

MU Guide

Commodity Futures Terminology

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This guide is intended to provide a basic understanding of commodity futures terminology. Though the terminology of trading agricultural commodities goes far beyond the scope of this guide, this information can be used to build a knowledge base from which a broader understanding of the futures market can be developed.

Arbitrage: The simultaneous purchase and sale of similar commodities in different markets to take advantage of a perceived price discrepancy.

Basis: The difference between the current cash price and the futures price of the same commodity for a given contract month.

Bear market: A period of declining market prices.

Bull market: A period of rising market prices.

Broker: A company or individual that executes futures and options orders on behalf of financial and commercial institutions or the general public.

Call option: An option that gives the buyer the right, but not the obligation, to purchase (go “long”) the underlying futures contract at the strike price on or before the expiration date of the option.

Cash (spot) market: A place where people buy and sell the actual (cash) commodities, that is, a grain elevator, livestock market, or the like.

Commission (brokerage) fee: A fee charged by a broker for executing a transaction.

Convergence: A term referring to cash and futures prices tending to come together as the futures contract nears expiration.

Cross-hedging: Hedging a commodity using a different but related futures contract when there is no futures contract for the cash commodity being hedged and the cash and futures markets follow similar price trends. For example, hedging cull cows on the live cattle futures market.

Daily trading limit: The maximum price change set by the exchange each day for a contract.

Day traders: Speculators who take positions in futures or options contracts and liquidate them before the close of the same trading day.

Delivery: The transfer of the cash commodity from the seller of a futures contract to the buyer of a futures contract.

Forward (cash) contract: A cash contract in which a seller agrees to deliver a specific commodity to a buyer at a specific time in the future.

Fundamental analysis: A method of anticipating future price movement using supply and demand information.

Futures contract: A legally binding agreement, made on the trading floor of a futures exchange, to buy or sell a commodity or financial instrument sometime in the future. Futures contracts are standardized according to the quality, quantity and delivery time and location for each commodity. The only variable is price, which is determined on an exchange trading floor.

Hedger: An individual or company owning or planning to own a cash commodity — corn, soybeans, wheat, U.S. Treasury bonds, notes, bills, etc. — and concerned that the costs of the commodity may change before it can be either bought or sold in the cash market. A hedger achieves protection against changing cash prices by purchasing (selling) futures contracts of the same or similar commodity and later offsetting that position by selling (purchasing) futures contracts of the same quantity and type as the initial transaction and at the same time as the cash transaction occurs.

Hedging: The practice of offsetting the price risk inherent in any cash market position by taking an equal but opposite position in the futures market. Hedgers use the futures markets to protect their business from adverse price changes.

Initial margin: The amount a futures market participant must deposit into a margin account at the time an order is placed to buy or sell a futures contract.

In-the-money option: An option having intrinsic value. A call option is in-the-money if its strike price is below the current price of the underlying futures contract. A put option is in-the-money if its strike price is above the current price of the underlying futures contract.

Intrinsic value: The difference between the strike price and the underlying futures price for an option that is in-the-money.

Liquidate: Selling (or purchasing) futures contracts of the same delivery month purchased (or sold) during an earlier transaction or making (or taking) delivery of the cash commodity represented by the futures contract.

Long position: One who has bought futures contracts or plans to own a cash commodity.

Maintenance margin: A set minimum margin (per outstanding futures contract) that a customer must maintain in a margin account.

Nearby (delivery) month: The futures contract month closest to expiration. Also referred to as spot month.

Open interest: For a given commodity, the total number of futures or options contracts that have been neither offset by an opposite futures or option transaction nor fulfilled by delivery of the commodity or option exercise. Each option transaction has a buyer and a seller, but for calculation of open interest, only one side of the contract is counted.

Option: A contract that conveys the right, but not the obligation, to buy or sell a futures contract at a certain price for a specified time period. Only the seller (writer) of the option is obligated to perform.

Option premium: The price of an option; the sum of money that the option buyer pays and the option seller receives for the rights granted by the option.

Out-of-the-money option: An option with no intrinsic value; that is, a call whose strike price is above the current futures price or a put whose strike price is below the current futures price.

Purchasing hedge (long hedge): Buying futures contracts to protect against a possible increase in the price of cash commodities that will be purchased in the future. At the time the cash commodities are bought, the open futures position is closed by selling an equal number and type of futures contracts as those that were initially purchased.

Put option: An option that gives the option buyer the right but not the obligation to sell (go short) the underlying futures contract at the strike price on or before the expiration date of the option.

Selling hedge (short hedge): Selling futures contracts to protect against possible declining prices of commodities that will be sold in the future. At the time the cash commodities are sold, the open futures position is closed by purchasing an equal number and type of futures contracts as those that were initially sold.

Short position: One who has sold futures contracts or plans to sell a cash commodity. Selling futures contracts or initiating a cash forward contract sale without offsetting a particular market position.

Speculator: A market participant who tries to profit from buying and selling futures and option contracts by anticipating future price movements. Speculators assume market price risk and add liquidity and capital to the futures markets. They do not hold equal and opposite cash market risks.

Spread: The price difference between two related markets or commodities. For example, the April-August live cattle spread.

Strike price: The price at which the futures contract underlying a call or put option can be purchased (call) or sold (put). Also called exercise price.

Technical analysis: Anticipating future price movements using historical prices, trading volume, open interest, and other trading data to study price patterns.

Time value: The amount of money option buyers are willing to pay for an option in the anticipation that, over time, a change in the underlying futures price will cause the option to increase in value. In general, an option premium is the sum of time value and intrinsic value. Any amount by which an option premium exceeds the option's intrinsic value can be considered time value.

Underlying futures contract: The specific futures contract that can be bought or sold by exercising an option.

Volatility: A measurement of the change in price over a given time period. It is often expressed as a percentage and computed as the annualized standard deviation of percentage change in daily price.

Volume: The number of purchases or sales of a commodity futures contract made during a specified period of time, often the total transactions for one trading day.

Note: This glossary was adapted from the *Commodity Trading Manual*, published by the Chicago Board of Trade, Chicago, Illinois, 1994.