Combining Forex Spot And Futures Transactions
by Noble DraKoln (Contact Author | Biography)

In 1972, for the first time ever, everyday investors were allowed to trade the difference in currency values in the United States. Much of the world had just stopped pegging their currencies against the dollar and the oil industry was fueling a worldwide explosion in importing and exporting activity. To tap into this, currency trading was introduced in the form of futures contracts. At the time, the Chicago Mercantile Exchange (CME) was strictly involved with agricultural products, but it saw the potential economic success of servicing the then nascent currency exchange market and decided to give it a chance.

By 2008, currency trading exceeded $3 trillion dollars daily, but the majority of traders only participate in a fraction of the currency opportunities available to them. However, the currency market is a multilayered kaleidoscope of spot, futures and options trading. The currency market also has very distinct trending patterns that can become more difficult to interpret the shorter the time frame to trade. This is the problem that many new currency traders face as they enter the world of spot trading, but it can be overcome by combining spot, futures and options currency trades. Read on to learn how this works.

Spot Trading Challenges

With the introduction of the Commodity Futures Modernization Act of 2000, spot currency trading (forex) became the rage. Traders that were new to currency trading could enter the spot market with as little as $300, giving them leverage of almost 500:1. While the leverage is inexpensive, small fluctuations can represent larger losses, as well as large profits, in a short period of time. Another major drawback to spot currency trading is the potential interest rate charges of holding on to a spot contract past the requisite 24-hour time period. Combine these issues with the slippage that occurs as a result of sporadic trading activity, and the challenges quickly become apparent as to why traders may find trading in the forex spot market difficult. (For more, see *Getting Started In Forex*.)

There is a better way. When currency trading was first introduced in the futures market, it was created to act as protection - a hedge for multinational corporations and banks that needed to protect themselves from the downside risk of buying free floating currencies. They would take delivery of a particular currency, such as the Canadian dollar, and then short it in the futures market or buy a put in the options market just in case the currency dropped in value. This protection would allow them to hold on to their Canadian dollar trade longer in the face of short-term fluctuations that were simply minor retracements in an overall longer term trend. In the past 30 years, nothing has changed. The currency spot market can still be protected by the futures currency market, and the option currency market can protect both the spot and the futures currency market. (For related reading, see *Practical And Affordable Hedging Strategies*.)

The interrelationship between the currency spot and options and futures currency markets is rarely

exploited by retail traders. Retail traders are typically fixated on fast profits with little regard to the downside risk beyond placing a stop order. This approach is just one-third of the currency universe. With the proper combination of the spot market and the futures market, or the spot market and the options market, a currency trader can optimize performance by taking advantage of both the short-term fluctuations while catching the long-term moves that would be missed by trading the spot market alone.

Downside Risk of Spot Forex Transactions

In Figure 1, we can see the euro trending upward from $1.44 to $1.60. This entire move of 16 cents (1 cent = $1,000 when using a standard contract of 100,000 units) represents a potential gain of $16,000 in the spot market. From February of 2008 to April 2008, there were multiple pullbacks and retracements.

On March 17, 2008, the market dropped in value from $1.56 to $1.53. This represents a $3,000 loss. The market eventually rebounds, but hindsight is 20/20 - while you are in the trade, there is no such consolation.

A $3,000-dollar drop could wipe out the margin of a full-sized spot forex contract. So, while you could be right about the market's overall direction, you can be wrong on your timing in executing the trade. (For related reading, see *Trading Is Timing*.)

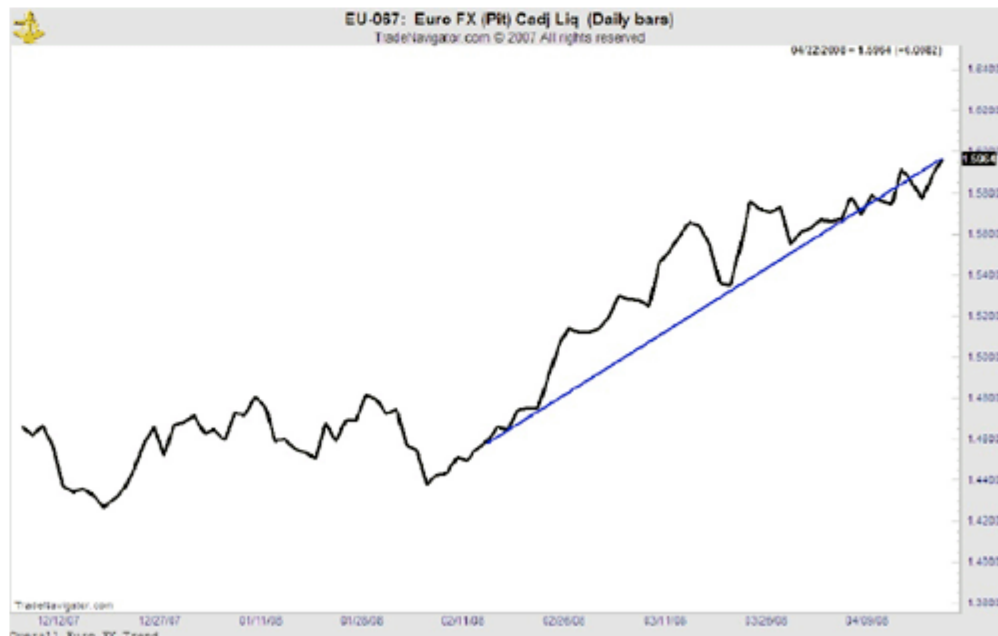

Figure1
Source: TradeNavigator.com

While a trader with a strong money management program would not hold on to a loss of this magnitude all the way down, the fact that the trader must perfectly time the top and bottom of the market's activity in order to succeed makes profiting a herculean task. Fortunately, there is a simple

way to protect your account in the face of these factors. In Figure 1, it can clearly be seen that the market is trending up. In order to take maximum advantage of this momentum, there is no doubt that the smart money would go long the euro, as shown in Figure 2. To avoid a sudden pullback in price, the easiest position protection is to either short the euro in the futures market or purchase a euro put option. (For more on this strategy, see *Prices Plunging? Buy A Put!*)

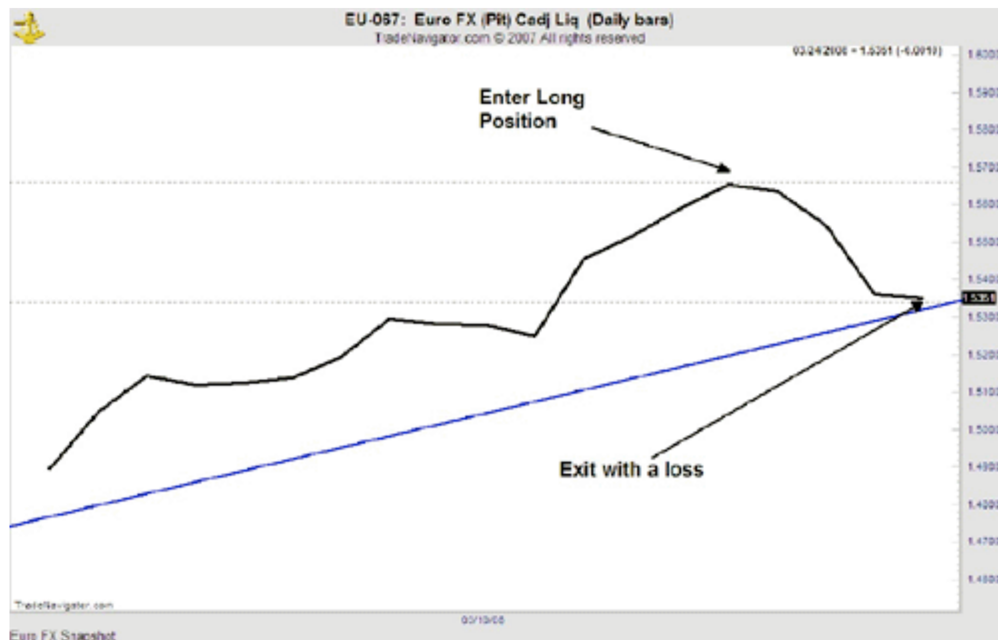

Figure 2
Source: TradeNavigator.com

Using Futures Contracts to Manage Spot Risks
If a euro futures contract is used, two new variables are added to the equation: the margin to use on the contract and the possibility that the market will move against your spot transaction. The margin in the euro futures market comes in either a full-sized contract or a mini futures contract. As of June 2008, a full-sized euro contract required a margin of $3,105 and every one-cent move would be equal to $1,250. A mini euro contract required a margin of $1,553, about half as costly, and a one-cent move equaled $625. (To learn more, see *Forex Minis Shrink Risk Exposure*.)

Depending on the amount of capital available to you, a full-sized futures contract makes the most sense as a source of protection from downside risk. On the other hand, you are losing an additional $250 for each one-cent move if you decide to use a futures contract to protect yourself and the market moves against you. You could also attempt to use a mini-euro contract, but the opposite problem would occur. Every one-cent move is worth $625 in the mini, but every one-cent move in the spot is $1,000. This leaves the position underprotected by $375 and defeats the purpose of the protective position altogether.

Using Options to Manage Spot Risks
Another route that a trader can take is to use a CME euro put option. Based on an option's volatility,

where its price is in relation to the underlying asset, and the time until expiration, the value of the put option will fluctuate. In this instance, we can choose to purchase a put option at the same price as when we decide to go long the spot euro contract. This would be considered an at-the-money option purchase. The option can range in value, but a general rule is that the option price will typically fall between 10-20% of the value of the futures margin. This could range anywhere from $300 to $600 in this instance. This small upfront cost is worth spending if it will help protect you from a $3,000 loss.

Because an option's loss is limited to the amount invested, the spot trader's risk exposure never exceeds the premium's value. This means that the underlying spot position can increase in value without the worry that you will lose $250 for every one-cent move against you, like you would if you had a futures contract protecting you. (For more, see *Getting Started In Forex Options*.)

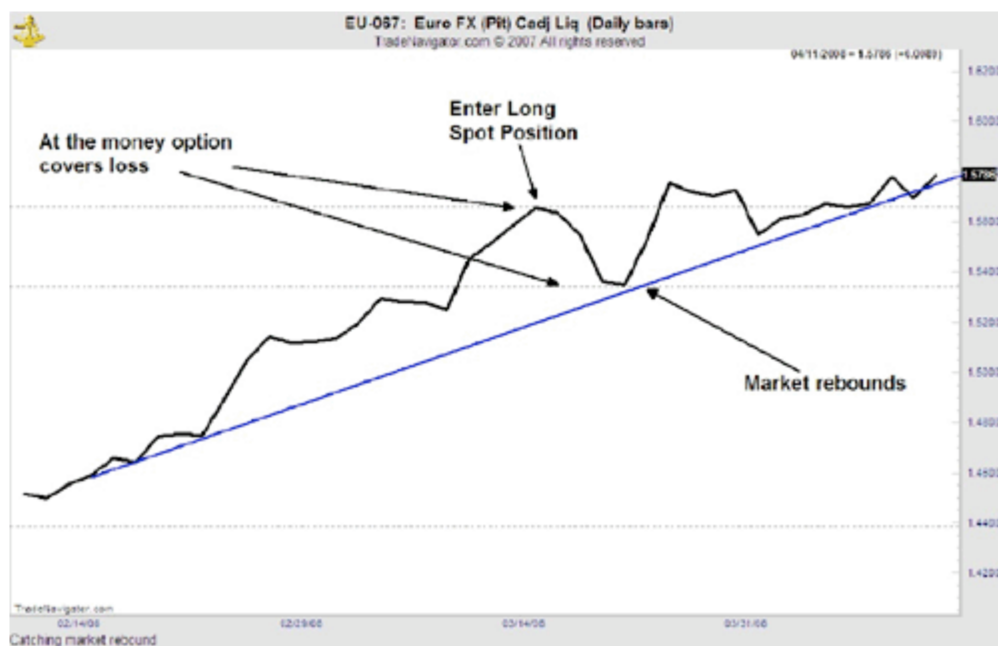

Figure 3
Source: TradeNavigator.com

In Figure 3, the euro successfully rebounds from its low and eventually exceeds the original entry price of the spot euro contract. Without the option contract as protection, there would have been a potential loss of $3,000 for a spot position, with little to no recourse. The only hope for the spot trader losing money would have been to use a stop loss-order and hope to catch the rebound in time to make up for the loss.

Conclusion

The spot, futures and option currency markets were designed to be traded together, creating a daisy chain of protection with one another. Retail traders that limit their trading to just the spot market rob themselves of one of the most important risk-management tools available to them. Trading in this combination format of spot and futures or spot and options is not perfect. Typically, for the smaller

retail trader, combining currency spot and futures contracts can actually have the undesired effect of being too expensive while opening the trader up to unexpected additional price risks. Combining spot forex trading with options contracts has exactly the opposite effect, creating maximum protection and minor expense.

No matter which tool is used to protect the spot position, the potential for loss still exists. It's simply a matter of shifting the loss from the primary position to a secondary position. By trading in this way, spot forex traders can develop a longer term outlook when they initiate a position. They will be able to trade without the fear of being right about the market, but not being able to afford to stick around because the leverage is so great. Plus, they will add another dimension to their trading: hedging, which was once thought to only be the domain of multinational banks.

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