Futures Contracts: The Basics

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If you have experience with stocks and are looking into other potential trading opportunities, you've probably considered futures contracts. Futures contracts allow you to expand your investment opportunities beyond the stock market, and you might be able to begin trading them with the same brokerage account you already use to invest in stocks. But you should avoid jumping into your first futures trade with the assumption that your knowledge of stocks is enough to get started—because although stocks and futures do have similarities, they also have some significant differences.

This article lays out the basics of futures trading: what futures contracts are, how they’re traded, and the unique benefits trading them offers.

# What are Futures Contracts?

Trading futures—“futures” and “futures contracts” are used interchangeably—can be more complicated than trading stocks for a variety reasons, which primarily relate to restrictions on time and quantity that are built into futures contracts.

These restrictions, along with several other important aspects of futures trading, are explored below.

### Derivatives

Futures belong to a class of investment vehicles known as derivatives, which means their price is *based* on an underlying asset. Derivatives can be thought of as an indirect investment in something.

For example, if you buy a pound of gold, you are directly investing in gold. If you buy a futures contract for gold, the value of the contract is based on the price of gold but also on other features, such as the contract’s expiration date. The contract’s value is, in part, *derived* from the price of gold—but you’re investment is the contract.

### Contract Specifications

Futures contracts are standardized to specify an amount of the contract’s underlying asset and an expiration date. If you buy a single futures contract for gold, the contract represents 100 troy ounces of gold. If you buy a single futures contract for crude oil, the contract represents 1000 barrels of crude oil. These numbers don’t vary.

A contract’s expiration date, however, does vary. For example, if you buy one futures contract for gold, it will always represent 100 troy ounces, but the expiration date could be in February, April, June, August, October, or December. This means that if it’s January and you want to buy a futures contract in gold, you can decide if you want that contract to expire in a month, in nearly a year, or at some point in between.

The price of a contract that expires in February will be different from price for a contract that expires in December. This is based on changes in the value of gold that could potentially occur between February and December.

A contract’s specific expiration date is usually the third Friday of the expiration month, and different assets often have different expiration months available for their futures contracts.

### Buyers and Sellers

Every futures contract has a buyer and a seller. If you buy a futures contract in gold, there is someone on the other side selling you that contract. The buyer and the seller have opposing goals. The buyer hopes the value of the contract will go up. The seller hopes for the opposite. Buying a futures contract can be compared to going long on a stock—selling can be compared to shorting.

### Settling a Contract

When a contract expires, the buyer is obligated to buy the contract-specified amount of the asset from the seller. Likewise, the seller is obligated to sell this same amount to the buyer. The price of the asset is the price at which the contract was purchased and sold, even if the exchange happened months prior. In some cases, it’s permissible to exchange the cash value of the asset instead of the asset itself. In other cases, however, the asset must be physically delivered to the buyer.

Either side can exit the contract before the expiration date by passing it along to someone else. In this case, the buyer or seller realizes a profit or loss, based on changes to the contract’s value since they purchased or sold it.

### Types of Futures Contracts

Futures contracts are available in a large variety of assets.

An unexhaustive list of assets covered by futures contracts includes:

* Metals, like gold, silver, copper, and platinum
* Energy-based assets, like crude oil and natural gas
* Agricultural products, like corn, soybeans, wheat, and pigs
* Currencies, both traditional and crypto
* Stock indexes

# Trading Futures Contracts

Now that you have a basic understanding of what a futures contract is, it’s time to look at how and why someone might trade futures contracts.

### Hedging vs. Speculation

Futures contracts are traded for two principal reasons: hedging and speculation. Speculation is more straightforward and can be likened to trading stocks. If you think Apple’s stock is going to go up, you buy the stock hoping to make a profit. Similarly, if you think the price of gold is going to go up, you can buy a futures contract in gold. If the price goes up before the contract expires and you sell the contract to someone else, you can make a profit.

Hedging involves buying a futures contract to offset future price variations that could negatively impact your business. Imagine you own a hamburger processing plant. It’s March, and you’re afraid that the price of cattle could rise over the summer. If you buy a cattle futures contract that expires in September, you lock in the price of the cattle you’ll buy in September six months ahead of time. This allows your business to budget more assuredly.

### Example Trade

The following examples will give a more fully rounded idea of how a futures trade can play out. We’ll start with the same contract, but end the trade two different ways—as a speculator, and then as a hedger.

It’s July, and you buy a single wheat futures contract that expires in December. The price of contract is $800.00 and guarantees the delivery of 5,000 bushels of wheat. When you check the value of the contract in September, it’s gone up to $900.00. If you’re a speculator, you can sell the contract and make a profit based on the difference between the current price and the price you bought the contract at—in this case, a $100 profit.

If you bought the contract as a hedger, however, you hold onto the contract. The guarantee of getting wheat at $800.00 in December is more important to you than a short-term cash profit.

# The Benefits of Futures Trading

Overall, futures markets offer a more flexible trading environment than the stock market. While this can be advantageous to an experienced trader, some features of futures markets can be viewed as double-edged swords.

* **More trading hours.** While the U.S. Stock Exchange is only open on weekdays from 9:30 AM to 4:00 PM ET, many futures markets are open 23 hours a day, six days a week. Trading hours can vary depending on the underlying asset, however. Agricultural futures tend to have more restrictive hours than other markets, though they’re still typically less restrictive than the stock market.
* **Leverage.** Leverage is when your broker allows you to borrow money to trade with based on the value of your trading account. Most stock accounts only allow you to borrow the value of your account (e.g., if you have $30,000 in your account, you can trade with $60,000). Futures accounts often allow you to trade with ten times the value of your account—and sometimes more. This means if you have $10,000 in your account, you can buy up to $100,000 worth of futures contracts.

This can lead to greater returns than the stock market, but also to greater losses.

* **Day trading requirements.** If you’re a stock trader and you make more than three round-trip trades in a week (a round-trip trade means you both buy and sell a stock between the opening of the market on Monday and its closing on Friday), your broker will tag you as a pattern day trader. If this happens, you’re required to have at least $25,000 in your trading account. If you don’t, your account can be suspended.

Futures trading has no day trading account requirements—no matter the value of your account, you can make as many futures trades as you want.

* **Tax benefits.** If you buy a stock, sell it within a year, and make a profit on the sale, the profit is taxed as a short-term capital gain. Short-term capital gains taxes can be significantly higher than long-term capital gains taxes, which you are only eligible for if you hold on to a stock for longer than a year.

If you make a profit on a futures position that you’ve held for less than a year, however, only 40% of the profit is taxed at the short-term rate. The remaining 60% is taxed as a long-term capital gain.

# Conclusion

Those are the basics to futures contracts. While futures can offer more flexibility than stocks, their dynamics are somewhat more difficult to understand. And the same flexibility that makes futures trading appealing can also, in inexperienced hands, be a potential hazard.

# Sources

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