

Choosing the Market that Best Fits You

A Quick Guide to the Main Financial Markets in Existence

One of the most important decisions that new traders need to make is choosing the financial market that best fits their own trading style. In fact, outstanding differences exist among the stock, options, ETFs, futures and forex markets both in terms of risks involved and trading possibilities that each one of them has to offer.

The Stock Market

Because of the attention it gets from worldwide media on a daily basis, the stock market is undoubtedly the best-known by the general public. Emerging companies usually enter the market to raise capital, letting investors acquire a portion of their business that traders later try to resell to third parties for a profit. The rate at which traders buy and sell stocks determines their value on the market; factors that push traders to buy or sell stocks include quarterly revenue reports, new products, rumors, and general news regarding the company.

Because of the large number of companies listed on each stock exchange – NASDAQ alone lists over 3,200 of them – a player in the stock market will usually manage to closely monitor only a few dozens of companies. This can limit the trader's profit opportunities or, even worse, push unexperienced traders to diversify their portfolios by investing in companies that they haven't researched properly, which can expose them to significant risks.

Another risk associated to the stock market is market manipulation, the practice by company investors – often within the company itself – to take actions aimed to increase or decrease the value of a stock in order to buy or sell at a profit.

The Stock Options Market

A stock option is a contract between a buyer and a seller that gives the buyer the right, but not the obligation, to buy (“call option”) or sell (“put option”) an asset at a later time at an agreed price. If the buyer chooses to exercise this right, the seller is forced to sell or buy the asset at the price written on the contract. The underlying asset can be a piece of property, shares of stock, or even a futures contract (see below).

Exchange-traded options are an important class of options that have standardized features, which are being adopted to make trading on public exchanges easier; but options can also be traded over the counter (OTC) between private parties.

One of the main advantages in trading stock options is the reduced risk when compared to other markets. In fact, there are several mathematical models that try and describe how the value of an option will change in response to certain events, often with surprising accuracy. This makes the risks associated with options trading quite low for the trader who has learned to correctly apply those models to his own investment strategy.

The Futures Market

A futures contract is a contract that obliges its owner to buy or sell a standardized quantity (“lot”) of a certain commodity at a certain date (“delivery date”) in the future, at a price (“settlement price”) determined when the contract was stipulated.

The main difference between options and futures is that while the owner of an option is under no obligation to fulfill his end of the deal, both parties in a futures contract are forced to do so on the settlement date. To exit the commitment before the settlement date, the holder of a futures contract would need to hedge his exposure by either selling a long position or buying a short one.

The ETF Market

ETFs, or “exchange-traded funds”, are securities traded on the stock exchange market that hold assets such as stocks or bonds. ETF traders benefit from the diversification that is typical of an index fund while also being able to sell short, buy on margin and purchase as little as one share at a time. Their low costs (compared to mutual funds) and tax efficiency also contribute to make them a choice for a growing number of investors.

An ETF trades at approximately the same price as the NAV of its underlying assets and tends to track an index, such as the Dow Jones Industrial Average or the S&P 500.

Common criticism to exchange-traded funds include that they often represent short-term speculation and that most of them don't provide enough diversification. Some analysts also claim that ETFs can and have been used to manipulate market prices, particularly through short selling.

The Forex Market

With an estimated daily trading volume of \$3.2 trillion – 30 to 50 times the volume traded in the entire US stock exchange – the forex (“foreign exchange”, or “currency trading”) market is by far the biggest financial market in the world. Forex is an highly leveraged and highly liquid market that is open 24 hours a day, 5 days a week and is currently experiencing an unprecedented boom because of its unique characteristics.

Opening a trade in the forex market means buying a lot (100,000 units) in a first currency while selling a second one at the same time; when the trade is closed, the two currencies are being sold and bought back respectively. The trader's profit depends on how the ratio between the two currencies changed in the meantime.

With reliable and high speed Internet connections becoming more and more common around the globe, forex brokers soon started offering their services online, where clients can trade directly from a web-based interface and enjoy commissions that are typically very low (spreads only).

Unfortunately, because of the very high leverage – up to 400:1 – that brokers usually offer their clients, many unexperienced traders are led to believe that they can comfortably start trading on this market even with a very low starting balance, without realizing that high leverage can (and most certainly will) work against undercapitalized accounts in the long run.