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Index Futures

An index future is a future where the underlying asset is a stock index. The NSE stock index (CNX Nifty) was launched on 12 June 2000. It has been observed that investors like to hedge their entire share portfolio and not just one or two stocks. A portfolio of 10 to 15 stocks tends to have a strong correlation with the indices. Index futures may be:

- Value-weighted (consists of each stock of the index value in proportion to the market value of the outstanding shares) Ex: S&P 500, NYSE
- Price-weighted (is the one that gives a weight to each stock that is proportional to its stock price) Ex: NIKKEI

In a value-weighted index, all blue chips with heavy market capitalization have more weight, whereas in price-weighted index, a small equity company can also have major weight based on its price.

Trading and Settlement

Index futures are standardized like all futures. The size and the tenure of these futures need to be understood. The size represents the minimum quantity of the index that is bought or sold - trading lots are in multiples of this number. The tenure is the minimum duration for which a futures contract can remain open. At the end of the period, both of the parties to the contract necessarily settle. Settlement is in cash, and obviously the seller of the index future does not deliver the underlying securities of an index.

Index futures and SEBI

SEBI has specified the minimum size of 2 lakh and a maximum tenure of three months. Given the current Nifty and Sensex levels, futures contracts based on these will have a minimum market lot of 150 and 50.

Advantage

Index futures help an investor to take a position on the market and also hedge the share portfolio against adverse market conditions. One can get out of the futures position anytime before the contract expires by entering into a reverse contract

How does it work?

An Index future is essentially a forward contract and hence requires payment of an initial amount, called the upfront or initial margin, equal to 6 to 10 percent of the value of the contract. They are marked to market daily, i.e. profits and losses are received and paid out by the contracting parties every day.

For example, an investor may be optimistic that the Nifty will rise in the future. He buys 100 Nifty futures, paying an initial margin of 7%. At the time he sells, he gains if the Nifty rises. His profit is the difference between the selling price and the buying price (margin) multiplied by the number of futures purchased.