Stocks And Futures' Structural Differences

After I mentioned a list of differences yesterday between stocks and futures, I realized I had to end the mystery, such as it is. I went back to something I wrote in January 2002 and was astonished at how the changing nature of markets had started to erode or transform these differences. Without further ado:

1. All futures contracts have a definite life and all bonds save perpetuities mature. This creates patterns of convergence toward a final value not present in stocks. A stock is born with the presumption it can live forever and therefore has no convergence;
2. Stocks' price behavior is affected by dividend payouts and by corporate actions such as splits and rights offerings; these distort a stock's history in a way unseen in futures;
3. Stocks fulfill their economic mission of raising capital and distributing the risk of ownership at birth. I used to say, "Futures exist for price discovery and risk management purposes," but this has changed with the widespread adoption of long-only commodity index funds. Now futures' forward curves reflect the dynamics of these funds as much as they do the vagaries of insurance and storage demands;
4. The mechanics of indexation and portfolio balancing affect stock prices for reasons wholly extrinsic to fundamental valuation. In a major shift, we now can say the same for futures markets;
5. I used to say stocks traded within a consistent set of trading hours while many futures markets traded in a near-continuous 24-hour day that made the concept of opening and closing prices obsolete. Now the stock-trading day is nearly as unbounded as the currency and interest rate markets' day;
6. The underlying asset for futures contracts used to be constant; this is changing. For example, corn used to be driven by the demand for livestock and human food, but now we feed 40% of the crop to yeast to make ethanol. These sorts of changes will make the long-term comparison of futures markets as difficult as that of stock markets where the very nature of companies change regularly;
7. I used to say stock prices are far more volatile than those for storable commodities as they could be driven by nothing more than hope or rumor while process inputs had real industry economics behind their prices. Commodity index funds have overwhelmed these fundamentals with a wall of money;
8. I used to say stocks demanded a trend-following approach while commodities demanded a mean-reverting approach. After a decade of stocks going up and down in a massive range and commodity prices mostly going straight up, this observation needs a little fine-tuning;
9. Stocks gap on the open more often than commodities as earnings announcements and corporate actions tend to take place after the end of the day or before the U.S. opening. In addition, the flow of information is more restricted in stocks, especially after Sarbanes-Oxley. The concept of insider trading and fair disclosure is not part of the commodities world;
10. Trade in futures markets is symmetric between buyer and seller; there is nothing like the short-selling restrictions or uptick rules we see in stocks. Yet.
11. Stocks have rule-based margins set by the Federal Reserve under Regulation T, at least for small players. Stock margins are a down payment; futures margins are a performance bond and are set by the exchanges in response to market volatility. Exaggerated moves in futures tend to force players out of the market;
12. Finally, the taxation of stocks and futures is different. Stocks have favored treatment for long-term capital gains and qualified dividends; futures have favored treatment under Section 1256 (60% long-term and 40% short-term). Futures also have hedge accounting treatment under FAS 133. All of these considerations affect trading patterns, especially at year-end.

There you have it: In less than ten years six of the twelve differences I noted between stocks and futures changed materially as the result of changes in market structure, money flow, tax treatment or some other cause. The two markets still have different trading terrains and that demands different price patterns and analytic approaches. But the one-size-fits-all approach does not work, never did and does not work for different reasons now than it did in 2002. This is change we can believe in; something has to be.