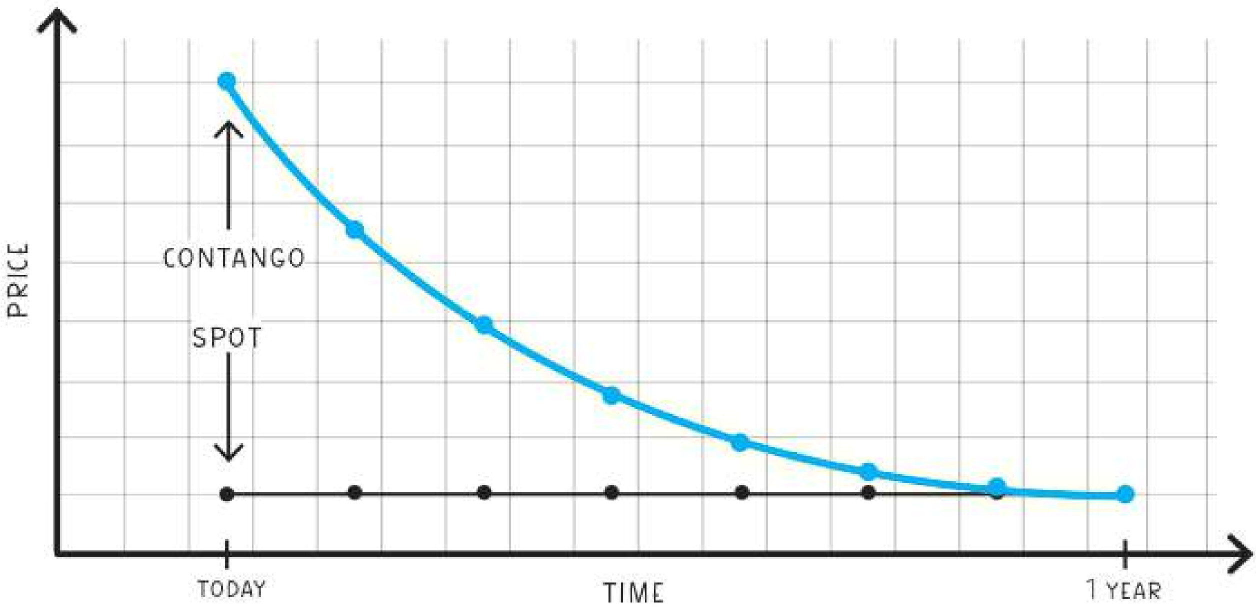
3.10 REASONS FOR DIFFERENCE BETWEEN SPOT PRICE AND FUTURES PRICE


Explainer Video

You must have observed that there is a slight difference between the spot price and the futures price of assets. At times, the futures contract is more expensive than the spot price and at other times, the opposite holds true as well. This difference sometimes is such that the Futures Price is greater than the Spot Price, or vice versa shall be true. These conditions are financially called Contango and Backwardation, respectively.

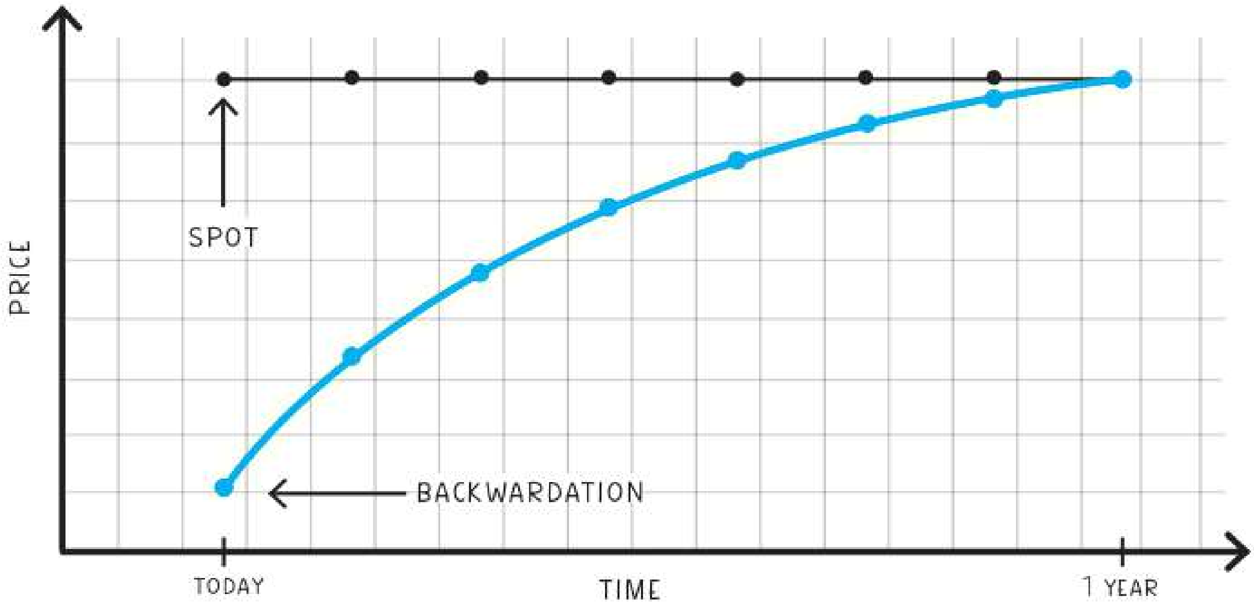
CONTANGO

If the Futures Price > Spot Price, it is said to be a Contango market.



BACKWARDATION

If the Futures Price < Spot Price, it is said to be a Backwardation market.

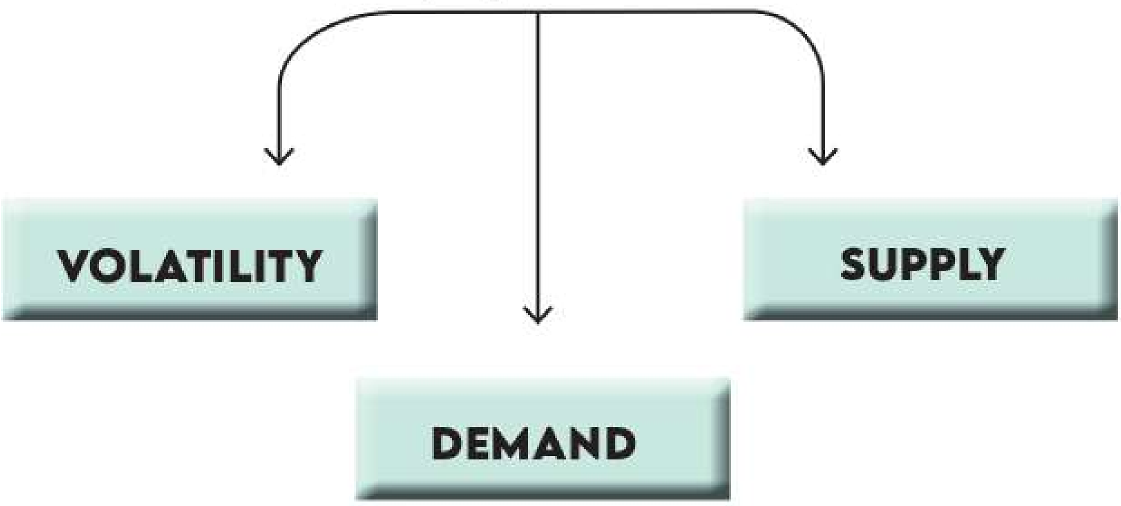


There is a difference between spot price and futures price due to the implied interest rates. When you buy a derivative contract, you only invest 15-20% as margins for the exposure. However, to buy from spot market, you will have to invest 100% of the exposure. So, the 80-85% cash that you have left when investing with Futures will earn some returns. The difference between the rates is to remove impact of such interest.

Lets say, you buy an asset worth ₹10,00,000 with 15% margin requirement. If you purchase from Spot market, entire amount will be consumed. But if you purchase from Futures market, 15% i.e. ₹1,50,000 will be consumed and ₹8,50,000 will still be idle with you.

The difference ₹8,50,000, which, if invested elsewhere, would give an extra interest/ return on investment. This extra earning with the leftover capital is the main reason behind the difference between TCS Spot Price and TCS Futures price. The difference ensures no one is penalized while buying at Spot or Futures prices.

Other reasons for Futures price and Spot price differences



SUMMING UP THE DIFFERENCE

₹10,00,000

BUYING AT SPOT PRICE

₹10,00,000

(USES UP ENTIRE CAPITAL)

BUYING THE FUTURES

₹1,50,000

(CONSUMES ONLY A PART OF CAPITAL)

₹8,50,000

(REMAINING CASH CAN BE INVESTED ELSEWHERE)