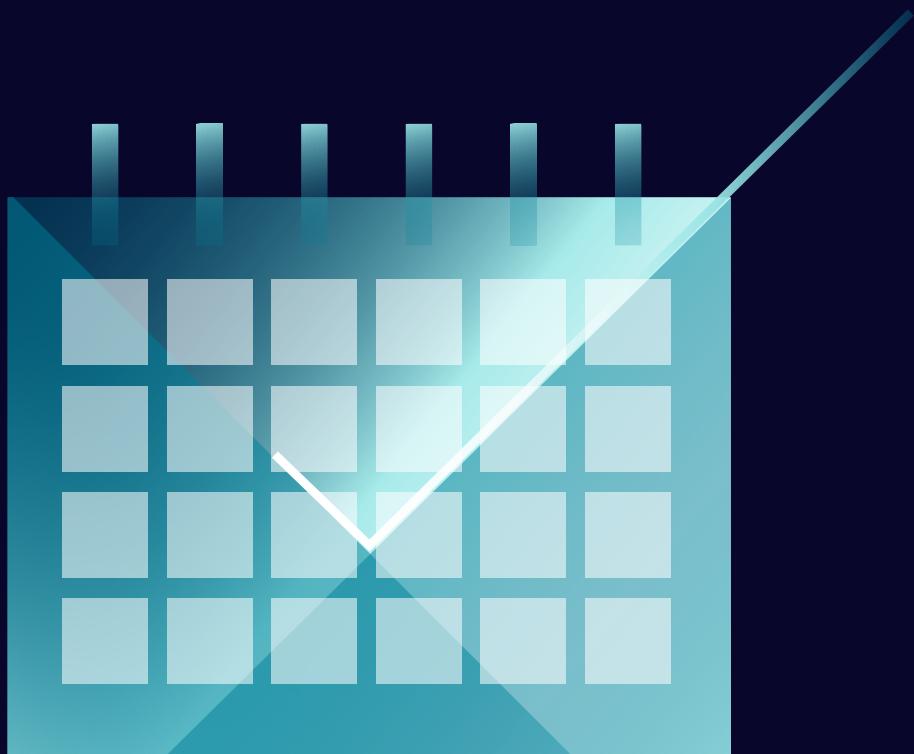


Understanding Futures

A Beginner's Guide



Futures trading is a critical component of the global financial system, allowing market participants to manage risk or speculate on price movements across various asset classes. Let's start with the basics and build our way up to more advanced concepts.

What are Futures Contracts?

Futures contracts, or simply "futures," are legally binding agreements to buy or sell a standardized asset at a predetermined price on a specific date. The underlying assets can range from commodities like wheat to financial instruments like the Nasdaq-100 Index.

How Futures Trading Works

Unlike buying stocks or bonds, futures trading involves unique mechanisms. Both buyers and sellers must deposit initial margin, which can be as low as 3-12% of the contract's notional value. The notional value is calculated by multiplying the underlying asset's price by the contract size.

For example, if the **Nasdaq-100 Index** is at **22,000** and the **E-mini Nasdaq-100 contract** size is **\$20 times the index value**, the notional value would be **\$440,000 ($\$20 \times 22,000$)**. The initial margin requirement might be **\$44,000 (10% of \$440,000)**.

-  1. Leverage

Futures trading involves significant leverage, amplifying both potential gains and losses.
-  2. Margin Calls

If market movements cause the account equity to fall below the maintenance margin threshold, traders receive a margin call, requiring them to add funds or close their position.
-  3. Contract Lifespan

Futures contracts have a limited lifespan and can be offset, rolled over, or held to expiry.
-  4. Market Access

Futures contracts can be traded nearly 24 hours a day via electronic platforms.
-  5. Ease of Going Short

Selling a futures contract to go short is basically the same as buying one to go long - both involve a simple transaction to open the position.

Equity Index Futures

Equity index futures, such as the E-mini Nasdaq-100, offer market participants the ability to trade equity market exposure beyond regular stock market hours. These products provide benefits like deeper liquidity, flexibility in trading long or short positions, and reduced counterparty risk due to central clearing.

Example: Leverage with Micro E-mini Nasdaq-100 Futures

Let's consider a hypothetical scenario with the Micro E-mini Nasdaq-100 futures, a more accessible, smaller contract.

Contract Size	Current market price	22,000
1 MICRO E-MINI NASDAQ-100 CONTRACT	Total contract value	$22,000 \times \$2 = \$44,000$
  \$2 x NASDAQ-100 INDEX	Initial margin requirement	\$4,400 10% OF THE CONTRACT VALUE

If a trader bought one Micro E-mini Nasdaq-100 futures contract at an index price of 22,000 and the index went up to 23,000, they would make a \$2,000 profit. This is calculated by multiplying the point gain by the contract's \$2 multiplier:

$$(23,000 - 22,000) \times \$2 = \$2,000$$

A 1,000-POINT GAIN IS EQUIVALENT TO
2,000 TICKS (AT \$5.00 PER TICK)

CONTROVERSLY, A 1,000-POINT MOVE AGAINST
THE TRADER'S POSITION WOULD BE AN ADVERSE OF
2,000 TICKS, OR A LOSS OF \$2,000

The Role of Futures in Markets

Futures trading plays a vital role in price discovery for various assets, from commodities to financial instruments. Market participants collectively determine current prices based on news, expectations, and economic outlook.

Market Data and Insights

Traders have access to valuable data, including daily volume and open interest from exchanges like the CME, as well as the Commitments of Traders report from the Commodity Futures Trading Commission. These insights help traders gauge market sentiment and potential future movements.

	Futures Contract	Forward Contract
 Specifications	Standardized with respect to quality, quantity, and delivery (physical or cash-settled). Futures exchanges set the specifications, which apply to all market participants.	Customizable in terms of quality, quantity, and delivery (physical or cash-settled). The two parties involved in a forward contract negotiate the specifications privately.
 Trading	Facilitated via a recognized futures exchange, which, through its clearinghouse, serves to guarantee the performance of both sides of a contract should one party default.	Takes place bilaterally (trader to trader). Forward contract trading is said to be 'over the counter' (OTC). The absence of a third party guaranteeing their performance means that forwards involve what is known as counterparty risk .

Equity Index Futures and Options

The U.S. stock market operates from 9:30 AM to 4:00 PM ET, Monday through Friday. However, investors interested in equity market exposure can extend their trading hours significantly. Equity index futures and their associated options markets are accessible nearly 24 hours a day, six days a week.

Beyond extended hours, these markets offer several advantages. Participants benefit from deeper liquidity and the flexibility of easily trading both long and short positions, without short-selling restrictions.

Central clearing also reduces counterparty risk. Furthermore, a variety of contract sizes and styles cater to diverse trading strategies. For instance, CME Group provides both E-mini Nasdaq-100 (NQ) and Micro E-mini Nasdaq-100 (MNQ) futures, with the latter requiring less capital, making it potentially more attractive to smaller investors.

Equity index products serve a broad spectrum of users, including portfolio managers, endowments, asset managers, mutual and ETF funds, and self-directed traders. CME Group offers futures and options on multiple global equity indices to meet the needs of various market participants.

Options on Futures Contracts Explained

An option on a futures contract gives the holder the right, but not the obligation, to buy or sell a specific futures contract at a predetermined price (the strike price) on or before the expiration date. In exchange for this right, the buyer pays a non-refundable premium to the seller.

This financial structure enables various trading strategies. For instance, a buyer can use an option as a form of insurance against unfavorable price movements. If the market moves against their position, their maximum loss is limited to the premium paid. Conversely, the seller receives the premium as income but is obligated to fulfill the contract terms if the buyer exercises their option.

Key Considerations



For the Buyer: The potential loss is capped at the premium paid, providing a form of risk management.



For the Seller: The seller collects the premium but assumes the obligation to fulfill the contract if exercised. Option sellers have unlimited risk.

Conclusion

Futures markets are a cornerstone of the financial system, enabling risk management and speculation across various asset classes. By understanding the basics of futures trading, including leverage, margin requirements, and contract specifications, market participants can better navigate these markets. As we've seen, futures trading involves complex concepts and significant risks, but also offers opportunities for profit and risk management.

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