STOCK FUTURES: A SCINTILLA OF HOPE ?

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With the introduction of derivatives, there was a hope among the investors which soon disappeared as index futures and options failed to titillate the market. With the arrival of stock futures, the volume trading in derivatives is increasing day by day. This paper is an attempt at analysing the reasons of popularity of stock futures in the light of investors' perception and recent changes in capital markets in India.

I. INTRODUCTION

With the ban on *badla,* the market whose domain has been speculation was striving for some surrogate, a deferral product, which could fill this gap in stock market and be on driver's seat to catch the carry forward system. The market found its ambrosia in stock futures, which displayed the potential to rake the *moolahs.*

Stock futures saw the light of the day in India on November 9, 2001. To everyone's surprise the turnover in stock futures on both the BSE & NSE brimmed the turnover in other derivative instruments. With the introduction of stock futures late in the last year, the market has stopped making demand for *badla.*

The presence of stock futures and options has been able to provide choices to investors in the Indian derivatives market. Now Indian markets also possess a handsome gamut of exchange traded equity derivatives which have provided liquidity as well as depth to indigenous market.

Derivatives have been present in Indian market for approximately two years now (in June 2000, Index futures were introduced as first exchange traded equity derivative product in the Indian stock market) but the volumes in the derivatives segment have grown at a phenomenal pace only in the past few months, particularly after the launch of stock futures and options. The figures in the derivative markets confirm the above statement. The derivatives volume in the month of October 2001 was Rs 5477 cr., which increased to Rs 12,919 cr., in December 2001 and crossed more than Rs.20,000 cr. a month in the current year. Also, stock futures account for more than 65% of the daily volumes traded and interestingly volumes are still growing.

The average daily volume in stock futures in terms of number of contracts being traded on NSE is the second highest next only to Spain. Among the Asian markets, only Hong Kong and

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India currently are offering stock futures as exchange traded equity derivative product. The other markets, including Singapore have not yet introduced this product (though Singapore and Hong Kong are the largest derivatives market in Asia] due to the instrument being inherently riskier than other derivative products. Then, why is it that the Indian market not only has lapped up this product, but also is visualizing it as potential blockbuster or behemoth in the making?

II. DERIVATIVES, FUTURES, AND STOCK FUTURES

To know this, one is required to have understanding of stock futures and more basically of derivatives as such. *Derivatives* are financial contracts whose pay off structure is arrived at by analyzing the value of one or more *underlying*, which can be a commodity, security, share price index, interest rate, exchange rate, oil price, or the like. Worldwide the most successful equity derivative contracts are index futures, followed by index options and security options.

Futures are exchange traded standardized contracts to sell or buy, a stipulated quantity (or quality, where applicable) of one or more underlying such as currency, commodity, security, index, or some other specified item at predetermined price on or before a stated date in future. These contracts are traded on commodity exchanges and on other futures exchanges. Investors can buy and sell futures like any other commodity. When an investor buys a future contract he assumes *long position* and possesses right as well as obligation of taking delivery of stated underlying item. Similarly, when an investor sells a contract, he takes a *short position*, and assumes a right and obligation to deliver the underlying at a stipulated date. *Index futures* are future contracts where the underlying item is cash or stock market index, for example, index futures based over NSE nifty or BSE sensex.

Stock futures are future contracts where the underlying asset is stock of individual company. For example, stock futures can be drawn upon shares of Satyam, Infosys, Reliance, etc. and hence the underlying security in this case would be the shares of these companies. Now the question arises as to what makes these ordinary looking instruments so special. And, what are the factors due to which this instrument has got overwhelming response in India?

III. SPECIALITY, POPULARITY, AND DOWNSIDE OF STOCK FUTURES

To start with, stock futures, to the ease of investors, require the same skills as directly trading shares in the stock market do, which is not true for other index based futures and options. Being a deferral product it allows carry forward of positions which demand a thorough understanding of nuances of their use. The Indian markets are well acquainted to deferral products due to the *badla* system in the past.

Derivatives, being risky instruments, require the establishment of very good surveillance and monitoring system. According to market participants, the measures of risk management are adequate in India. Our country has developed adequate systems to ensure real time and scientific regulation, monitoring and collection of margins.

Stock futures allow trading on margins, which facilitates investors to take positions in stock for a lower investment as against the one required for the same position in cash market. It facilitates investors as with the margins players can take larger position with lower investments as compared to the cash market. The security of investment is ensured by *mark to market mechanism*. Also, stock futures provide arbitrage opportunities from mispricings.

With the lack of other instruments which can satisfy investor's needs, the popularity of the new product is obvious. Foreign futures exchanges offer a variety of products (Chicago Board of Trade offers 48 futures and options], which give a wider choice unlike in India where only 4 instruments are present in the market.

Stock futures akin to other derivatives require infrastructural and regulatory support. Fortunately, Indian markets have equipped themselves accordingly. The banking sector is promoting the electronic funds transfer facility aggressively and the details for having the securities lending and borrowing scheme are being worked out by the SEBI and exchanges in association with the market participants. SEBI and other stock exchanges are taking initiatives to popularize derivatives by conducting regular seminars and training programmes to educate investors with the environment for trading derivatives.

On the downside, stock futures are very risky in nature. Though risk is inherent in the very nature of derivatives market, stock futures in addition to normal risk contain the risk of underlying security also. This can arise due to volatility in the underlying scrip, or due to manipulation in the concerned stock. Whereas the former risk arising out of volatility cannot be controlled and would affect market in general, this is not the case with the latter risk arising out of manipulation. This type of risk can be avoided but requires strict vigilance on the part of regulatory authority, which is SEBI in the Indian context. One cannot doubt the capabilities of SEBI, but the past experience has been really sour. It is only when SEBI would take more stringent actions against the frauds and defaulters and acquires more conservative norms, one can expect the *bourses* steaming.

IV. REQUIREMENTS OF REALIZING PROMISE OF STOCK FUTURES

Despite this stock futures hold a promise. Their introduction has changed the structure and volumes of derivatives market for sure. But as per market specialists the market still lacks the depth. Barring stocks like Reliance, Satyam and Infosys;, there is not much volume in other stocks. The reasons are varied ranging from large retail investments, confusion over taxation to physical settlement of stock futures.

As per market watchers, existing portfolios of participants in stock futures market is largely retail [approximately, sixty to seventy percent of participants comprises retail investors and brokers. This reflects the absence of major institutional participation as yet. Stock futures are currently being used largely for speculation and most of the volumes can be attributed to arbitrage activities. Initially, foreign institutional investors were allowed to trade only in the index futures up to the amount of their exposure in the cash market. Now RBI has finally allowed the FIIs to participate in all exchange traded products. Despite this, the trade by FIIs account for only 3-4 % of total volumes in the segment. As such in the long run also FIIs do not hold any big promise as they lack necessary expertise.

In case of mutual funds also there were regulatory restrictions due to their guidelines requiring delivery of assets. With the lifting of such regulations one can expect big volumes from this segment too. But, for this SEBI has to be more specific as it has allowed mutual funds to trade in derivatives purely for *portfolio balancing* and *hedging*. Both of these terms are vague and the industry has been waiting for two years to get elaborations on these. Once this is done mutual funds would be able to enter in the derivatives market in a big way.

There are also some confusions over taxation, which are keeping funds and even big investors out of the derivatives market. The moot point is whether the profit and gains from derivatives market would be treated as income from other sources or capital gains for individuals or whether it should be treated as business or speculation profit for a firm.

The retail investors mainly have been deterred from derivatives due to the huge minimum lot size required. The minimum lot size is Rs. 2 lakhs for trading in this segment. Now SEBI, considering it to be a big hurdle in market development, is thinking to reduce the minimum contract size. With this the volumes in the market are sure to increase.

One of the important issues which can provide impetus to derivatives trading is physical settlement of stock futures, which was to be introduced in April but unfortunately is still pending. Physical settlement provides a mechanism for arbitrage traders to earn safe and steady returns on investments by buying stock in cash market and selling them for a premium in futures. This provides an avenue for earning safe returns. With its introduction, both cash and derivatives markets would be able to see an entry of investment portfolios rather than trading portfolios. This would be able to attract a new set of players like mutual funds that are sitting on core portfolios.

With the requirements of the players being served effectively through this instrument and SEBI's willingness to resolve the related issues in near future, stock futures seem to hold a promise.

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