Part 6: Equities & Index Futures – A Great Marriage For Rocky Times

This is the last 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.

Index Futures Markets have been a boon for savvy professional as well as individual investors who know how to utilize these contracts for their equity portfolios. This is very true when Index Futures is used to hedge the market risk of holding equities especially in bearish or uncertain market conditions.

There are various ways one could use the Index Futures market in combination with a basket of equities to reduce or eliminate the downside market risk, and below we will illustrate a few popular strategies for accomplishing that.

Take for example if you had a basket of blue chip stocks in the Malaysian stock market; in a bearish market you have the option of selling the stocks or using Index Futures contracts to remove the downside risk. Most times for a long term investor holding a portfolio of stocks for long term capital appreciation or for dividend yields, selling stocks is not an option. Other reasons could be that the investor is holding a large position in stocks and selling them would have deleterious effect on the stock price.

The sensible way for a savvy investor is to hedge the risk during the downturn. Here is how it can be done; assuming his portfolio of stocks is worth RM300,000, Kuala Lumpur Composite Index at 1495 and September KLCI Futures is trading at 1500. He would need to sell an equivalent value in the Index Futures to offset his stock holdings. In the case of Bursa Malaysia Kuala Lumpur Composite Index Futures, this will mean selling approximately four futures contracts (4 contracts x 1500 X RM50 multiplier) worth a notional value of RM300,000.

Let's see how this Strategy works out:

If the stock market drops 10%:-

Portfolio of stocks value – RM270, 000 with a loss of RM30, 000

September Futures trades say @ 1350; Index Futures gain = (4 contracts x 150 points x RM50 multiplier) RM30, 000.

Combination of both Stocks and Futures return will yield a zero loss situation. The amount that was lost in stocks when the market dropped was offset by the gain of selling futures.

The above is an ideal hedging example where the portfolio and the futures tracked perfectly. In the real world there is a possibility of slight differences in the profit/ loss of the hedge depending on the ratios of how many contracts is hedged against the stock value as well as the correlations (Beta) between the stock portfolio and the broader index. However one can see from the above simple example of the distinct advantage of using Index Futures to protect a stock portfolio. In a nutshell to hedge your stock portfolio one has to take an opposite position in the Index Futures market.

There are many other combinations available to combine Index Futures with your equity portfolio for different purpose. For example by adding futures one can decrease the volatility of the portfolio. Alternatively one could increase the responsiveness or Beta of your portfolio in a Bull market to take advantage of the uptrend. All these wonderful combinations can be advised by your Futures broker who deals in Index Futures and they will be glad to work out the strategies that best suit your requirements.