Share futures, SFE's latest addition to its equity derivatives range, have attracted considerable attention from fund managers, financial institutions and individual investors. Les Hosking explains how share futures will allow them to better manage their Australian equity portfolios and serve also to further internationalise the Australian sharemarket.

E quity instruments have been an important part of SFE's product range since the launch of the Share Price Index (SPI) futures contract in February 1983. Today SPI futures and options are the benchmark equity derivatives product in Australia. With combined volumes exceeding 17,000 contracts a day, worth an estimated $700 million, turnover in SPI futures and options exceeds that of the underlying stockmarket by about 1.4 times.

Having observed the shift from fixed-interest securities to equity securities over the past two years, SFE expanded its equity product range by downsizing the SPI in October 1993 and launching the SPI overnight options in March this year. Share futures are the third stage of SFE's product expansion. International share futures and "flexible" equity options (OTC-type equity options traded on an exchange) are also planned.

What are share futures?

Share futures are futures contracts on the shares of listed companies. They are priced on the basis of 1,000 shares of the underlying stock, so an investor buying one futures contract is effectively buying exposure to 1,000 shares. For example, if BHP shares were trading at $17, one BHP share futures contract would be worth $17,000.

BHP, NAB & NCP have been selected for share futures because they are the leading stocks in their respective industry sectors and have strong international recognition (see Table 1). SFE's objective is to concentrate the initial interest and liquidity in these three leading stocks, with the intention of listing share futures on other stocks later in 1994.

Cash settlement

All share futures positions which are still open at expiry are automatically cash settled with reference to the settlement price. Trading of share futures will cease at 4.10 pm generally on the last Thursday of the settlement month.

In calculating the settlement price, SFE obtains bid and offer quotations for each share futures contract from the ASX's SEATS system during the final two hours of trading (2 pm to 4 pm). These quotations are taken on a minute-by-minute basis, so that 120 bid-and-offer quotes are collected for
Share futures at a glance

- Listed on three of Australia's leading companies: Broken Hill Proprietary (BHP); National Australia Bank (NAB); News Corporation (NCP).
- Other share futures stocks to be selected later in 1994.
- Two quarter months available for trading, with expiry dates timed to coincide with equity option expiry.
- Priced on the basis of 1,000 shares of the underlying stock (approximate underlying value $10,000-$18,000).
- Lower brokerage cost. For example, purchase of 1,000 BHP shares on the stockmarket attracts brokerage (at 2%) of about $300; the same exposure using share futures costs around $30.
- All positions are cash-settled at expiration; no delivery of shares.
- No adjustments for dividends and an identical adjustment outcome to equity options for all other capital reconstructions (share splits, bonus and rights issues, etc).

Impact on equity market

Empirical and anecdotal evidence have pointed to the formative role that SFE's three interest-rate future contracts played during the 1980s in the development of the Australian bond markets.

Now established as an important market for global bond portfolios (ranked as the tenth largest in Salomon Bros. Global Bond Index), SFE's 10-year bond, 3-year bond and 90-day bank bill futures and options contracts are used as benchmark hedging and trading tools for bond investors, providing the markets with greater liquidity and depth and reducing the incidence of gapping (where interest rates move rapidly with little trading in between).

SFE sees its range of equity products — SPI futures, SPI options and share futures — as fulfilling the same hedging/trading role and in essence acting as the stockmarket's pressure valve to absorb excess volatility.

Consequently, as has occurred in the bond market, the underlying stockmarket should experience increased turnover as more domestic and global investment portfolio managers invest in Australia, in the knowledge that cost-efficient and accessible hedging tools are available. Ultimately, more investors and accessible hedging mechanisms will increase the liquidity and efficiency of the market, thus lowering the cost of equity raisings.

In-depth market research by SFE has indicated that participants in SFE's share futures markets will comprise a broad spectrum of investors including:

- institutional fund managers;
- principal traders (mostly associated with stockbroking firms);
- equity options traders;
- stockbrokers involved in special sales, rights issues and placements;
- international investors (particularly those trading Australian stocks or ADRs in London and New York);
- private investors; and
- traders, including SFE locals.

Share futures applications include:

- portfolio hedging (selling BHP share futures while still holding BHP shares to negate an exposure);
- anticipatory hedging (buying NAB share futures now, effectively on margin, ahead of physical purchases when the funds are available);
- sector exposure (each of these stocks is the leading stock in its respective industry sector);
- options hedging;
- trading;
- arbitrage and spread trading (between equity options, share futures and the SPI);
- for offshore investors, reducing their currency risks; and
- hedging and trading over 19.5 hours per day.

Lower brokerage and the leverage opportunities available from trading share futures will promote more frequent trading of these "blue chip" stocks in both the institutional and private-client sectors, which will add to the liquidity of the market (eg, a 10-cent move per share represents a $100 move per share futures contract with, estimated brokerage at $30 per contract).

A natural provider

SFE is recognised internationally as the provider of liquid Australian futures and options contracts. In December 1993, SFE was the tenth-largest futures exchange in the world. The exchange has a solid reputation, provides deep, liquid markets with international appeal and is an active

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Table 1: Share futures — the ground-breakers

<table>
<thead>
<tr>
<th></th>
<th>BHP</th>
<th>NAB</th>
<th>NCP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares on Issue</td>
<td>1,665,897,152</td>
<td>1,333,562,629</td>
<td>1,844,470,466</td>
</tr>
<tr>
<td>% of All Ords Index</td>
<td>10.8</td>
<td>5.7</td>
<td>6.4</td>
</tr>
<tr>
<td>Industry Classification</td>
<td>Diversified resources</td>
<td>Banks &amp; finance</td>
<td>Media</td>
</tr>
<tr>
<td>% of above industry sector in All Ords Index</td>
<td>11.8</td>
<td>14.5</td>
<td>9.7</td>
</tr>
</tbody>
</table>

The three selected stocks are consistently among the most actively traded stocks in the Australian sharemarket.

FIVE MOST ACTIVELY TRADED STOCKS AT ASX

<table>
<thead>
<tr>
<th>ASX CODE</th>
<th>Company</th>
<th>Value of monthly turnover $ Mil</th>
<th>Volume Mil</th>
<th>Mkt Cap at month end $ Mil</th>
</tr>
</thead>
<tbody>
<tr>
<td>BHP</td>
<td>B.H.P</td>
<td>1208.1</td>
<td>65.7</td>
<td>31951.9</td>
</tr>
<tr>
<td>NAB</td>
<td>NAT:BANK</td>
<td>671.1</td>
<td>54.5</td>
<td>16932.0</td>
</tr>
<tr>
<td>WBC</td>
<td>WESTPAC</td>
<td>595.8</td>
<td>124.3</td>
<td>9881.3</td>
</tr>
<tr>
<td>WMC</td>
<td>WM.C</td>
<td>591.4</td>
<td>81.2</td>
<td>7737.0</td>
</tr>
<tr>
<td>NCP</td>
<td>NEWS CORP</td>
<td>571.0</td>
<td>38.9</td>
<td>18851.0</td>
</tr>
</tbody>
</table>

Note: Figures above are as at 31 January 1994.
participant in the development and regulation of the Australian futures industry.

There are other reasons for confidence in share futures. The exchange has an existing infrastructure of licensed futures brokers, with Chapter 8 of the Corporations Law, administered by the ASC, specifically dealing with futures regulation. Strict licensing requirements ensure brokers have a high level of knowledge and education specific to futures trading. Many ASX members are either members of SFE or are affiliated with members of SFE.

These existing intra-organisational links will promote activity between the cash, options and futures markets.

SFE has developed a world standard clearing facility, SFECH, which underpins the financial integrity of the futures market and reduces the problem of counterparty credit risks. SFECH's established clearance and settlement systems offer a proven clearing infrastructure that will readily accommodate contracts such as share futures with the least overhead cost to the market.

Margins will be determined in the existing manner by reference to the volatility in the underlying spot price. Sophisticated risk-monitoring and management systems allow SFECH to implement changes to the margin requirements as they are required — even during a trading session.

The introduction of SPAN margining in 1994 will allow inter-commodity margining concessions between share futures and the SPI and potentially between the share futures themselves.

Share futures contracts will aid and promote the capital-formation process by offering an additional, but distinguishable hedging alternative to investors.

These contracts will complement SFE's successful SPI futures and options contracts (the first futures contract on an equity product outside the United States) and will be a natural addition to the equity trading and hedging menu of professional equity market participants.

Table 2: Share futures — contract specifications

<table>
<thead>
<tr>
<th>Company</th>
<th>BHP Co Ltd</th>
<th>National Aust Bank</th>
<th>News Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code</td>
<td>BHPF</td>
<td>NABSF</td>
<td>NCPSF</td>
</tr>
<tr>
<td>Contract Unit</td>
<td>1,000 Shares</td>
<td>1,000 Shares</td>
<td>1,000 Shares</td>
</tr>
<tr>
<td>Contract Value</td>
<td>at $17 = $17,000</td>
<td>at $12 = $12,000</td>
<td>at $10 = $10,000</td>
</tr>
<tr>
<td>Minimum Tick Size</td>
<td>1 cent</td>
<td>1 cent</td>
<td>1 cent</td>
</tr>
<tr>
<td>Tick Value</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>Contract Months</td>
<td>Two contract quarters listed in a March/June/Sept/Dec cycle</td>
<td>Two contract quarters listed in a Jan/Apr/Jul/Oct cycle</td>
<td>Two contract quarters listed in a Feb/May/Aug/Nov cycle</td>
</tr>
<tr>
<td>Cash Settlement Price</td>
<td>Derived by averaging SEATS generated bid/ask information (on a minute by minute basis) over the last 2 hours of trading before expiry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quotation</td>
<td>Prices are quoted in terms of cents per share</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Termination of Trading</td>
<td>Trading will cease at 4.10pm generally on the last Thursday of settlement month (refer to By-Laws for details)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Settlement Day</td>
<td>The business day following the last day of trading</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share Adjustments</td>
<td>No adjustments for dividends and an identical adjustment out come to equity options from other capital reconstructions (share splits, bonus &amp; rights issues etc)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trading Hours</td>
<td>9.30am - 12.30pm, 2.00pm - 4.10pm SYCOM 4.40pm - 6.00pm</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial Margin (Deposit)</td>
<td>Initial margins are determined by the SFE Clearing House according to the volatility of the underlying stock, subject to change from time to time. As an indication only, these initial margins will be around $500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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