
Basic Concept
of
Future Trading

OVERVIEW

- The Futures market is an integral part of the Financial Derivatives world. 'Derivatives' as they are called is a security, whose value is derived from another financial entity referred to as an 'Underlying Asset'.

- The financial derivatives have been around for a long time now.

- Given the similarities between the forwards and the futures market, I think the best possible way to introduce the futures market is by first understanding the 'Forwards market'.

FORWARD MARKET

- The Forward market was primarily started to protect the interest of the farmers from adverse price movements.
- In a forward market, the buyer and seller enter into an agreement to exchange the goods for cash.
- The price of the goods is fixed by both the parties on the day they enter into the agreement.
- **Forward contracts are traded only in the OTC (Over the Counter) market,**

EXAMPLE OF FORWARD MARKET

- One is a jeweller whose job is to design and manufacture jewellery. Let us call him 'ABC Jewellers'. The other is a gold importer whose job is to sell gold at a whole sale price to jewellers, let us call him' XYZ Gold Dealers'.

- On 9th Dec 2018, ABC enters into an agreement with XYZ to buy 15 kilograms of gold at a certain purity (say 999 purity) in three months time (9th March 2019). They fix the price of Gold at the current market price, which is Rs.2450/- per gram or Rs.24,50,000/- per kilogram. Hence as per this agreement, on 9th March 2015, ABC is expected to pay XYZ a sum of Rs.3.675 Crs (24,50,000/Kg*15) in return for the 15 kg's of Gold.

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WHAT ABOUT THE RISK IN FORWARD MARKET?

- The risk is not just with price movements, there are other major drawbacks in a forward contract and they are–

- **Liquidity Risk**
- **Default Risk/ / Counter party risk**
- **Regulatory Risk**
- **Rigidity**

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- **Liquidity Risk** – In our example we have conveniently assumed that, ABC with a certain view on gold finds a party XYZ who has an exact opposite view. Hence they easily strike a deal. In the real world, this is not so easy.

- **Default Risk/ Counter party risk –** Consider this, assume the gold prices have reached Rs.2700/- at the end of 3 months. ABC would feel proud about the financial decision they had taken 3 months ago. They are expecting XYZ to pay up. But what if XYZ defaults?

- **Regulatory Risk –** The Forwards contract agreement is executed by a mutual consent of the parties involved and there is no regulatory authority governing the agreement. In the absence of a regulatory authority, a sense of lawlessness creeps in, which in turn increases the incentive to default.

- **Rigidity –** Both ABC and XZY entered into this agreement on 9th Dec 2018 with a certain view on gold. However what would happen if their view would strongly change when they are half way through the agreement? The rigidity of the forward agreen is such that, they cannot foreclose the agreement half way through.

FUTURES CONTRACT

- The Futures contract or Futures Agreement is an improvisation of the Forwards Agreement.

- The Futures Contract is designed in such a way that it retains the core transactional structure of a Forwards Market and at the same time, it eliminates the risks associated with the forwards contract.

FEATURES OF FUTURE AGREEMENT

- Standardized Contracts.
- Futures Contracts are tradable.
- Futures Market is highly regulated.
- Futures Contracts are time bound.
- Futures Contract mimics the underlying .

BEFORE YOUR FIRST FUTURES TRADE

- Before we dig deeper and understand the working of a futures contract, we need to understand a few other aspects related to futures trading.
- Following points is what is required.

- **Lot size.**
- **Contract Value.**
- **Margin.**
- **Expiry.**

- **<u>Lot size</u> -** Futures is a standardized contract where everything related to the agreement is pre-determined. Lot size is one such parameter. Lot size specifies the minimum quantity that you will have to transact in a futures contract. Lot size varies from one asset to another.

- **<u>Contract Value</u> -** In our example of ABC jeweller and XYZ Gold Dealers, ABC agreed to buy 15 kg's of Gold at the rate of Rs.2450/- per gram or Rs.24,50,000/- per kilogram. Since the deal was to buy 15 kg's, the whole deal was valued at Rs.24,50,000 x 15 = Rs.3.675 Crs. In this case it is said that the 'Contract Value' is Rs.3.675 Crs. Simply put, the contract value is the quantity times the price of the asset. We know the futures agreement has a standard pre-determined minimum quantity (lot size). Going by this, the contract value of a futures agreement can be generalized to **"Lot size x Price".**

- **Margin –** Again, referring back to the example of ABC jeweller and XYZ Gold Dealers, at the time of agreement i.e. on 9th Dec 2014, both the parties would have had a gentleman's word and nothing beyond that. Meaning both the parties would have just agreed to honour the contract on the agreement's expiry day i.e. 9th March 2015. Do notice there is **no** exchange of money on 9th Dec 2014.
  However, in a futures agreement the moment a transaction takes place, both the parties involved will have to deposit some money.

- **Expiry –** As we know, all futures contracts are time bound.
  The expiry or the expiry date of the futures contract is the date up to which the agreement is valid. Beyond the valid date, the contract ceases to exist. Also be aware that the day a contract expires, new contracts are introduced by the exchanges.

THANK YOU