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INTRODUCTION

Bursa Malaysia Derivatives Berhad, formerly known as Malaysia Derivatives Exchange Berhad (MDEX), is a wholly owned subsidiary of the Bursa Malaysia Group. It operates under the supervision of the Securities Commission and is governed by the Futures Industry Act (FIA) 1993. Bursa Malaysia Derivatives Berhad also falls under the jurisdiction of the Ministry of Finance of Malaysia, thus offering investors the security of trading on a regulated Exchange with infrastructure and regulations comparable to that of established markets worldwide.

The following derivatives products are currently offered for trading via an electronic screen-based system on Bursa Malaysia Derivatives Berhad:

1. Crude Palm Oil Futures (FCPO)
2. Crude Palm Kernel Oil Futures (FPKO)
3. Kuala Lumpur Composite Index Futures (FKLI)
4. Kuala Lumpur Composite Index Options (OKLI)
5. 3-Month Kuala Lumpur Interbank Offered Rate Futures (FKB3)
6. 3-Year Malaysian Government Securities Futures (FMG3)
7. 5-Year Malaysian Government Securities Futures (FMG5)
8. 10-Year Malaysian Government Securities Futures (FMGA)

This brochure presents an overview of equity derivatives, namely the FKLI and OKLI.

WHAT IS A STOCK INDEX?

A stock index is basically an index of market prices of a particular group of stocks. It provides a broad measure of trends across the market. The underlying index for the FKLI and OKLI is the Kuala Lumpur Composite Index (KLCI).

Defining the KLCI

The KLCI is the benchmark of the Malaysian stock market. It is also one of the best known indices in this region and widely used by local and foreign fund managers and investors as a performance benchmark to measure their portfolios held in Malaysia. The KLCI is a market capitalisation-weighted index (shares outstanding multiplied by stock price) of 100 blue chip stocks across all sectors on the Main Board of the Malaysian market. The influence of each stock on the index's performance is directly proportional to its relative market value. The 100 component stocks are picked from sectors like Consumer Products, Industrial Products, Construction, Trading, Finance, Properties, Plantation, Mining, Infrastructure Projects, Hotels and Technology.

THE EQUITY DERIVATIVES PRODUCTS

What is FKLI?

The FKLI which was introduced in December 1995 is a derivatives contract that allows the seller of the contract to deliver, and the buyer to take delivery of a basket of stocks that make up the KLCI at a future date. However, upon expiry on the last business day of the contract month, no physical delivery takes place as the contract specification provides for settlement on a cash basis. The final settlement value is derived from the average value of the KLCI for the last half hour of trading on the final trading day.

Market participants can use the FKLI for trading, hedging and arbitraging strategies. The FKLI prices are determined by market supply and demand, with Bursa Malaysia Derivatives Berhad providing the marketplace for buyers and sellers to come together and trade.

The FKLI contract multiplier was reduced from RM100 to RM50 in September 2003. This modification facilitated retail investors' access to the FKLI market by lowering the margin requirement and break-even point.

What is OKLI?

The OKLI, which was introduced in December 2000, is a contract which gives the holder the right, without the obligation, to buy (Call) or sell (Put), the KLCI at a specified price on a specific future date.

An OKLI Call Option gives the buyer the right, but not the obligation, to purchase the KLCI at a stipulated exercise price upon expiry of the option.

An OKLI Put Option gives the buyer the right, but not the obligation, to sell the KLCI at a stipulated exercise price upon expiry of the option.

An option buyer assumes limited risk with the prospect of unlimited rewards, while an option seller, who must perform his obligation under the options contract assumes unlimited risk in return for limited rewards.

Advantages of Equity Derivatives

The FKLI and OKLI contracts offer market participants many benefits, some of which are listed below:

- Provide a mechanism for hedging as well as reallocating risk to those more tolerant of it
- Serve as a pricing benchmark as well as a price discovery tool
- Provide information about future stock index movements
- Portfolio management for stock market participants:
  - to hedge and cross hedge against price risk
  - to arbitrage when the opportunity arises
  - to speculate for profits
  - to earn additional income during quiet market conditions (this refers to options)
  - to allocate assets without having to sell the underlying.

Reasons to Trade Equity Derivatives

- Traded on the highly cost-effective and efficient electronic trading platform, in a transparent and liquid derivatives market
- Excellent hedging instrument for institutional users that hold a sizeable portfolio of Malaysian stocks
- Take advantage of the leverage factor by holding a much larger position with a small amount of funds
- Profit from various combination strategies with stock portfolio, derivatives and options.

Users of Equity Derivatives

Institutional Users

Institutional users such as fund managers, insurance companies, financial institutions and large companies are among the most active users of the underlying market. Equity derivatives greatly assist them in risk management and diversification of their portfolios.

Hedgers

Market participants who employ certain strategies in the derivatives market to minimise their risk exposure in the underlying market.

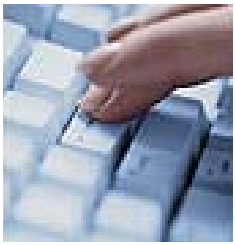
Arbitrageurs/Basis Traders

The arbitrageurs' primary purpose is to trade both the underlying and derivatives market in tandem to capture any temporary price distortions between the 2 markets. They use derivatives and the cash market in tandem to secure virtually risk-free profits in an inefficient marketplace.

Local Members and Retailers

These are individual investors or traders who assume risk in return for trading profits. They are an important group of liquidity providers.

WHY USE EQUITY DERIVATIVES?



The following is a summary of the principal uses of equity derivatives:

- **To hedge a stock portfolio**

  An insurance company or fund manager with a portfolio of stocks will sell the FKLI against its portfolio or use options to protect itself against a decline in their value caused by a falling stock market

- **A temporary substitute for holding physical stocks**

  An institution, which is in a tight cash flow situation and is unable to obtain the physical stocks now, could buy equity derivatives as a temporary substitute for holding stocks until it has the available funds. The derivatives position would then be liquidated once the stocks are acquired

- **Directional trade**

  Traders benefit from low transaction costs, ease of opening and closing positions, narrow bid/ask spreads, transparent pricing and the ability to sell the contract first in a bearish market. High liquidity, volatility and a tendency to trend provide opportunities for generating trading profits

- **Arbitrage transactions**

  During periods when derivatives are trading above or below their theoretical "fair value", it is possible to undertake arbitrage strategies by buying or selling the derivatives and simultaneously selling or purchasing the underlying stock(s). The arbitrage can then be held to expiry or reversed prior to maturity, once the pricing anomaly has been corrected.

EXAMPLES OF TRADING STRATEGIES

Scenario 1

A fund manager has RM20 million invested in the local stock market. To protect against a fall in the stock index and subsequent drop in the value of his stock portfolio, he can hedge by selling the FKLI, selling an OKLI call option or buying an OKLI put option.

Scenario 2

A company has RM15 million in deposits maturing in 3 weeks' time. Their financial controller wants to change investment strategy and invest this amount in the local stock market. However, he is afraid that the local stock market would have risen by the time he gets the money. In order to "fix" the buying price today, the company executes an anticipatory hedge and buys the FKLI. Once the money to buy the actual stocks has been released, it can close out its derivatives position and buy equities.

Scenario 3

A trader realises that the FKLI has been trading at a huge premium to the stock market. He decides to arbitrage by selling the derivatives and buying component stocks of the KLCI. By doing so, he has "locked in" his profits and can close out his positions once the gap between both markets return to normal.

Scenario 4

An institutional investor believes that the local stock market will be trading within a tight range for the next few weeks. In order to generate more profits from his current stock portfolio, he could sell a put and call at the same exercise price (Strategy: Sell Straddle). If he believes that the market will fluctuate within a broader range, he can sell the put at a lower exercise price and sell the call at a higher exercise price. (Strategy: Sell Strangle).

Scenario 5

The FKLI and OKLI contracts could also provide trading opportunities for those who simply wish to take a view on the direction of the local stock market. The leverage offered by the derivatives market means that large percentage returns can be realised through accurate forecasting of upward or downward trends.

Some Practical Examples

Trading the FKLI

Investor Z thinks that the local stock market will fall in line with the overall negative outlook on regional markets. He wants to use this situation to his advantage and decides to enter the FKLI market.

The following table shows his trading strategy and the outcome:

Situation	Action	Profit/Loss Profile
April 22 KLCI Level 900.00	Sells 5 lots FKLI Contracts at 900.00	Value: RM225,000 *
April 30 KLCI Level 880.00	Buys 5 FKLI Contracts at 870.00	Value: RM217,500
Profit/Loss		5 x (900.00-870.00) x RM50 = RM7,500 (Profit)

Assumption: Transaction costs not taken into account.

*The formula for calculation of contract value:

Value = No. of lots x Index Price x Value per lot (1 lot = RM50)

Value = 5 lots x 900.00 x RM50 = RM225,000

Trading the OKLI

Buyer of a Call option	Seller of a Call option
Situation	
Trader A thinks that the KLCI market is currently bullish. Assumes Options market will trade above 825.00 points.	Retailer B predicts that the KLCI market is slightly bullish but will not exceed 825.00 points.
Strategy	
Trader A intends to buy at 800.00 points (also known as the strike price). He is willing to pay a premium of 25.00. (Total cost = 25 x RM100 = RM2,500).	Offer made by Trader A suits Retailer B. Retailer B sells (or writes) an OKLI option at 800.00 points and receives RM2,500 upfront.
(A) If market expires ABOVE 825.00 points at month end	
Trader A would then be making a gain. This theoretically suggests that his profit potential is unlimited as the market could trade higher • He has the right to buy at 800.00 points • Cost = RM2,500 (premium paid) • Break-even target = Strike price + premium 800.00 + 25.00 = 825.00	Retailer B would then be making a loss based on how the market gains after passing the 825.00 mark. Theoretically, the loss potential is unlimited • Must comply with buyer's wish to buy thus obligated to sell at 800.00 points • Premium received = RM2,500
(B) If market expires BETWEEN 800.00–825.00 points.	
Trader A would only be able to cover part of his premium paid when he exercises his call at 800.00 points • The right to buy at 800.00 points • Cost = RM2,500 • Assuming OKLI expires at 810.00 points (10 point profit, or RM1,000) • (Premium - Profit) = Net loss (RM2,500 - RM1,000) = RM1,500	Retailer B would be earning part of the premium paid when Trader A exercises his right to buy at 800.00 points • Must comply with buyer's wishes to buy, i.e., obligated to sell • RM 2,500 (premium received) – RM1,000 (Trader A exercises option to buy) • Net gain = RM1,500

Buyer of a Call option	Seller of a Call option
(C) If market expires **BELOW** 800.00 points at month's end	
Trader A would be suffering a maximum loss of RM2,500 because of the premium paid to Retailer B, At this level, he would not want to exercise his “right to buy" because he will be buying at 800.00 points when the market is below that level.	Retailer B woud be enjoying a maximum profit of RM2,500 from the premium paid upfront by Trader A.

Trading Strategies at a Glance

User	Strategy	Application
Institutional investors & Retail investors	● Hedging	● Long stocks/sell derivatives ● Buy/sell options
	● Investing future cash	● Buy derivatives (sell when stock is bought)
	● Change asset allocation	● E.g., Sell bond derivatives buy stock index derivatives
	● Directional trade	● Buy/sell derivatives

CONTRACT SPECIFICATIONS

KLCI Futures

Contract Code	:	FKLI
Underlying Instrument	:	Kuala Lumpur Composite Index (KLCI)
Contract Size	:	KLCI multiplied by RM50.00 Contract Value = Price x Contract Multiplier
Minimum Price Fluctuation	:	0.5 FKLI index point valued at RM25.00
Contract Months	:	Spot month, the next month, and the next 2 calendar quarterly months. The calendar quarterly months are March, June, September and December.
Trading Hours	:	First trading session: Malaysian time: 08:45 a.m. to 12:45 p.m. Second trading session: Malaysian time: 2:30 p.m. to 5:15 p.m.
Daily Price Limits	:	20% per trading session for the respective Contract Months except the spot month contract. There shall be no price limits for the spot month contract. There will be no price limit for the second month contract for the final 5 business days before expiration.
Speculative Position Limit	:	10,000 contracts, net gross open position
Final Trading Day	:	The last Business Day of the Contract Month.
Final Settlement	:	Cash Settlement based on the Final Settlement Value.

Final Settlement Value	:	The Final Settlement Value shall be the average value, rounded to the nearest 0.5 of an index point (values of 0.25 or 0.75 and above being rounded upwards) of the KLCI for the last half hour of trading on Bursa Malaysia Securities Berhad on the Final Trading Day excepting the highest and lowest values.

CONTRACT SPECIFICATIONS

KLCI Options

Contract Code	:	Calls; C OKLI Puts; P OKLI
Underlying Instrument	:	Kuala Lumpur Composite Index (KLCI)
Contract Size	:	KLCI multiplied by RM100.00 Contract Value = Price x Contract Multiplier
Minimum Price Fluctuation	:	0.1 OKLI index point valued at RM10.00
Contract Months	:	Spot month, the next month, and the next 2 calendar quarterly months. The calendar quarterly months are March, June, September and December.
Trading Hours	:	First trading session: Malaysian time: 08:45 a.m. to 12:45 p.m. Second trading session: Malaysian time: 2:30 p.m. to 5:15 p.m.
Exercise Price Interval	:	20 index point intervals for the spot and next month. 40 index points interval for the next nearest 2 quarters.
Option Series	:	At the start of daily trading, there shall be at least an In-the-Money Exercise Price, an Out-of-the-Money Exercise Price, and an approximate At-the-Money Exercise Price for each contract month of both the Call Options and Put Options. A new option series will not be introduced if it would expire in less than 10 Business Days before the Expiration Date.
Exercise	:	European style exercise. Options shall be exercised in accordance with the rules of the Clearing House.

Final Trading Day	:	The last Business Day of the Contract Month.
Final Settlement	:	Cash Settlement based on the Final Settlement Value.
Final Settlement Value	:	The Final Settlement Value shall be the average value, rounded upwards or downwards to 1 decimal point (0.05 being rounded upwards) of the KLCI for the last half hour of trading on Bursa Malaysia Securities Berhad on the Final Trading Day excepting the highest and lowest values.

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FUTURES AND OPTIONS TRADING INVOLVES RISK. THEREFORE, KNOW THE RISKS BEFORE YOU TRADE.

The Business Rules of Bursa Malaysia Derivatives Berhad supersedes all matters pertaining to derivatives contracts. The current Business Rules of Bursa Malaysia Derivatives Berhad should be referred to concerning trading related issues. Please note that contract specifications of each product is subject to change from time to time.

Please contact your broker or Bursa Malaysia Derivatives Berhad concerning current contract specifications.

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