ReadySetCrypto Futures Masterclass

Module One: What Are Futures and Why Trade Them?

Module One
What Are Futures & Why Trade Them?

By Doc Severson

• We Are Not Financial Advisors or a Broker/Dealer: Neither ReadySetCrypto® nor any of its officers, employees, representatives, agents, or independent contractors are, in such capacities, licensed financial advisors, registered investment advisers, or registered broker-dealers. ReadySetCrypto ® does not provide investment or financial advice or make investment recommendations, nor is it in the business of transacting trades, nor does it direct client commodity accounts or give commodity trading advice tailored to any particular client's situation. Nothing contained in this communication constitutes a solicitation, recommendation, promotion, endorsement, or offer by ReadySetCrypto ® of any particular security, transaction, or investment.

• Securities Used as Examples: The security used in this example is used for illustrative purposes only. ReadySetCrypto ® is not recommending that you buy or sell this security. Past performance shown in examples may not be indicative of future performance.

• All information provided are for educational purposes only and does not imply, express, or guarantee future returns. Past performance shown in examples may not be indicative of future performance.

• Investing Risk: Trading securities can involve high risk and the loss of any funds invested. Investment information provided may not be appropriate for all investors and is provided without respect to individual investor financial sophistication, financial situation, investing time horizon, or risk tolerance.

•Cryptocurrency Trading Risk: crypto trading is generally more complex than stock trading and may not be suitable for some investors. Margin strategies can result in the loss of more than the original amount invested.

Table of Contents

Introduction to Futures Contracts	4
What Are Futures?	5
Futures vs. Spot	8
Defining a Futures Contract	10
Short vs. Long	11
Leverage	13
Summary	14
Homework and Next Steps	15

Introduction to Futures Contracts

Welcome to module one of the ReadySetCrypto Futures Masterclass!

We'll start at a high level and start to work our way down; what we have to do before anything else is define *what* a futures contract is and *why* you would want to trade one. Why go through the bother of setting up a futures account when you can just trade crypto on your regular spot broker account? Before I define WHAT futures trading is, I must first "get real" with you and define the landscape of this type of trading.

Futures trading is, by far, the most addictive, exhilarating, frustrating method of trading that I've ever done. There is no style of trading that carries with it more potential of gain AND risk, compressed into what is normally a very short timeframe. This is not the relaxing, lay-back-in-your-hammock-in-the-backyard style of trading...nor is it the "hey I'll just check on my position at the coffee shop" type of investing.. This is combat via close quarters battle, and it really favors the "athletes" of the trading world; ones that can think quickly and accurately under duress. This is definitely not hodling using long-term fundamental analysis.

But it's also not "gambling" in the classic sense that you have no control over the odds in your favor. There ARE very specific setups that carry edge with them, and they can be precisely defined….but they can also be fleeting/elusive, requiring excellent patience, discipline, and overall control over your own actions. The "easy" trade is rarely the one that carries edge with it; profiting in these markets and timeframes require you to do what others either cannot or will not do.

I will never say that futures trading is EASY, however we can make it SIMPLE or at the very least LOGICAL, if we have the discipline to follow a narrow path towards securing edge in our trades.

As I write this, Futures trading is just getting off the ground in the Crypto markets; for some spot currencies, futures trading already represents the majority of the intraday volume, as we'll see. And for all the reasons that we'll list in this module, it's likely to continue to dominate the volume in specific currencies going forward.

One last point that I'd like to make before we get into the nuts and bolts….is that once you learn to trade futures in one market...you'll find that those skills will translate laterally into any other financial market that you'd like to trade. For example, futures trading represents the single most actively-traded instrument on stock indices like the S&P500, which represents $23.5 trillion in market cap. They are used by institutions for speculation, risk management, and portfolio hedging. Futures do most of the heavy lifting for positional management for the larger billion-dollar institutions. It makes complete sense that futures will do the same for the Crypto markets as well. Let's get into it!

What Are Futures?

Before I define these, let me first say that there is a very loose definition in terms of what a "futures contract" is in the crypto markets vs. the larger, more established "commodities" and "equities" markets. Here is the textbook definition of a futures contract from Investopedia:

"*A futures contract is a legal agreement to buy or sell a particular commodity or asset at a predetermined price at a specified time in the future. Futures contracts are standardized for quality and quantity to facilitate trading on a futures exchange. The buyer of a futures contract is taking on the obligation to buy the underlying asset when the futures contract expires. The seller of the futures contract is taking on the obligation to provide the underlying asset at the expiration date.*"[1]

In the commodities markets, this definition makes sense as you can use a futures contract to "lock in" the future price of a barrel of oil, a bushel of wheat, or units of corn, natural gas, sugar, coffee, etc. If you are operating an airline and you forecast the price of oil and fuel rising, you can go "long" some forward-dated contracts to lock in the forward price of fuel at today's lower prices. (a famous business application executed by Southwest Airlines!) If you are a grain farmer and you believe that this year's crop will be poor, you can establish short positions in wheat or corn futures which will hedge off your risk from a poor season. This is how businesses hedge future risk against price or demand changes, by using long or short futures contracts. And in this context, hopefully you can see the relevance to the name "futures." A futures contract is just that, a contract to buy or sell a unit of something at an agreed-upon price in the future.

And at present, we actually do have honest-to-goodness futures contracts for Bitcoin, as underwritten by the Chicago Mercantile Exchange, and the Chicago Board Options Exchange, or just CBOE as they are known today. (We'll also have futures underwritten by the ICE soon via Bakkt) We'll talk about how to use those instruments in a minute, but they represent futures contracts in the classical sense of a futures contract. And as you'll see, they are very different from trading the "spot" currency.

Still not sure why we would trade a futures contract in Bitcoin? It probably made sense to hedge the forward price of oil or corn, but hedging the forward price of Bitcoin? Let's start out by listing some of the basic advantages of futures contracts, and why we trade them:

[1] https://www.investopedia.com/terms/f/futurescontract.asp

- **Leverage** - Futures contracts typically carry some form of financial leverage, meaning that a smaller retail account can get more "bang for the buck" per trade if you are capital-constrained like the majority of retail traders.

- **Bidirectional** - Many crypto brokerages only allow you to trade "long," or buying the asset. Few crypto brokerages allow you to trade "short," or create bearish positions.

- **Liquidity** - Most futures contracts have the advantage of increased liquidity due to the use of live or automated Market Makers, meaning that it's relatively easy to secure a fill into the futures contract. The Cryptos that offer Futures contracts are going to be the most heavily-traded instruments in the entire market.

To be fair, there are also disadvantages to some of these characteristics, which can be detrimental to the retail trader. Leverage, for example, creates a double-edged sword. While many brokers that implement "leverage" in their contracts tout how fast you can make money, don't forget that leverage means that you can lose money with equal speed.

So obviously one of the big advantages with being able to trade futures contracts on crypto is that you can establish a short position - one that gains value as the underlying spot price of the crypto decreases. Imagine going short some Bitcoin futures contracts back in January 2018, right before the fall. Depending on the size of your Bitcoin holdings, a short futures contract might have been able to completely absorb the risk of the price decline by going UP in value as the price of Bitcoin went down.

And while that application of futures contracts is totally valid, quite frankly very few retail traders have a large enough crypto portfolio that they are hedging their risk with futures contracts. Most retail traders are trading futures contracts through a type of trading known as scalping. They look for very short-term edges/inefficiencies in the market, establish a position, and look to make a very quick profit in the position.

By the end of this module I hope to show you the advantages of trading futures on crypto, as well as the risks, and in doing so, show you how you can secure gains in any market, whether it's going up, down, or sideways.

Other Types of Futures Contracts on Crypto

Depending on who the "futures' broker is, they might make an attempt to replicate the CME/CBOE type of forward-settlement futures contract, or they might create their own hybrid futures contract. There are a couple of commonly-available types of this instrument:

- **Perpetual Swaps** - These have no "time" element and do not expire/settle on an expiration date. They have all of the same characteristics of a futures contract, however, and can be traded short or long.

- **Contracts for Difference** - these are essentially the same as a swap contract, however they typically do not punish the seller by charging an interest rate.

For the purposes of this program, we will consider all of the different types of directional derivatives like swaps, CFDs, or any other type of synthetic directional contract….a "Futures" contract that has a specific amount of leverage and can be traded short or long.

Futures vs. Spot

To this point in this module I've been using this term "spot" price or "spot" currency; what does that mean?

The "Spot" Currency is simply the actual price of a currency vs. the denominated base currency, such as Bitcoin vs. the US Dollar, usually denoted as BTC/USD. You can think of the "Spot" price as the "actual" cryptocurrency or the "underlying" price, versus a derivative like a futures contract, swap, or CFD.

That Spot currency might have several different prices at any given time, depending on what exchange it's trading on. You might see BTC/USD trading at one bid/ask price at Coinbase, and a peek over at OKEx might show it trading at a completely different price; note the different prices for Bitcoin per exchange in Figure 1:

Figure 1

Bitcoin Markets

#	Source	Pair	Volume (24h)	Price
1	BitMEX	BTC/USD	** $605,743,436	* $3,572.50
2	CoinBene	BTC/USDT	$292,171,947	$3,622.62
3	DOBI Exchange	ETH/BTC	$205,107,727	$3,621.22
4	OEX	ETH/BTC	$181,073,592	* $3,624.80
5	ZBG	BTC/USDT	** $142,913,068	$3,622.39
6	Fatbtc	BTC/CNY	$141,335,300	$3,647.65
7	Coineal	BTC/USDT	$129,515,487	$3,622.23
8	OOOBTC	BTC/USDT	$115,204,168	$3,624.43
9	IDAX	BTC/USDT	$110,793,087	$3,622.46
10	BW	BTC/USDT	$107,447,933	$3,622.18
11	Simex	BTC/USD	$107,085,121	$3,576.12
12	Bibox	BTC/USDT	$104,045,929	$3,621.51
13	BitForex	BTC/USDT	$101,864,856	$3,620.78
14	HitBTC	BTC/USDT	$99,289,049	$3,625.43
15	Liquid	BTC/JPY	** $96,368,181	$3,569.12

Notice how the prices in the right-hand column are different, depending on which exchange that you're using. The larger and more liquid the market, the "tighter" those price spreads will be, meaning that there will be less of a difference of the spot price from exchange to exchange. Eventually we will have sub-second arbitrage to keep those prices much tighter than the spreads seen today, but that's all part of the maturation process for a financial market.

If you've bought or sold any cryptocurrencies in the past, you were more than likely trading the spot currencies vs. some fiat currency (Like USD or Euro) or you were using Bitcoin as the reference currency.

Defining a Futures Contract

When you trade a futures contract, the first thing that you MUST know are the contract specifications. These are details like (but not limited to):

- **Leverage or Value/Point:** How much does the contract value change as the price goes up or down?
- **Trading Hours:** Does the contract trade 24x7 or does it follow a different exchange timeframe?
- **Expiration/Settlement:** How often does the contract expire? How is the contract "settled?" How is the "settlement price" determined?
- **Initial Margin Requirement:** How much account value is required to be set aside in your account to hold a contract?
- **Short vs. Long:** Does the contract treat a "long" contract differently than a "short" contract?
- **Hold Time:** Does your broker charge a different rate to hold a trade overnight vs. intraday?

There are many other details that we'll have to tackle, and unfortunately this is going to be defined on a broker-by-broker basis, because the only defined/regulated futures contracts are currently those underwritten by the CME/CBOE in Chicago. The rest of these Futures/CFDs/Swaps will be defined by the provider themselves.

To get an idea of how a futures contract normally is defined, (irrespective of whether you can actually trade this contract) you might want to visit the CBOE page that defines the contract specifications for a look at the actual XBT contract spec. [2]

Again, other brokers that provide a "synthetic" futures contract will define their contract specifications, although in many cases you might have to decipher the fog of legalese to truly understand what you, the contract holder, are liable for.

In any case, it is a must that you fully understand the specifications and the fine print of the contract that you are trading.

---

[2] http://cfe.cboe.com/cfe-products/xbt-cboe-bitcoin-futures/contract-specifications

Short vs. Long

One of the principle advantages of trading futures contracts is that they can be traded "short" as well as "long." Everyone is familiar with a "long" trade; buy low, sell high. Trading to the short side, or establishing a bearish trade in crypto using spot currencies, can be somewhat of a daunting process.

Not only is it difficult to find a broker that will let you set up a bearish "short" trade, but it requires you to endure all sorts of friction. You'll need to first select a broker that will allow it, then set up a margin account, and then endure them charging you an interest rate for "borrowing" the coins that you are turning around and selling to open the position. It's a wonder that anyone can make any money to the downside with this arrangement.

But futures contracts are ambidextrous; they can be just as easily traded short as they can be traded long. Let's show a little example of how futures can be used short and long. Figure 2 shows three price points, A, B, and C.

Figure 2

- **Point A:** BTC/USD = $4120
- **Point B:** BTC/USD = $3440
- **Point C:** BTC/USD = $3760

Let's cherry-pick this example just for fun and assume that we established a short position at point A, covered it and went long at point B, and closed that long position at point C.

Let's also assume that we used one contract of the CBOE Bitcoin XBT futures.

The XBT has a minimum price granularity of $5, or each "tick" in the price of the contract would be $5, and the value of the contract either falls or appreciates $5/tick, which is a 1:1 correlation to the dollar.

Let's first consider the short trade from point A to point B:

- **The price moves from $4120 to $3440 with a short contract, so for one contract we make $680 minus commissions.**

Now let's consider the long trade from B to C:

- **The price moves from $3440 to $3760 with a long contract, so for one contract we make $320 minus commissions.**

The trading experience for both trades was completely "linear" and frictionless, regardless of whether we went long or short. This is one huge advantage of using futures.

Note that not all brokers/futures providers are the same when it comes to "long" vs. "short." Some of the more popular solutions out there will still charge an interest fee on short positions.

Leverage

Using “leverage” means that you can control more position size than you should be able to considering the size of your account. For example, it is possible to secure positions using 100:1 leverage; let’s see a quick example.

Let’s assume that you were trading a BTC/USD futures contract with 100:1 leverage, and the price of BTC/USD is $3700. This means that if you wanted to take a long position on BTC, and wanted to trade using the 100:1 leverage, you would leverage the gains and losses of one full BTC, yet would only be required to have $37 in your account to set up the trade.

If BTC went from $3700 to $3750, you would realize a $50 gain in your account which would be a 135% return on your capital. Unfortunately, a drop in BTC from $3700 to $3663 means that your account has “blown up.”

Leverage is a double-edged sword, as it can work for you as well as against you. Using leverage does not relieve you of operating by the principal tenets of Risk Management which we’ll cover in later modules as we get closer to building your system and then trading it.

It’s not about what you can make; it’s about what you can lose. Professionals always begin the discussion by asking how much risk is there….how much can I lose? They never begin a trade discussion by asking how much they can win.

In some cases leverage can be set on the broker platform, and in other cases it is fixed and cannot be set. Position size is ALWAYS a variable that can be altered, however.

Summary

In this module I just want to get you comfortable with the who/what/where/when/how of futures contracts - an easy introduction. Depending on your experience with futures in other markets, this might be old news for you and you just want to get into the “Trading” stuff…..or you might still be confused as to what futures are or why we would use them.

I encourage you to use all of the resources in each module - the video and quiz as well - to help round out the experience and perhaps answer some questions you’re struggling with. And nothing beats hands-on experience for learning something new, however as we’ll see in upcoming modules, I don’t want that “experience” to cost you anything to start out.

In Module Two, we’ll shift gears and show how futures contracts can be traded for profit.

Homework and Next Steps

Please complete the following tasks before moving to the next module:

- [ ] Watch the associated video for this module.
- [ ] Take the module quiz.
- [ ] Are there any trading applications to this point in your investing career where you would have benefited from using Futures contracts?