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Future Trading : A Boon

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In future trading is an agreement to buy or sell a specified quantity of financial instrument/ commodity in a designated future month/time at a price agreed upon by the buyer and seller. The contracts have certain standardized specifications with the date and time of expiry of the contract.

Functions of future trading : It is useful to producer because he can get an idea of the price likely to prevail at a future point of time and therefore can decide between various compting commodities, the best that suits him. It enables the consumer get to an idea of the price at which the commodity would be available at a future point of time. He can do proper costing and also cover his purchases by making forward contracts. The futures trading is very useful to the exporters as it provides an advance indication of the price likely to prevail and thereby help the exporter in quoting a realistic price and thereby secure export contract in a competitive market. Having entered into an export contract, it enables him to hedge his risk by operating in futures market. Other benefits of futures trading are:

– Price stabilization-in times of violent price fluctuations - this mechanism dampens the peaks and lifts up the valleys *i.e.* the amplitude of price variation is reduced.

– Leads to integrated price structure throughout the country.

– Facilitates lengthy and complex, production and manufacturing activities.

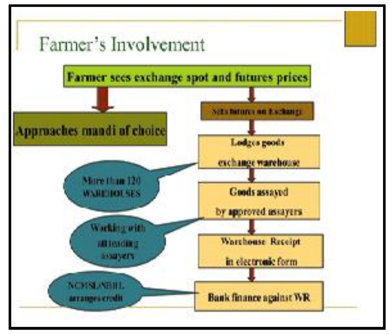
– Helps balance in supply and demand position throughout the year.

– Encourages competition and acts as a price barometer to farmers and other trade functionaries.

Futures trading perform two important functions of price discovery and price risk management with reference to the given commodity. It is useful to all segments of economy. Futures trading perform two important functions of price discovery and price risk management with reference to the given commodity. It is therefore useful to all the segments of the economy and particularly to all the constituents of the commodity market ecosystem. It is important to know how resorting to commodity trading benefits the constituents.

Benifts of future trading :

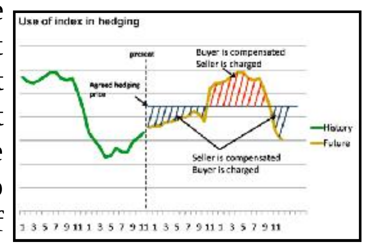
Benefits to investor, producers, consumers and manufacturers:



Price risk management: All participants in the commodity markets ecosystem across the value chain of different commodities are exposed to price risk. These participants buy and sell commodities and the time lag between subsequent transactions result in exposure to price risk. Commodity derivatives markets enable these participants to avoid price risk by utilizing hedging technique.

Price discovery : This is a mechanism by which a fair price value is determined by the large number of participants in the commodity derivatives markets. This is the result of automation and electronic trading systems established in the commodity derivatives exchanges.

High financial leverage: This is possible in commodity markets. For example, trading in gold calls for only 4% initial margin. Thus, if one gold futures contract (each gold futures contract lot size is 1 kg) is valued at Rs. 12,00,000.00, the investor is expected to deposit an initial margin of only Rs. 48,000.00 to be able to trade. If the price of gold goes up by even 2% per kg, the investor would make a profit of Rs. 24,000 before the expiry of the contract, if is has taken buy position. This is the benefit of leveraged trading transactions.



Commodities as an asset class for diversification of portfolio risk: Commodities have historically an inverse correlation of daily returns as compared to equities. The skewness of daily returns favours commodities, thereby indicating that in a given time period commodities have a greater probability of providing positive returns as compared to equities. The 'Sharpe ratio' of a portfolio consisting of different asset classes is higher in the case of a portfolio consisting of commodities as well as equities.

Commodity derivatives markets are extremely transparent in the sense that the manipulation of prices of a commodity is extremely difficult due to globalization of economies, thereby providing for prices benchmarked across different countries and continents.

An option for high net worth investors: With the rapid spread of derivatives trading in commodities, the commodities route too has become an option for high net worth and savvy investors to consider in their overall asset allocation.

Useful to the producers : Commodity trade is useful to the producer because he can get an idea of the price likely to prevail on a future date and therefore can decide between various competing commodities, the best that suits him.

Useful to the consumers : Commodity trade is useful to the consumer because he can get an idea of the price at which the commodity would be available at a future point of time. He can do proper costing/ financial planning and also cover his purchases by making forward contracts. Predictable pricing and transparency is an added advantage.

Corporate entities can benefit by hedging their risks if they are using some of the commodities as their raw materials. They can hedge the risk even if the commodity traded does not meet their requirements of exact quality/ technical specification.

Useful to exporters : Futures trading is very useful to the exporters as it provides an advance indication of the price likely to prevail and thereby help the exporter in quoting a realistic price and thereby secure export contract in a competitive market.

Improved product quality : Since the contracts are for standardized commodities, it becomes essential for the producer/ sellers to ensure that the quality of the commodity is as specified in the contract. The advent of commodities futures markets has also enabled defining quality standards of different commodities. The quality testing and certification agencies contribute towards standardization and assessment of quality of the commodity.

Credit accessibility : Buyers and sellers can avail the bank finance for trading in commodities. Nationalized as well as private sector banks have come forward to offer credit facilities for commodity trading. More and more banks are likely to fall in line looking at the huge potential that commodity markets offer in India.

Benefits to Indian Economy : As the constituents of the commodities market ecosystem gets benefited, the Indian economy is also benefited. Growth in the organized commodity markets and their constituents implies that there would be tremendous advantages and benefits accrued to the Indian economy in terms of business generation and growth in employment opportunities. With India importing bulk of raw material, there is scope for minimizing price risk for international commodities for the Indian economy as a whole. With the increasing consumption of commodities, especially in developing countries like China and India, the prices of commodities are volatile, thereby emphasizing the need for organized commodity derivatives exchanges for the participants in the commodity markets ecosystem.

Regulatory measures : Futures trading are also capable of being misused by unscrupulous speculators. In order to safeguard against uncontrolled speculation certain regulatory measures are introduced from time to time. They are:

– Limit on open position of an individual operator to prevent over trading;

– Limit on price fluctuation (daily/weekly) to prevent abrupt upswing or downswing in prices;

– Special margin deposits to be collected on outstanding purchases or sales to curb excessive speculative activity through financial restraints;

Summarize: Farmers are likely to benefit from the existence of futures trade, even without using futures markets directly. In the absence of a well-functioning forward or futures market, farmers bear the brunt of price instability. With a futures market, traders or processors (e.g., oilseed crushers) need not build as large a cushion to protect themselves against unfavorable price movements. As a result, they will reduce the risk premiums in their marketing or processing margins and be able to pay farmers more for their products, sell cheaper, store more and be more active in the markets. The degree to which traders or processors increase prices to farmers depends on the level of competition, and on the price information available to farmers. As futures exchanges have an interest in making their prices as widely available as possible, there is a good chance that farmers will indeed be able to benefit. In addition, because of the lags between planning and production, farmers can benefit from the market-determined price information available from futures markets, which serves as an important basis for their production decisions. In India, there is active competition among traders and processors of agricultural commodities.

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