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What are the Differences Between Spot FX and Futures Trading?



The term 'forex market' can be thought of as an umbrella term that encompasses several distinct trading arenas and financial instruments, each with their own set of rules, practices and peculiarities.

Within this wider sphere, two particular types of foreign exchange that are worth differentiating between are what's known as 'spot forex' and 'futures' trades, the latter of which being a popular form of FX derivative.





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What is Spot Trading in Forex?

When you refer to forex in conversation without any further specification, you're usually talking about spot FX trading.

Perhaps the most straightforward type of currency exchange, as the name implies it occurs 'on the spot': you simply execute your trade and the transaction is completed as soon as possible after confirmation, just like when buying any other type of goods.

Typically, spot FX trades entail the physical delivery of the underlying asset — such as lots of currency or a specified quantity of a commodity — meaning you take legitimate ownership of the security you've chosen to purchase; this usually occurs within two days of closing, which is the time it generally takes to transfer funds between bank accounts.

The spot forex market is the largest and most liquid market of any kind in the world, commonly realising over one trillion US dollars' worth in transactions per day worldwide.

Further reading: <https://www.americanexpress.com/us/foreign-exchange/articles/what-is-spot-exchange-rate/>

What is a Derivative Futures Contract and How Do They Work?

A common type of forex derivative, futures contracts are legally binding agreements that commit both parties to trading a certain amount of a security — e.g. a particular currency pair or commodity against a currency such as the USD — at a pre-determined price, or 'exchange rate', at some specified point in the foreseeable future.

Investors can trade futures in two ways; firstly, by simply owning the instrument they're trading to begin with, or secondly by going short and gambling that their target security will have decreased in value by the time the contract settlement date rolls around (thereby enabling them to profit off the eventual price difference).

In this regard, futures contracts can be traded between investors purely for profit without the underlying asset ever being physically transferred to the buyer (so long as the trade is closed before the deadline) — for instance, most retail traders wouldn't know what to do



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A more long-term tactic, strategically speaking, futures contracts are often traded on specific futures exchange markets.

These types of arrangements often relied upon by large corporations in order to hedge against market uncertainty — by essentially ‘locking in’ the price of a given product for an agreed time period — and protect themselves from sudden shifts in global currency exchange rates.

Further reading: <https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/currency-futures/>



What are the Main Differences Between Spot FX and Futures Trading?

As you’ve probably gathered from the above rundown, the main points of difference between spot and futures trades are the point at which the trading price is decided, and when the instrument in question is actually delivered to the purchasing party.





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For futures, meanwhile, the price is decided up-front at the signing of the contract and the product is delivered on the pre-agreed settlement date (if the contract is still open and valid).

Further reading: <https://forextraininggroup.com/the-difference-between-trading-spot-forex-and-currency-futures/>

What are the Risks and Benefits of Derivatives vs Spot Trading?

Generally speaking, the more immediate and dynamic nature of spot forex allows you to trade a vast amount of different currencies and commodities with a higher degree of liquidity than derivatives contracts.

However, the number of fluctuating variables regarding — for example, variable spreads, overnight rollover costs and potential slippage — mean that it's also easier to get caught out if you're not careful.

By contrast, the negotiated pricing arrangements present in futures contracts means most (if not all) of the cost of your trade should be visible to you before you sign on (virtual) the dotted line; the obvious trade-off is that you're then committed to these specific terms for the duration of the contract.

As a rule of thumb, newcomers to the trading game will likely find spot forex the easier of the two categories to get to grips with; this is because it requires a smaller initial capital to participate and exposes the trader to less long-term risk (as they can withdraw from trades more freely).

Some more seasoned forex investors are able to capitalise on both types of trades simultaneously — engaging in spot trades day to day whilst also keeping a portfolio of futures contracts — which allows them to benefit from their respective perks; this unsurprisingly requires a high degree of knowledge and skill to pull off consistently, but is a worthy goal for keen traders to work towards!

Further reading: <https://tradingsim.com/blog/6-key-differences-spot-market-futures->



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1

