

The Future Is Now

Single-stock futures can offer a relatively simple, inexpensive way to hedge appreciated positions in client portfolios. **By Brad Zigler**

HEDGING, OR RISK TRANSFERENCE, has long been the hallmark economic function performed by futures markets. And now, with futures contracts on individual stocks rolling out, advisers can offer their clients downside protection and a floor on accumulated profits for specific names in their portfolios. Futures also allow a winning short-term position to be locked in, until the shares can be sold on a tax-advantaged long-term basis. And because of their pricing simplicity, security futures offer

a more straightforward means for managing portfolio risks than options.

In general, financial advisers have shunned options. "They are expensive to trade and can be difficult to manage," says Howard Simons, a consultant for Nasdaq-Liffe Markets, a Chicago-based electronic exchange for trading single-stock futures. Futures may also face resistance, according to Larry Klein, an RIA and marketing consultant in Walnut Creek, Calif. "Most financial advisers tend toward packaged

products," says Klein. "They like the idea of raising money and handing it over to a money manager or a fund. Using futures on individual stocks is way too much work for them."

Yet the ranks of those willing to do such work could expand. Bernie Schaeffer, owner of Schaeffer's Investment Research, an investment advisory service in Cincinnati, cites "the astounding growth" of futures contracts on the S&P 500 and Nasdaq 100 as a sign that advisers already are comfortable with using broad-based futures. "The potential constituency [of single-stock futures] is seriously underestimated," he says.

That's in part because advisers have had few tax- or pocketbook-friendly portfolio hedging opportunities, outside of index options. The handful of bear index mutual funds available only represent inverses of the S&P 500 or the Nasdaq 100, and so don't provide much accuracy. Employing such broad-based index funds for selective hedging is akin to swatting flies with a sledgehammer—effective perhaps, but clumsy and possibly dangerous. They can be costly, too, with annual expense ratios ranging from 1.31% to 2.5%.

Exchange-traded funds (ETFs) can themselves be shorted to hedge a portfolio's sector or style exposure. But "shorting sector ETFs has the same short sale problems associated with stocks," Simons says.

Security futures offer "better leverage," says Christopher Krohn, managing director of strategy and marketing at OneChicago, an electronic futures exchange for stocks, narrow-based indexes, and ETFs. "They allow 20% margin instead of the 100% required of a cash stock trade or 50% under Reg T," he adds. "No uptick rule, either. And stock needn't be borrowed for a futures short sale, just as cash isn't borrowed to finance long futures positions."

Security futures hedging mechanics are fairly straightforward. A short hedge, employed to protect the value



of a particular stock holding or portfolio component, is established by selling security futures contracts. For example, say your client owns 500 XYZ shares that have rallied to \$50 in June. To lock in the gain for the next three months, until a sale qualifies for long-term capital gains treatment, you sell five August XYZ futures contracts at the current price of \$50.25, thereby creating an obligation to deliver 500 shares of the stock in the third week of August (that is, unless the contract is bought back beforehand).

If you cover the short contract before delivery, the difference between the current price for August futures and the original sales price will dictate the profit or loss on the hedge leg. Since the futures price will track the underlying stock price closely, a gain on one leg tends to offset losses on the other. Otherwise, the short futures position is offset by delivering the stock shares in August, closing out both hedge legs.

To continue the example, suppose the stock falls to \$40 in July. If the hedge is closed and the stock sold, the \$5,000 loss in the stock's market value could be virtually offset, before commissions and fees, by a \$5,060 gain on the futures leg, as depicted below:

	Long stock – Short futures = Net (basis)		
June:	\$50.00	– \$50.25	= -0.25
July:	\$40.00	– \$40.13	= -0.13
Net:	-\$10.00	– \$10.12	= 0.12
x 500 shares	-\$5,000	– \$5,060	= \$60

Of course, had XYZ's price risen instead, losses on the short futures hedge would have swamped the gains accrued on the open stock position, again more or less resulting in breakeven. This calculation doesn't include commission which, with futures, is typically charged on a round-turn basis, covering both the cost of opening and closing a position on the way out.

Security futures have the same price and risk profiles as stock or ETF

Rules of the Road

Security futures may be traded in either a securities account or a futures account, but either way account holders must first acknowledge receiving the appropriate risk disclosure statements, complete any requisite paperwork, and otherwise meet eligibility criteria set by the carrying broker.

Brokerage firms wishing to effect security futures transactions must be dually registered with the SEC and the Commodity Futures Trading Commission (CFTC). Firms currently registered with either one of the agencies can simply "notice" register with the other regulator to become eligible to trade securities futures.

Representatives who've passed either the Series 7 or the Series 3 (registered commodity representative) exams can solicit and enter security futures transactions if they work for a firm dually registered with the SEC and CFTC. On top of that, reps must have completed an online security futures training course offered by the NASD or the National Futures Association (NFA).

The exchanges trading security futures offer educational material on their Web sites:

Nasdaq-Liffe Markets:

<http://www.nqix.com/nqix/publications/InvestorPublications.stm>

OneChicago:

http://www.onechicago.com/010000_learningctr/oc_010000.html—BZ

shares. But there are distinct differences in how they are traded. Most important, margin is always employed in futures, whether taking a long or a short position. Futures margin isn't a down payment, nor does it represent borrowing. Rather, it's a performance bond, a deposit.

For security futures, initial margin is set at 20% of the current contract value for outright positions, which can be satisfied with cash or margin securities. For clients holding an offsetting position in the underlying stock or fund, the minimum margin is only 5% of the leg with the higher market value. Our XYZ hedge, for example, starts off with a maintenance requirement of only \$1,256 (5% x 500 shares @ \$50.25).

With low hedge margin requirements and the ability to use non-cash means for satisfaction, security futures could challenge the primacy of options as a stock or fund hedging vehicle. They're also easier to understand than options. As a general rule of thumb, when the price of a stock or fund rises, the associated security futures price also goes up.

Options, on the other hand, regularly exhibit non-linear behavior with respect to time, price, and volatility. Many options traders can attest to seeing options prices sometimes head in a counterintuitive direction, or not move at all, in response to movement in the underlying stock or fund. Simply put, options pricing depends on a complex mathematical model, rather than the straightforward arithmetic used for security futures.

Schaeffer says security futures will resonate with those who have trouble understanding options, who dislike paying option premiums, and who "want dollar-for-dollar participation in the movement in the underlying [security]." Unlike options, Krohn notes, security futures are "a perfect directional hedge" because there's no need to evaluate the impact of strike prices or implied volatilities. Without strike prices, the hedge protection offered by security futures is immediate. The breakeven point is near the futures' sale price, too, since no premium is paid. Option breakeven points, in contrast, can be distant from the current price of the underlying stock or fund.

There's a difference in hedging cost structure as well. The cost of a futures hedge is the cash flow required to maintain margin. But for a long option hedge, the cost is the premium, which is a wasting asset (a short option may not be desirable as a hedge since it may not provide the necessary offsetting profit potential).

Security futures don't provide the precision of options, however. Options can be used in various combinations for finely-targeted hedge purposes. With security futures, hedging is more or less a binary operation. It's either on or off. The only way to adjust net bullishness in a futures hedge is by modifying the number of contracts employed. For example, instead of a full five-contract hedge, our XYZ hedge could have been limited to the sale of only three futures contracts, leaving a bullish "tail."

Corporate employees with large concentrations of company stock in their 401(k) or pension plans represent a substantial clientele for potential security futures hedgers, according to Krohn. Futures, he notes, could be used to mitigate ownership risk until a retirement plan selling window opens. "For these employees, security futures offer a significant benefit," he says, in offsetting concentration risk.

"Hedging with security futures is very efficient and very low risk if you ignore the question of when to hedge," says Simons. It's here where advisers add value by helping clients define risk tolerance levels, investment horizons, and the utility of hedging in the first place.

If the stock or the fund isn't viewed as a long-term investment, if no adverse tax consequence constrains an immediate sale, and if asset allocation isn't compromised by liquidation, then a hedge is unnecessary. If a hedge is employed, however,

clients should understand that for the life of the hedge (a 100% hedge at least), risk exposure is being traded for essentially a money market return, together with any dividends earned on the long stock or fund position. In times like these, however, a money

market return can look pretty good. FP

Brad Zigler is a freelance business writer in Santa Rosa, Calif.

