Let's Talk About Single Stock Futures

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04 August 2022

Last month the Saudi Exchange (Tadawul) launched single stock futures (SSF) contracts – its second in a series of derivatives products to be introduced in the Saudi stock market. This new addition was released just two years after the launch of the MT30 Index futures contract, which was the first exchange-traded derivatives product in Saudi Arabia. Diversifying the asset classes available for investors in the capital markets is one of the country's main financial sector objectives. And as such, the introduction of derivatives can play an integral part in attaining such an endeavor. They provide for an effective tool to manage risk, expand products available for trading, enhance pricing transparency, and promote a well-functioning capital market.

As many of you are aware, a futures contract is a legally binding agreement between two parties, where both parties agree to buy or sell a particular asset of a specific quantity at a pre-specified date in the future for a fixed, predetermined price. Unlike the MT30 index futures, which derives its value from an underlying index, SSFs are based on individual stocks. The first tranche of SSF is based on ten listed companies. The choice of underlying stocks has taken into consideration typical factors, such as market capitalization and liquidity, to ensure sufficient trading activity in the SSF market. Each contract consists of 100 shares of a given stock, and trades are funded by depositing an initial margin. The initial margin (generally around 20% of the stock's cash value) would be determined by the Securities Clearing Company (Muqassa) based on the potential volatility of the underlying and investor's classification.

Following a number of capital market reforms in the last couple of years, the Saudi stock market was successfully included in major global indices such as the FTSE Russel and S&P DJI Emerging Markets. And since then, it has been attracting more foreign investments. The launch of a new type of equity derivatives does seem like the next logical step towards enhancing local and foreign institutional investors scope in managing market risk and maintaining exposures to target investment benchmarks. Thus, such an introduction could undoubtedly add further depth and breadth to one of the largest stock markets in the region.

A LITERATURE OVERVIEW

The impact of derivative trading on cash markets depends on many factors. It would include the regulatory structure, trading mechanism and infrastructure, contract design, and the time of introducing derivatives in the market. Having said that, the literature around the impact of SSF and derivatives, in general, on the underlying stocks (cash market) is somehow mixed.

In terms of volatility, the introduction of SSF trading doesn't seem to influence the volatilities of their underlying counterpart. In fact, the underlying price volatilities had decreased by empirical examination in markets such as Thailand & Russia post the introduction of SSF. As for price discovery, the corroborative empirical evidence concerning the role of equity derivatives at large in the process in which the cash market incorporates new information into asset prices is well documented. This entails that the prices in the derivatives market lead the prices in the spot market as they reflect new information more efficiently.

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Even so, a complete consensus among researchers around this particular role is still absent due to some conflicting or inconclusive results involving the direction, volatility, and pace of information flow between the two markets. What about liquidity? There is a considerable amount of debate regarding the impact of derivatives on the liquidity of the underlying assets. In markets such as the U.S., several studies have indicated a positive correlation between the introduction of derivatives and trading volumes of the underlying by statistically inspecting the volumes prior and post listing of the derivatives. On the other hand, in a market like Malaysia, the introduction of SSF did not seem to impact the cash market liquidity levels. While in India, some studies suggest that it had an adverse effect by diverting speculative activities from the cash market to the derivatives market.

Regardless of their impact on the cash market, there is enough evidence in the literature to suggest that derivatives markets tend to attract informed traders – be it for hedging, arbitraging, or speculating. Why not if they provide less transaction cost, less upfront money requirement, and fewer trading restrictions. When it comes to SSFs, their ability to structure a strategy focused on one individual company's stock and offer leverage compared to stock trading makes them an attractive proposition for some traders.

They can also offer traders a decent alternative to short selling. Short selling occurs when a trader borrows a security and sells it on the open market, planning to buy it back later for less than the sale price. The Kingdom has regulated this trading mechanism since 2017 and subsequently amended it in 2021. Nevertheless, for reasons beyond the scope of this article, short selling is heard rather than seen locally. With SSF now in the market, traders can mimic the economic objective of short selling with relative ease and less cost, given the lack of the Uptick Rule required in short selling.

Apart from SSF’s capacity to assist fund managers and institutional investors in managing their investment portfolios according to different risk appetites, they can also play a key role in the nation’s initiatives toward developing the Exchange Traded Funds (ETFs) industry. Globally, SSF and index futures alike are usually utilized as effective tools to either raise leverage or deleverage ETF’s and meet investors' required returns. Furthermore, an ETF fund manager may employ derivatives to hedge against the unfavorable movement in the underlying or entice investors who would bet against the direction of the underlying by investing in what is called inverse ETFs. It is worth noting that derivatives in general, and SSF in particular, are risky by nature. Traders and investors should understand that the risk of losing significantly more than the initial investment is consistently present. Dealing with derivatives would require vigilance. Positions are marked to market daily, and the possibility of margin calls must always be taken into consideration. With SSF, it is important to consider the level of volatility of the underlying stock as it has a direct relationship with the variability of trader’s open futures position. Moreover, the liquidity levels of the chosen futures instrument are of utmost importance. Illiquid instruments can exhibit excessive price disparities and, thus, could be a major determinant in the success or failure of a trading/hedging strategy.

THE EXPERIENCE SO FAR

Since its launch in August 2020, the MT30 index futures have attracted modest liquidity, to say the least. Based on press statements from Tadawul’s CEO, the instrument has traded more than 500 contracts with a total notional value of SAR 150 million. Moreover, he highlighted the strategic intentions behind its launch and that it targets a specific group of international investors that follow the MSCI. By looking at similar markets, the total notional value of derivatives usually matches or surpasses the equity trading value. The total trading value in the Saudi stock market has amounted to SAR 2.24 trillion in 2021. Thus, it is fair to say that the Kingdom’s path towards reaching a peer-like level of volumes is yet far and unclear. Nevertheless, a limited level of liquidity is, to an extent, expected in the first year or two as market participants get familiar with the new product and the market reaches a form of maturity. To provide some global context, the below table, sourced from the World Federation of Exchanges 2021 report of derivatives activity, shows the top ten exchanges by the number of stock index futures contracts traded in 2021. When it comes to index futures, the B3 (a Brazilian stock exchange) constitutes around 60% share of global volume. As for the top stock index futures traded, the E-MINI S&P500 has been the most active, with more than 403 million contracts traded in 2021.

Exchange	Volume		Notional Value (in $ millions)		Open Interest	
	2021	YOY change	2021	YOY change	2021	YOY change
B3 - Brasil Bolsa Balcão	4,635,926,846	58%	21,259,755	64%	1,161,892	26%
CME Group	1,199,850,886	-4%	156,902,744	19%	4,216,814	1%
Eurex	427,873,692	-29%	22,792,243	-20%	10,210,973	-4%
Japan Exchange Group	281,426,655	-29%	14,339,735	-16%	1,248,898	-14%
Moscow Exchange	170,198,291	-1%	521,374	29%	643,300	39%
Singapore Exchange	169,113,478	-9%	NA	NA	1,468,648	7%
Taiwan Futures Exchange	118,411,890	6%	7,531,968	42%	162,218	-9%
Korea Exchange	118,261,251	-23%	6,758,521	-1%	564,970	-14%
Hong Kong Exchanges and Clearing	100,555,940	-10%	10,646,408	6%	675,762	19%
Borsa Istanbul	95,121,918	-7%	119,217	-33%	353,312	-29%
Others	468,187,996	-15%	30,999,129	-1%	9,859,819	63%
Grand Total	7,784,928,843	18.7%	271,871,095	11%	30,566,606	13%

Source: WFE

Several exchanges worldwide have attempted to introduce single stock futures, but not all have succeeded. The progression of trading activity and thus liquidity in the local exchange-traded derivatives market will rely on many aspects. The below brief is a non-exhaustive list of some of the key determinants:

Underlying & Contract Characteristics: Stocks with large market size, higher volatility, and deeper liquidity have shown to have a positive impact on contract success. In addition, regular mispricing between the spot and futures markets also invites informed investors to the single-stock futures market. Besides, factors such as the contract size, tick size, and contract months on a particular stock significantly contribute to the increase of open interest and traded volume. Few researchers have suggested that a smaller contract size can positively affect the futures trading volume, which in turn contributes to the success of the futures contract. On the other hand, tightening the daily price limit can have the opposite effect.

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Investors Type & Knowledge: In a market where individual/retail investors heavily contribute to daily trading volumes, it would not be a surprise for such a market to experience limited liquidity in futures. As mentioned earlier, derivatives markets attract informed traders/investors, and hence, a futures contract would theoretically succeed if it addressed a commercial hedging need. This would require that informed speculators would be able to manage the risk of taking on the hedger's positions. Realistically, the possession of knowledge among retail investors around futures market and the way in which they operate is instrumental to its success.

Additionally, the fact that futures are to some degree ambiguous from a Shariah-Compliant perspective seems to discourage a particular group of investors from trading them. A focused informational approach to address this gap may very well attract more investors.

Market Makers & Liquidity: Various researchers have highlighted the vital task of market makers in boosting liquidity. The most common types of market makers are brokerage houses. They would always provide transparent two-sided markets when a market is open. Even if liquidity is ample at certain times, their role when markets are volatile and spreads are wide may well allow for less price deterioration in a particular security. Market makers provide necessary liquidity and depth to markets and, at the same time, profit from the difference in the bid-ask spread.

It remains to be seen whether SSF will perform as intended in the coming months and years. I believe the Saudi Exchange as well as the entire ecosystem supporting this initiative deserves credit for their efforts in advancing the Saudi stock market. It is worth noting that the launch of exchange-traded derivatives would not be possible without the development of the associated regulatory framework and market infrastructure. I have no doubt that, with time, this latest introduction will further promote the growth of the derivatives market in the country to include additional derivatives products. The next phase in line is exchange-traded options. Although more complicated to implement and trade than futures yet are, on a global scale, considered the most actively traded among equity derivatives products.

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