Gold Futures Investing

Gold Leverage

A future is simply a deal to trade gold at terms (i.e. amounts and prices) decided now, but with a settlement day in the future. That means you don't have to pay up just yet (at least not in full) and the seller doesn't need to deliver you any gold just yet either. It's as easy as that.

The settlement day is the day when the actual exchange takes place - i.e. when the buyer pays, and the seller delivers the gold. It's usually up to 3 months ahead.

Most futures traders use the delay to enable them to speculate - both ways. Their intention is to sell anything they have bought, or to buy back anything they have sold, before reaching the settlement day. Then they will only have to settle their gains and losses. In this way they can trade in much larger amounts, and take bigger risks for bigger rewards, than they would be able to if they had to settle their trades as soon as dealt.

Gold Leverage

Now you can see how futures provide leverage, sometimes known as gearing.

For example, suppose you had $5,000 to invest. If you buy gold bullion and settle you can only buy $5,000 worth. But you can probably buy $100,000 of gold futures! That's because your margin on a $100,000 future will probably be about 5% - i.e. $5,000.

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If the underlying price goes up 10% you would make $500 from bullion, but $10,000 from gold futures.

Sounds good, but don't forget the flip side. If the price of gold falls 10% you'll lose just $500 with bullion, and your investment will be intact to earn you money if gold resumes its steady upwards trend.

But the same 10% fall will cost you $10,000 with futures, which is $5,000 more than you invested in the first place. You will probably have been persuaded to deposit the extra $5,000 as a margin top-up, and the pain of a $10,000 loss will force you to close your position, so your money is lost.

If you refused to top-up your margin you will be closed out by your broker, and your original $5,000 will be lost on a minor intra-day adjustment - a downwards blip in the long-term upward trend in gold prices.

You can see why futures are dangerous for people who get carried away with their own certainties. The large majority of people who trade futures lose their money. That's a fact. They lose even when they are right in the medium term, because futures are fatal to your wealth on an unpredicted and temporary price blip.

Gold Futures 'On-Exchange'

Big professional traders invent the contractual terms of their futures trading on an ad-hoc basis and trade directly with each other. This is called 'Over The Counter' trading (or OTC for short).

Fortunately you would be spared the pain (and the mathematics) of detailed negotiations because you will almost certainly trade a standardized futures contract on a financial futures exchange.

In a standardized contract the exchange itself decides the settlement date, the contract amount, the delivery conditions etc. You can make up the size of your overall investment buy buying several of these standard contracts.

Dealing standard contracts on a financial futures exchange will give you two big advantages:-

Firstly there will be deeper liquidity than with an OTC future - enabling you to sell your future when you like, and to anybody else. That is not usually possible with an OTC future.

Secondly there will be a central clearer who will guarantee the trade against default. The central clearer is responsible (among other things) for looking after margin calculations and collecting and holding the margin for both the buyer and the seller.

Dealing Gold Futures

To deal gold futures you need to find yourself a futures broker. The futures broker will be a member of a futures exchange. The broker will manage your relationship with the market, and contact you on behalf of the central clearer to - for example - collect margin from you.

Your broker will require you to sign a detailed document explaining that you accept the significant risks of futures trading.

Account set-up will take a few days, as the broker checks out your identity and creditworthiness.

Gold Futures Rollover

There is an acute psychological pressure involved in owning gold futures for a long time.

As a futures contract ends - usually every quarter - an investor who wants to keep the position open must re-contract in the new period by 'rolling-over'. This ‘roll-over’ has a marked psychological effect on most investors.

Having taken the relatively difficult step of taking a position in gold futures investors are required to make repeated decisions to spend money. There is no ‘do nothing’ option, like there is with a bullion investment, and rolling over requires the investor to pay-up, while simultaneously giving the opportunity to cut and run.

The harsh fact of life is that if investors are being whip-lashed by the regular volatility which appears at the death of a futures contract many of them will cut their losses. Alternatively they might attempt to trade cleverly into the next period, or decide to take a breather from the action for a few days ('though days frequently turn into weeks and months). Unfortunately every quarter lots of investors will fail the psychological examination and close their position. Many will not return. The futures markets tend to expel people at the time of maximum personal disadvantage.