

# CAPITAL

THE WEEKLY MARKET EDGE

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## The futures game

The Edge had a one-on-one with Ralph Yiehmin Liu (right), managing director of Singapore-based Advanced Risk Management Solutions Pte Ltd (ARMS), to get an idea of the up- and downsides of Kloffe. ARMS is responsible for conducting the Malaysian Futures and Options Registered Representative course.

Below are excerpts of the interview.

*How different is trading on financial futures vis-a-vis the equity market and what are the advantages and disadvantages of the financial futures trading over that of the stock market?*

First of all, the equity market is more suited for long-term investment purposes. The futures market can assist in that process by offering a way for conservative investors to hedge off their risk when appropriate. If the investor's intention is to use the futures market as an alternative for investment, futures market can also be utilized through some specific trading programmes or through managed futures funds.

In addition to hedging and investing, the futures market could be the great vehicle for those interested in short-term directional trading. For the more sophisticated users, futures can also offer more additional dimensions in trading. For example, spread trading and arbitrage trading have totally different dimensions than the market directional views.

Even for directional views, futures market offers investors the chance not only to go long (to bet the market to go up) but also to go short the market (to bet the market to go down) which is not currently available or as easily done in the cash equity market.

When you establish a futures position, you need to deposit money in the margin account, which is around 7.5 per cent of the nominal amount of the contract for KLOFFE, whereas you need to pay the full amount or at

least 40 to 60 per cent of the nominal value through margin trading in the equity markets.

The transaction cost of trading futures is usually much cheaper than the equity markets. Basically there are two major types of transaction costs: bid/ask spread (the difference between bid-and-ask prices), and brokers' commission. There may be also some other minor, less significant charges involved for both markets such as exchange levy and stamp duties, etc. In an established futures market, both the bid/ask spread in the futures market and the brokers' commission are usually lower than those of the equity market. Investors should perform a few simple calculations to verify that that is the case before transacting.

With all these advantages, the futures market will definitely offer a lot more attractive opportunities for traders and hedgers to trade and invest than what the equity market can offer.

*What are the risks involved in investing in equity markets and how can futures be used to manage these risks?*

The risk of investing in stock market consists of systematic (market) risks and non-systematic (firm-specific) risks. Investors can significantly reduce the firm-specific risks by diversifying their portfolio. A portfolio of 15 to 20 stocks should usually be good enough for this diversification purpose. Empirical studies have shown that by including more

stocks than that would not achieve any further diversification benefits.

The market risk however, could be best managed by using futures. The futures contract could be a very effective instrument to reduce this systematic risk if handled properly. Investors should try to understand not only the methodology of calculating the hedge ratio, but also the concept of basis risk inherent in the futures hedging activities. They should seek help from knowledgeable remisiers or financial consultants before they start taking any action.

*In the case of stocks and shares, a seemingly "bad" investment decision could well turn out to be a positive one given time. Can the same happen in the case of financial futures trading?*

The trading strategy for stocks and futures should not be the same. Once you buy the stocks and pay for them in full, you could hold on to your stocks forever if you like, irrespective of whatever happens to the stocks, because the risk you bear is only losing the money that you have paid for the stocks. No further money would be lost.

Trading in the futures markets is quite different. The money you paid is just to cover the margin requirement. It is sort of a good-faith money. Your position will be marked-to-market and the P/L (profit and loss) will be calculated and realized on a daily basis. If the market moves against you



and your margin account balance drops below certain level, there will be a margin call.

The question is how much investable money you have to cover a margin call before the market turns around to the direction which is in your favour. The worst-case scenario could be that you might be forced to close out your position which you might still have confidence in for your long-term view, simply because you don't have enough money to meet the margin call anymore.

However, if you have only spent a small proportion of your investable money in the margin account and you do have enough money left to continue to meet the margin calls, then you could stay on with your position if you think it is a good trading decision. However, you should bear

in mind that "you could" does not necessarily mean that "you should".

*What, therefore, should be the investment and trading strategy?*

The appropriate investment strategy depends on your investment horizon, risk tolerance level and available capital. The low transaction cost and the better liquidity in the futures market enable investors to do short-term trading, typically within a few-days horizon or even intra-day.

For a longer investment horizon, you can do it both in the futures market as well as in the stock markets, but you have to have adequate capital as well as a clear and prudent investment objective.

When investing in the equity index futures over long invest-

ment horizon, the investor can either invest in the most liquid, usually the nearest contract month, and roll it over to the next contract months periodically before the existing contract expires, or simply establish a long position on the deferred contract month. Which strategy is better depends on the situation at the given time such as the liquidity, the basis between different contract months, etc.

Basically, as far as profit from the market view is concerned, the investor can simply take a long position if he is bullish on the market and establish a short position if he is bearish on the market.

Futures can be used as hedging instruments to protect your stock investment portfolio. They can also be used for arbitrage trading, as well as spread trading. Here is how they work:

#### • Hedging

Since investors are only allowed to take long positions in the stock market at the moment, the way to hedge their position against a bearish trend is to take an opposite (short) position in the futures market. Any potential losses from the long cash position will be roughly offset by the gains from the short futures position when the market declines as predicted.

#### • Arbitrage

An arbitrage trading position is to take a certain position in the cash market and at the same time take an opposite position in the futures market in order to take profit from any price discrepancy between the fair value of the relationship between the cash and the futures (the theoretical basis) and the real relationship (the existing basis) in the market, after considering cost of borrowing/lending and other transaction costs such as commission, stamp duties and market impact, etc.

#### • Spreading

Spread trading is to take two different positions (opposite in directions) in different contract months of futures. This strategy is usually employed by those investors who want to make money from a price discrepancy on the basis between those two future contract months. The strategy can also be used to roll-over an existing position from a certain contract month to the next contract month.

#### Some people like the Malaysian stock market to a casino — volatile.

How would you describe the financial futures market?

The economic rationale for the futures market is to give opportunity to those who are exposed to risk but are risk averse, to transfer that risk to those who are willing to take risk in exchange for potential return. This risk transference process needs liquidity in the market which will be provided only by active participation by the various players, be it a speculator, hedger or arbitrageur. The futures market, as compared to the stock market, provides better liquidity, lower cost and faster execution of trades, and therefore better serves as the economic vehicle of risk transference.

It is quite debatable whether futures add or reduce the volatilities of the stock market. It is important to understand that volatility may not be a bad thing. As long as you can use the futures to hedge your investment portfolio, what's so bad about having higher volatility which could potentially increase your return?

Isn't it so that we always hear people complain that a certain stock market is so boring because it lacks volatility and many investors are discouraged from participating?

What are the differences between forward and financial futures trading? What are the advantages and disadvantages?

Futures are exchange traded derivatives with standardized product, whereas forwards are over-the-counter products which are usually customized to client's specific needs.

The advantage of futures are price transparency, the enforcement of the daily marked-to-market valuation, lower transaction cost and the ease for investors to offset or change their positions. In contrast, for the forwards, there is no price transparency and daily marking-to-market. The transaction cost could be very high, and it could be very difficult or costly for investors to offset or change their positions.

Nonetheless, the forwards may have some advantages over futures from time to time in that it can satisfy the investor's specific needs to hedge his position when no relevant futures contracts may be available.

Is it true the financial futures market is a trading place more for the big boys?

From an execution perspective, trading in the futures market is conducted through the KATS electronic trading system at KLOFFE where the best bids and offers have to queue up to be matched off and be cleared as good trades in a competitive manner, so there shouldn't be any advantage for the big players over the small ones.

The futures market is actually a bit democratic in the sense that the leveraging offered in the futures market gives any investor who has limited financial capability the same access to the market in order to initiate a trade with a much bigger exposure.

However, the important thing to bear in mind is that although the initial capital required is small, the same thing cannot be said about the risk. It should be noted that by giving the same access to the market to the small players, it basically leaves the risk management responsibility to them as well.

Is there any correlation between the performance of the local stock market and the financial futures market?

Yes, very much so. The futures are priced off the stock market in the following way: For example, buying the stock index futures with the maturity of March 1996 is equal to buying the stock index in the cash market and borrowing the money from the money market with the same maturity as the futures contract.

Theoretical futures price can be calculated from the following formula:

$$F = S * (1+r-d)^T$$

$$F = \text{futures price,}$$

$$S = \text{spot price,}$$

$$r = \text{interbank money market rate for the same maturity with futures contract,}$$

$$d = \text{dividend yield of the stock index,}$$

$$T = \text{time to maturity (in years).}$$

The future price and the spot price will move in the same direction and they will converge at the maturity date.

The recent introduction of call warrants has not exactly got off to a roaring start. Do you see the same trend for financial futures trading?

There are some key differences between futures trading and call warrants trading. Call warrants are bull market products. When the market is not doing well, investors do not make money on these products. Therefore, it is difficult to generate investor's enthusiasm.

Futures are different. Investors can use it for both directions, bull as well as bear market. Investors can take a long position in the bull market to make money from the appreciation of the futures prices, or they can take a short position in the bear market to make money from the depreciation of the futures prices. Furthermore, investors can also use futures to hedge their equity portfolio against potential price drops in the bear market.

The underlying asset of equity index futures is the stock index (KLCEI). It is a play on the entire Malaysian equity market, whereas the underlying assets for the previously issued call warrants are just individual stocks. Therefore, it is not surprising if the futures market will be able to draw stronger investor's interest than the call warrants market. Given

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"Discipline, discipline, discipline!" is my best advice. Establish a clear trading plan before you jump in.

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#### • Limit order

A limit order specifies a price limit for the execution of the transaction and allows the investor to avoid the dangers associated with market orders. A buy limit order indicates that the futures contract may be purchased only at the price designated or at a lower price. As in our example, the limit price of 974.5 is lower, and a better price than, the current last traded price of 977.0. A sell limit order indicates that the futures contract may be sold at the price designated or at a higher price. The danger with a limit order is that there is no assurance that it will be executed. The designated price may never be reached.

#### • Stop order

A stop order is a type of conditional order. It specifies that the order is not to be executed until a certain level is reached and then it becomes a market order. A buy stop order specifies that the order is not to be executed until the market rises to a designated price. A sell stop order specifies that the order is not to be executed until the market price falls below a designated price. A stop order is especially useful when the investor cannot watch the market constantly. Profits can be preserved or losses minimized on positions by allowing market movements to trigger a strategy. It can also be used to establish a new position before an imminent major move in the market.

#### • Day order

The limit or stop order will lapse at the end of the dealing day if it has not been enacted du-

ring the day.

#### • Good till cancel order (GTC)

This order remains valid until either filled or cancelled. It is prudent that a record of such orders is kept and monitored on a daily basis.

#### • Good to date order

This order remains valid until either filled or cancelled at a specified date.

#### • Fill or kill (immediate or cancelled)

This is an immediate order transaction. If not filled immediately it must be withdrawn. An example is an investor's intention is to take out a large bid or offer, but if this cannot be achieved, then he does not wish to be seen as a large counterparty in the market.

#### • Basis orders

These orders are best illustrated by examples. First, to place an order to trade between two futures contracts, that is, buy March sell June at a differential of 12 ticks. This is commonly used in spread trading. The next example is to buy or sell a futures contract at a specified level to the cash index. The cash KLCEI may be at 975.0 and the futures contract is trading at a 20 ticks premium; the investor may wish to buy if he can pay 15 ticks premium or less.

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