

THE HANDBOOK OF
**FINANCIAL
FUTURES**
A GUIDE FOR
INVESTORS AND
PROFESSIONAL
FINANCIAL
MANAGERS

NANCY H. ROTHSTEIN
EDITOR IN CHIEF

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The Handbook of Financial Futures

**A Guide for Investors and
Professional Financial
Managers**

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Editor in Chief

and

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The investment and hedge strategies outlined in this book are not suitable for every investor or financial manager, and no specific investment recommendations are intended. Readers should satisfy themselves by seeking competent investment advice so that they thoroughly understand the risks as well as the potential rewards of trading in and hedging with financial futures.

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Foreword

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The greater part of inventive advance seems to be accounted for by the accumulation of comparatively small changes.—Jewkes, Sawers & Stillerman, *The Sources of Invention*.

Economists and businesspeople have long been concerned with the process of invention and innovation. Although the primary area of attention has been in the industrial arts, students of technological change would probably agree that nonpatentable creative activity in the economic and financial environment has spawned enormous social benefits. Simple examples of financial innovation include the development of double entry bookkeeping as well as the limited liability corporation. These may rank with such inventions as oxygen steel making or even the steam engine. Among the most neglected areas of financial innovation has been the development of organized futures markets. Within this broad field, the recent development of financial futures—the focus being interest rate futures markets but also extending to currencies, stock indexes, and options on interest rate futures—has begun to revolutionize not only futures markets themselves, but all sectors of the United States and world capital markets as well as the financial institutions and corporations associated with these markets. These developments have attracted the attention of both academics and practitioners, and we are in the process of witnessing the development of an entirely new profession. This profession is devoted to the use of financial futures markets for risk management. This publication presents the first professional handbook in this area, to be read by a wide variety of users and students of this new tool. The book itself is evidence of the birth of this profession. (It is important to note here that both men and women are engaged in the practice of this profession and that the pronouns “he” and “his” have been used only in a generic sense in this book, to avoid awkward grammatical constructions.)

Since 1970 futures trading in the United States alone has increased from 13.6 million contracts to 98.5 million contracts in 1981. Volume in the first eight months of 1982 has already reached 72.4 million contracts. In addition to active markets in primary commodities such as grains and metals, futures

markets now exist for live animals such as hogs and cattle as well as processed commodities such as soybean meal and plywood. The latter two areas of small change have provided enormous growth to futures markets as a result of inventive activity. However, the most startling contribution to the growth of these markets has occurred in financial futures, which now account for 36.9 percent of all futures contracts traded. In an industry where the general public identifies soybeans and pork bellies with futures markets, the largest single market in the world has become the U.S. Treasury bond futures market at the Chicago Board of Trade. Similarly, the most active contract at the Chicago Mercantile Exchange is the U.S. Treasury bill futures market. It is interesting to note that if interest rate futures were not included in volume statistics, the industry would be only 73.6 percent of its current size.

It is relatively easy to describe the effects of financial futures markets on the exchanges themselves. The expansion of these markets and the associated increase in trading volume has required the construction of new trading floors. Furthermore, exchanges have expanded their ability to disseminate information as the demand for price discovery has soared. The electronic dissemination of information has caused exchanges to become associated with a much wider variety of communications networks. The memberships of the exchanges have also changed dramatically. Market makers on the exchange floors have been drawn from the financial sector as well as from the leading universities' MBA programs. There has been an entry of bank and nonbank primary dealers in U.S. government securities to the exchange community through the purchase of memberships and the development of clearing entities.

It is somewhat more difficult and complex to describe the impact of these markets on risk management. Dealers in all types of securities have developed research departments or sections of departments to broaden their understanding and use of these markets. Specialists in hedging underwritings have emerged within these firms. Arbitrage departments have developed within financial institutions. Asset and liability managers within commercial banks have begun to develop entirely new strategies. Certain institutions have even begun to reintroduce the fixed-rate loan as the result of an ability to hedge against interest rate fluctuations.

In spite of the enormous growth in financial futures it is important to emphasize that risk management using financial futures is really an infant industry. Interest rate futures as an infant industry will encounter the same difficulties and opportunities that confronted interest rate futures themselves. The birth of the concept of interest rate and GNMA futures at the University of California, Berkeley, and its subsequent gestation period at the Chicago Board of Trade provided excitement and reward to those individuals associated with this inventive activity. As interest rate futures developed, numerous skeptics were converted, who then developed interest rate contracts on other exchanges in the United States and throughout the world. This history will probably repeat itself with the development and maturing of risk management using interest rate futures. This handbook, for the first time, begins to integrate the use of these markets—and should help to alleviate skepticism about them—for both the beginner and the professional. It also proves to be of interest to the investing public. It is hard to imagine a more timely publication in view of the

current economic environment. It appears that risk managers will have to be interested in hedging techniques until they are entirely sure that the fiscal and monetary policies which provided the impetus and growth of these markets have been entirely removed by a more rational economic policy. Even in those circumstances it may not be possible to avoid the use of these markets as a result of relatively smaller interest rate risk. This is an important rationale for the current publication. It provides the reader with the ability to develop a thorough knowledge of financial futures markets. Alternatively, it can be used as a reference guide for individuals who seek only some basic information about financial futures. Professionals can use this book to obtain specific information in more advanced areas.

It is important to reiterate that these markets are still in their infancy and that professional risk managers are still on the early part of the learning curve. As these markets grow and as exchanges develop new contracts, academicians and professionals will develop new techniques. Financial institutions, portfolio managers, and industrial corporations will develop an entirely new vocabulary. It is reasonable to assume that if interest rate volatility persists, a new lexicon of "interest rate insurance" will emerge. Individuals who are able to change with the economic environment will provide significant benefits to their particular institutions as well as the entire U.S. and world economies. It is important to welcome all readers of this new handbook into this new world of risk management.

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I express my sincerest gratitude to many individuals and concerns for their contribution to the completion of this book. First, I wish to thank my husband Steven, my daughter Caroline, and my family for their continued patience and support in helping me to complete *The Handbook of Financial Futures*. Two individuals to whom I express special appreciation are my mentors, Dr. Richard L. Sandor and Dr. Mark J. Powers, both of whom have played a central role in the development of my knowledge and expertise in financial futures. They have been a source of inspiration and direction, for which I am deeply grateful.

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Nancy H. Rothstein

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