

Behind the screens with the JSE's Equity Derivatives Division

Derivatives markets play an important role in the transfer of risk from those wishing to avoid it to those prepared to take risk in the hope of a substantial reward. Trading risk has taken place for centuries, only recently through stock exchanges. However on-exchange trading provides clients with transparency and price discovery. It can also eliminate counterparty risk.

The development of exchange-traded derivative instruments in South Africa started in the late 1980's when local investment bank Rand Merchant Bank started trading contracts on various equity indices and long bonds. This was followed, in September 1988, by twenty one financial institutions meeting to establish the South African Futures Exchange (Safex) and the Safex Clearing Company (Safcom). Due to new legislation in 1990, namely the Financial Markets Control Act of 1990, Safex was officially licensed as a derivatives exchange. Safex was acquired by the JSE in July 1991.

The JSE acquired Safex in July 1991 and agreed to retain the Safex branding and to create two divisions – Safex Financial Derivatives and Safex Agricultural Derivatives. Safex Agricultural Derivatives is now known as JSE Commodity Derivatives Division while Safex Financial Derivatives is now called JSE Equity Derivative Division.

Today, the JSE's Equity Derivatives market provides a platform for trading futures, options and other more sophisticated derivatives instruments. While the equity derivatives market is primarily used by professional investment managers, they often have a great appeal to the private investor. Such parties must however, ensure that they enter the markets with their eyes open, as the rewards may be high, but the downside can be equally enormous.

Before becoming involved in derivatives, potential participants must examine their motives for using the products offered. Generally speaking there are four broad categories of market participant:

- hedgers who use those who use futures and options to protect an existing portfolio against possible adverse market movement;
- arbitrageurs who profit from price differentials of similar products in different markets
- investors who use futures and options to enhance the long-term performance of a portfolio of assets; and
- speculators who use futures for short-term profits.

Futures and options are very useful tools for those in categories 1 to 3. They can also be excellent tools for speculators, but the pitfalls are great and the inexperienced must beware.

On the face of it, the chances of making a profit or loss when speculating in futures appear to be equal. Furthermore, speculating in futures can be more dangerous than speculating in shares, because of the gearing effect. With shares the most you can lose is what you pay initially, whereas with futures you can lose multiples of your original outlay.

The regular administration of margins prevents participants from accumulating large unpaid losses, which could impact on the financial position of other market users (systemic risk). Such margining systems do not exist in over-the-counter (OTC) markets.

It is important to protect and safeguard clients' interests.. For this reason, regulation plays a crucial role. The Equity Derivatives market is overseen by the Financial Services Board and controlled in terms of the Financial Markets Control Act (1989). Certain regulatory activities include the registration of all members and clients, strict financial requirements for members and regular inspection of members' records and procedures.

Derivatives products available

Single Stock Futures

Single Stock Futures are derivative instruments that give investors exposure to price movements of an underlying financial instrument (shares). A futures contract is a legally binding agreement that gives the investor the right to buy or sell an underlying listed share at a fixed price on a future date.

Equity Options

An option is a derivative instrument that gives the investor the right (not the obligation) to buy (call option) or sell (put option) shares at a fixed price on a future date. Options provide a cost-effective way of obtaining a large amount of exposure with very little risk.

Equity Index Futures

Equity Index Futures give investors exposure to price movements of an underlying Index. Participants can invest in a basket of equities without trading the individual constituent equities. A futures contract gives the investor the right to buy/sell an underlying listed financial instrument at a fixed price on a future date.

Variance Futures

Variance Futures are contracts that obligate the holder to buy or sell variance at predetermined variance strike price at a specified future time.

Dividend Futures

Dividend Futures (DIVF) are derivative contracts used to hedge against dividend risk that accompany trade in Single Stock Futures (SSF's). These contracts are booked in conjunction with a relevant SSF and offer a simple transaction to enable investors to protect themselves against any perceived dividend risk.

International Derivatives (IDX)

International Derivatives (IDX) give investors exposure to price movements of internationally listed shares. Investors are able to trade Single Stock Futures on internationally listed companies without the restrictions associated with exchange control regulations or the expense of setting up foreign trading accounts. The IDX range of products listed on the JSE includes SSFs on companies such as Nokia, LVMH Moët Hennessy Louis Vuitton, Bank of America, Apple and Berkshire Hathaway.

Can-Do Futures and Options

Can-Do Futures and Options are derivative products that give investors the advantages of listed derivatives with the flexibility of “over the counter” contracts. Investors can negotiate the terms of an Options contract, choosing the underlying asset as well as the expiry date. The market will always require innovative derivatives, but due to the global financial crisis it also requires additional regulation, oversight and security which these on-exchange instruments provide. In response to this market need, trade in Can Do derivatives, which offer the flexibility of OTC instruments but the regulation of on-exchange derivatives, jumped by 25%.



To find out more about the trading opportunities this market offers to both private and professional traders contact the JSE Equity Derivatives Team on 011 520-70000 or email derivativetrading@jse.co.za