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A whole new ballgame for futures investing

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If you think you've got the investment game figured out, check the field again. Congress just authorized a new player for the roster.

Sometime in early 2002, individual investors will have the right to deal in futures contracts on specific stocks. Investors who work for institutions such as hedge funds and insurance companies will gain that right in late 2001 if regulators finish drafting the ground rules.

Single-stock futures could become a new tool for investors seeking profits or protection from the stock market's daily spasms. For the three Chicago exchanges that deal in derivatives trading—contracts based on the value of some underlying security or commodity—it could become their biggest source of new business in two decades.

Congress approved single-stock futures late Friday as part of a final spending package before adjournment. At the outset, the futures probably would be offered on only the most widely traded stocks, such as Microsoft Corp. or AT&T Corp. What does this new type of investment mean and what are the pitfalls? Some questions and answers:

Q. *What are single-stock futures?*

A. On an established exchange, you could deal in shares of Microsoft, for example, based on a price the market thinks the stock will be worth on a future date—the way trading works in corn or soybeans. Let's say a contract for Microsoft shares expiring in January 2002 is commanding $55 a share.

A seller might think that's a good buy for Microsoft, which closed Monday at $47.81 a share. The buyer in effect is betting the stock will rise above $55 before the contract's expiration. The buyer realizes his profit (or loss if Microsoft remains in the doldrums) by taking delivery of the stock, and selling it.

Q. *And this is illegal now?*

A. Yes. Congress expressly outlawed it in 1982 when adopting regulations for financial trading.

Q. *Then what are all those traders in Chicago doing when the markets go crazy?*

A. They're trading futures and options contracts based not on a single stock, but on a popular index, such as the Standard & Poor's 500 or the Dow Jones industrial average. This goes on in different forms at the Chicago Board of Trade, Chicago Mercantile Exchange and the Chicago Board Options Exchange.

At the CBOE, many more traders are involved in *options* on single stocks. Options confer on their owners the right, but not the obligation, to buy or sell a stock at a set price before a set date. An option to buy 100 shares of Microsoft next month at $47.50, nearly its current price, went for $4.25 a share Monday.

Q. *Single-stock options sound an awful lot like futures. Why are the futures needed for stocks?*

Leo Melamed
Force behind rewrite

A. Both can be used to hedge or speculate. Get it right, and you make money even if the price of the underlying security falls.

Leo Melamed, chairman emeritus of the Merc and a force behind the rewrite of the nation's financial regulations, said futures are inherently simpler than options, and that trading objectives can be attained in fewer transactions and with lower costs. "There isn't so much vigorish involved," he said, using a Yiddish term for interest paid to lenders.

Options trading is divided into calls and puts, with calls giving the holder the right to buy a stock price, and puts conferring the right to sell at a certain price. Melamed said an options trader has to make two transactions—selling a call and buying a put, for example—to accomplish the objective of one futures trade.

Bill Ryan, manager of a call center for Options Industry Services in Chicago,

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which handles queries about options trading, had doubts. He said options trading can be structured to hold risk to a minimum, while the futures may allow for more losses in fast moving markets.

"I also would be concerned about how the futures market would account for dividends or mergers and acquisitions," he said.

Q. *Are single-stock futures for the average investor or just the professionals?*

A. A lot depends on the rules the exchanges will draft with federal regulators. An options contract usually represents 100 shares of stock. At their inception, the single-stock futures contracts could represent 1,000 shares of stock, which could gear it more to professionals.

Scott Early, an expert in futures trading regulations at law firm Foley & Lardner, said if the exchanges make it too large, it's out of reach for speculators, but if it's too small, it doesn't interest big institutions.

Q. *What should an investor remember about futures vs. options?*

A. Remember that it costs only $4.25 per-share to control 100 shares of Microsoft through a call option. That's called the "premium." You don't have a premium in a future.

But if Microsoft moves the wrong way, the premium limits the option buyer's loss. The futures loss could be wider, depending on an investor's reaction. "It's a different approach, and a different strategy entirely for the market," Melamed said.