SINGLE STOCK FUTURES

Single Stock Futures have taken the world by storm and the JSE was recently ranked number one in the world in terms of volume. So just what are they?

WHAT ARE SINGLE STOCK FUTURES?

Single Stock Futures (SSFs) are futures contracts on individual shares (stocks). A futures contract is a legally binding agreement that gives you the right to buy or sell an underlying asset at a fixed price on a future date. SSFs are traded on an exchange, in South Africa's case, the JSE. Their contracts are standardised which means they have set specifications when it comes to size, expiry dates and tick movement (the minimum upward or downward movement in the price of a security). One can trade in either the physically settled contract (at expiry date, the actual underlying shares will be traded between counterparties) or the cash settled contracts (at expiry, cash will change hands).

The value of an SSF contract is normally equal to 100 times the particular share's futures price (gearing). For example, if company A is trading at R20 then holding one futures contract is the equivalent of investing R2 000 in that company. Due to this gearing, SSFs allow you to have exposure to an underlying share, without actually having to trade in the underlying contract. You can exit a futures contract before the expiry date – this is called 'closing your position'. The JSE offers four expiration dates: the third Thursday of March, June, September and December respectively.

TRADING IN SINGLE STOCK FUTURES

When you trade in SSFs there are two positions that you can take: 'long' (buy) or 'short' (sell). When you 'buy long' you're buying exposure to the underlying security because you believe the price of the underlying share will increase. If it does so by the time the contract expires (or before the contract expires), you will be able to sell or 'close' your position, thereby realising a profit. 'Selling short' on the other hand, will yield you a profit if the futures price goes down over the life of the contract.

All counterparty risk has been eliminated when trading in SSFs on the JSE. This is due to the initial margin as required by the exchange when trading in futures. This initial margin can be regarded as a 'good-faith' deposit, that the investor has to pay upfront (usually the maximum amount that can be lost in one day) to protect both parties should one party to the contract not hold up his part of the agreement. Interest is earned daily on this margin which is held by the exchange.

This means that, unlike shares, you only need to put down between 10% and 15% of the value of the underlying shares. When you close your position, both your initial margin and interest is paid into your margin account.

At the end of each trading day, every contract is marked to market (M-t-M) – in other words, the exchange independently calculates a fair value (or closing price) for each contract. The difference between your traded price, if traded on the day, or the previous day's M-t-M, if this is a brought forward position, can be calculated as profit or loss, payable to the exchange via the clearing member. This payment is called variation margin.

For example, let's assume that you bought one futures contract on company X for R50 on 25 April 2007, and the exchange establishes the closing price for that future on 26 April 2007 to be R52. This is deemed to be the M-t-M price on 26 April 2007 for a September 2007 company X futures contract. This represents a positive movement of R2 for the buyer in the futures price, resulting in a R200 profit (1 x R2 x 100 [nominal per contract]).

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Conversely, this represents a negative movement of R2 for the seller of the futures contract. The exchange will require that the seller pay R200 into his variation margin account which will then be paid into the buyer's (your) variation margin account.

WHO USES SSFs?

Derivatives have two main users: hedgers and speculators. Hedgers seek to reduce risk by protecting an existing share portfolio against possible adverse price movements in the physical (or spot) market. Hedgers have a real interest in the underlying shares and use futures as a means of preserving their performance. Speculators use SSFs in the hope of making a profit on short-term movements in the futures contract price. They often buy and sell derivatives contracts in their own right without transacting in the underlying share. Speculators may have no interest in the underlying shares other than taking a view on the future direction of its price.

WHY USE SSFs?

- SSFs offer you an opportunity to protect/hedge your share portfolio by selling SSFs in the same companies
- SSFs incur lower brokerage costs than actually trading in the underlying shares
- Your initial margin earns interest for the duration of your contract
- Corporate actions affecting the underlying shares are also taken into account on the Futures contract
- SSFs are characteristically liquid and easily traded
- With margin requirements of approximately 10%, SSFs provide a highly capital efficient way to participate in equities
- The JSE independently calculates the closing price on all listed SSFs
- You can sell short futures, benefiting in a downward move in price.

Only experienced investors or investors with the help and advice of an experienced adviser should participate in this market

SHARES VS SINGLE STOCK FUTURES

SHARES:	SINGLE STOCK FUTURES:
Investor X thinks the shares in company A will increase and buys 100 shares worth R250 each, costing R25 000 in total. Three months later company A's shares are worth R300 each and investor X sells his shares for R30 000 and pockets the profit of R5 000.	Investor Y also thinks that company A's share price will increase and wants to buy 100 shares but doesn't have R25 000 to buy them. His friend tells him about SSFs so he decides to buy one futures contract at a price of R250. He has to put down a deposit (initial margin) of R2 500 but is still exposed to his desired 100 company A shares. Three months later company A's share price increases to R300. Investor Y decides to close his position. He then gets back his R2 500 deposit, with interest, and the difference in the price of the underlying share, ie, R50 x 100 = R5 000.

The reason investor Y makes the same amount of profit as investor X, but with a significant difference in cost, is because of the gearing effect of SSFs. This effect is great when you're making money. Trading in futures could also result in losses, if the market does not go your way.

For this reason, only experienced investors or investors with the help and advice of an experienced adviser should participate in this market. One of the attractions of SSFs is that you can make money in a rising or falling market but it is important for any investor entering this market to be aware of the risks involved.

The JSE also lists options on futures which are exercisable into the underlying futures. This means that when the option expires, or is exercised before expiry, the buyer or seller of the option then becomes the buyer or seller of a futures contract.

To find out more about Single Stock Futures, email derivativestrading@jse.co.za or visit http://www.safex.co.za/ed

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