Frame Funds.


# AN INTRODUCTION TO FUTURES

**Contact Details**

**P.** 02 8668 4877
**E.** investors@framefunds.com.au
**I.** www.framefunds.com.au

Suite 25, Level 6
58 Pitt Street
Sydney, NSW 2000

# Disclaimer

The information contained in this document has been prepared by Frame Funds Management Pty Ltd (Frame Funds) ACN 608 862 442, a Corporate Authorised Representative CAR 123 9068 of Primary Securities Limited AFSL 224 107 and is given to only 'wholesale clients' (as defined in the Corporations Act 2001 (Cth)). Frame Funds is the investment manager of the Frame Futures Fund ABN 29 676 502 781 (Fund). The trustee of the Fund is Primary Securities Limited ACN 089 812 635, AFSL 224 107.

By accepting this document, you are representing that you are a 'wholesale client'' and that you will keep this document and the information therein confidential including not providing it to retail clients or ineligible investors. This document does not take into account the objectives, financial situation or needs of any particular person. The Fund is not a bank deposit.

Any person seeking to make an investment should review the Information Memorandum and seek legal, financial and taxation advice (as appropriate) to determine if an investment in the Fund is suitable for them. The information in this document is intended only for purposes of providing a general understanding of an investment in the Fund and is not intended to be a definitive statement on the subject matter nor should it be relied upon in making a decision to invest in the Fund.

Persons should rely solely upon their own investigations in respect of the subject matter discussed in this document. Any forward looking statements, opinions and estimates provided in this document are based on assumptions and contingencies which are subject to change without notice.

Forward-looking statements including projections and estimates are provided as a general guide only and should not be relied upon as an indication of the future performance of the Fund. Investments can fall as well as rise. Past performance is not necessarily indicative of future performance.

No representations or warranties, express or implied, are made as to the accuracy or completeness of the information, opinions and conclusions contained in this document. In preparing this document, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available to Frame Funds.

While we believe the sources of such information to be reliable, we do not represent that the information is accurate, complete or should be relied upon.

To the maximum extent permitted by law, neither Frame Funds nor its directors, employees or agents accept any liability for any loss arising in relation to this document.

This document does not constitute an offer to sell or a solicitation of an offer to buy interests or securities in any jurisdiction to any person to whom it is unlawful to make such offer or solicitation.

Neither this document nor any information contained in it may be reproduced, distributed or transmitted by any means, in whole or in part, without the written permission of Frame Funds.

The information in this document is current as at the date specified and is subject to change.

# TABLE OF CONTENTS



# 1. Introduction

The idea of futures trading can be a daunting one to the average retail investor, after all as Yvon Chouinard once said, “Fear of the unknown is the greatest fear of all”.

Futures trading can often be perceived as being “risky” or even “a gamble”. But the reality is that, if used properly, futures markets can actually help reduce risk, increase the opportunities for upside growth and align your investments more closely to your objectives.

The resources available to the retail investor are somewhat dwarfed compared to that of large institutional firms. Therefore, we owe it to ourselves to get informed about the different financial instruments so that we can add those tools to our investment repertoire.

In this guide, we explore the basic fundamentals of futures trading. We cover the History, What, Why and How of Futures trading so that once we’re done, you will not only have a comprehensive understanding of the futures market, but also know what avenues to take to get involved.


## Did you know?

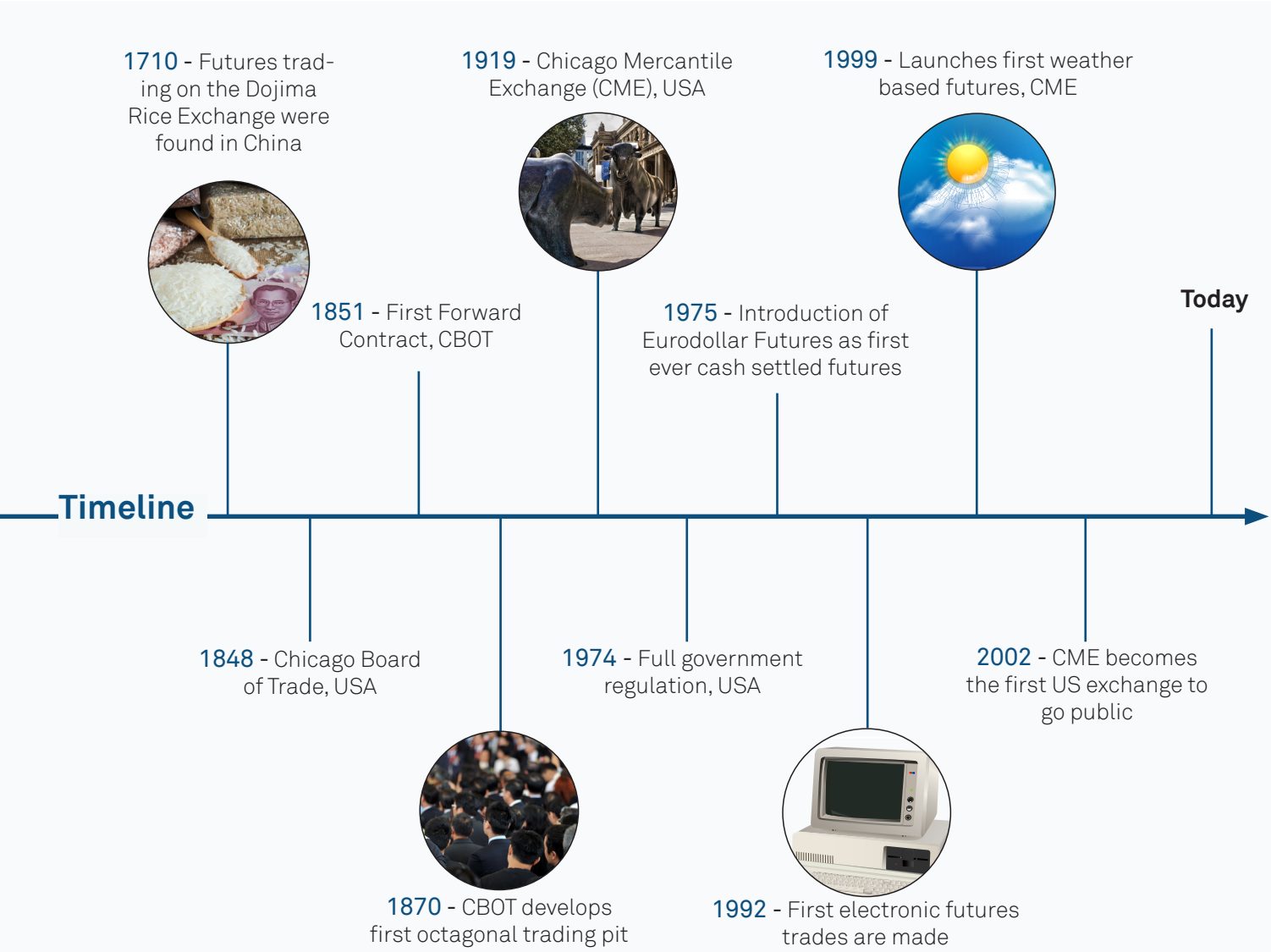
Futures have a finite life span. Compared to equities, futures have a set expiration date, after which the contract stops trading.

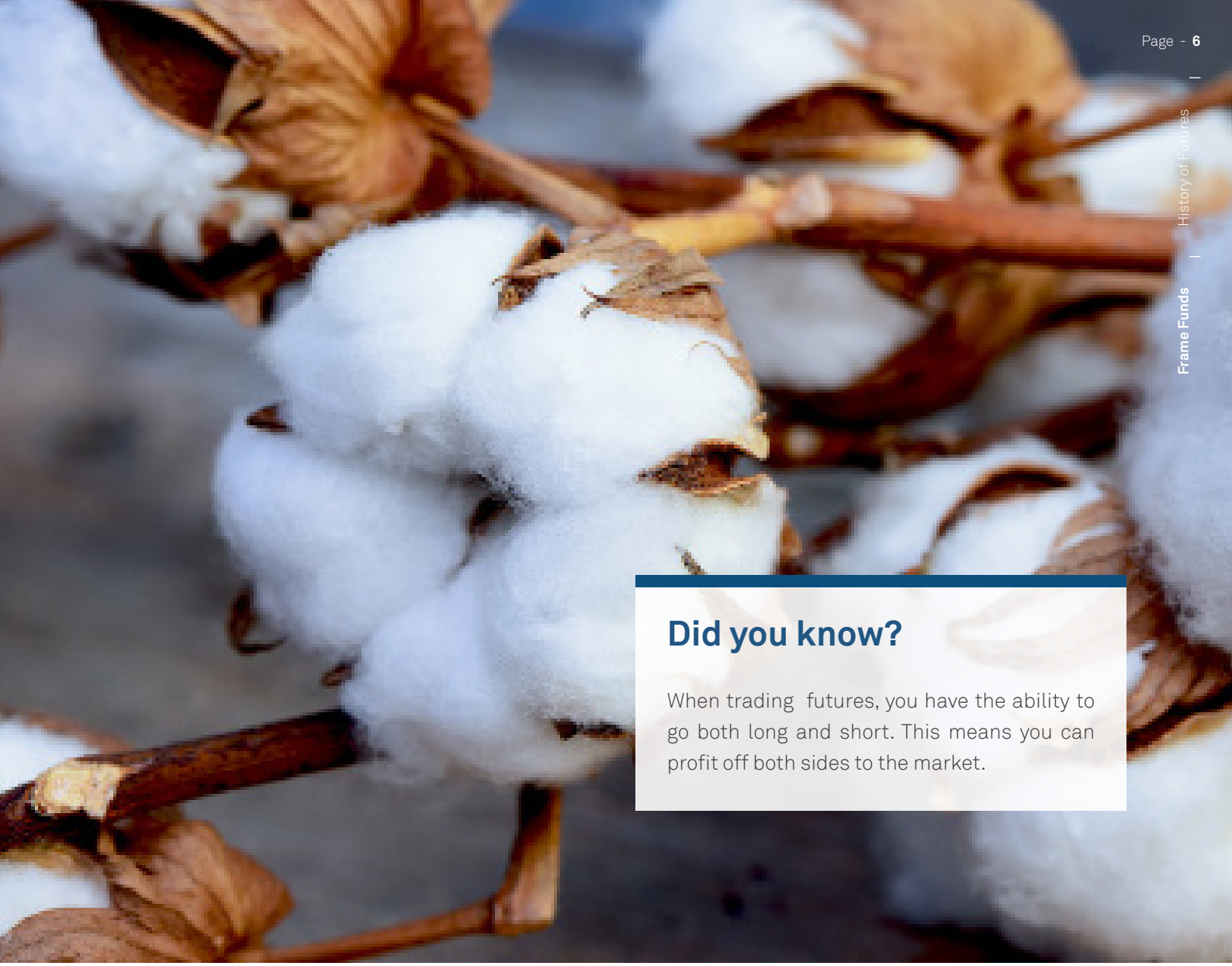
While futures trading is a relatively modern world phenomenon, we can trace back mankind's need to secure the future price of an asset back to the 17th century.

Before the invention of the futures contract, economic cycles placed producers, such as wheat and cotton farmers, at the mercy of fluctuating periods of 'plenty' and 'scarcity'. The inability to predict prices created too much uncertainty and risk for both parties, and thus we saw financial evolution take place. Contracts were drawn up between the producer and merchant, and this established the price of the commodity at a specified date for delivery.

There are two main categories when it comes to futures market participants; hedging and speculating. Hedgers are producers or purchasers of a financial asset or commodity who essentially protect themselves against unanticipated price movements. These producers sell the asset on a specified date to the purchaser who then must buy the asset at the agreed price. Speculators on the other hand, essentially bet on price movements of assets.

Once it was identified that you didn't have to physically deliver the assets as long as you exited the contract before the expiry date, traders started flooding the market.





## Did you know?

When trading futures, you have the ability to go both long and short. This means you can profit off both sides to the market.

The Chicago Board of Trade (CBOT) was established in 1848. Then in 1851, it standardised the first official "exchange traded" forward contract, giving birth to the world's first ever futures contract. Earlier recognition of futures trading can even be observed in 1710 in Japan at the Dojima Rice Exchange.

One of the most talked about transitions the futures markets faced was the move into electronic trading platforms. 'Open outcry' was the traditional language used by traders as they entered the 'pits' of the trading floors. This type of communication came in the form of hand signals, shouting, pushing and in some circumstances, fist to fist combat. However, as our society entered the technological age, and the opportunity to reduce costs and improve trade execution speed was apparent, open outcry gradually stopped crying. In 1992, the first electronic futures trade was made, signifying the origins of the type of trading we witness today.

Today we have almost 97% of futures traders actually speculating on the future price of the commodity to make a return, rather than utilising the contract to hedge himself from future prices changes in his product.

# 3. Hedgers, Speculators and Money Managers

So now that we have established that futures trading originated from producers protecting their profits by hedging against commodity price movements, let's explore the main participants of the futures markets.

**Hedgers:**
This category is broken down into farmers, manufacturers, importers and exporters, all who have the single objective of protecting their business from large fluctuations (rally or falls) of the underlying asset they are involved in.

For example: A corn farmer who is looking to sell his produce may face a large difference between the price he expects for his produce, compared to the price at the time he transacts with his buyers. In May, the farmer expects to harvest 20,000 bushels of corn during November. By using futures contracts, the farmer can lock in a specific price in May to reduce the risk of a potential fall in prices before November.

Now depending on the industry, the ability to pass on costs may not be that simple, and generally it will be the manufacturer that is forced to wear the cost.

Hedging is primarily used in commodities markets, but is commonly used by other participants such as fund managers and investors to hedge portfolio movements as well.

## Futures market participants

## Did you know?

Of the thousand commodity exchanges that existed in the United States a hundred years ago, only 9 exist today.

**Exchanges:**
A key participant of the Futures markets are the exchanges themselves. A Futures Exchange is the central marketplace where buyers and sellers can trade futures contracts. Major exchanges include the Chicago Mercantile Exchange, Chicago Board of Trade, New York Mercantile Exchange and the Sydney Futures Exchange. Since the recent advancement in technology, exchanges have converted to electronic trading.

**Speculators:**
Speculators or traders on the other hand, do not trade futures to protect, but rather to anticipate price movements. The desire to receive or delivery the actual underlying asset does not exist, rather by entering and then closing the contract, traders seek to profit from these fluctuations.

**Portfolio Managers:**
Money managers that control large pools of assets are required to maximise their investor's returns. The portfolio manager will utilise the futures markets to control the overall market exposure through the use of hedging facilities. This allows funds to implement their investment strategies smoothly, without being interrupted by large macro-economic themes.

# 4. Construction of a futures contract

In this chapter we go through the basic terminology and structure of a futures contract. Depending on whether you place the trades yourself or you have a broker/fund manager to execute the trades for you, you may not need to know the specific details. But as we realised earlier the unknown can be daunting, so let's get a brief overview of how futures contracts are designed.

To understand futures trading, we first need to understand what a 'Derivative' is. Derivatives are critical to our modern financial markets, used globally over a variety of different assets such as commodities, currency pairs, equities, indices and more.

A derivative is a financial product whose value is based on an underlying physical asset or financial instrument. Simply put, it derives its value from the movement in price of a different asset. This could be gold, wheat or even stock indices.

A futures contract is a type of derivative, which in its purest form is a standardized contract for the purchase and sale of an asset for future delivery.

## Examples of futures contracts

| Underlying | Contract Code |
|---|---|
| S&P/ASX200 | SPI |
| Germany 30 | DAX |
| USD (Dollar Index) | DXY |
| Soybeans | ZS |
| Corn | ZC |
| Sugar No. 11 | SB |
| Brent Crude Oil | BZ |
| Dow Jones Industrial Average | YM |
| S&P500 | ES |

## Did you know?

Cell phones were banned on the trading floors in the '90s.

# Construction of a Futures contract

For example, let's take a look at the SPI Sep 15'16 contract:

## Futures contract example

| Underlying | Ticker | Expiry | Multiple | Exchange | Price | Margin |
|---|---|---|---|---|---|---|
| S&P/ASX200 | SPI | Dec 15'16 | 25 | SFE | 5400 | $4286.25 |

## a. Underlying

Let's start with the multiple asset classes. Futures markets span from commodities to global market indices. The optionality available for investors and traders means that investors have a wider range of markets to search for opportunities. Not only will this provide more opportunities to potentially make a higher return, but it can also help structure your investment portfolio more in-line with your objectives and risk profile.

In the above example, we explore the SPI Sep 15'16 contract, which is a derivative of the S&P/ASX 200 Index. This gives investors the ability to trade the overall Australian share market (top 200 largest companies), rather than being restricted to just the individual companies. Obviously, it goes without saying that this would encompass a different investment strategy and an investor would be more interested in factors that affect the Australian Economy as a whole, rather than microeconomic factors within a specific company.

Broadening the investment horizon from simply direct equities, gives investors further avenues to diversify their strategies and mitigate their risk.

## b. Expiry

A futures contract is also defined by its expiry date. This states the date at which the physical asset or financial instrument must be delivered. So, make sure to exit your positions before the expiry date because before you know it, you may end up having 100 live cattle sent to your front door.

## c. Multiple

Each contract will have a set multiple. This sets the amount a contract will be worth. For example, the SPI Dec 15'16 contract has a multiple of 25. This means that if a trader decides to buy 2 contracts, at 5400 points, the total exposure for the trade will be:

2 X 5400 X 25 = $270,000

As you can also see, the total consideration of the trade depends on the price level at which the contract is trading at.

Each contract is different, and multiples may differ depending on the broker you use.

## d. Margin

In the stock market, the term margin refers to the amount calculated by the clearing house as necessary to cover the risk of financial loss on options contracts, futures contract and CFDs.

The initial margin is the minimum deposit determined by the Clearing House on all futures contracts and exchange traded options and exchange traded CFDs. This margin must be paid by the Clearing Participant to the Clearing House. The client must pay the Clearing Participant.

The variation margin is a call made by the clearing house for additional funds or eligible security to be lodged to cover an unfavourable movement in the price of futures, options or exchange traded CFDs.

# 5. Benefits of trading futures

So far, we have covered the history of futures, who trades and for what reason, and the basics of a futures contract structure. Now we discuss why futures are beneficial, and what risks are associated with trading futures.

## a. Flexibility

Futures markets provide the flexibility of taking either a long or short position. A long position refers to the purchasing of an asset, with the anticipation that the price of that asset will increase, whereupon the owner will sell the asset at a higher price.

However, a short position on the other hand refers to the anticipation to profit from the price of the asset falling.

To take a short position, the trader identifies a futures contract that they believe is going to depreciate in value. They will then sell a futures contract today with the expectation the price will decline in the future.

So now, if the price of the underlying asset depreciates, the trader goes back to the market, and buys back the same futures contract for a lower price. And consequently, closes their previous position. This leaves the trader with the difference between the original price and current price.

Now when trading futures, the most important thing is that as a participant of the futures market, you can profit from any market, bull or bear.

## b. Efficiency

By utilising futures contracts, you can increase the efficiency of the strategy that you are targeting. In other words, futures can help construct a portfolio or trading strategy which is more in line with your investment objectives and risk profile.

Another benefit is that trade ideas generated from a specific hypothesis can be more effectively executed. For example, let's say a speculator anticipated a rally in the price of gold due to global growth concerns, with investors fleeing towards safe haven assets. Now the majority of retail investors would only invest in direct equities and may look to benefit from this rationale by purchasing shares in a gold mining company.

### Did you know?

A Bull symbolizes an upward market as the animal raises its head and horns when attacking.

However, a futures investor could remove all company and managerial risk that is often associated with a stock, and simply invest in the underlying commodity, that is gold. This creates simplicity for the investor, whilst removing undue company risk that is irrelevant from the original hypothesis.

## c. Risk Management

As we discussed earlier, futures broaden the investment horizon by allowing investors to access multiple asset classes. This gives the investor the ability to diversify their portfolio across not only different companies, but different assets, adding another layer to the capital preservation strategies available to investors.

Furthermore, the hedging facilities from futures allow investors to reduce large market volatility non-specific to the individual holdings of their portfolio. For example, a portfolio may consist of several companies which are diversified across multiple sectors. However, if an investor was to anticipate a large macroeconomic event that would bring the market down over the short term, the portfolio would be at the mercy of market fluctuations, regardless of the long term prospects of the companies in the portfolio. By using stock index futures to offset these fluctuations, the investor can maintain their portfolio, whilst simultaneously mitigating their downside risk. Now like any activity in the market, futures also come with risks and should be clearly understood by every trader or investor before considering to participate in the market.

Some of the risks associated with futures are (please refer to the Product Disclosure Statement issued by your broker for futher information):

**Potential Liability:** When you trade futures on margin, you get exposure to the full value of the contract for a fraction of the cost (the initial margin), but your potential profit and loss are based on the full value of the contract, not just the money you have paid. This means that futures trading can result in losses that could exceed your initial deposit.

**Volatility:** As futures markets cover a broad range of assets, some of these markets can provide large amounts of volatility. Now depending on your experience level, navigating through volatile markets can be an extremely lucrative environment, especially with the ability to go long and short, however it also poses its risks.

**Leverage:** Although leverage can be a powerful tool to maximise your potential returns, it can also magnify losses. Thus, it is crucial to implement stop losses with every position to limit the potential loss on the trade.

However, remember that the stop loss will define your total downside risk, so it is important to understand the reward to risk ratio you will be choosing.

For example, take a look at the table below.

| | |
|---|---|
| Fund Balance | $50,000 |
| Underlying | S&P/ASX 200 |
| Ticker | SPI |
| Current Price | 5400 points |
| Multiple | 25 |
| No. of Contracts | 1 |
| Total Exposure (Price x Multiple) | $135,000 |
| Risk Management | 2% |
| Maximum $ Loss (Fund Balance x % Risk) | $1,000 |
| Stop Loss Points (Maximum $ Loss / Multiple) | 40 points |
| Stop Loss Level (Current Price - Stop Loss Points) | 5360 points |
| Price Target | 5480 points |

* Assuming the stop loss order is executed at the stop price and there is no slippage.

The risk management value has been set to 2% by the trader. That means that he/she is willing to take a maximum loss of 2% on their total funds before closing out of the trade.

So, based on the $50,000 fund balance we can calculate that the maximum loss taken on a trade is going to be $1000 (excluding slippage). Now here's the tricky part, to set a stop loss price equivalent to a 2% or $1000 for any particular trade, it will depend on how many points the maximum loss represents. If we divide $1000 by the multiple and no. of contracts, we get 40 points. Which means our stop loss will be set at 40 points below the current price of 5400, ie. 5360.

When placing stop losses you need to be aware of slippage. Slippage refers to the difference between the expected price of the trade and the price at which the trade is actually executed. Upon your stop loss being executed, the order will immediately be placed to market by your broker and executed at the best available price at or below your stop loss price.

So now that you have your stop loss, if you compare it with the price target of the trade, you will get your return to risk ratio. See below for a graphical representation.

## Risk Management Example (S&P/ASX200)

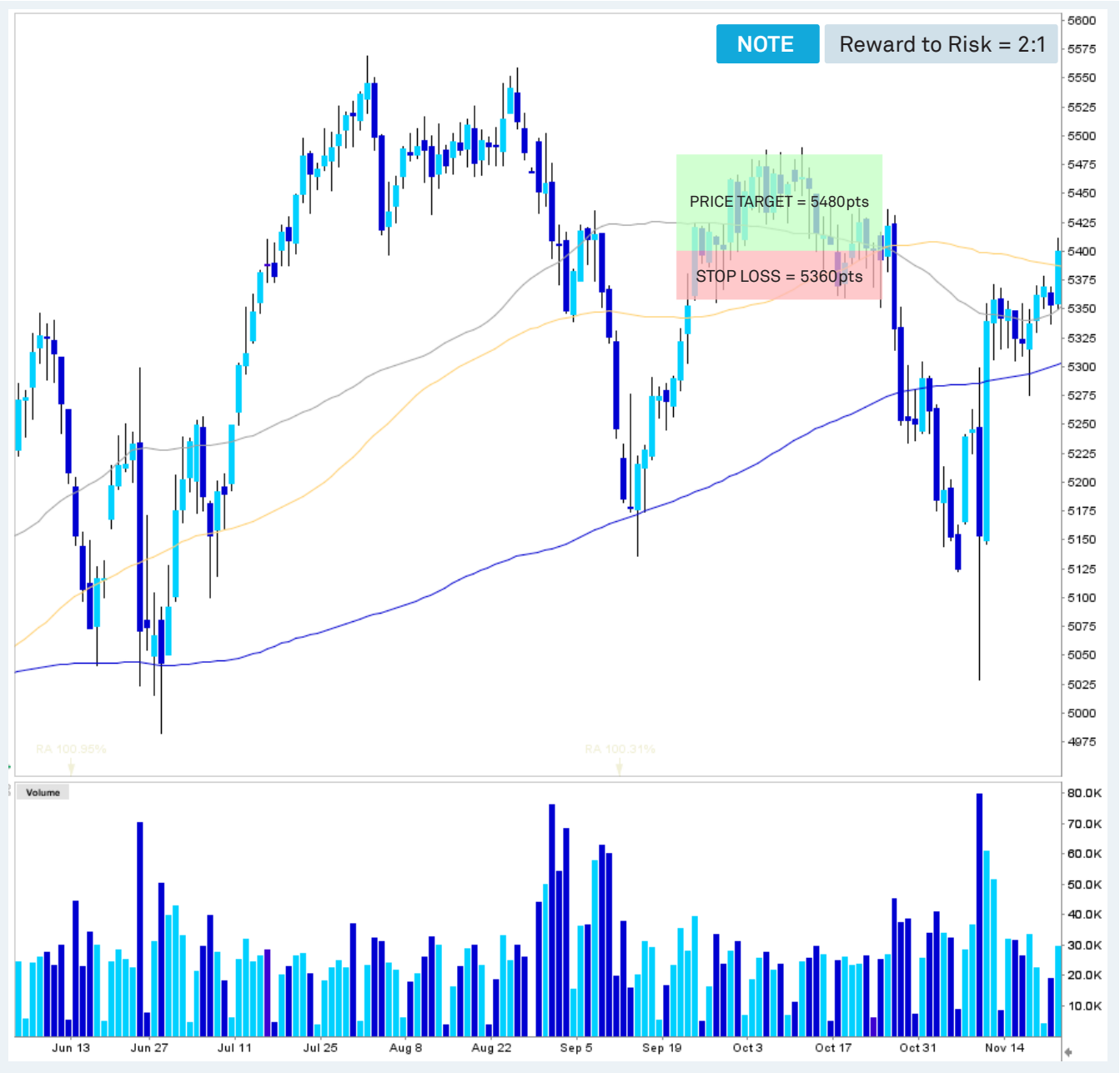



Figure 1. S&P/ASX 200 Index (SPI Futures Contract). This figure shows the Reward to Risk of a long position on the S&P/ASX 200.

# 6. Getting started

So now that you have a basic understanding of the futures markets and the benefits it can provide to our investment strategy, how can you actually take advantage?

There are multiple avenues one can take to participate in the futures market. You could jump online and use a broker or you could go straight to the Chicago Mercantile Exchange Pits and scream your way into the futures market. But the simplest and effective way is probably the use of managed funds. By utilising an investment vehicle such as a managed fund, you can get all the benefits of a wide-ranging investment futures strategy, without the need to be monitoring the markets all day, every day.

Futures trading, being more volatile and quicker in nature requires more attention than an investment strategy without futures. Like anything, for a better strategy, there needs to be more time dedicated, with a Managed Fund you can let the portfolio manager do the heavy lifting for you.

Also, managed funds can provide a means of risk mitigation through instant diversification. As managed funds will generally have larger levels of capital available relative to an individual investor, capital restriction is not really a problem when it comes to diversifying across multiple asset classes.

However, when evaluating managed funds, it is very similar to evaluating a stock, look at the fundamentals. Before investing in any money manager, crucial assessments should be made. Firstly, how have they performed. A track record should not be an indicator for future performance, but rather an insight into the funds ability to weather certain market conditions.

For example, how did the fund perform in a bear market? Was it able to reduce its risk? Secondly, performance fees. What is the incentive of the fund manager? Is it aligned with your returns, or with theirs?These are very important considerations that you should make before investing your hard earned cash!

# Frame Futures Fund

The Frame Futures Fund invests in globally listed equities, listed index futures, listed commodity futures and cash products with the aim of delivering strong capital growth over the long-term.

Allocations within these investments are adjusted depending on the market stage. The Frame Futures Fund investment approach is to invest in higher reward/risk ratio trades when the market is rising and falling.

The Frame Futures Fund investment parameters allow clients to take advantage of large momentum based movements within the market, in both rising and falling markets. For example, in a falling market it has the flexibility to short sell, and in a rising market it also has the flexibility to take long positions.

The Frame Futures Fund carries specific leverage capacity limits enabling it to remain nimble and versatile while protecting its ability to continue to achieve its performance objectives.

Click on the boxes below to download detailed information related to the Frame Futures Fund investment strategy, risk management processes and how the Frame Futures Fund uses leverage.

Frame Funds.

# Contact

**Frame Funds Management Pty Ltd**
Ph: +61 2 8668 4877
Email: investors@framefunds.com.au
Address: S25, L6, 58 Pitt Street
Sydney, NSW, 2000
Website: www.framefunds.com.au