"Gold Deriatives – A Golden Opportunity for Investors"

CMA (Dr.) Supriya Agrawal

A Gold future is simply a deal to trade gold at terms (i.e. amounts and prices) decided now, but with a settlement day in the future. That means you don't have to pay up just yet (at least not in full) and the seller doesn't need to deliver you any gold.

The settlement day is the day when the actual exchange takes place - i.e. when the buyer pays, and the seller delivers the gold. It's usually up to 3 months ahead.

Most gold futures traders use the delay to enable them to speculate - both ways. Their intention is to sell anything they have bought, or to buy back anything they have sold, before reaching the settlement day. Then they will only have to settle their gains and losses. In this way they can trade in much larger amounts, and take bigger risks for bigger rewards, than they would be able to if they had to settle their trades as soon as dealt.

Gold Future's Margin

Delaying the settlement creates the need for margin, which is one of the most important aspects of buying (or selling) a gold future.

Margin is required because delaying settlement makes the seller nervous that if the gold price falls the buyer will walk away from the deal which has been struck, while at the same time the buyer is nervous that if the gold price rises the seller will similarly walk away.

Margin is the down payment usually lodged with an independent central clearer which protects the other party from your temptation to walk away. In gold future trading, margin amount is required and depending on current market conditions it might be anything from 2% to 20% of the total value of what you dealt. If you have bought and the gold price starts falling you will be obliged to pay more margins. As a buyer you cannot get out of paying margin calls in a falling market until you sell.

Gold Futures for Leverage

Gold futures are also used for leverage of position or gearing of financial position.

For example, suppose you had Rs. 3 Lacs to invest. If you buy gold bullion (Physical Gold) and settle you can only buy Rs. 3 Lacs worth of gold in cash market. But you can probably buy Rs. 30 Lacs of gold futures. That's because your margin on a Rs. 30 Lacs gold future will probably be about 10% - i.e. Rs. 3 Lacs.

If the underlying price goes up 10% you would make Rs. 30,000 from gold from cash market, but Rs. 3 Lacs from gold futures. If the price of gold falls 10% you'll lose just Rs. 30,000 with gold from cash market and your investment will be intact to earn you money if gold resumes its steady upwards trend. But the same 10% fall will cost you Rs. 3 Lacs with futures. Now you have to deposit margin against this loss or otherwise close your position. If you refused to top-up your margin you will be closed out by your broker, and your original Rs. 3 Lacs will be lost on a minor intra-day adjustment - a downwards blip in the long-term upward trend in gold prices.

To deal gold futures you need to find yourself a futures broker. The futures broker will be a member of a futures exchange. The broker will manage your relationship with the market, and contact you on behalf of

the central clearer to - for example - collect margin from you. Your broker will require you to sign a detailed document explaining that you accept the significant risks of futures trading. Account set-up will take a few days, as the broker checks out your identity and creditworthiness. Note that gold futures are dated instruments which cease trading before their declared settlement date.

Gold is bought as the ultimate defensive investment. Many people buying gold hope to make large profits from a global economic shock which might be disastrous to many other people. Indeed many gold investors fear financial meltdown occurring as a result of the over-extended global credit base - a significant part of which is derivatives. The paradox in investing in gold futures is that a future is itself a 'derivative' instrument constructed on about 95% pure credit. There are many speculators involved in the commodities market and any rapid movement in the gold price is likely to be reflecting financial carnage somewhere else.

Gold futures are best used to hedge physical position to avoid any unsystematic risks.

Associate Professor
S. S. Jain Subodh Management Institute, Jaipur

Reference

1. www.moneycontrol.com
2. www.zeebusiness.com
3. www.investing.com
4. www.economictimes.com