

## Chapter 6 : Risk and Benefit of Financial Futures

Corporate risk management has expanded dramatically over the past decade. This expansion reflects a better understanding of the benefits of a well-structured risk management program as well as a material reduction in the costs of risk management products.

Have you ever wondered whether trading in futures could make you rich or increases the value of a firm ? Well, it can -if you know what you're doing. And if you accept the reality that, at times, even well-informed and experienced traders lose - and they can lose big.

As with any form of trading or investing, certain precautions must be taken and certain preparations must be made before positioning any capital. **The precaution is to go slowly. The futures markets present fascinating possibilities for gain, but they are very unlike investing in stocks and bonds. They also involve much more risk.**

The preparation is to investigate the possibilities, benefits, advantages, and rewards. You must get to know the market, become familiar with the terminology, procedures, and techniques. You must first determine your investment objectives and evaluate how the futures can help you meet those objectives. Understanding why a firm hedges has direct implications for how one should measure these corporate exposures as well as what instruments the firm should use to hedge.

## **6.1 Risks Exposure and Hedging**

Many novice futures traders (and even some professionals) erroneously think that the primary reason that futures trading is notoriously risky is that futures prices are more volatile than are prices in other investment arenas. However, statistical analysis shows that the volatility of futures prices is approximately the same as that of equity prices, for example. What makes futures trading a risky affair is the low margin required and the resulting high leverage. If we were able to trade common stocks on thin margin, they too would be considered very risky investments. In the 1920s, listed equities were traded with margin requirements comparable to those in today's futures markets. Economists and historians still disagree on the extent (if any) to which this leverage contributed to the stock market crash of 1929 and the subsequent Great Depression.

## **6.2 Margin**

Every holder of a long or short contract must deposit with his or her brokerage house a certain amount of money to guarantee performance on the contract. This deposit is known as margin, and its size plays an important role in the explanation of why futures trading can be both very risky and very profitable.

## **6.3 Leverage**

The ratio of an investment's full value to the amount of capital that is required to own or to control it is also a risk factor when trading in futures. For example, if we buy something worth \$100 by putting up a deposit of \$50, our leverage is 2:1. If we pay for

something in full, the leverage is 1:1. In futures trading, the available leverage is often 10:1 or 20:1, or more. It is important to realise that the greater the leverage, the smaller the price move that is required to bring about the same percent change in the value of the investment.

## **6.4 The Market**

Futures markets today are among the most efficient and liquid investment mechanisms in existence. The greater the number of participants in any market, the greater is that market's liquidity. Buyers are forced to compete with one another, as are sellers. In highly liquid markets, the spread between the buyers' bid prices and seller's asking prices at any time is driven down by this competition. Thus, the size of the bid/ask spread is a good measure of market liquidity.

In today's futures markets, bid/ask spreads can represent as little as 0.1% or less of the price of the commodity or financial instrument. For instance, if gold is trading at about \$400.00 per ounce, a typical quote from the futures trading floor might be \$400.00 bid, \$400.20 asked. This means that buyers are presently willing to pay \$400.00 per ounce and that sellers are willing to sell at \$400.20 per ounce. With ample volume on both sides of the quote, sellers are reasonably assured that the lowest price at which they will sell is \$400.00. Needless to say, quotes will change in time, but at any moment the bid/ask spread is likely to remain at about 20 cents per ounce. This 20 cents equates to less than 0.1% of the price of gold. Compare this with the securities market, where a stock trading at \$50.00 per share might have a bid/ask spread of 25 cents. This equates to 0.5% of the

price of the stock. Compare it again , to the real estate market where the bid/ask spread on a \$200,000 house might be as great as \$20,000, which equates to 10% of the price. The bid/ask spread in futures markets, and therefore the liquidity of these markets, has few rivals in the trading world. It is this high degree of liquidity that has helped futures trading gain such a prominent role in commerce and finance.

## **6.5 The Functions of Financial Futures Market**

Futures markets today are more active and more economically beneficial than at any other time in their history. Among their most important functions, futures markets provide the following:

- a. A mechanism for shifting price risk from those who do not want this risk to those who do want it.**

Shifting of risk is one of the reasons for the birth of the futures contract. One important by-product of this risk shifting is the enhanced creditworthiness of commercial enterprises, which would otherwise be more vulnerable to price fluctuations. Banks and other funding sources are prepared to extend more favourable financing terms to individuals and to organisations that are less exposed to possible changes in the prices of their products or raw materials. This translates into reduced financing costs that, in turn, lead to lower prices for consumers and to a more efficient economy.

**b. Increased price stability**

Critics of futures markets often claim that futures trading leads to abnormal price volatility, but the facts say otherwise. Numerous studies have supported the premise that liquid futures markets increase price stability.

**c. A forum for price discovery**

Each day, the prices of contracts that are traded on futures exchanges reflect, and make public, the broad consensus of what the worth of commodities and financial instruments will be at various times in the future. This allows more sensible planning by industry participants than would be possible without access to such unbiased consensus forecasts.

**d. Order in the trading practices of diverse market participants.**

Futures markets provide a central reference point for prices to all those interested. The markets provide rules and regulations that promote fair and orderly trading conditions.

**e. A forum for collection and dissemination of information/**

This free and open distribution of information affecting prices enables traders to compete on nearly equal terms. Insider information is at a minimum, and prices tend to reflect as accurately as possible all the known forces that influence the supply of and demand for the financial instrument or commodity.