Standard

| SSFs |

What is single stock futures?

Attractive option for those looking to outperform broad market

SINGLE STOCK FUTURES (SSFS) aren't for the faint-hearted. However, they do give traders a mechanism to exploit any market movement – up or down – by going long (buying when you believe a share price will increase) or short (selling where you believe a specific share price will fall). Shorting can be used to hedge a portfolio, or profit from a falling market.

Kurt Pagel, head of futures trading at the Standard's Online Share Trading, says that SSFs fit the profile of high risk/high reward. In theory, more risk can bring more reward, which is why SSFs are attractive to those looking to outperform the broad market. Remember that high risk also implies that losses can also be substantial.

An SSF is a derivative whose value is determined by the movements of the underlying share, which has to be delivered if the contract is allowed to expire.

An SSF is a contract to trade 100 shares in a specific JSE-listed share. The contract specifies the underlying share, the price it will trade at and the date on which the futures trade is to take place (known as the expiry date). The contract terms are standard for all SSFs and prescribed by the JSE.

As SSFs are traded on an exchange there's limited counter-party risk, as the exchange becomes the counter-party to every trade. (Counter-party risk is the risk that the other party selling you the SSF or buying the SSF from you won't commit to their side of the trade.) The JSE determines the expiry dates for all SSFs – set as the third Thursday of March, June, September and December.

SSFs have five main uses: to hedge risk, to speculate, to invest, to engage in arbitrage and to provide liquidity.

- **HEDGING RISK:**
  Investopedia.com defines a hedge as: "Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract. An example of a hedge would be if you owned a stock then sold a futures contract stating that you will sell your stock at a set price, thereby avoiding market fluctuations.
  "Investors use this strategy when they are unsure of what the market will do. A perfect hedge reduces your risk to nothing (except for the cost of the hedge)."
  Standard Bank says hedging helps to "reduce the exposure to the market while avoiding the transaction costs of selling the shares and lock in the return on the underlying shares without having to sell them".

- **SPECULATE:**
  SSFs provide a cost-effective and leveraged way to benefit from anticipated share price movements.

High risk also implies that losses can also be substantial.

- **INVEST:**
  Investors – who tend to have longer investment horizons than speculators – can use SSFs to establish a "synthetic" position in a share. That means the investor can benefit from share price movements without incurring the full capital outlay.

- **ENGAGE IN ARBITRAGE:**
  Standard Bank says that arbitrage is aimed at making profits without taking on any risk. "The idea is to buy shares that are underpriced in one market while selling (shorting) the same shares that are overpriced in a different market. Whichever way the market moves, the technique, if implemented correctly, results in a profit. The usefulness of SSFs in that strategy is found in the heavy gearing, which amplifies the effect of price corrections when they come."

- **PROVIDE LIQUIDITY**
  Though the liquidity (or tradability) of the SSF does depend on the liquidity of the underlying share, the issuers have undertaken to provide both buying and selling prices at all times. Good liquidity is vital for the market to function effectively.

SSFs provide five key advantages over investing directly into the underlying shares. First, they offer gearing on money. That means an investor's actual exposure to the price movement of the underlying share is many times that of the actual value of the investment, as the initial margin (deposit placed with the JSE to cover the higher risk) is usually 10% to 25% of the full contract value. But the trader's exposure is to the full contract value, so he actually earns the return on the total value of shares that the futures contract covers.

However, gearing can be a double-edged sword and can increase losses as well as profits. Consequently, stop-losses should always be used when trading SSFs.

Second, investors avoid many of the costs of actually trading in the underlying shares as they don't have the complication of borrowing stock for settlement – the case if you short a share directly.

The third benefit of investing in SSFs is that you can reduce the risk of your share portfolio by using them to sell a share posi-

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tion short without having to sell the actual shares.

Fourth, SSFs allow you to engage in "pairs trading" where you go long on a share in a sector that you believe will outperform and sell short on another in the same sector that you believe will underperform.

Fifth, either long or short trades can be executed simply and cost-effectively. Standard Bank estimates that an SSF costs 0,42% of the total rand value of the exposure, compared with 1,06% when you buy the underlying shares directly.

It's important to remember that you never need to fulfil your obligations in terms of delivering the underlying shares to settle an SSF contract. The investor can close out or wind up the SSF position at any time before the expiry date. At the same time, you can take out contracts for the same position for a later expiry date. ¤

The risks of investing in SSFs

WITH HIGHER RISK comes the possibility of higher reward – which is just one reason why single stock futures (SSFs) should be considered as part of an investment strategy.

However, Kurt Pagel – head of futures trading at the Standard's Online Share Trading – says that though SSFs have a higher risk profile, they don't have to be risky investments if properly managed.

There are two key sources of risk in SSFs: their geared nature and corporate actions. Standard Bank says: "The main risk associated with SSF trading is attributable to the effect that gearing has on the SSF position. Gearing can cause significant losses over a short period of time on an SSF position, as the effect of any losses on the underlying share can be up to 10 times more on the SSF. Even though leverage is also referred to as a benefit, the risk is equal and opposite to any profit that can be earned from an SSF trade."

Novice SSF traders need to remember that there's no limit to their loss – unlike warrants, instalment shares or equities – and they'll be required to top up their initial margin in a loss-making position.

The second key risk of SSFs is that corporate actions (such as a takeover, capital reduction, rights issue, share buyback, share conversion, cash or scrip dividend, share redemption, merger or acquisition) could change the benefits that shareholders receive for each share they own. That in turn may affect the price and/or quantity of an SSF position. SSF holders should ascertain the effect – if any – of a corporate action before the Last-Day-to-Trade of the event.

The main risk associated with SSF trading is attributable to the effect that gearing has on the SSF position.

As a side note, special dividends and capital reductions aren't part of SSF pricing, so the JSE manages their effect on the SSF quantity held by a factor of the underlying price to the special dividend or capital reduction.

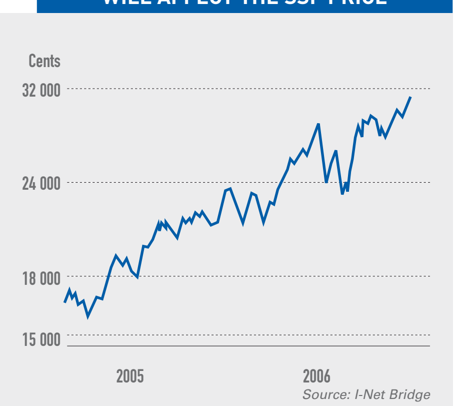
Pagel has some tips to manage the risks of investing in SSFs. First, he advises traders in SSFs to trade those futures where they know and understand the underlying share and what drives its price movements. Pagel says that buying (or selling) the futures contract only adds gearing to the equation – the real driver of returns is the underlying share. He advises trading what you know, thus reducing the risk of the trade.

The second piece of advice is that you should actively manage your portfolio more regularly than you would an ordinary share portfolio. That means monitoring your positions at several intervals daily.

Lastly, Pagel says all SSF traders should use stop-losses to limit their downside.

In conclusion, Pagel says that investing in SSFs isn't a gamble, as the risk can be managed using the strategies outlined above. It's up to each individual investor to ensure he retains that control. ¤

ANGLO AMERICAN - SHARE PRICE WILL AFFECT THE SSF PRICE



Source: I-Net Bridge

Pricing SSFs

IN A NUTSHELL, there are four main variables that affect the pricing of Single Stock Futures (SSFs).

- **THE UNDERLYING SHARE PRICE:** The share price of the underlying share is the main determinant of the price of the SSF. Both the commission and interest rate use that as their calculation base.

- **INTEREST:** Interest is calculated on the value of the underlying share exposure for the remaining term of the contract.

- **DIVIDENDS:** Long SSF positions don't earn ordinary dividends and short SSF positions aren't liable to pay ordinary dividends, thus the SSF bid and offer prices are adjusted accordingly to compensate the holder of the SSF position. However, the dividends priced into the SSF contract are only estimates of what the company will actually pay, based on the company's dividend history.

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From time to time the assumption may change or the actual ordinary dividend that's declared may differ from the amount used in the SSF price calculation. Dividend protection calculations will be made, with the difference either debited or credited against the trading cash amount of the client.

- **COMMISSION:** Commission is charged as a percentage of the underlying trade. ¤

SSF trading tools

ONLINE SHARE TRADING from the Standard is the only broker to offer a full online trading service for single stock futures. It offers a number of educational and trading tools that will help you master SSF trading.

On the education side, Online Share Trading offers free education seminars to all its clients, which cover the basics of SSFs. It has also published an online SSF brochure, which is available at www.securities.co.za.

Online Share Trading offers tools that will help you both monitor the relevant SSF prices and implement and execute stop-losses.

First, it offers SMS alerts to all its SSF account holders. Those SMS alerts will flag market movements and let you know if your account's cash balance is reducing.

Second, it offers a stop-loss trigger that will automatically execute stop losses. In a fixed price trigger the investor sets the price to close out the position. Though Online Share Trading can't guarantee that the trade will be executed at that price, it will attempt to do so at the best available price.

Visit Online Share Trading for more info on SSFs.

A trailing stop-loss trigger increases in line with the SSF price and will be triggered as soon as the price falls a certain predetermined level from the peak. That means the trader will exit the position at a profit rather than the loss incurred if the stop-loss remained at a specific level.

In addition, Online Share Trading provides an automatic close out to protect the account holder and prevent the trading account from becoming overdrawn. All positions will be automatically closed out if:

- The mark-to-market value of all positions at any time during the trading day is a loss and that loss is greater than the sum of the available trade balance (prior to that loss) and the additional margin required by Online Share Trading.
- At 14:00 two business days prior to the expiry of an SSF contract if the holder hasn't elected to roll the SSF into a longer-dated contract.
- Online Share Trading also offers a cost-effective way to trade SSFs. It charges a flat brokerage rate of R89/trade plus VAT and a market maker's commission of 0,4% of the underlying exposure. (That commission is already included in the SSF bid or offer price.) No UST, Strate or Investor Protection Levy fees are paid on SSFs. ¤

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What's the term used to describe a contract to trade 100 shares in a specific JSE-listed share? The contract specifies the underlying share, the price at which it will trade and the date on which the futures trade is to take place.
2. What are the two key sources of risk in SSFs?
3. Which is the only broker to offer a full online futures trading service? ¤

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