Introduction to forwards and futures

Forwards and futures are agreements to buy or sell a share or bond at a fixed price on a specified date in the future. The share or bond that forms the basis of the contract is called the underlying asset. The purpose is to lock in the price of the asset, no matter how the price might change through to maturity. Forwards and futures can be used for both investment and hedging purposes.

Difference between forwards and futures:
- Futures require an initial margin and periodic margin settlement (daily).
- Forwards are only settled at maturity and do not require a margin along the way.
- Futures entail a lower counterparty risk and often better liquidity conditions than forwards.

At maturity, the contract is typically settled as physical delivery of the asset, unless you close the position early (prior to maturity).

Opportunities offered by forwards and futures!
If you expect the price of an equity or a bond to move higher, you can opt to buy a future or forward on the targeted asset.

Upon buying futures, you must provide an initial margin as well as a periodic margin, whereas forwards do not require periodic margin payments along the way.

Conversely, if you expect a price dip, you can sell a future or forward on the specific asset and make profit if the value indeed drops.

Spreads
You can combine buy and sell on two different shares:
- Buy a future/forward on the share that you expect will be the better performer.
- Sell a future/forward on the one that you expect will be the poorer performer.
- You will earn a profit, if the purchased share performs better, in relative terms, than the sold share.

1. Benefits and drawbacks!

Benefits	Drawbacks
You can make an investment without providing the full amount upfront.	Contracts are binding - i.e. you must buy/sell at the predetermined rate.
Chances of making a profit in both bullish and bearish markets.	Risk of incurring leveraged losses, potentially exceeding the amount invested.
You can reduce or eliminate the inherent risk of an asset that you own.	Liquidity may be low in stressed markets.

2. Returns!

Returns depend on movements in the market rate relative to the contract rate.
- When you buy a future/forward: you make a return if the market rate exceeds the contract rate at maturity.
- When you sell: you make a return if the market rate is lower than the contract rate.

You incur a loss, if the market rate moves against your position.

3. About risk!

Risk at unfavourable price movements
Leveraged losses may arise on both buy and sell contracts.

Buying futures/forwards
If the underlying asset ends up having no value, the contract also has no value.

Selling
Your loss is basically unlimited, if the asset price rises sharply.

Hedging opportunity
If you own an asset that may potentially decrease, you can sell a future/forward to lock in the price.
If the price increases, you will lose out on a potential return.

Currency risk
When you trade in contracts on assets denominated in other currencies, you assume a currency risk.

Market volatility
High volatility may cause major price fluctuations, on both the asset and the contract.

Liquidity risk
If you want to close a position early (prior to maturity), you must find a counterparty. Liquidity may be low in turbulent markets and make it more expensive or more difficult to close the position.

4. What you should know before trading!

When trading financial instruments, you enter into a framework agreement with the bank.
- The Bank will monitor your risk.
- The Bank may call the contract or require collateral, if the value becomes negative.

Taxation
Tax rules depend on whether you trade as a private individual, a business, a corporation or via a pension pot. Consult your accountant to get a specific assessment.

Expenses
Trading in forwards and futures entail:
- Trading costs
- Premium/discount dependent on liquidity and turnover
- The Bank's marginal for costs and earnings

Jyske Bank A/S · Vestergade 8-16, DK-8600 Silkeborg
Tel. +45 89 89 89 89 · Fax. +45 89 89 19 99 · jyskebank.dk

SWIFT Code JYBADKKK
Business Reg. No. DK-17616617