3.3 IMPORTANT TERMS TO UNDERSTAND FUTURES

Before we move on to understand how futures are used in practice, let us go through some important terms to understand Futures contract better.

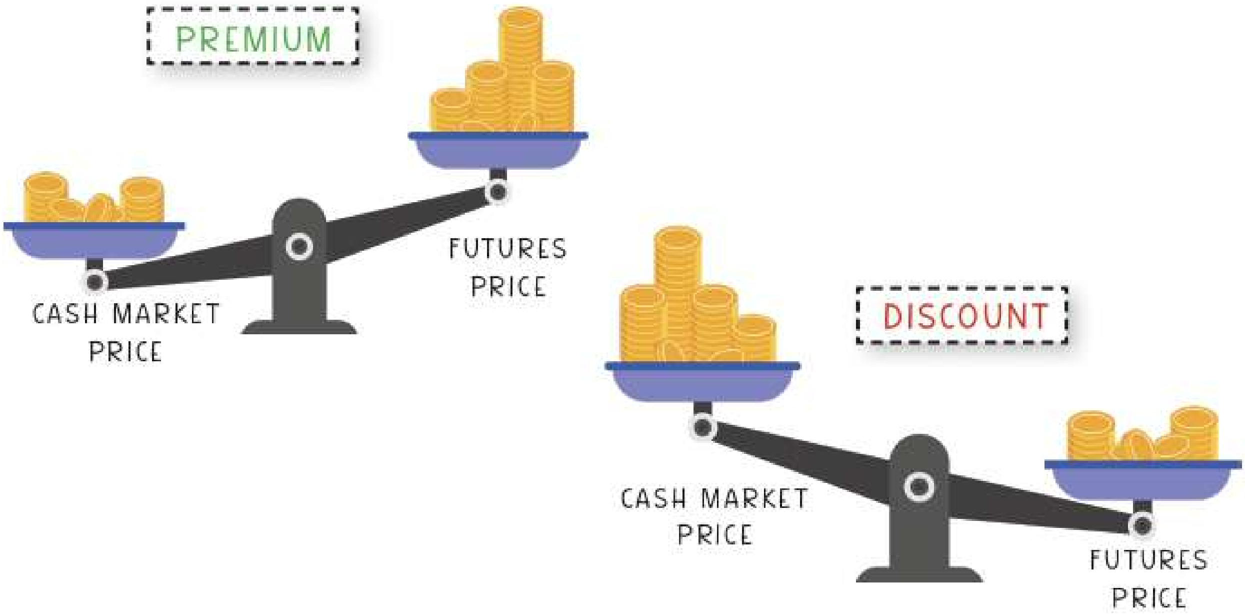
SQUARING OFF

Squaring Off a position basically means exiting a position that you have i.e. selling the contract that you own. Here, we take the opposite trade to the current position. If you sell futures contract that you have bought, or buy shares that you had previously short sold, it is called Squaring off.

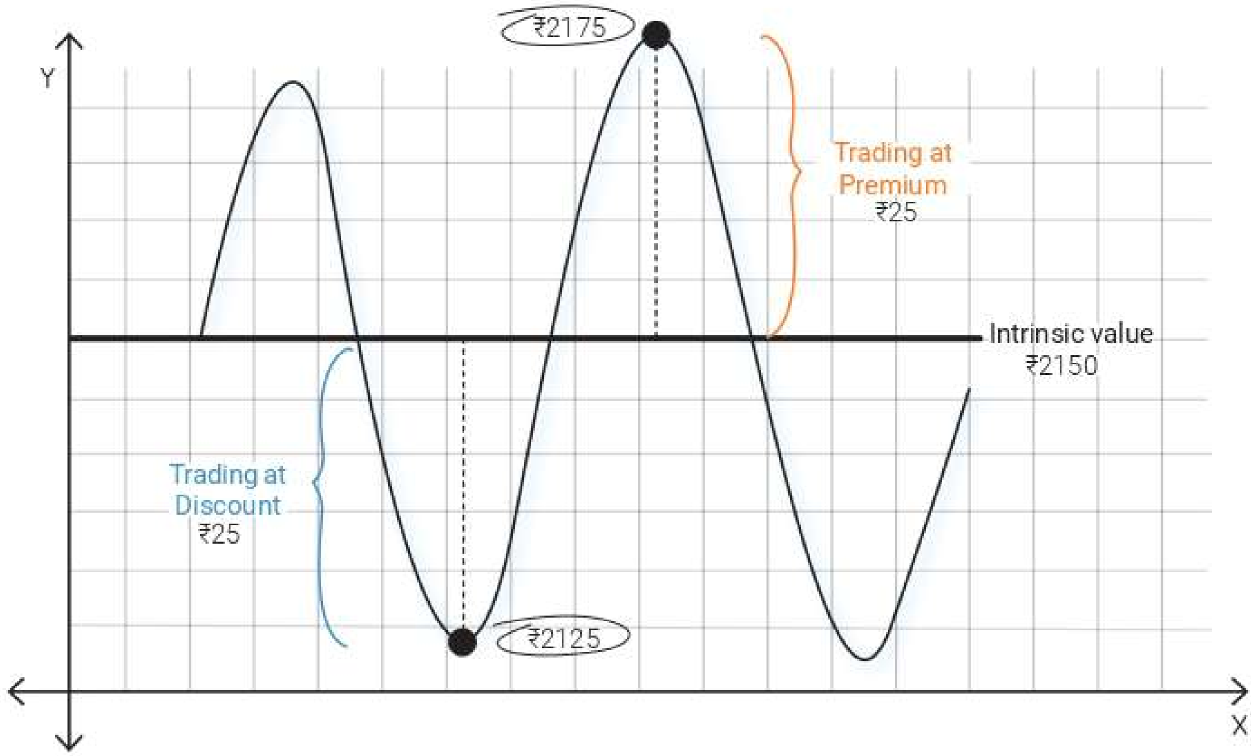
For example, if you have have bought TCS Futures, you will have to sell it to square off the position i.e. remove your exposure. If you had previously short sold, then you will have to buy to square off the position.

PREMIUM OR DISCOUNT

Future contracts quote at a similar price as the underlying asset but not exactly same. If the future contract is quoting higher than the cash market, it is called Premium. If it quoting at a price lower than the cash market, it is called Discount.

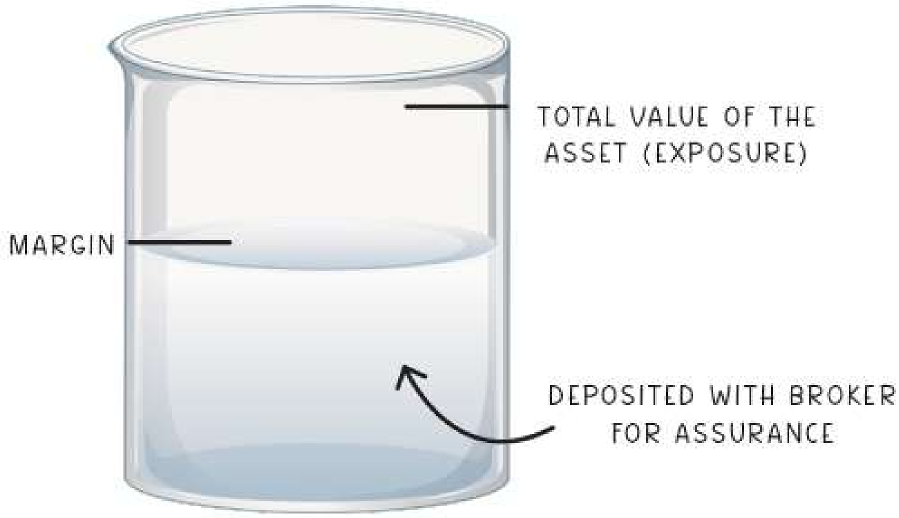


Let's say that each share of TCS is trading for ₹2150. Now, if the future contract is quoting for ₹2175, then we can say that it is trading at a premium. If the contract is trading at ₹2125, then we can say that it is trading at a discount. It is suggested to check for at least 5 companies, if the future contract is trading at a discount or premium.



MARGIN

A security amount that is deposited with the broker that they can use to meet the liabilities in case there is a loss, is called Margin. This is mandatory in futures contracts. If Margin falls below a certain amount than you are required to refill the same otherwise the broker will square-off your position.



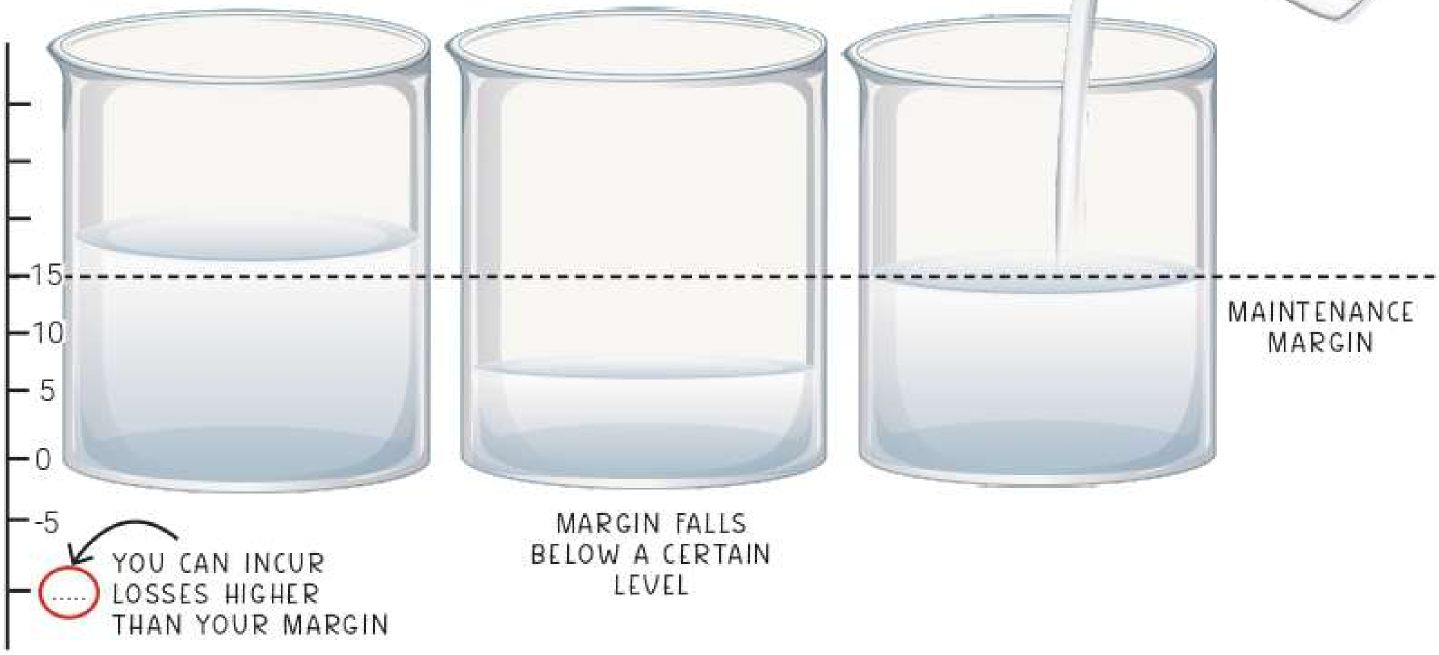
INITIAL MARGIN

The initial margin is the safety deposit made at the time of entering the futures contract. You must have this amount in your trading account to execute transactions. Brokers also give margin taking your assets as collateral. That means, lets say you have assets worth ₹5,00,000 in your Demat account. So, against that, the broker may allow ₹3,00,000 that can be used as margin. However, you will still need some cash to meet daily mark to market settlements. Lets take an example where 20% of the lot value needs to be maintained as Margin amount.

MARGIN = ₹2,00,000 x 20%
= ₹40,000

MAINTENANCE MARGIN

Maintenance Margin is the margin that is required throughout the life of the position. If the margin falls below a certain level, you will need to re-finance the same to hold on to your position. However, margin should not be considered as the maximum losses that you an incur. You can incur losses higher than your margin too. In most cases, initial margin and maintenance margin are same.

EXPIRY DATE

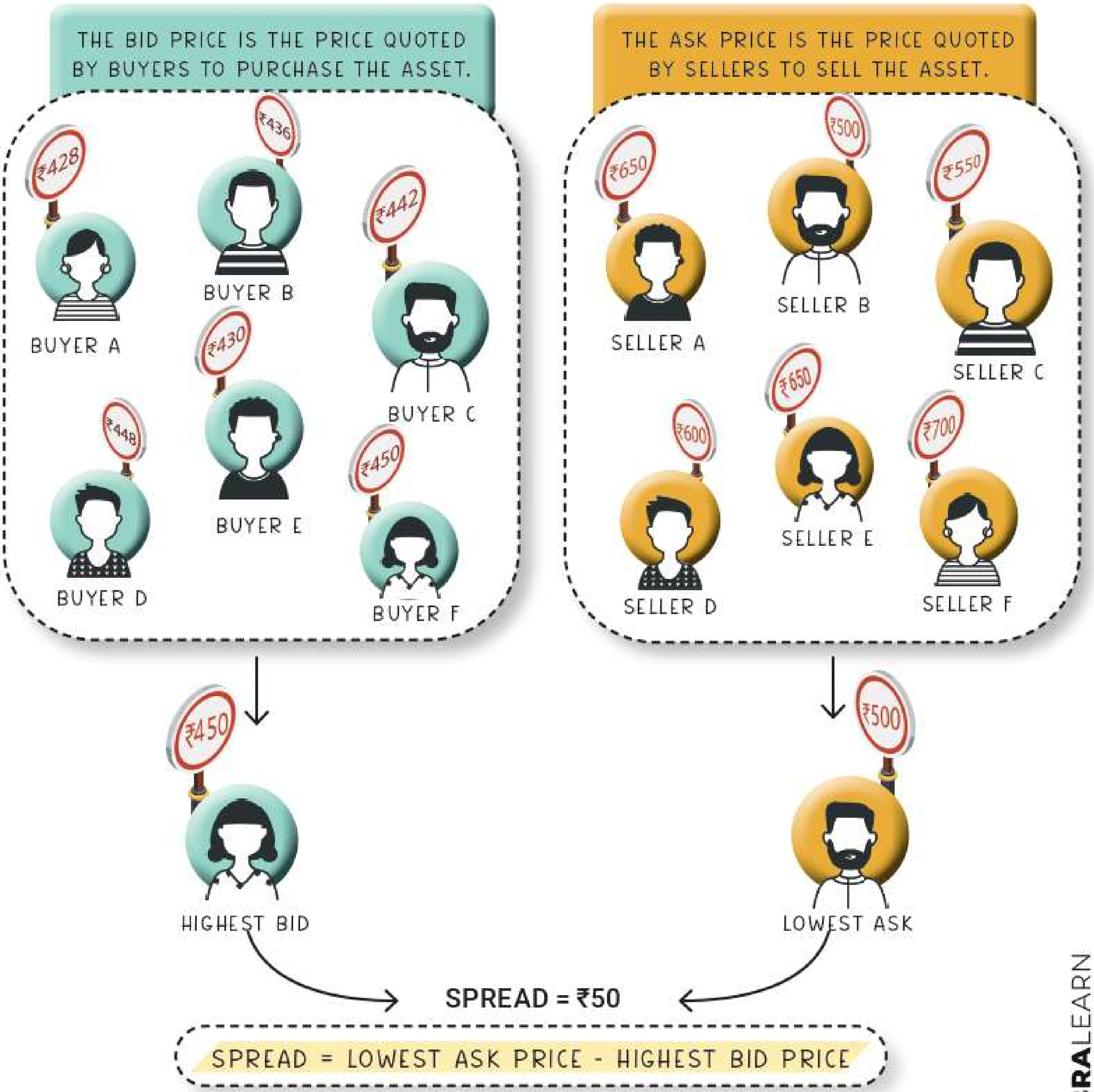
Expiry of the contract is the last date or the date till which the contract is valid. All profits and losses till this date needs to be settled. Every derivatives contract has an Expiry date. In India, for stock related futures, they expire on last Thursday of every month.

SETTLEMENT

Settlements refer to the actual payment of the profits and losses. For Futures, as we discussed earlier, the settlements are done on a daily basis.

BID ASK SPREAD

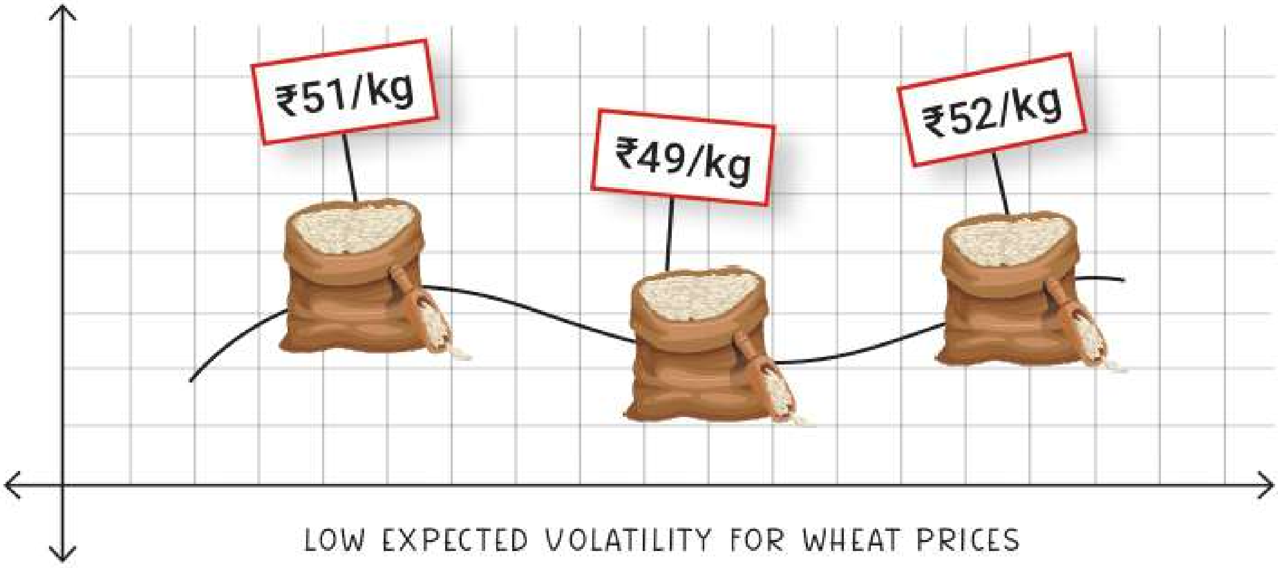
Entire stock market operates with an auction model in place. Buyers bid about the highest price they are ready to pay for an asset or a derivative and sellers quote the lowest price that they are comfortable selling. The former is know as Bid Price and latter is the Ask Price. Whenever they meet, trade gets executed. The difference between the two is called Bid-ask spread. So, whenever you buy anything, you will pay the Ask Price and to sell something you will get the Bid Price.



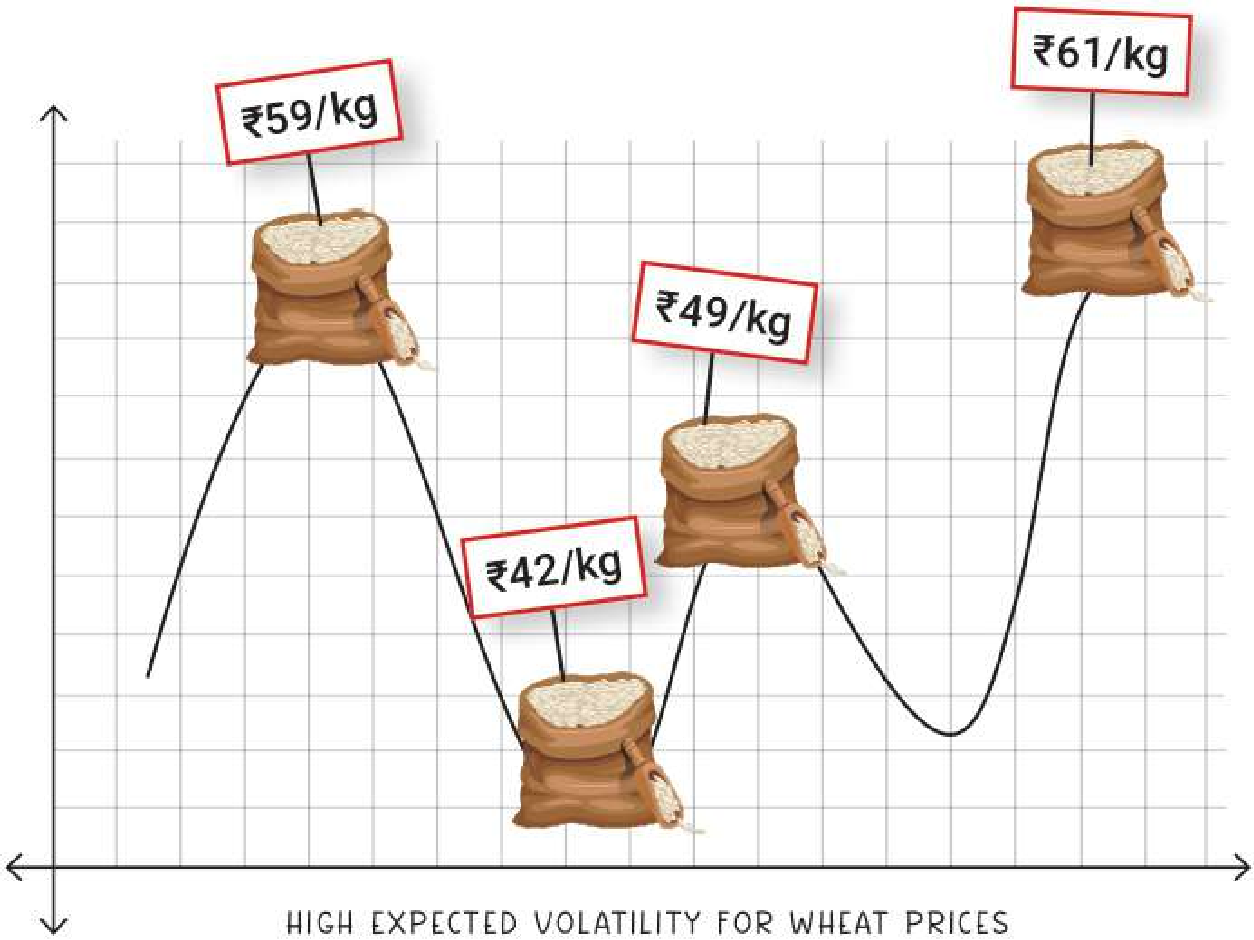
The spread is the difference between the bid and ask prices of an asset. If there are a large number of buyers and sellers in the market, then the id-ask spread will be low. If the market has fewer buyers and sellers, then bid-ask spread would be high. Bid-ask spread adds to the transaction costs that we incur when buying and selling derivative contracts.

IMPLIED VOLATILITY

Implied volatility is the market's expectation of how volatile an asset is going to be. If an asset is highly volatile- it will have higher swings in its prices. It is one of the most important inputs in calculating option prices.



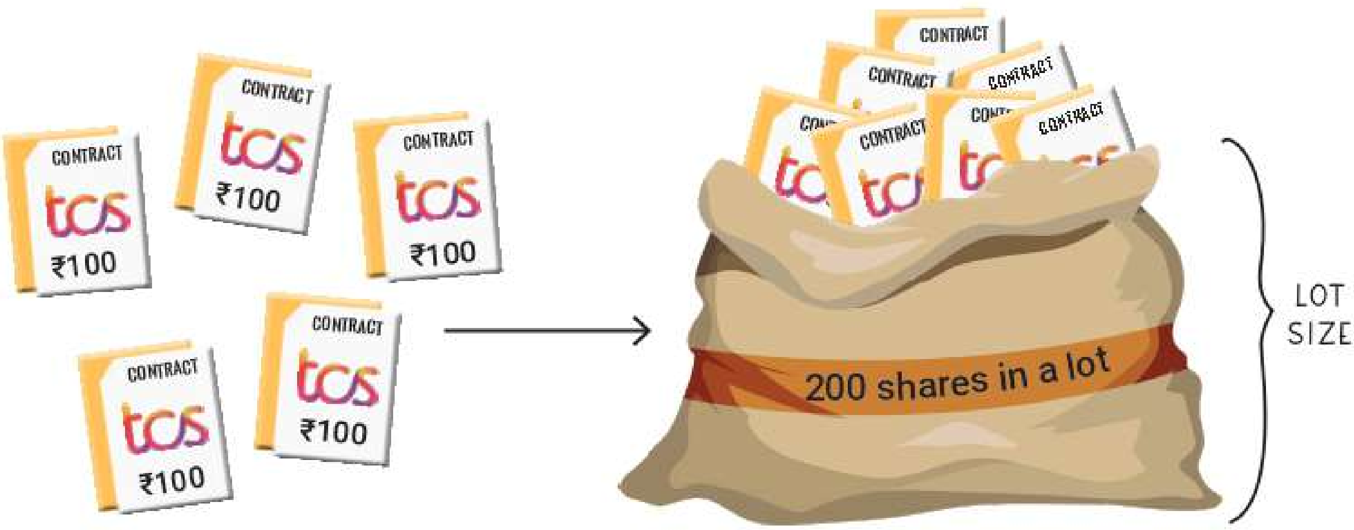
LOW EXPECTED VOLATILITY FOR WHEAT PRICES



HIGH EXPECTED VOLATILITY FOR WHEAT PRICES

LOT SIZE

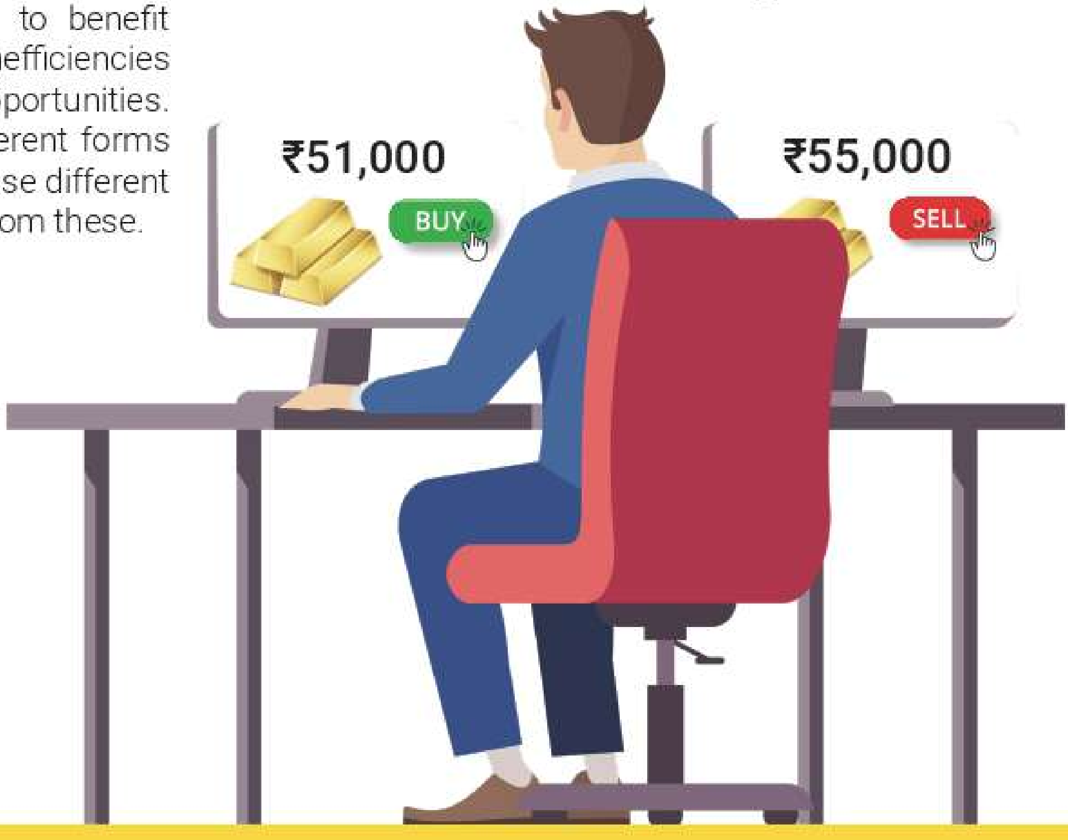
When buying Futures or Options, you cannot buy a single share or a few of them. You need to buy them in lots. Each lot will represent a certain number of shares. The number of shares that each lot represents is called Lot size. Transaction can only be executed in lots i.e. multiple of lot sizes. You can not have futures on 1 share of TCS. You will have to buy one lot at least where each lot is say, 200 shares.

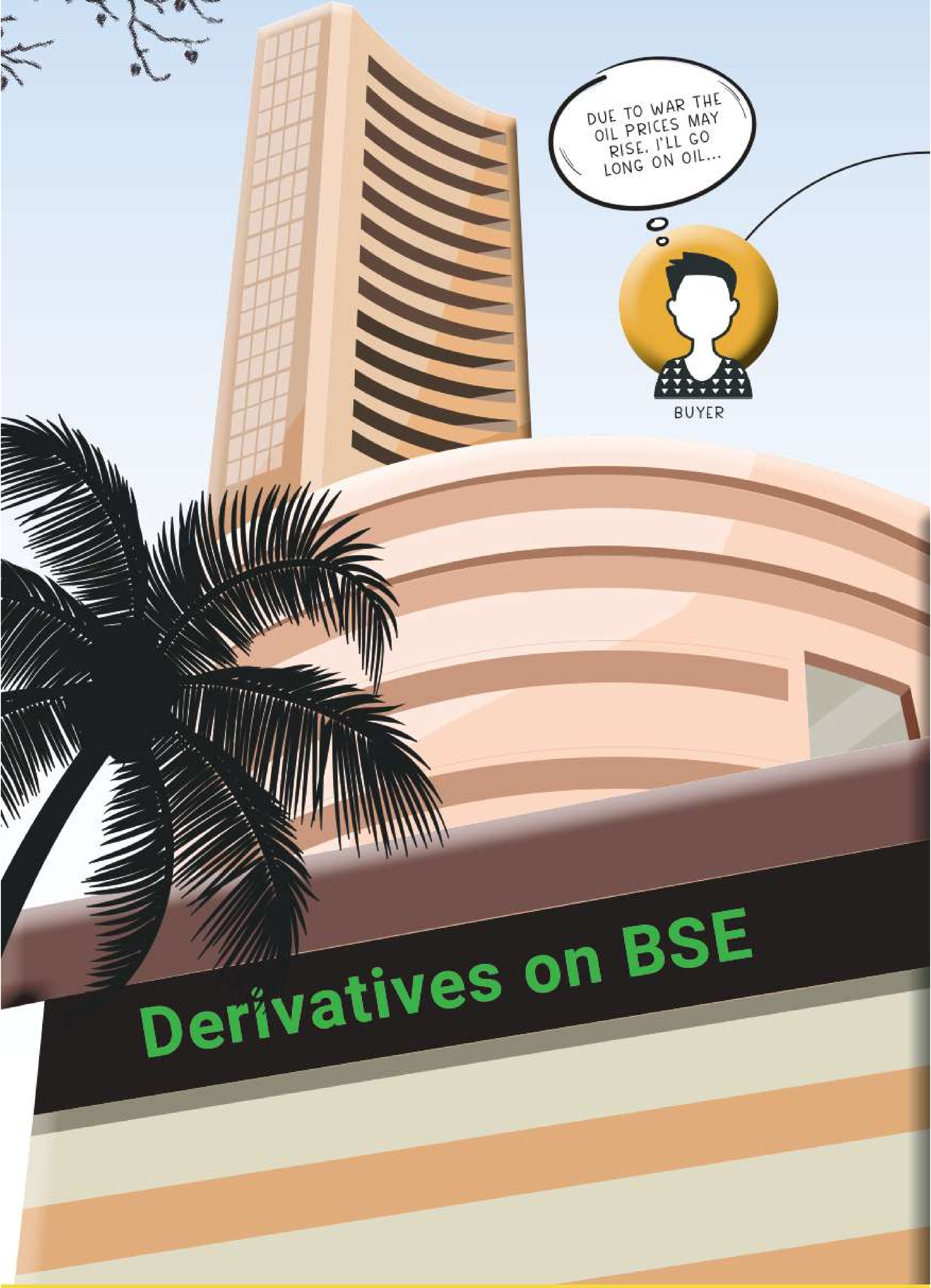


200 Shares X ₹100 = ₹20,000

ARBITRAGE OPPORTUNITY

An arbitrage opportunity is essentially the discrepancies in price that arise in the market for an asset. Lets say that there is a huge difference between price of an asset and its futures contract. Now, we know that on maturity, both these prices merge. So, we might buy shares and sell futures to benefit from the difference. Such opportunities where trader intends to benefit from such market inefficiencies are called Arbitrage opportunities. They can arise in different forms and different traders use different strategies to benefit from these.



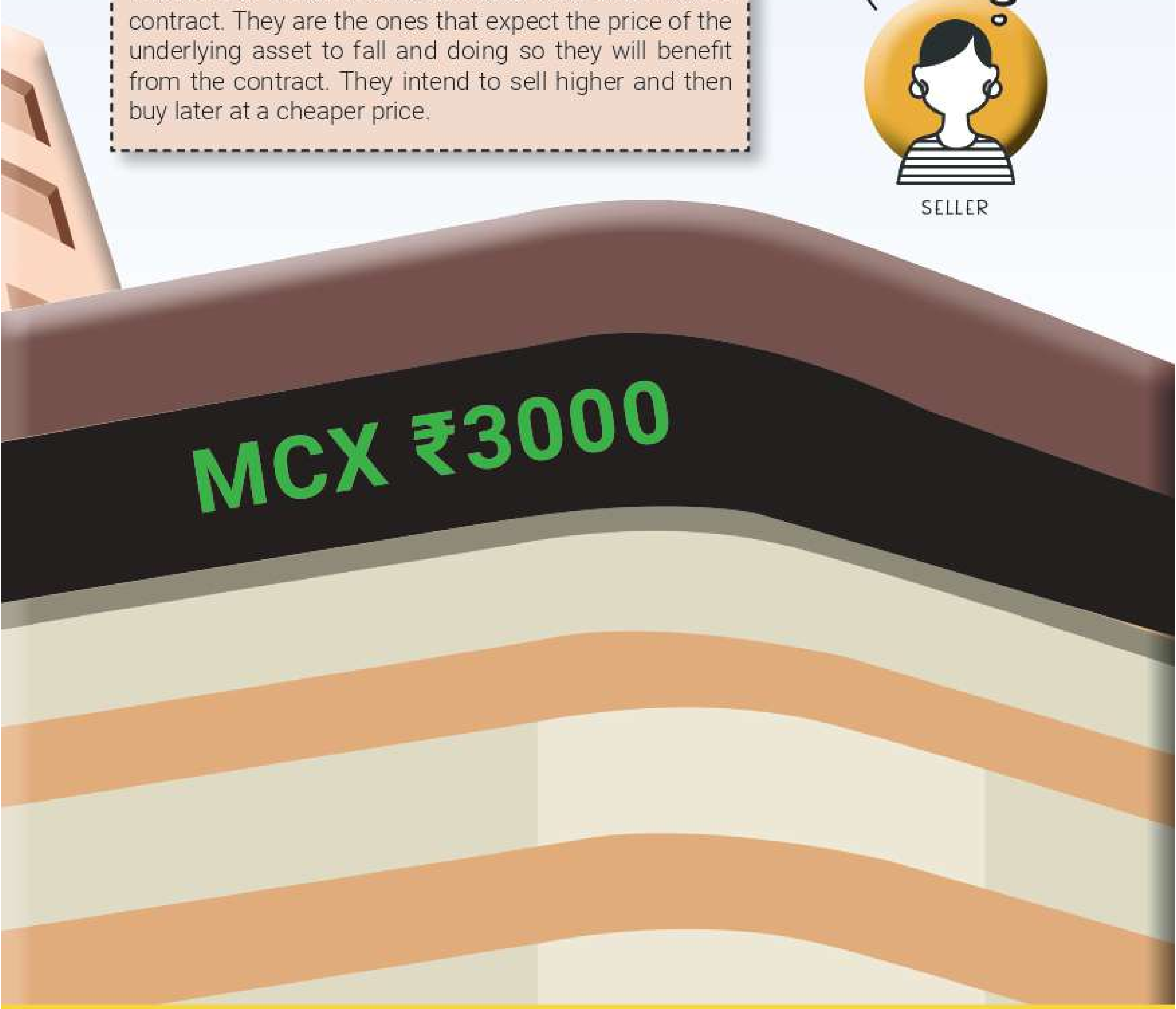

DUE TO WAR THE OIL PRICES MAY RISE. I'LL GO LONG ON OIL...
BUYER
Derivatives on BSE

LONG POSITION

The buyer of the contract is said to be long on a futures contract. They are the ones expecting the price will rise in future. They enter the contract, therefore, to buy at low and then sell at a higher price later as per their expectation of a price increase.

SHORT POSITION

The seller of the contract is said to be short on a futures contract. They are the ones that expect the price of the underlying asset to fall and doing so they will benefit from the contract. They intend to sell higher and then buy later at a cheaper price.



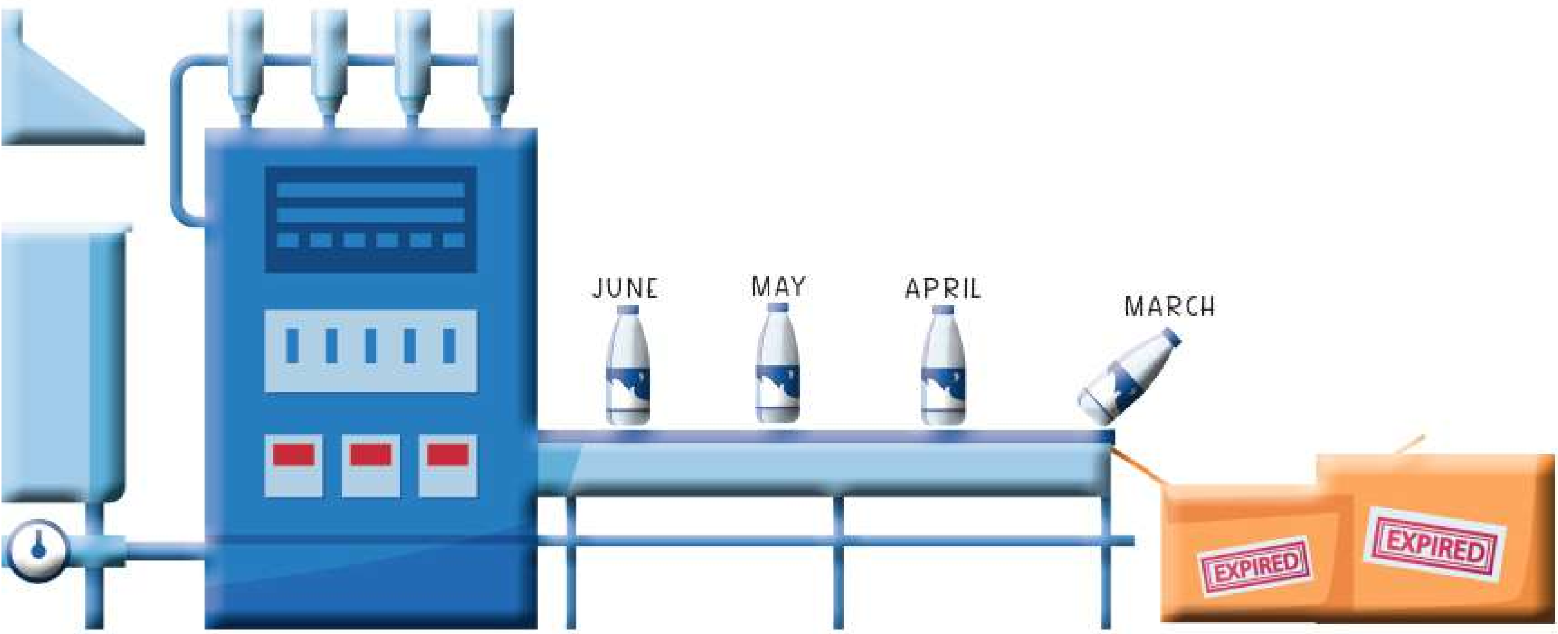
SPOT PRICE

The spot price is the current market price at which an asset is trading. For instance, TCS = ₹3000.

FUTURES PRICE

Futures price is the price at which the futures contract of the underlying asset is trading. We will have different prices for same futures contract with different expiries. For instance, TCS 21 NOV FUT = ₹2900.

CONTRACT CYCLE



Contract Cycle refers to the time when a particular contract is released in the market or is open to trade and the time when it expires. It also includes, how many different expiries trade at a given point in time in the market for the same underlying asset. For instance, for Indian stocks, three expiries are active at any point in time. At any point, you can trade with futures contract that have - expiry in current month, expiry in month after this and expiry two months from now. This shows when a contract is active and when it expires.