What are commodity futures?

Commodity futures are buy/sell contracts of commodities at a price fixed today, but realized on a future date. Read on for more information.

Commodity futures are contracts or agreements between two parties, agreeing to buy or sell certain units of a commodity on a future date at a fixed price. On this future date, the buyer has to pay the price that was agreed when the contact was made, and the seller has to transfer the ownership of the said commodities to the buyer.

So, if you believe that the price of a certain commodity, say coffee, will rise in the next couple of weeks, you can buy a futures contract which promises to sell coffee at today's price. When this commodity is transferred in your name, you can sell it at a profit. However, if the price falls, you will have to sell your contract at a loss.

Where to trade?

Commodity transactions take place on a regulated commodity exchange. While any individual or institution can take part in such trading, it needs to be done through a broker, who is a member of an exchange and has the authority to carry out transactions on behalf of the traders.

Commodity futures, like currency derivatives, allow you to operate on a margin. This means that you need to invest only a small percentage of the total transaction value while trading. This allows you to earn more profit with a lesser amount (while exposing you to a higher risk).

For instance, many brokers might allow you to buy a futures contract of 1,000 barrels of oil worth $50,000 for with an initial amount of $5,000. With such exposure, even a small rise in the price could result in huge profits, and vice versa.

Things to remember

While entering into a commodity futures contract, it is important to note that the buyer should sell his holdings before the expiry of the contract. Not closing an existing position might result in possession of a large quantity of unwanted commodities.