How to Trade Commodities for Beginners

By Matthew Corica

Investors have been feeling the painful reality from the recent market correction due to the sub-prime mortgage crisis, and are wondering where to invest their hard earned saving over the coming years. We listen to news reports almost daily talking about the losses suffered on the world stock markets, and have seen first hand the damage done to our stock portfolios and superannuation. As a professional investment advisor and dealer, I know exactly where the money goes in these hard economic times. The money always travels towards index futures and commodity markets because investors will scramble for new opportunities, which are currently not present in the global stock markets, and will only be found in other more versatile markets.

A commodity is a normal physical product used by everyday people during the course of their lives, or metals that are used in production or as a traditional store of wealth and a hedge against inflation. For example, these commodities include grains such as wheat, corn and rice or metals such as copper, gold and silver. The full list of commodity markets is numerous and too detailed for this article. The best way to trade the commodity markets is by buying and selling futures contracts on local and international exchanges. Trading futures is easy, and can be accessed by using the services of any full or on-line futures brokerage service. Traditionally, there is an expectation when trading commodity futures of achieving higher returns compared to shares or real estate, so successful investors can expect much higher returns compared to more conventional investment products.

The process of trading commodities, as mentioned above, must be facilitated by the use of trading liquid, exchangeable, and standardised futures contracts, as it is not practical to trade the physical commodities. Futures contracts give the investor ease of use and the ability to buy or sell without delay. A futures contract is used to buy or sell a fixed quantity and quality of an underlying commodity, at a fixed date and price in the future. Futures contracts can be broken by simply offsetting the transaction. For example, if you buy one futures contract to open then you sell one futures contract to close that market position.

The execution method of trading futures contracts is similar to trading physical shares, but futures contracts have an expiry date and are deliverable. Australian retail futures brokers that deal with commodity speculators do not allow the delivery of a commodity, so I will be making no jokes about having a sea container full of coffee delivered to your front doorstep because it will never happen. Futures contracts have an expiry date and need to be occasionally rolled over from the current contract month to the following contract month. I usually only have to roll a trade, when I am trading trend following signals and the trade turns into an extended hold position because my stop-loss or profit-target has not been hit in the time originally estimated.

You have probably heard that many commodity markets have fallen during the recent market correction, and you are asking yourself why I am talking about trading commodity futures. The reason is because the biggest advantage to trading commodity futures, for the private investor is the opportunity to legally short-sell these markets. Short-selling is the ability to sell commodity futures creating an open position in the expectation to buy-back at a later time to profit from a fall in the market. If you wish to trade the up-side of commodity futures, then it will simply be a buy-to-open and sell-to-close set of transactions similar to share trading.

The big problem that I have seen by talking to new traders is that they believe an on-line trading platform and the software tools supplied will make them a successful trader. You must learn trading techniques and develop trading strategies to become successful. The best method that I have found is by developing mechanical based trend following strategies that remove illogical decisions based on emotions. Mechanical trading can be defined as methods of generating trading signals and quantifying risk that are independent of the trader’s discretion. The mechanical method is preferred because it is impossible to base all your trading decisions on a discretional method, as human beings are prone to changing their judgment, subconsciously, when trading over months or many years.

If you do not plan to develop your own mechanical based strategies, then you can use the strategies of any licensed investment advisor that specialises in trading futures markets. You will pay slightly higher brokerage fees, but will benefit from the advisor's years of experience. If you choose to use the services of a professional advisor, then ask the advisor if they trade mechanical based strategies, and the process of how they developed their own original back-tested models. Use only an advisor that has developed their own proprietary computer code for back-testing, as the over-the-counter retail back-testing packages can create false results, and are not designed to test every detail that is required for true professional strategy development.

If you have the desire to trade the lucrative commodity futures markets, then now is the time to start learning and getting involved. The commodity markets will always produce rising of falling trends, and with the abundance of information and trading opportunities available there is no reason for any investor to exclusively trade the share market when there is potential profits from trading commodity futures.

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