FUTURES CONTRACT

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Presenting "Futures"

FUTURES CONTRACT

One of the most exotic terms in trading is “Futures”.

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Let’s say there’s is a farmer who cultivates wheat

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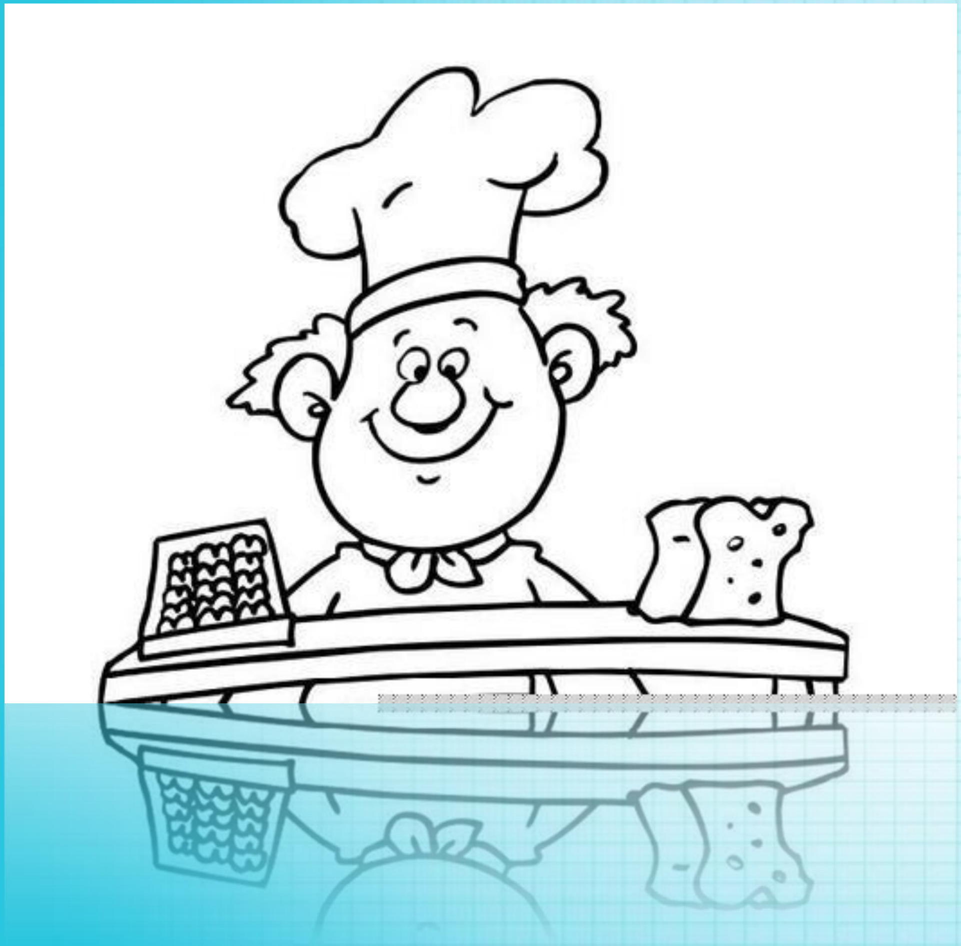
And a baker who needs

wheat as an input for making bread



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- The farmer thinks that the price of wheat which is currently trading at Rs. 100 could fall to Rs. 90 in 3 months.
- The baker on the other hand feels that the price of wheat on the other hand might become Rs. 120 in 3 months.

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- In such a case both get together and sign a contract which says that at the end of 3 months the farmer would sell wheat to the baker at Rs. 110.

  Thus the farmer is protected against possible fall in prices
- And the baker is protected against the price of his input going up beyond Rs. 110

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Such a contract is called a “Futures” contract because it is a contract that has to be executed at some future date

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Thus "Futures Trading" is nothing but having a point of view about the direction of the future price of a commodity/stocks/currency.

And when two parties have opposite views about future price movements they obviously are open to sign a mutually beneficial deal like the farmer and the baker did in our example

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Now, let's say that after 3 months the price of wheat reaches Rs 120

In this case the farmer will have to sell for Rs.110 as per the contract and undertake a opportunity loss of Rs. 10 as his call that prices would go down was not correct.

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The baker on the other hand would be happy to receive wheat at Rs 110 due to the “Futures Contract” at a time when the prevailing market price is Rs 120.

Thus he clearly makes a profit of Rs 10 because his expectation on price movement turned out to be correct.

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- However at the end of the period both parties achieve their goals of protecting their interests.
- While there may be an opportunity loss of the farmer but still he lands up making a profit of Rs. 10.
- At least he would have been at peace for the period of 3 months since he remained protected against any price fall or loss

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- **The baker on the other hand gets wheat at Rs 110 and makes a clear gain of Rs 10.**
- **He can now plan his manufacture more profitably than his competitors who would by in the market at the spot price of Rs 120**
- **Since his call was right about the price movement, he landed up making the gain of Rs 10 due to the futures contract.**

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Thus in a sense both parties landed up meeting their business objectives and the "futures contract" helped them plan their business well by protecting their interests against unpleasant price fluctuations.

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- **I hope I have been able to explain to you the so called exotic product which as you can see is a very logical protection tool for a buyer and seller of the "Futures Contract" having different views about price movements and both being keen to reduce their losses.**
- **Thus at the end one gains more and one gains less but both are happy that they could plan their business well**

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Hope this story succeeded in clarifying the concept of "Futures"

Thinking of Investment

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