1.4 SPOT TRADING AND FORWARD TRADING

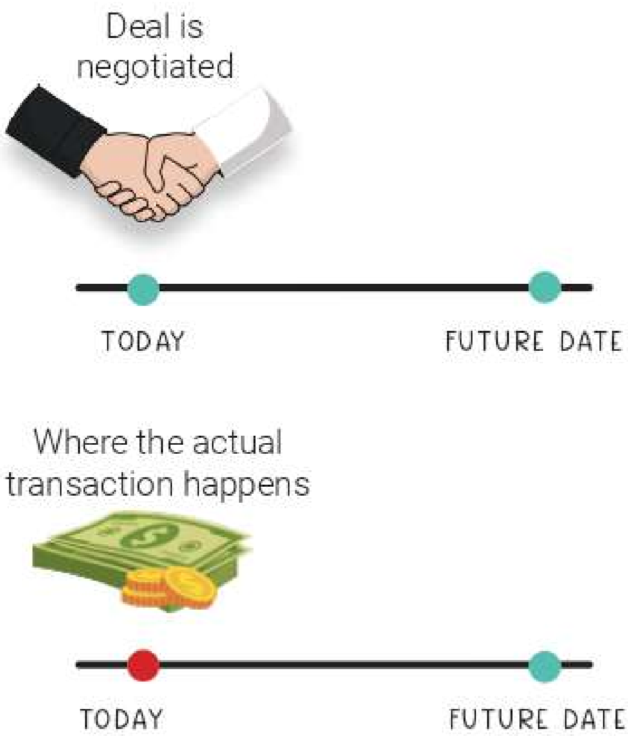
Explainer Video

WE CAN TRADE IN TWO WAYS:

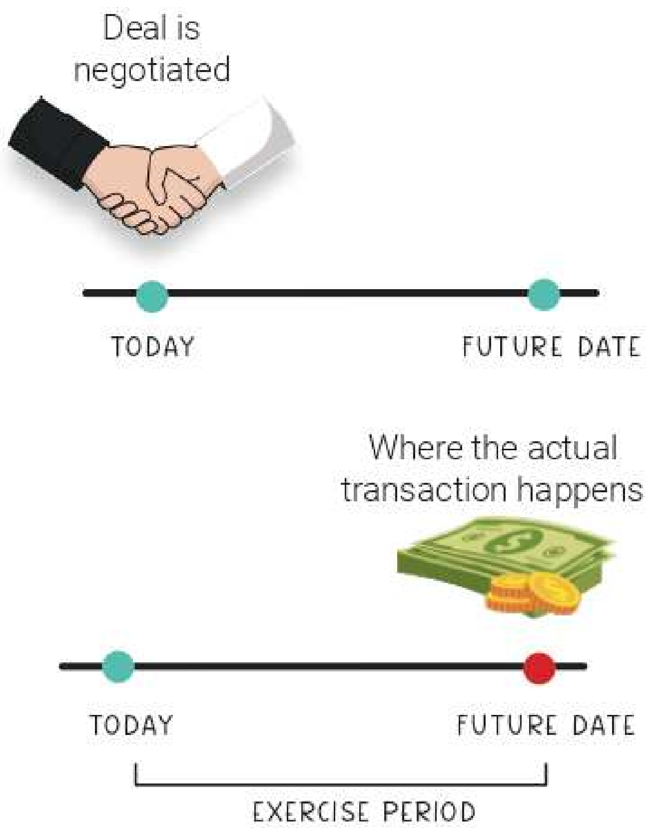
SPOT TRADING

FORWARD TRADING

Spot Trading or Cash Trading is when a purchase or sale is made directly and immediately from the market.

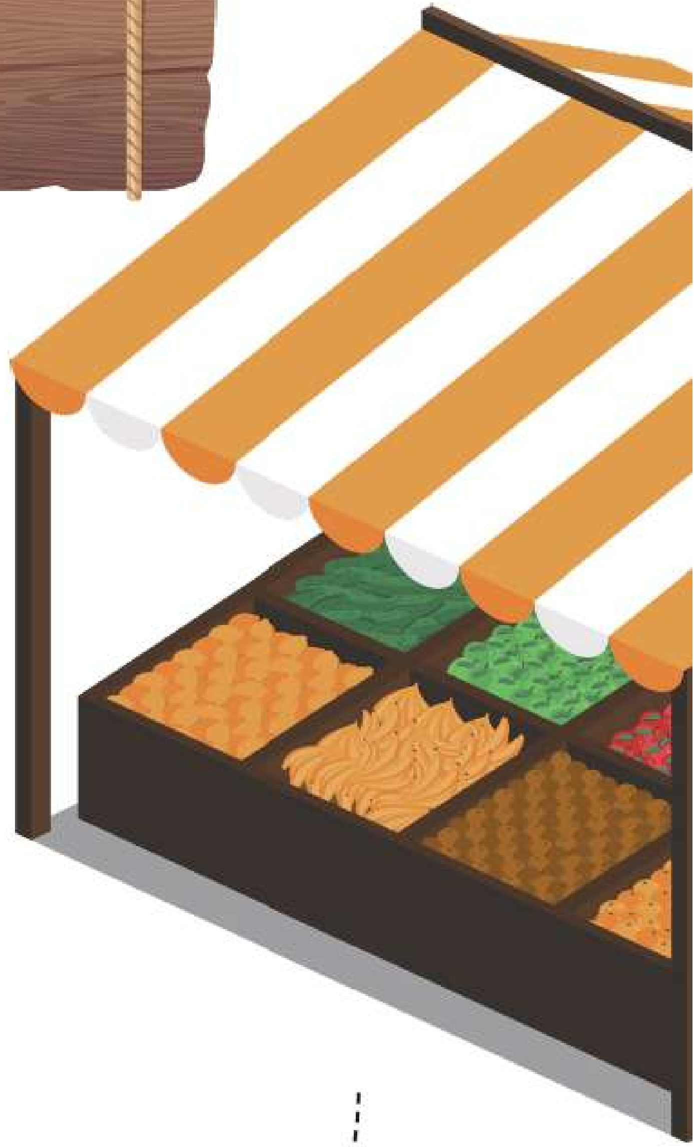


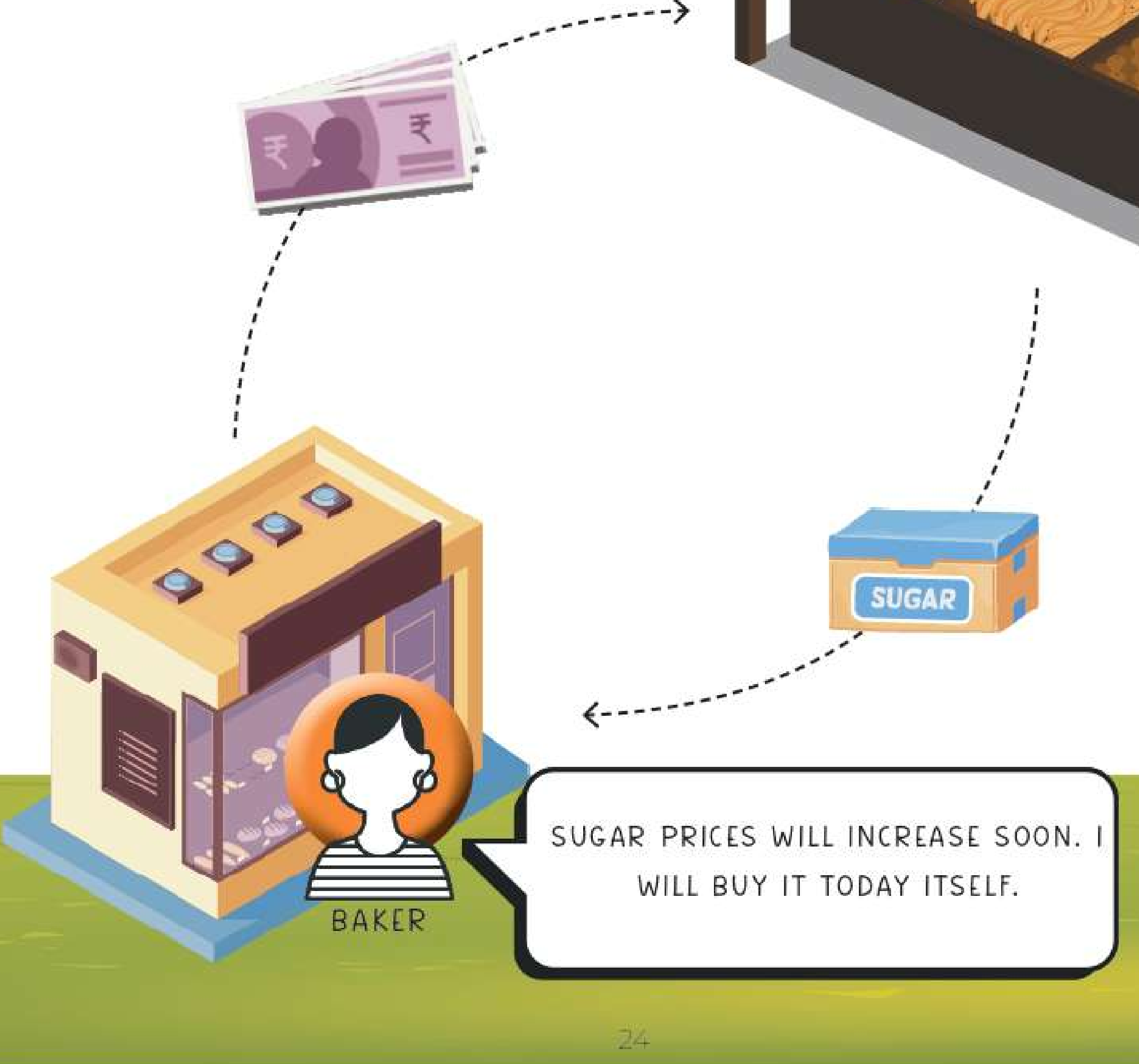
Forward Trading is where two parties agree to trade an asset at a future date, at a predetermined price.



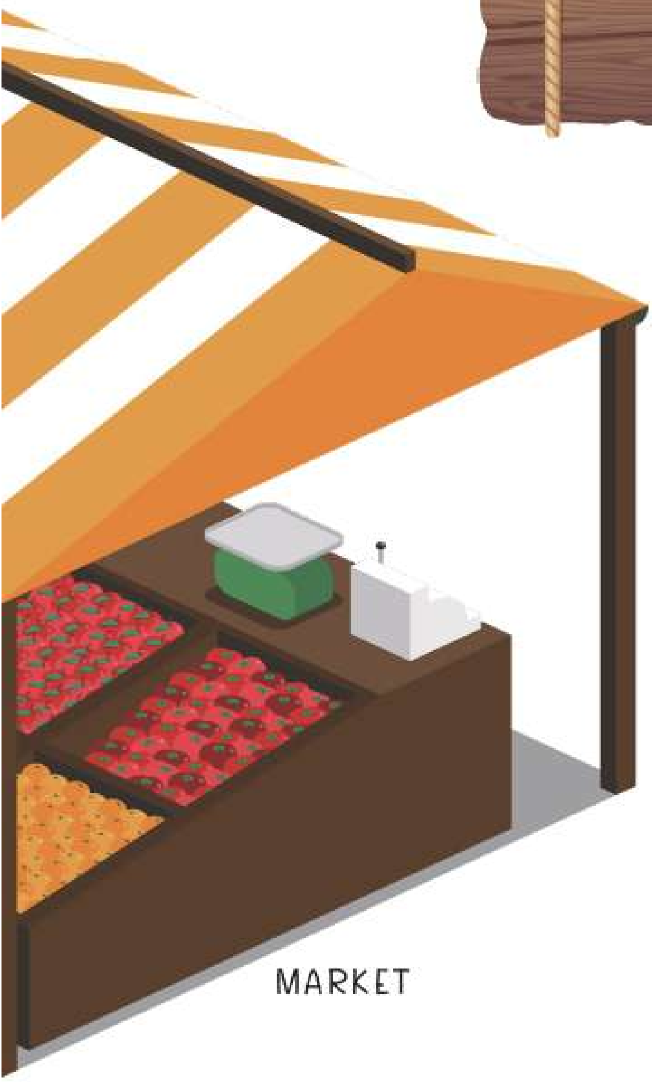
SPOT MARKET

Now, to buy the underlying asset at the spot - you have a pay-out of the total spot price today. Meaning, that if you have a bakery shop and you need sugar (a commodity, as a raw material), you buy sugar at the market price, in cash – the total amount, today to protect yourself against the fear of an increase in the price of sugar in future when you might need it.

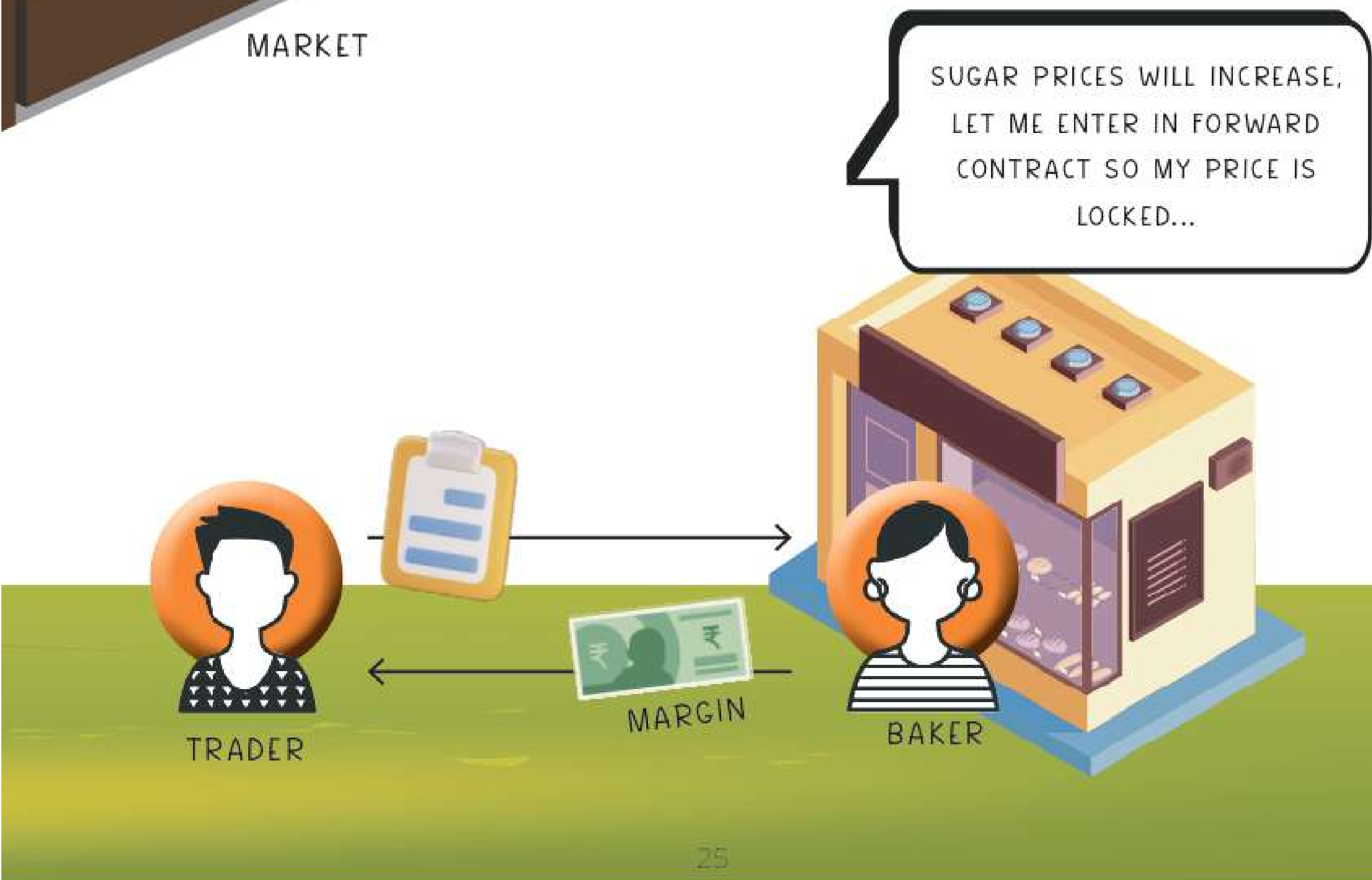




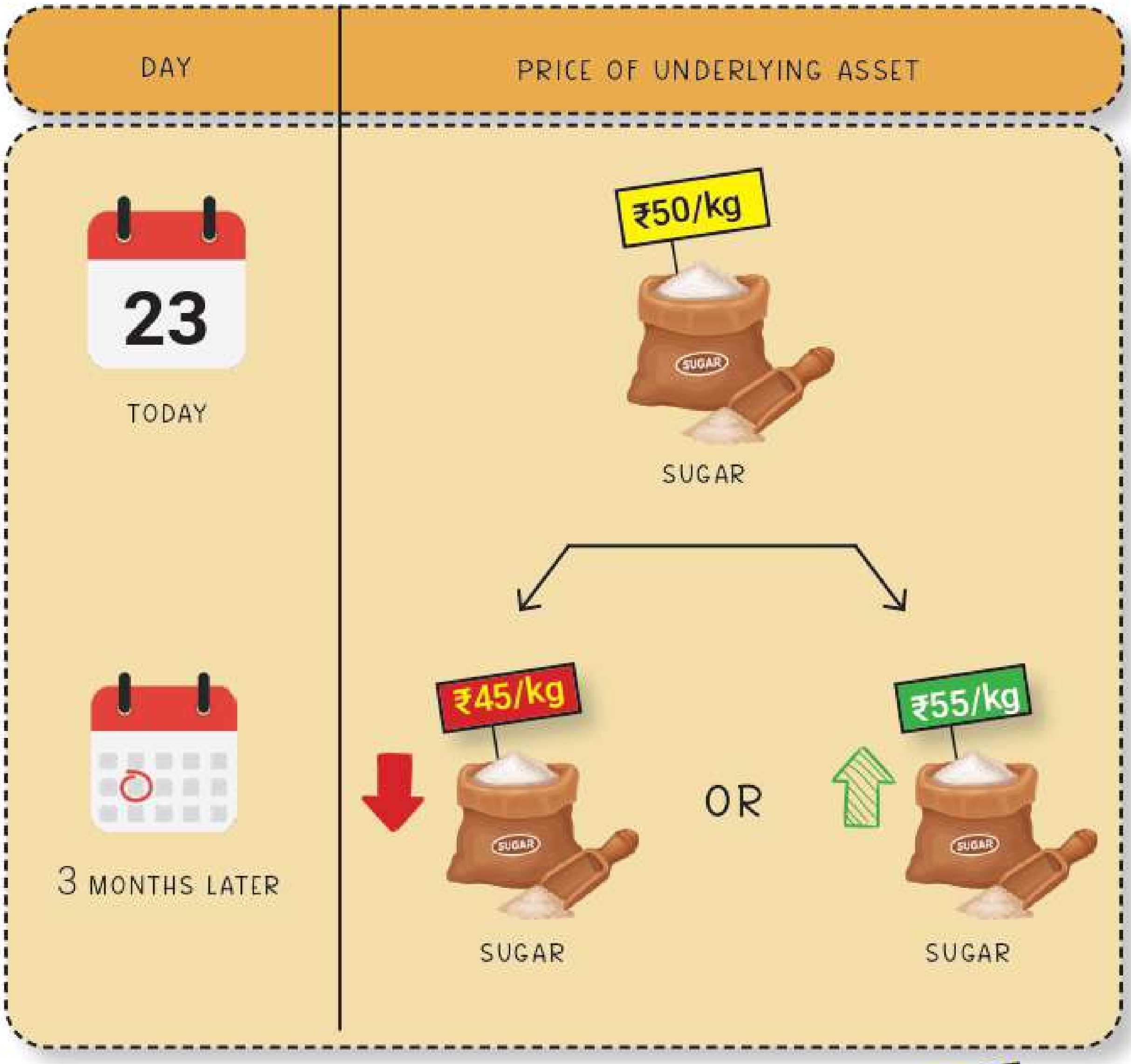
FORWARD MARKET

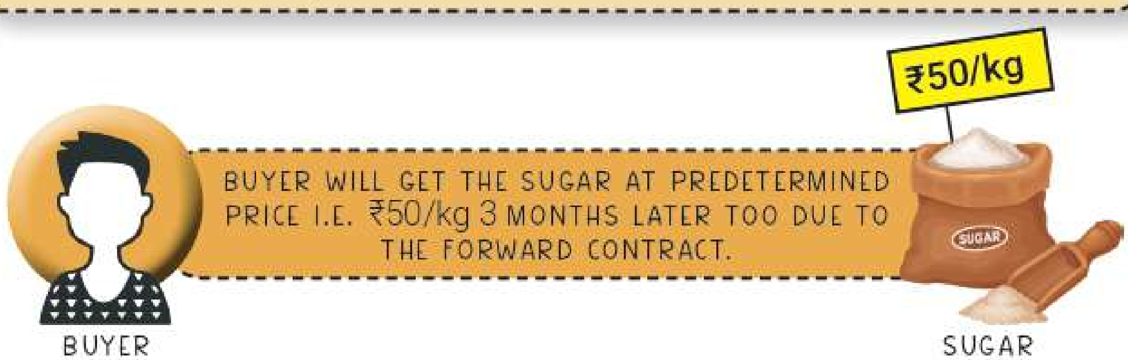


Alternatively, buying the underlying asset through a forward makes you enter a contract (legally binding) to purchase the same underlying (commodity – sugar, in this case) at a predetermined price at a later date decided today. You might have to pay a small amount i.e. margin money while entering this forward contract (derivative). However, this amount will be much smaller than paying the entire amount. Also, you will get the Sugar at the pre-determined price irrespective, if the price increases or decreases in the future.



Purchasing the asset using a Forward contract at a predetermined price has further protected you against any price fluctuations (uncertainty) of the underlying asset (sugar).





Meaning that if the price of sugar after - 3 months is 10% more, you will still have the benefit of buying it at the predetermined price. Also, if the price of sugar after - 3 months is 10% less, you will still have to buy the sugar at the same predetermined price. Therefore, the derivative here plays a significant role in protecting you against any price fluctuations of sugar in the market. This is very important for those who have high exposure to such price fluctuations. It is important for them to purchase.

Now when you buy a commodity that you need after 3 months, you will also have to store it which will include some storing costs. When you buy using forward contracts, because you do not receive physical delivery, you do not have to incur any storage costs too.

This is how those who actually need the commodity use derivative contracts to manage and reduce their risks. However, from a trading point of view as well, we can enter trades and try to benefit from such derivative contracts. This is what we will discuss in this book and chapters coming ahead.

SPOT TRADING VS FORWARD TRADING

SPOT MARKET	FORWARD MARKET
23 TODAY	FUTURE DATE
FINANCIAL ASSETS ARE TRADED.	THESE ARE MORE FINANCIAL CONTRACTS AND NOT ASSETS IN THEMSELVES.
TRADE EXECUTED IMMEDIATELY.	EXECUTED ON A SPECIFIC FUTURE DATE.
ENTIRE AMOUNT NEEDS TO BE PAID UPFRONT. THE ENTIRE TRANSACTION IS CLOSED ON THE SPOT ITSELF WITH CASH AND ACTUAL GOODS EXCHANGING HANDS.	ONLY MARGINS NEED TO BE PAID AT THE TIME OF ENTERING INTO THE CONTRACT.
COMMERCIAL BANKS, BROKERS, CUSTOMERS OF COMMERCIAL BANKS AND BROKERS.	HEDGERS,SPECULATORS, ARBITRAGEURS, MARGIN TRADERS. BEYOND THIS, THEY ARE COMMONLY USED TO MANAGE RISKS.

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