

# 7 Reasons Passing Up E-minis Is a Huge Mistake

## 'Miniature' contracts are relatively simple, have several advantages

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Sometimes, smaller is better. And futures contracts are one of those times.

Futures contracts usually lie far outside the periphery of traditional investors. Traditionally the playground of institutional investors and hedge funds, futures are contracts that obligate someone to buy or sell a commodity (say, corn) or financial instrument (say, bonds) at a pre-determined price in the future.

You can see why individual investors might stray away.

However, E-mini index futures — which literally are miniature versions of the contracts — are a bit more accessible. Specifically, E-mini index future contracts are a great way for average investors to invest in something as simple as market direction. The Chicago Mercantile Exchange offers a number of these contracts for indices like the Dow Jones Industrial Average, S&P 500 and Nasdaq.

For instance, think the Nasdaq is about to make a run? Analyze the macroeconomic climate, technical patterns and indicators, investor sentiment, momentum swings or whatever it is that helps you decide whether the Nasdaq is likely to advance. Then trade E-mini NASDAQ Composite Futures to profit off a move north.

And as nice as the simplicity of it all is, there's actually several other reasons to trade E-Mini Index Futures:

### **Low Margins**

One reason why futures contracts are bigger among institutional investors and hedge funds is the sheer cost involved. Futures contracts have high margin requirements — which is collateral to cover the credit risk. In some cases, futures' margin requirements can hit into the tens of thousands of dollars.

And just like E-mini futures contracts are miniature versions of futures contracts, E-mini prices are mere fractions of the costs of their larger counterparts.

## Highly Correlated Equity Markets

Asset prices are more closely linked today than they have been over much of the past decade. The technical term is “correlation,” meaning that U.S. stocks and the broader indices frequently move in tandem with other markets around the world. Bad news comes out of Europe? The U.S. equity markets tank across the board.

To make money trading individual stocks, you first must develop a point of view on the overall stock market. Is it going up or down? You then have to roll up your sleeves, do lots of research and choose an individual security. The problem with this approach is that the highly correlated markets are working against you. You might have the stock picking prowess of Warren Buffett, but the stock you pick still is likely to rise or fall based on the direction of the overall market.

Why not save yourself all that time, work and headache? Figure out the direction of your favorite index (the S&P 500, for example) and leave it at that. Trade the E-mini S&P 500 contract on the Chicago Mercantile Exchange instead.

## Leverage

Leverage is the greedy little devil that sits on investors’ shoulders. Leverage, be it through futures or through multiplying ETFs, give investors the chance to make much greater gains on an investment than they could through a conventional security — and just like those same futures and ETFs, you face the potential for massive losses.

For instance, the E-mini S&P 500 is priced at \$50 per point, so a 10-point gain in the index would net an investor \$500 — much more than you would get for the same day’s trading in, say, the **SPDR S&P 500 ETF** (NYSE:SPY). Of course, a bet in the wrong direction, and you can see how the downside is equally as magnified. The upside is, the relatively low capital needed for trading E-minis at least makes the leveraging a bit easier to swallow.

## Liquidity

E-mini index futures are liquid, meaning a large volume of contracts trade daily. And you want volume, because that means tight bid/ask spreads. Penny stocks are a great example of how low volume can hurt investors — but in short, it’s better to know that if you’re buying, someone’s selling for or very near the price you’re buying at, and vice versa if you’re selling. E-mini contracts trade at a clip of more than 2 million per day, so lack of liquidity isn’t an issue.

## Equality

The E-mini index futures market is wholly electronic, which means there’s no one in the pits making markets — and that takes out the risk of personal preferences, like those of market makers on the NYSE or Nasdaq, who can delay the filing of or outright refuse your trade. It’s a first-in, first-out (FIFO) system, with no regard to the size of the trade.

## **You Can Go Short**

Just like stocks, you can go long OR short on futures. Unlike stocks, there's no restrictions. In 2008, amid the financial crisis, the U.S. put a temporary kibosh on short-selling financial stocks, and several European countries did the same for some of their banks while chaos ensued last year. Other permanent short-selling bans have been put in place — for instance, on naked short-selling, in which you short an asset without borrowing it first or ensuring it can be borrowed.

E-mini index futures are pretty much unchained because of the nature of the product. Index futures aren't small bits of ownership in individual companies — they're market products meant to capitalize on a constantly changing market. So short away!

## **Tax Efficiencies**

The key word in “E-mini index futures contract” is “futures.” Because those are the rules by which you are taxed.

With stocks, you play by the rules. If you hold a stock for less than a year, it's a short-term holding and is taxed just like ordinary income, within your income bracket. Only by holding onto a stock for more than a year do you get that sweet 15% tax rate for long-term capital gains.

E-mini index futures contracts, on the other hand, offer a 60/40 split on your bill to Uncle Sam: 60% of your trade is considered a long-term capital gain, while the remaining 40% is shuffled into “short-term” — regardless of how long you held the contract.

For taxation purposes, you'll receive a 1099-B form from your broker. Let's say you made \$10,000 trading E-mini index futures — 60% of that (\$6,000) can be claimed as long-term capital gains and will only be taxed at 15%, with just the remaining \$4,000 taxed as short-term gains at your ordinary income rate.