floor of the Chicago Board of Trade Building, had tall windows that looked out over La Salle Street.) Inside, in the corn pit, a selling panic immediately developed, as the pit traders scrambled to sell out their corn futures. Traders around the world saw prices crashing and joined in the selling frenzy. The market quickly went down the limit! On this break, the speculator covered his entire short position and was saved from bankruptcy.

How did the floor broker know it would rain at 10:30 that morning? It seems he was owed a favor from his drinking buddy, the chief of the Chicago Fire Department. The chief brought out the hook and ladders, and decided it was a good day to wash those tall windows that looked out on La Salle Street!

So you're thinking of trading, but you don't know the chief of the Chicago Fire Department? Actually, today, even if you do know him, it wouldn't matter much because computer traders from tens of thousands of locations globally have replaced the pit traders, and computers don't care about the weather.

So, let's assume you've just finished reading a private newsletter, a firsthand report of how the "witch's tail disease" is devastating the cocoa crop in Ghana. Cocoa sounds like a moneymaker, but you have no way of knowing for sure how true all this is. You do like chocolate, but you didn't even know it all starts with a bean called the cocoa bean. (You thought it came out of a can.) Hey, you don't even know where Ghana is, and you're thinking of trading cocoa against the likes of Hershey and Nestlé and whoever else really does know what's going on? Why would you do this? To make money, of course!

You do know one thing: You can observe that the cocoa market is moving higher, and it's moving fast. Although you aren't exactly losing money by doing nothing, it's starting to feel that way. Do you have the guts to act? Do you have the money? Is now the time?

You assume that the shorts (those betting on lower cocoa prices) are beginning to experience financial pain. The longs (those betting on higher cocoa prices) are experiencing the opposite emotions: elation and the satisfaction that comes from being right. The accounts of the longs are growing bigger—money from nothing. The shorts are watching their money evaporate.

Let's think about this for a moment, because it's time for your first lesson: Even though trades are now entered using computers, trading is a human game. As a result, emotions affect price as much as, or perhaps more than, the news. You will learn that price movements themselves affect future price movements. It's all a function of who is being hurt and who is benefiting. It's a function of which side of the market is being "sponsored" by the "strong hands." Shorts and longs act differently, based on price movements, and those movements affect their emotions as much as their pocketbooks.

Your job as a trader is to identify what happens next. To do that, I want you to start thinking about how others feel because feelings affect actions. People who are generally right tend to do certain things (on balance). People who are generally wrong tend to act differently. The majority acts a certain way, but be warned: The majority is usually wrong at major turning points (although they also can be right at times).

So, determine whether the majority is now long or short cocoa. The shorts are in pain, the longs are not; but then again, this can change just as fast as the market's tone changes.

Here's lesson number two: On balance, when talking about futures trading, the uninformed majority will lose. Because the profitable minority act in a completely different manner, you must learn what makes these people tick and how to act like them. One fact is certain: People make markets and, generally, people tend to act the way they did in the past. With certain stimuli, they could act opposite how they generally act, but you are playing the odds here. You need to identify what manner of move the market is in now. Is it a "normal" move, or is it extraordinary? (At times,

the market acts in an extraordinary manner, and these can be the best times to play.) If you, as a trader, are able to accurately predict what the next pattern will be, your rewards will be substantial.

In this book, I present various methods designed to identify profitable market patterns. No method is foolproof, and the best I can do is try to put the odds in your favor. My goal is to teach you to approach commodity futures and options trading like a business. This is not a casino. In a casino, risk is artificially manufactured for risk's sake, and the odds are engineered in favor of the house. In the commodity futures and options markets, you are dealing with natural risks associated with the production and consumption of the materials that make life possible and worthwhile—food, metals, financial products, and energy. You cannot bend these risks to your will, but you do have tools to manage them. Unlike in a casino, in the market, I believe you can move the odds to your side of the table. To do this, you must be disciplined.

You will need patience, and you will need guts. I cannot force these qualities upon you, but I can describe how a successful trader acts. It will then be up to you to act the right way. To profit in the commodity futures and options markets, you will need a systematic approach, a well-thought-out strategy. I will present you with some good ideas, but it's up to you to implement them systematically. After all, a strategy is just a consistent approach to trading.

Do you have what it takes?

If you've decided to risk some of your hard-earned cash, go for the big bucks, and trade commodities, you need to know that this is a zero-sum game—that is, for every dollar someone makes, someone else loses it. Some of the money goes to your commodity broker in the form of commissions, and a small amount goes to the Exchanges for their fees. Then, if you are lucky or skillful enough to win, you owe the taxman some of your profits. When you lose on any particular trade, most of your loss is transferred electronically to someone else's account (and you still pay that commission). You will never see this person on the other side of your trade, but he (or she) is out there somewhere.

You will be pitted against some of the best financial minds in the world. Professional traders, hedge fund managers, commercial firms that use commodities, and other commercial firms that produce commodities. Then there are those other individuals with more experience than you have. Can you hope to compete? The answer is, emphatically, yes! But I didn't say it would be easy, did I? You will need to develop a sensible trading plan and a feel for the markets. This book will help you. You must develop certain human qualities, too, which nobody can give to you.

More than 50 years ago, the legendary speculator W.D. Gann discussed the four qualities essential for trading success: patience, knowledge, guts, and health and rest. Gann's observations are just as valid today as they were half a century ago, and trust me, you must have these qualities if you ever hope to compete and win. (If you don't have them now, then develop them!)

Patience

According to Gann, patience is the most important of the essential qualities for trading success. A good trader possesses the patience to wait for the right opportunity. If you are a good trader, you will not be over-anxious, because over-anxiousness consumes capital and, over time, will tap you out. When you are fortunate enough to catch a good trade, you need the patience to hold it when it starts to move your way. Perhaps the primary failing of the amateur is to close out a profitable position too soon. In other words, patience is required for both opening and closing a position. Hope and fear need to be eliminated. Gann tells us if you are in a profitable position, instead of fearing that the profit will turn into a loss, you should hope it becomes more profitable. You have a cushion to work with in this case. When you are in a losing position, instead of hoping it will turn around, you should fear that it will get worse. If you see no definitive change in trend, use your essential quality of patience and just wait.

Knowledge

The stakes are high, and the competition is intense. You need a well-thought-out and thoroughly researched trading plan before you begin, and you need to do your homework. Your plan should always have a mechanism to cut the losses on the bad trades and to maximize profits aggressively on the good ones. You must be organized and remain focused at all times. If your plan is a good one, you need the consistency to stick with it during down periods.

My personal goal is to make money daily, but that is not always possible, so I try not to lose too much on losing days. It is a constant trial to maintain the vigilance necessary to not let good judgment lapse. If you are a novice, it makes sense to “paper trade” before you trade for real. If you are trading currently, you should keep a logbook. Log your triumphs and your failures. You want to avoid making the same mistakes again, but I must warn you, all traders repeat mistakes. At the very least, learn not to make the mistakes so often. By keeping a record of what you do right and what you do wrong, you can identify areas of weakness and areas of strength. If you are not totally prepared on any given day, don’t trade. You can’t “wing it” in this business because the competition will eat you up. Over time, you will develop what I call a “trader’s sense.” You will know when a trade doesn’t feel right, and when this happens, the prudent thing to do is to step aside. You cannot ignore the danger signals, and when they occur, you must act without hesitation. You must have a game plan and stick to it, but the paradox here is that you also need to be flexible. At times, it is best to do nothing, and you need to fight the urge to play for every pot. And, as I said before, stay focused. At times, I’ve been distracted by day trades and missed the big move because I missed the big picture. By the time I finally saw the light, it was too late.

Jesse Livermore, the legendary trader of the 1920s, once shared one of his secrets: He attempted to buy as close to what he termed “the danger point” as he could, and then he placed his stop loss. In this way, his risk per trade was low. This makes sense, but how do you know where that ‘danger point’ is? In normal markets, you

need to accept normal profits, but on those rare occasions when you have the chance to make a windfall, go for it. But, how can you tell when a market is normal as opposed to extraordinary? It takes experience, and it takes knowledge, an essential quality for success. Knowledge takes study and hard work. Reading this book is a good first step.

Guts

Call it nerve, courage, bravado, or heart; I call it guts, and this one quality is as essential as patience and knowledge. Some people have too much guts, and this isn't good because they're too hopeful and tend to overtrade. Some lack the guts to act (either to enter a position when the time is right or to cut a loss when it isn't). This is a catastrophic fault and must be overcome. You need guts to pyramid positions, which is not easy, but it's where the big money is made. In this book, I am going to teach you to trade without hope, without fear, and with the right amount of guts. I will instruct you to enter positions on the proper basis and then urge you to remember at all times that you could be wrong. You will need a defensive plan to cut your losses when you are wrong. I've been a student in the school of hard knocks many times, but I've never lost my guts. At times, I know I've had too much and have overtraded, but then there are some people I know who have an inability to pull the trigger, and that is just as deadly. Looking back only brings regrets, so you need to face the future with optimism, knowledge, patience, and guts.

Health and rest

Gann's fourth essential quality for trading success is health and rest. If you don't feel right, you won't trade right, and that is the time to remain on the sidelines. When you stick with something too long, your judgment becomes warped. Traders who are continually in the market without rest get too caught up in the day-to-day fluctuations and eventually get tapped out. At least twice a year, it makes sense to close out all your trades, get entirely out of the market, and go on a vacation. When you return, recharged, your trading will improve.

So, that wraps up Gann's four essential human qualities required for success. You'll need them. Shortly, this book delves into specifics that will help you travel the rocky road leading to trading success. Some of the most important lessons I've learned over the past 30 years are in the pages to come, and they should help you make money. However, if you don't have patience, guts, knowledge, and good health, all the rules in the world are just words.

So, with that said, let's get into the meat of the matter. I'm not trying to be all things to all people, but I do believe this book appeals, to novice and veteran traders alike. We'll begin at the beginning. If you are new to this game, you'll need to know how the game is played, what the rules are, and how the money works. I strive to be as complete as possible, and at times, it might actually appear simple. If it were really so simple, however, most people wouldn't lose, but the nature of the futures markets is to punish the majority. Let's begin our journey to join the minority, because it is the minority who reap the rewards!

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