Forwards and Futures

Forwards and futures are derivative arrangements that involve two parties who agree to buy or sell a specific asset at a set price (forward price) by a certain date in the future (contract maturity / expiration date). By locking in the price for an asset, buyers and sellers can hedge against risks associated with price movements - or speculate.

Unregulated and not traded on exchanges, forward contracts are arrangements made Over-The-Counter (OTC) and settle just once: at the end of the contract. – The exact terms of a forward are privately negotiated (not made public) and customized to the specific needs of the two parties involved, who are obligated to fulfil at maturity. However, this flexibility implicitly embeds a certain degree of risk that one party may default, upon which the contract would not be fulfilled (i.e. counterparty risk). With settlement of forwards not guaranteed, these instruments are not readily available for retail investors.

Futures, on the other hand, are standardized contracts defined on standardized assets with fixed maturity dates. As they are traded on exchanges they are regulated instruments, marked to market daily and also settled on a daily basis (not just at maturity). And, as highly liquid they can be bought or sold any time. - In contrast to forwards which come along with a counterparty risk, this is almost zero for futures. Instead, futures are equipped with an institutional guarantee provided by the clearinghouses that back them. Further, they require a deposit: This initial guarantee (margin) serves as collateral to cover any potential risk of default. And, as a future´s value is marked to market daily, also profits and losses of the instrument are settled on a daily basis. - Futures are instruments frequently used for speculating, betting on the direction in which the price of an asset will move. Usually they are closed out and settled in cash already prior to maturity, with physical delivery subsequently never happening.

Typical underlyings for forwards and futures are financial assets (such as stocks, bonds, market indices, interest rates, currencies) or commodities (such as natural gas, gold, copper, silver, oil, electricity, coffee beans, sugar).

	FORWARDS	FUTURES
STRUCTURE	CUSTOMIZED	STANDARDIZED
PURPOSE	HEDGING	SPECULATION
TRANSACTION	NEGOTIATED DIRECTLY	QUOTED & TRADED
REGULATION	NO	YES
GUARANTEE	NO	INITIAL GUARANTEE (MARGIN)
COUNTERPARTY RISK	HIGH	LOW (BACKING BY CLEARINGHOUSE)
MATURITY	WITH DELIVERY	USUALLY EARLIER
EXPIRY DATE	NEGOTIATED	STANDARDIZED

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