

Stocks And Futures: Vive Le Difference

What do market analysts have in common with Afghanistan? They're always fighting with each other. Since Rodney King's famous plea, "can't we all just get along?" has been answered with a resounding "No!" let's move to the other end of the spectrum and launch a good barroom brawl. Ready?

Hey, you technical analysts, you can't trade stocks and futures with the same trading system!

This missive is launched out of more than a simple desire to sink my teeth into a juicy slab of social irresponsibility. The forthcoming launch of single stock futures (SSFs) is going to blend for the first time the trading patterns of individual equities with those of futures. In the interest of preventing needless unpleasant surprises for technical traders when that happy day arrives at last, let's offer the Top Twelve reasons why a one-size-fits-all approach might not be conducive to your financial health.

The Dirty Dozen

1. An old Wall Street joke, the only kind, asks the difference between a bond and a bond trader. The punch line is the bond eventually matures. Stocks, on the other hand, have no expiration date; they live for the life of the issuing corporation. All futures contracts, no matter how long-dated, have a finite life. As a result, all futures contracts have a convergence to the price of their underlying asset, and this convergence creates a price movement not present in the underlying stock.
2. A dividend-paying stock's price movements are affected by the dividend payment cycle. A stock should decline in price after the ex-dividend date. Other and more significant corporate actions such as stock splits, special dividends, rights offerings, etc., will produce even greater distortions in the price history. We need not account for any of these factors in futures trading other than in their partial effects on stock index futures.
3. Stocks exist to raise capital for the issuing firm and to distribute the risks and rights of ownership. Futures exist for price discovery and risk management purposes. As a result, futures markets can have complex forward curves that reflect both price expectations and hedgers' demands for insurance. This consideration along with basis movement renders all attempts to construct adjusted long-term continuous futures contracts imperfect.
4. The mechanics of indexation and portfolio balancing create money flows into and out of a given stock for reasons wholly extrinsic to either the fundamental developments in or the technical patterns of a given stock. As was the case for Yahoo in December 1999, these price movements can be quite significant. The very act of including or removing a stock from an index such as the S&P 500 or the NASDAQ 100 can raise or lower the price of the stock for reasons totally unrelated to either its fundamental outlook or its recent technical trading history.
5. The reported price movements of U.S. equities occur during a consistent set of trading hours and are produced by a consistent set of participating traders, both American and international, within those hours. The parallel situation no longer holds for important futures contracts. Significant price movements often occur during non-prime trading hours. For short-term interest rate and currency markets, the very concept of a trading day has been rendered artificial.
6. The underlying asset for futures contracts either remains constant or attempts are made to make it constant. The issuing corporation for any common stock is a dynamic entity. While 5,000 bushels of soybeans are always 5,000 bushels of soybeans, General Electric is changing constantly within a group of industries. As a result, the long-term price history of commodity futures can be studied for common technical and fundamental relationships. A comparison of a stock to its own history often is an apples-and-oranges affair.
7. Stock prices are far more volatile than those for storable commodities, financial markets included. Only non-storable electricity is consistently more volatile than most tech stocks. The fundamental value of any common stock is its discounted stream of expected future dividends, a vaporous concept. As a result, the opinions of analysts often are treated as a fundamental reason to buy or sell a stock; no parallel situation exists in the world of futures. The price of a stock can go anywhere without precluding any subsequent economic process, but you just can't turn \$10 per million BTU natural gas into ammonia-based fertilizer and stay in business for long. Commodity prices are bound by economic reality, while stocks can float on a dream.
8. All trading systems, at their most essential, are either trend-following or mean-reverting. You either try to buy high to sell higher or buy low to sell high. This bounded nature of commodity prices and the open-ended nature of equity prices should encourage mean-reversion trading systems for futures and trending trading systems for equities, yet the opposite appears to be the common practice. Futures traders often try for the rare home run, while stock traders bunt fat pitches down the middle. Go figure.

9. Stock prices gap more than do commodity prices; earnings announcements after normal trading hours and economic reports before normal trading hours can create numerous supply/demand imbalances. It is not unusual in the specialist exchanges, the NYSE and the AMEX, for trading to be suspended while either buyers or sellers are being sought. In addition, the information flow into equity markets is restricted relative to commodity markets. The concepts of insider trading and fair disclosure do not exist in futures markets.
10. Buying and selling in futures markets occurs under symmetric rules. There is no need to locate a physical supply of any commodity for sale to short a futures contract, and there are no uptick rules in futures trading. Asymmetric trading rules should create different price patterns.
11. The very different margin systems between the world of equities and the world of futures can force the hand of futures traders after a period of extended volatility. Equity margins are set by the Federal Reserve under Regulation T and are universal regardless of the volatility of the stock. Futures margins are set by the exchanges and respond to increases or decreases in the volatility of the underlying commodity. As futures margins inherently are a lagging indicator, they tend to be raised at the end of a protracted and volatile move and often contribute to its conclusion and reversal.
12. Futures and stocks are taxed on a different basis. While the unrealized capital gain on a stock is not subject to taxation under American law, the unrealized open equity on a futures contract is taxed on December 31st of each year. Moreover, the frequent expirations of futures contracts create a series of taxable events. Finally, the rules of hedge accounting (FAS 133) create a different set of tax incentives for those who use futures for hedging the risk of an underlying asset.

There you have them, all of the reasons why the technical analysts of the world had better do some homework in preparation for SSFs. Of course, that's not such a bad thing, for them or for the rest of us: When markets become more efficient, everybody wins.