Part 2:

The Fundamentals of Futures Markets

This is the second in a six-article series on how to trade futures, brought to you by Bursa Malaysia Derivatives Berhad (BMD) and OSK Investment Bank Berhad, in conjunction with BMD's 'Talk Futures' campaign aimed at creating awareness and educating investors on derivatives trading.

In the last segment we discussed the origins of Futures markets, now let's see how they basically work.

So what are futures again? Futures are derivatives in which the value depends on the underlying asset it is derived from. For example, the value of Gold futures will depend on the price of Gold (gold here is the underlying asset) itself. It is said to mirror the real price of a certain commodity and many players also use Futures as a prediction of where the price of the actual commodity will be heading to.

Certainly the price movement of a futures contract correlates with the price movement of its underlying asset. In other words, generally when the price of Gold increases in value, so will the Gold futures.

A futures contract can be described as an agreement set between two parties in which one party, the buyer, agrees to buy from another party, the seller, an underlying asset at a future date at a price that both parties agreed on today.

An underlying asset can be defined as the asset on which the price of a derivative, in this case the futures contract, depends on.

For example, let's say Dorian decides to have McDonald's delivery for lunch and he called the toll free line to place his orders. The order he made to McDonald's is similar to a futures contract. This is because Dorian (the buyer) has agreed to receive a product (burgers and fries) at a future time period (40 minutes later), with the price (price of his meal) and terms of delivery (his provided address) which already set with the seller beforehand, in this case with McDonald's.

Should McDonald's decide to increase the price of their burgers and fries within the next 40 minutes, although it will likely never happen, Dorian has locked in a lower price for his meal and will not have the risk of paying the difference of the increment. Bear in mind that futures are not as simple, this example illustrates futures with as little technical complexity as possible. We should get into what the basis of futures really is before going into the deeper waters.

It is important to remember that a futures contract is an obligation to buy or sell an underlying asset, normally a commodity, at some time in the future, at a price fixed upon today. This obligation must be fulfilled by the contracting individuals. It means that the buyer/seller is obliged to exercise the terms of the contract at its expiry date unless it is offset. This can be done by making an offsetting trade position from the one that the individual is originally in.

For example, let's say John bought a futures contract. To fulfill the obligation, John can simply offset his position by selling what he bought.

Although at times there are individuals that may choose to hold their position until the date of delivery. Albeit rare, but if that happens, the contract needs to be settled either with a cash settlement or an actual delivery of the physical commodity (or the underlying asset) by the exchange. As an example, if Melissa decided to hold her palm oil futures contract until delivery date, she will then need to find a way to store the palm oil that will be delivered physically to her doorsteps after the date of delivery. She is bound to accept the palm oil as stated in the contract.

It is important to know that when the word "commodities" are mentioned in futures, it can be defined very broadly. Commodities in futures may include physical commodities, financial instruments, and foreign exchange and stock indexes.

Most futures contracts however, are not physically delivered. That being said, if the contract is not closed-out before the date of expiry, the holder of the futures contract will pay or receive an amount of money equal to the difference in value of the contract from when it was opened to the final settlement price. This is called cash settlement.

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Although these scenarios could happen, bear in mind that most futures contract holders will close out their contract before the expiry date by taking an offsetting position as mentioned above.

In the next part of the series, we will cover who are the main players in the Futures markets and their roles in the market.