Spread trading is a powerful trading strategy that many retail traders have never heard of or know very little about. Too many investors associate spread trading with hedging and think its use is limited to banks and commercial traders. Spread trading began when markets were created, so risk could be hedged by primary users and transferred to another party. Banks and commercial traders know this and use it as their main trading strategy. They make money because they are risk averse and spread trading is their edge.

Spread trading has traditionally been applied to futures. The strategy requires a trader to hold a long and a short position simultaneously in the same or closely related markets. Since the introduction of CFDs, shares can be spread traded; this is commonly referred to as pairs trading. The CFD allows a trader to sell or be short a share in a leveraged manner similar to a futures contract. In each instance the trader is interested only in the price difference between the two contracts, as opposed to the outright price of the underlying futures or shares.

**Comfort zone**

Spread trading has several advantages for beginners and experienced traders alike because it features reduced volatility, lower margins and smoother trends than outright positions do. This lets traders operate in a less stressful environment, and allows them to learn pattern recognition, develop their money- and trade-management skills, and better define their comfort zone. As well, more spreads than futures or shares can be traded. A wide range, or diversification of trade selection, is an important aspect of a balanced portfolio.

Spreads often trade in a way that is unique and unrelated to other markets but that has the same technical merit and charting features as an outright position. Large commercial firms and professional traders establish and maintain spread positions, with history showing that the most successful traders are position traders. Smaller speculators are the least frequent users of spread trading. Market hype and many brokers would have you believe that spread trading is not as exciting or as profitable as day trading, or as a ‘secret’ proprietary trading approach. In reality however, those trading styles require large account balances, expensive membership fees with ‘special’ software and live data, and they generate much more trading activity, which usually means more brokerage.

**Markets to spread**

Any market can be spread traded, but the key point is to create and manage the amount of risk for the two contracts you pair up. In futures, the closer or more similar to each other the two contracts are (related), the less volatility, margin and risk you carry. An example in futures is a calendar spread, which normally has the least amount of
risk (for spreads) because the spread consists of identical contracts with different expiry months; e.g. corn, where a trader could be long May and short July: same commodity, different expiry months. This market has an average daily price range of one point; margin is $US300 and it typically trends within a limited price range for the duration or life of the spread (figure 1).

The less correlation there is with the underlying contracts, the greater the volatility, risk and margin. For example, a trader could be long June lean hogs and short June live cattle – different but closely related markets with identical expiry dates (figure 2).

As a comparison, using CFDs we could trade (buy) ANZ against (sell) Westpac; both are banks listed on the ASX, have similar market capitalisation and balance sheets and provide very similar products and services (figure 3).

If you were comfortable with a little more risk you might trade RIO against BHP (figure 4). Over the last three months, the ANZ/WBC spread has a $1.50 range, whereas RIO/BHP has a price range of $8.00. The spread is an entirely new (trading) entity and will either narrow or widen in price. In either case you need to create a basis for your decision-making before employing a strategy.

Your comfort zone for managing risk will determine your combination of contracts.

**Features and benefits of spread trading (shares and futures)**

Every trader is looking for an edge or strategy that can produce consistent profits without huge drawdowns. Spreads offer the leverage of futures and CFDs; help to hedge systemic risk (outside factors that can affect price); eliminate the effects of stops; and you receive reduced risk without having to pay up for time premium as options traders do. When you factor in opportunity available, risk management, cost effectiveness and margin efficiency, trading calendar spreads (same commodity with different expiry months) in futures or closely related shares (as above) can be a far superior strategy to outright futures positions, CFDs, options and option spreads. In the futures markets, the major participants are producers and commodity funds.

**Reduced volatility**

Spreads are a natural hedge, with less risk than an outright position. Spread trading is also referred to as ‘hedge trading’ due to the nature of being long and short, especially in the same commodity, i.e. calendar spreads, where you are more likely to have smoother trends and less stress in managing a position. The lower risk and volatility associated with most spreads is evidenced by the lower margin requirements.

**Reduced margins**

Having reduced margins means you can afford to hold multiple spread positions. The margin on an outright futures position in heating oil is $5063; a calendar spread in heating oil requires $550 or 90 per cent less in margin. That’s an advantage for any trader, but especially for small accounts. Lower margins means greater use of your capital and allows you to maintain multiple spread positions. In the case of CFDs you can assign the exact amount of capital in equal amounts to your long and short position and your holding cost.
or ‘margin’ is dramatically less, similar to a leveraged futures spread. The emotional and psychological impact of cutting a non-performing or losing trade is reduced, improving your confidence and your management of profitable trades. The CME Group website (www.cmegroup.com) provides margin requirements for CME, CBOT, NYMEX and COMEX outright positions and their corresponding calendar spreads. The ASX website (www.asx.com.au) provides a list of ASX-listed CFDs.

**Position trader**

As a trend trader in spreads, you inherently become a position trader. You need only one or two trades in the life of each spread, which means fewer trades, easier trade management and your chart data are free or very low-cost for end-of-day or delayed data. This means huge savings in your operating costs.

**True market activity**

Most spreads are not subject to the influence of running stops (market manipulation) and are not very concerned with liquidity and slippage. Most calendar spreads are exchange-listed spreads, which means your position can be managed as effectively as an outright position, using stops or most other order types. And because you’re holding identical contracts, there is a more balanced effect on each leg of the trade, as distinct from an inter-market spread, which has different fundamental forces acting upon each leg, such as long soybeans and short wheat. When you apply a short position using a CFD and hold a long position in equal dollar amounts you trade in a more natural market environment, similar to that of futures spreads.

**Trading with a built-in edge**

Due to a spread being long and short, you’re not subject to the influences of large commercial involvement, as you would be in an outright position. Spread trading usually involves lower risk, because most commodities have carrying charges, which means spreads, especially calendar spreads, rarely go beyond a certain point. This is somewhat similar to spreading using CFDs, so long as you identify and find a strong fundamental correlation for the shares (pairs) you select. A ‘natural’ trend will evolve from the merits of the spread combination you have selected. This is a relief, and perhaps the best benefit of all, since you are insulated (hedged) from dramatic events elsewhere, such as the Nikkei dropping six per cent overnight.

If you have ever held an outright position such as gold, oil, corn, or a share, but have been stopped out only to watch your position come back and continue in ‘your’ direction, then spreads could be the edge you’re looking for.