Futures and Options

Study Exercise 1 before reading the following text:

Contracts can be made on futures markets to buy and sell currencies, various financial assets, and commodities (raw materials or primary products such as metals, cereals, tea, rubber, etc.) at a future date, but with the price fixed at the time of the deal. Currencies and commodities are also traded for immediate delivery on spot markets. Making contracts to buy or sell a commodity or financial instrument at a pre-arranged price in the future as a protection against price changes is known as hedging. Of course, this is only possible if two parties, for example, a producer and a buyer, both want to hedge, or if there are speculators who believe that they know better than the market.

Traders or speculators might wish to buy or sell a currency at a future price if it is expected to appreciate or depreciate, or if interest rates are expected to change. Prices of foodstuffs – wheat, maize, coffee, tea, sugar, cocoa, orange juice, pork bellies, etc. – are frequently affected by droughts, floods and other extreme weather conditions, which is why both producers and buyers often prefer to hedge, so as to guarantee next season's prices. When commodity prices are expected to rise, future prices are obviously higher than, or at a premium on, spot prices; when they are expected to fall they are at a discount on spot prices; when they are expected to stay the same, future prices are also higher, as they include interest costs.

As well as commodities and currencies, there is a growing futures market in stocks and shares. One can buy options giving the right to buy and sell securities at a fixed price in the future. A call option gives its holder the right but not the obligation to buy securities or a commodity or currency at a certain price during a certain period of time. A put option gives its holder the right to sell securities, currencies, commodities, etc. at a certain price during a certain period of time.

The buyer of a share option pays a premium per share to the seller, and only risks this amount. The seller of an option (known as the writer) risks losing an unlimited amount of money, depending on the performance of the underlying share, especially if he or she does not actually possess it. If you expect the value of a share that you own to fall below its current price, you can buy a put option at this price (or higher): if the price falls, you can still sell your shares at this price. Alternatively, you could write a call option giving someone else the right to buy the share at the current price: if the market price remains below this price, no-one will take up the option, and you earn the premium.

On the contrary, if you think a share will rise, you can buy a call option giving the right to buy at the current price, hoping to buy and resell the share at a profit, or to sell this option. Or you can write a put option giving someone else the right to sell the shares at the current price: if the market price remains above this, no-one will exercise the option, so you earn the premium.

The price at which the holder of a call/put option may buy/sell the underlying security is known as its exercise or strike price. A call (put) option has intrinsic value if its exercise price is below (above) the current market price of the underlying share. Call options with an exercise price below the underlying share's current market price, and put options with an exercise price above the share's market price, are described as being "in-the-money". On the contrary, call options with an exercise price higher than a share's current market price, and put options with an exercise price lower than the share's market price, are "out-of-the-money".

EXERCISE 1

Decide whether the following statements are TRUE or FALSE:

1. The price of a futures contract is determined at the moment the contract is made. TRUE/FALSE
2. Hedging is another name for speculating. TRUE/FALSE
3. Futures prices are always higher than spot prices, because they contain interest charges. TRUE/FALSE
4. In options, 'call' means 'buy' and 'put' means 'sell'. TRUE/FALSE
5. The amount of money one can make or lose on an options contract is determined at the moment the contract is made. TRUE/FALSE
6. You can sell an option to sell an asset you do not actually possess. TRUE/FALSE
7. If you think a share will rise, you can profit by buying a call option or writing a put option giving someone else the right to sell the shares at the current price. TRUE/FALSE
8. If you think the value of a share you own will fall below its current price, you can profitably buy a call option at this price (or higher) or write a put option. TRUE/FALSE
9. A put option has intrinsic value if its exercise price is above the current market price of the underlying share. TRUE/FALSE
10. A call option with an exercise price below the underlying share's current market price is "out-of-the-money". TRUE/FALSE

EXERCISE 2

Match up the following words (using them more than once if necessary) to make up at least ten two-word nouns:

call	contract	financial	forward	futures
instrument	market	materials	option	price
primary	product	raw	spot	strike

EXERCISE 3

Match up the following words or expressions to make eight pairs of opposites:

call option	discount	drought	exercise price
flood	futures market	hedging	in-the-money
market price	obligation	out-of-the-money	premium
put option	right	speculation	spot market

Fill in the blanks using the words from the box below:

contracts determined hedge speculative dependent market indexes derived merely swaps

Derivative - in finance, a security whose price is 1. ______________ on or 2.______________ from one or more underlying assets. The derivative itself is 3.______________ a contract between two or more parties. Its value is 4.______________ by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and 5.______________. Futures contracts, forward contracts, options and 6. ______________ are the most common types of derivatives. Because derivatives are just 7.______________, just about anything can be used as an underlying asset. There are even derivatives based on weather data, such as the amount of rain or the number of sunny days in a particular region. Derivatives are generally used to 8. ______________ risk, but can also be used for 9. ______________ purposes.

NOTE:

The difference between **futures** and **forwards** is that futures are *standardized deals* and forwards are *individual ´over-the-counter´* agreements between two parties.

The risk with currency and interest rate swaps is that the exchange and interest rates may change unfavourably.

CB 92/Discussion

Complete the gaps using the words that will fit the context.

1 If the price of cocoa does change before the date of the …………………………. contract, wither the producer or the buyer will have lost money by signing the contract.

2 The company could try to arrange an interest rate ………………………….with a company with ………………………….rate debt that expected interest rates to rise.

3 Such an investor can buy a ………………………….option giving the right to ………………………….the stock in the future at the current market price.

4 Such an investor can buy a ………………………….option giving the right to ………………………….the stock in the future at the current market price.

5 "…………………………." is the situation when one party´s gains are equal to the other party´s losses, e.g futures, options and swaps. In contrast, "…………………………." are mutually beneficial such as negotiations and business partnerships.