SPECIAL REPORT

BITCOIN FUTURES

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The purpose of this report is to explain the new Bitcoin futures contracts about to be listed at the CME and CBOE and to give a brief history of this relatively new trading vehicle.

BITCOIN BITS

Invented in 2009
by Satoshi Nakamoto

1/12/2009
First Bitcoin Transaction

21,000,000
Max number of Bitcoins

THE EVOLUTION OF BITCOIN

This concept was said to be originally invented by Satoshi Nakatomo in early 2009 coming on the heels of the financial collapse in 2008 as a way of avoiding governments and central banks. Bitcoin has soared during the past 6 months both in price and recognition. In fact, on January 1 of this year Bitcoin was trading at $970 and of this writing is trading near $11,800.

In its simplest form Bitcoin is a way for electronic cash payments to be sent directly from one party to another without going through a financial institution. Each user provides a digital signature. The network timestamps transactions by grouping them into a group based proof of transactions which cannot be changed without changing the entire transaction proof of work. This prevents the possibility whereby a user can "double spend" by using the same coin for separate transactions. The time stamp system shows which transaction occurred first and that would be the valid transaction in the case of a user trying to double spend. The coins are minted and the amount/coin is out of the senders system and into the receivers account. Most transactions are settled within 10 minutes.

As mentioned, each user has a digital signature. The first owner transfers the coin to the next by digitally signing into what is called the "hash" of the prior transaction and logs on with their private digital signature into a public key of the next owner. There are safeguards in place but as with most transactions, including financial transactions, one must be vigilant and should be well versed in using the system before starting. It is also widely suggested that one wait to make sure their transaction is accepted before assuming it is valid and they aren't a victim of double spending.

The point of this report is not to dwell on the mechanics, or Xs and Os of a cash/Bitcoin transaction. I have merely given the "Bitcoin 100" description of how the transaction works in actuality and I will list futures contracts applications as we move forward. At this time the Bitcoin protocol is limited to 21 million Bitcoins meaning that no more may be created. So the Federal Reserve Board cannot rush in and print millions more as they are want to do with US currency. At this point Federal regulators are trying to step in to place some restrictions and regulations since to date this has been an unregulated and very volatile phenomenon. This partially explains why for the first-time futures contracts relating to Bitcoins have been approved at both the CME (Chicago Mercantile Exchange) and the CBOE (Chicago Board Options Exchange). Trading will begin on Sunday evening December 10, 2017 at the CBOE which will be securities transactions. Trading begins on Monday December 18, 2017 at the CME for futures transactions with the CFTC (Commodity Futures Trading Commission) as the overseer or regulator.

THE FUTURES OF BITCOIN

The futures contract at the CME, beginning on Monday December 18 will be cash settled on expiration day meaning there are no Bitcoins to be delivered by the seller of the contract and no deliveries to the buyer. Using the $11,800 price the CME contract will be 5 Bitcoins with each one tick being $5 ($11,800 - $11,801) meaning each tick in the 5 Bitcoin contract will be $25 as the contract is for 5 Bitcoins. It is estimated by the CME that the margin for the futures contract will be roughly 30 % of the Bitcoin value so the margin at $11,800 X 30 % would be about $3540. So in reality your leverage would actually be about 6 % of the total value of the contract as it is a 5 Bitcoin contract worth 5 times the actual price. Of course, as with all futures contracts, margins can be changed by the Exchange, based on the volatility of the underlying future. The daily limit which the contract can move is 20% either above or below the previous day's close. This gives the contract a 40% trading range based on the prior day close. The trading hours will be the same as with financial and currency futures markets. It will open at 5:00 pm and close the next business day at 4:00 CST. Months traded as with currencies will be March, June, September and December plus the two closest "serial months" in this case now January and February. I spoke with officials at the CME and was told that they do not have options available at inception, but they will be monitoring the futures contract and based on volume and volatility they will be looking into adding options on the future starting after the first of the year. I will certainly keep all posted on this. The extreme volatility of price action for Bitcoin make options a more controlled way to attempt to manage risk.

The contract at the CBOE will begin on Sunday December 10 with slightly different specifications. The contract multiplier at the CBOE will be 1 Bitcoin at parity to the Bitcoin price so each Dollar move is $1 but the minimum tick will be 10 points/dollars meaning the minimum fluctuation ($11,800-$11,810) will be $10 here. It is also cash settled. The ticker symbol at the CBOE will be XBT. My opinion is that the CME contract will see more volume so going forward, that contract would be the one I would more closely follow.

The purpose of this report is not to make a recommendation either way. I'm sure a Google search at this point will find many companies more than willing to extol the virtue of investing in Bitcoin and the massive profits you can achieve. Also, there are still many varying opinions at this point. Some think this is just another fad if you will which will fade in time. Others think the price is massively inflated and should retreat at least for the near term. Still others look at this akin to the pioneer days of the internet and compare it to Google and Amazon in their early days and feel this is the wave of the future. I'm not willing to speculate on that right now. My intent is to look at Bitcoin futures the way I would look at any other futures contract. Compare it to gold if you will. Gold is trading near $1270 per ounce and there is a future contract for 100 ounces where each one dollar move equals $100. There are reasons traders speculate in gold which include bullish factors, bearish factors, or hedging possibilities. They/I do the research and determine whether or not to take a position based on the fundamental, technical, and psychological factors in play at the time. This is how I choose to view Bitcoin. Obviously if one believes it is overpriced they may choose to take a short position in the market. Those in the camp that this is the wave of the future would take the opposite approach. Hedge opportunities exist as well. What if you were an early buyer of Bitcoin from, for example, at a price of $1000 or less. A true hedge then would be to short a future contract if you had reason to believe Bitcoin prices may drop. If they do drop you in theory would make on your contract what you are losing in the value of the coin. If prices go up what you are losing on the future contract should be offset by the rising price of the Bitcoin.

THE OUTLOOK

As with any new exchange offering, I would watch price action for the first few weeks or months before jumping into the fray. A possible exception may be the hedging aspect I described if the holder of the coin felt that Bitcoin would be falling for any number of reasons. That strategy should only be employed if early trading shows a reasonable volume of contracts traded daily for easy entry and exit into the market. As noted, I will be following these contracts closely during the weeks ahead and into next year and will keep readers updated but will not be in a rush to be the first one on board.

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