# futures perfect

*Futures are exchange-traded contracts that require delivery of a commodity, bond, currency, or stock index, at a specified price, on a specified future date*

*By Chua Kong Ho*

**VOLATILE** stock markets can scare retail investors who face increased risks of suffering large losses.

So for the individual investor who wants to survive the ups and downs of such an environment futures are an option.

Futures are instruments that hedge funds and which professional money managers use to reduce risk on a daily basis.

Futures are exchange-traded contracts that require delivery of a commodity, bond, currency, or stock index, at a specified price, on a specified future date.

And unlike options, futures convey an obligation to buy – so the advantage is immediately obvious.

So, someone who is worried that a particular investment may drop in value in the future can lock that price in today by entering into a futures contract, thus reducing future uncertainty and therefore risk.

The following example illustrates how a futures contract works.

In this case, Seller A wishes to sell DBS shares in two months' time but is worried that the price may fall between now and then. And he wants to lock in a selling price of, say, $13 today.

Then, Buyer B comes along and is prepared to pay the asking price of $13 in two months' time.

So they enter into an agreement.

After two months, suppose DBS shares sell for $10 in the open market, A still profits by $3. Meanwhile, the loss to B is $3 because he has to pay A $13 for shares that he can only sell in the market for $10.

This is why futures trading is known as a zero-sum game – because A's profit is exactly equal to B's loss.

Another advantage of futures trading is that it frees up capital because the margin collaterals required are a small percentage of the contract value.

The typical capital outlay for single stock futures, for instance, is about 20 per cent of market value, with daily adjustment of profits and losses in your trading account.

Investors can trade in index futures and single stock futures (SSFs).

Stock indices are baskets of stocks that are weighted according to their market value and used as yardsticks by money managers worldwide.

An example of a stock index is the Straits Times Index. It includes stocks across sectors – think Singapore Airlines, Singapore Press Holdings, SingTel – and is used as a proxy for how the stock market and, by extension, the economy is doing.

Other indices traded on the SGX include the Nikkei-225, the MSCI Taiwan, MSCI Singapore and MSCI Hong Kong. The MSCI indices are independently compiled by Morgan Stanley Capital International.

The chief advantage of trading in stock index futures is that they allow an investor to trade a basket of stocks in a single transaction.

Because a stock index, like the MSCI or STI, includes companies from various industries, investing in stock index futures allows investors to conveniently diversify their holdings and risks, as their holdings are spread over a basket of stocks, as opposed to single stocks.

With such convenience, investors have responded in kind.

Annual trading volumes for Nikkei-225 futures hit a record 7.1 million contracts on the SGX in 2003, a 46 per cent jump from 4.9 million contracts traded in 2002.

Single stock futures, as its name implies, are futures of a single company stock.

Currently, investors can trade in the futures of 21 companies, including DBS Bank, Datacraft, ST Assembly.

Futures trading carries its risks as well as rewards.

Because futures trading is highly leveraged – a margin of 10 per cent gives a gearing of 10 times – a small movement in prices can result in large profits or losses.

The 10 times leverage means that a 10 per cent rise in the shares of company X from, say, $10 to $11, results in a 100 per cent profit.

Leverage both magnifies gains and losses, and it is for this reason that trading futures is viewed as being more risky than trading stocks.

To trade in futures, investors have to open a trading account with a futures or stock broker with futures licence. There are 33 companies holding such licences.



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