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Crude Oil Speculators have "Options"

By: Carley Garner PG 2

OFF THE WALL

By: Wyatt PG 8

Track'nTrade: Online Offers! PG 6

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In this issue...

Crude Oil Speculators have "Options"
by Carley Garner

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Off The Wall
by Wyatt

Crude Oil Speculators have "Options"

By: Carley Garner

Crude oil is perhaps the most notorious commodity market but it is also among the most treacherous. Nonetheless, speculators are drawn toward the leverage and volatility crude oil provides... and, more importantly, the stories of riches made and lost by its participants.

Before risking your hard-earned money speculating in crude oil, it is important to be aware of all speculative avenues available. For instance, it is possible to trade oil via ETF's that attempt to track the price of crude such as the USO (United States Oil); alternatively, investors can place bets on crude oil via the stock shares of firms that are correlated to crude oil prices, such as COP (Conoco Phillips); or traders can directly speculate in the price of oil through the purchase and sale of futures and options contracts. Despite the stock market alternatives, I believe futures, and options on futures, offer the only trading venue that provides the efficiency and the market access necessary to effectively trade price fluctuations in crude oil.

Value in trading Crude oil futures vs. stocks and ETFs

My preference for futures might be influenced by the fact that I am a commodity broker, but it goes much deeper than that. Here are a few key advantages to futures over equities.

Longer Trading Hours/More Market Access

Crude futures open for trade Sunday evening at the NYMEX (New York Mercantile Exchange) branch of the CME Group and, for all intents and purposes, oil futures trade around the clock until Friday afternoon. On the contrary, ETF and Stock traders are able to execute trades during the official day session of the NYSE, and similar exchanges, as well as in the designated pre-open and after-market sessions (which are often illiquid). The entire span of trading is limited to approximately thirteen hours... or less.

Preferable Tax Treatment

Additionally, futures and options traders enjoy preferable tax treatment. Positions, regardless of their time span, are taxed at a 60% / 40% blend between long term and short-term capital gains, respectively. This differs from equity traders, which are taxed at the higher short-term gains rate on all positions held for less than a year. Additionally, futures traders report a single figure to the IRS on Form 6781; they are not required to report each individual trade as stock traders are.

Pure Speculation

Even more compelling; why trade an imitation when you can trade the real thing? ETF's are simply funds created to track the price of crude oil but they might not always be perfectly correlated. Similarly, energy company stocks are exposed to both market risk and company specific risk in addition to being somewhat correlated to crude prices. In other words, each of these equity market products offer a less efficient means of profiting, or suffering losses, from speculations made. With equity market products, it is possible to be right in your expectations of crude prices but not make money due to ETF rebalancing or other peripheral interferences. On the other hand, those looking for pure speculation in crude oil, the futures market is the place to get it.

Unlike ETF's or energy related stocks, crude oil futures traders will make or lose money in lockstep with changes in price of the underlying asset. This is made possible by the fact that crude oil itself is

deliverable against the futures contract and while traders may not be exchanging physical barrels of crude, they are buying or selling agreements that represent the asset. This is as close to the real thing as you can get (without getting dirty).

Leverage

As if these arguments weren't persuasive enough, those trading crude oil in the futures markets are provided free leverage. In other words, there are no interest charges for shorting or trading on margin. Likewise, futures traders do not have to borrow shares, get approval, or make any other arrangements with their broker before selling short the market. Instead, crude oil futures traders simply buy or sell contracts at their leisure with a margin deposit of less than 10% of the value of the underlying asset. Of course, access to easy and free leverage has drawbacks; it can encourage traders to over-trade, over-leverage, or both.

Crude Futures or Options on Futures?

Once a trading venue is chosen, the "options" don't end there. Assuming you take my advice and look to the futures markets for opportunities, NYMEX crude oil traders have the ability to trade in three different manners; a full-sized futures contract, options written on this full-sized futures, or an E-mini version of the futures contract.

With the exception of the E-mini crude oil futures, crude futures and options can be executed in two separate venues; open outcry and electronic trade matching. Open outcry, or pit trading, takes place in a marked area on the trading floor of the NYMEX and entails the buying or selling of instruments by hand signals and shouting. It is quite exciting and can best be described as organized chaos. Although this was the original form of commodity trading, the practice is slowly dying at the hands of more convenient and, arguably more efficient, electronic trade matching. Electronic trade matching doesn't have a physical location; instead, the buy and sell orders placed by traders are executed in a cyber-environment with little or no human intervention.

Keep in mind that the difference between open outcry and electronic trade matching lies in the manner the trade is executed, not necessarily how the trade is placed. Specifically, it is possible to enter an order to be executed in the pit via an online trading platform using a specialized commodity symbol; if electronic execution is preferable to the trader, she would use an alternative symbol to enter her order online. Of course, if you place orders by phone you can verbally designate to your broker which venue you prefer your order to be place in. If you do not specify, most trade desks will automatically route it to electronic execution.

During the official day session, traders have the ability to use either venue for execution and because the contracts are fungible, it is possible to enter a position through the pit and exit electronically. Nevertheless, as a retail trader you are better off sticking to electronic execution in most circumstances. Leave the open outcry trading to the floor traders and institutions. There is one exception to this rule; retail traders wishing to execute multi-leg option spreads might find value in pit execution.

During the day session, both arenas are available to traders but in the extended overnight session it is only possible to trade crude oil electronically.

NYMEX WTI Light Sweet Crude Oil Futures

The global benchmark for crude oil prices is West Texas Intermediate crude oil; it is described as a light sweet grade because of its low density and low sulfur content. This WTI crude oil is the underlying grade for the futures contract traded on the NYMEX division of the CME Group. The delivery and price settlement details of the contract are determined by cash market activity in Cushing Oklahoma, which acts as a major commerce hub for domestic crude oil.

Do not confuse WTI crude oil traded on the NYMEX, with Brent crude oil futures which are traded on the Intercontinental Exchange. Brent crude is a benchmark for crude extracted from the Atlantic basin and mostly sourced from areas surrounding the North Sea.

The original full-sized version of NYMEX crude is written with 1,000 barrels of crude oil as the underlying. Quite simply, a trader long or short a single futures contract will make or lose money based on the value of 1,000 barrels. With crude oil worth $100 per barrel, the total value of a single futures contract is $100,000 ($100 x 1,000 barrels). Keep in mind that the margin, or required good faith deposit to trade crude, fluctuates between $4,000 and $6,000. Therefore, traders can expose themselves to the price fluctuations of a contract valued at approximately $100,000 with what equates to a down payment of approximately 5%. It is easy to see how quickly gains and losses can add up with this type of leverage.

With that said, although the exchanges set the required minimum margin it is the trader who ultimately controls the amount of leverage used. Those not wishing to use leverage can effectively eliminate it by depositing the full value of each contract traded. Specifically, if the value of WTI crude is $103 per barrel, a single futures contract represents $103,000 of the underlying asset. A trader funding an account with $103,000 to trade one lot at a time has eliminated the leverage in futures trading. Yes, I realize this isn't feasible for all traders but it is important that you realize that you are in control of your own leverage and risk, not the exchange.

The minimum tick in crude is one penny, and equates to a profit or loss of $10 to a trader. Accordingly, a dollar in price move in the underlying results in a profit or loss of $1,000 per contract. For instance, a trader that bought crude oil at $102.00 and sold at $103.00 would have walked away from the trade a winner in the amount of $1,000 minus commissions and fees.

As mentioned, there is also an E-mini version of the crude oil futures contract which is exactly one half of the original. Consequently, an E-mini contract represents 500 barrels of crude and a trader long or short in this market will make or lose $500 for every dollar in price movement, or $5 per penny. As you have probably inferred, the margin for mini crude is about half of the full-sized version and so is the volatility and market exposure. The E-mini crude oil futures contract will move in tandem to the full-sized version, but the minimum tick is 2.5 cents, rather than the 1 cent seen in the original contract.

NYMEX WTI Crude Options

Trading outright futures entails theoretically unlimited risk, relatively high margins and immediate risk upon entry. For many small retail traders, this is a deal breaker. However, there are ways to participate in crude oil with variable levels of risk, reward and volatility through the use of options. In my book, "Commodity Options", I outline several of the most popular option trading strategies and methods of adjusting them to fit the personality and goals of each trader.

Again, the NYMEX division of the CME Group provides traders with the ability to trade options via electronic execution or open outcry. There are advantages and disadvantaged to each, but it is nice to have access to both. For instance, since the advent of electronic crude oil options, it is much easier, and cheaper, for retail traders to access live price quotes. In addition, electronic fills are reported immediately and it is convenient to cancel and or replace existing orders. However, as previously mentioned, it can sometimes be more efficient to use open outcry execution for options.

For those interested in trading multi-leg spreads it is sometimes necessary to use the open outcry execution. Through the pit, it is possible to name a price (limit order) on a package of options (spread). In other words, orders can be placed on multiple options as an all or nothing proposition to be executed at a specific price or better. Although some trading

platforms are capable of spread orders intended for electronic execution, it is a work in progress. In some scenarios, electronic crude oil option traders must place each leg of a spread individually, often leading to partial fills or chasing prices on unfilled legs. For reasons mentioned, it is a good idea to have access to a commodity broker who, in turn, has direct access to specialists on the exchange floor.

Conclusion

The financial and commodity markets are "crude"; there aren't mulligans and mistakes can be costly. Traders spend endless hours studying the exciting parts of trading such as technical analysis, supply and demand graphs, and seasonal tendencies; however, the difference between profit and loss is just as much determined through the decision to speculate in the right arena and vehicle for your individual risk tolerance and personality. Before venturing into the crude oil market, be sure to educate yourself on the "options".

***Futures and options trading involve substantial risk of loss and are not suitable for all investors.**

Carley Garner is the Senior Strategist for DeCarley Trading, a division of Zaner, where she also works as a broker. She authors widely distributed e-newsletters; for your free trial subscription visit www.DeCarleyTrading.com. Her books, "A Trader's First Book on Commodities," "Currency Trading in the FOREX and Futures Markets," and "Commodity Options," were published by FT Press.Carley Garner is the Senior Strategist for DeCarley Trading, a division of Zaner, where she also works as a broker. She authors widely distributed e-newsletters; for your free trial subscription visit www.DeCarleyTrading.com. Her books, "A Trader's First Book on Commodities," "Currency Trading in the FOREX and Futures Markets," and "Commodity Options," were published by FT Press.

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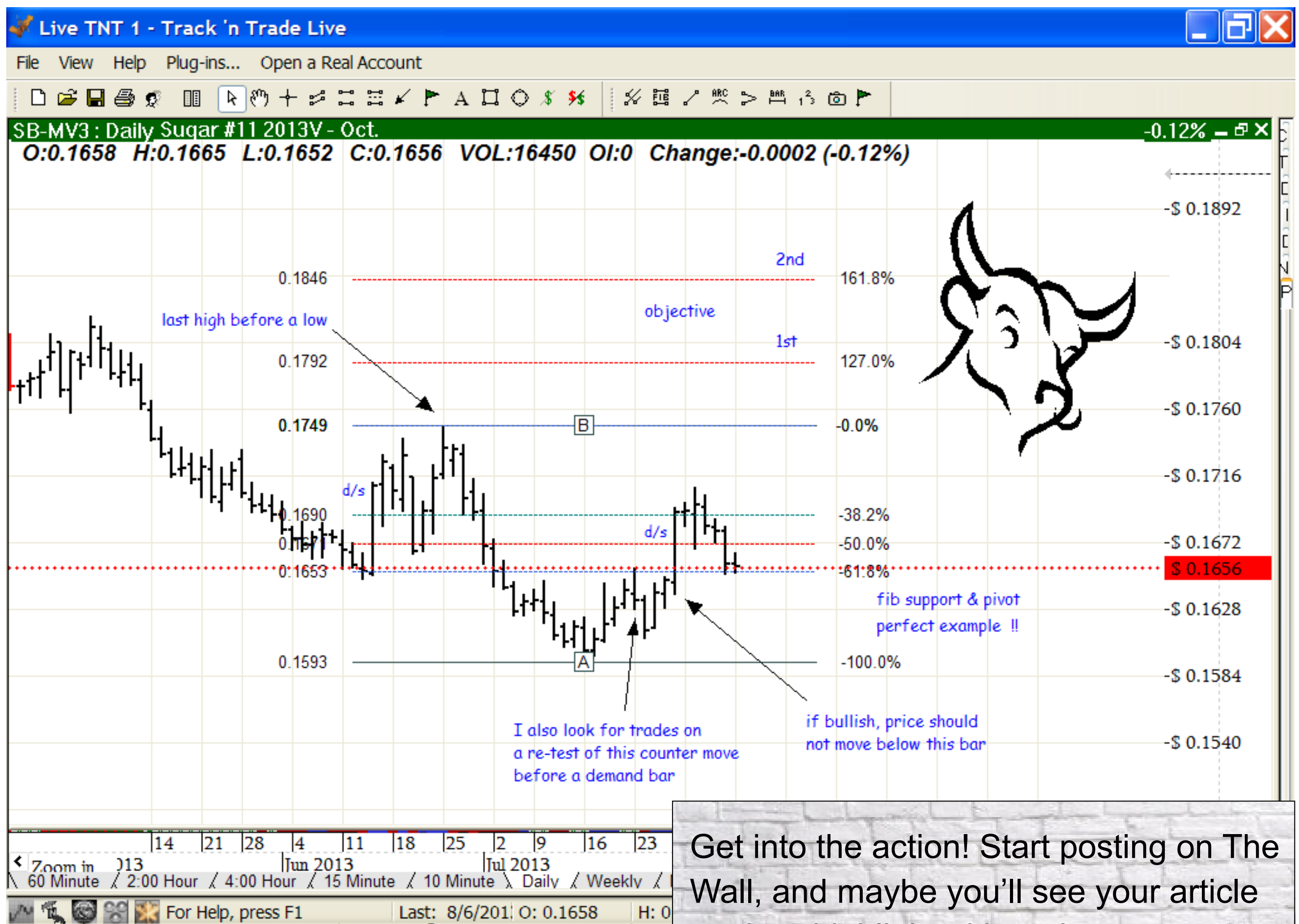
This Month's Off the Wall Chart comes from Wyatt!



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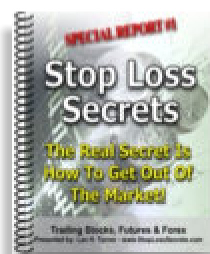

It seems that we spend 90% of our time studying and trying to figure out the best timing techniques for market entry, but we spend very little time actually learning the techniques of exiting the market. Getting into a market is easy, but getting out of the market, with a profit, is the true test of a traders skill.

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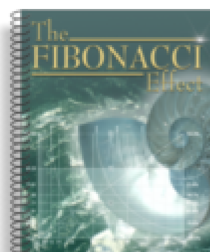

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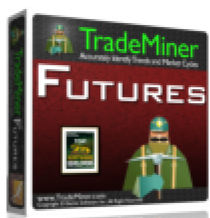

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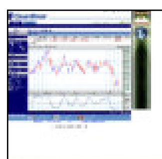

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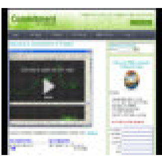

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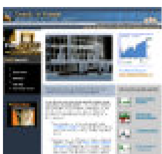

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