Hedging Your Investments with Index Futures

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Investing in the stock market can provide an excellent return on investment over the years. Simply by purchasing shares of the SPY ETF one can match the performance of the S&P 500. However, the stock market, not to mention individual stock prices, can be volatile. Bull markets tend to be followed by bear markets before bull markets re-emerge. One of the ways that you can protect yourself against short term loss is by hedging your investments with index futures.

What Is a Futures Contract?

A futures contract is an agreement entered into via a futures exchange in which the buyer takes on the obligation to purchase a security or commodity asset at an agreed upon price at a future date. The seller accepts the obligation to sell that security on the agreed upon date no matter what the market price is. If a person does not exit the contract before expiration they are obliged to buy or sell as specified in the contract. However, most futures traders and investors hedging their investments with futures exit by selling if they had purchased and buying if they had sold. Because the price of the futures contract will generally have gone up or down, the person will have made or lost money. The point of hedging your investments against loss with index futures is to make money by selling index futures and cover the losses in your portfolio.

How Do You Hedge a Stock Portfolio With Futures?

What stock investors are worried about is that the market will correct or crash and that their stocks will lose value. Index futures are commonly used to hedge against loss in a market downturn. This is because an index like the S&P 500 moves up and down with the economy and generally runs parallel to a basket of large cap stocks. By selling index futures such as for the S&P 500 the investor protects against a downturn as the futures contract will increase in value if the index falls. Rather than waiting for the contract expire the investor will exit the contract by buying and use the profit to offset portfolio losses.

What Are Index Futures?

Index futures are cash settled futures contracts on indexes like the S&P 500, Dow Jones Industrial Average, or NASDAQ. Most of these contracts settle quarterly in March, June, September, and December. The futures market trades nearly 24 hours a day with a brief break for settlements six days a week. The S&P 500 futures contract is the most heavily traded index future The SP contract is the base futures contract for the S&P 500. Multiply the S&P 500 by $250 to get its price. As of this writing, the S&P 500 is 4441.37 which makes the SP contract worth $1,110,342.50. The E-mini future contract is a fifth of the SP contract making it worth $222,068.50. If you choose to trade index futures to hedge your stock portfolio you will need to have money in your brokerage account to cover the necessary margin. In general, the amount needed for margin for futures trading is less that needed for day trading but it needs to be enough to cover your obligations as the market progresses. The CME requires at least $6,300 in maintenance margin for overnight trading of futures and most experts suggest the traders only risk one or two percent of account equity on any given trade.

Is It Better to Hedge Risk with Options of Futures?

Depending on the strategy that you use, both options can futures can add risk to your investment life instead of taking it away. If you are interested in hedging your investments with index futures or options you need to be clear about your strategy, understand the risks, and pay constant attention. If you are unable or unwilling to do this, both approaches can lead to trouble. Because when you buy a call or put option you have the choice of exercising the contract or not, this is commonly a safer route that futures where you are locked into the contract unless you exit at a loss.

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