



The Basics of Single Stock Futures



Over the years, the stock market has afforded opportunities for investors to share in the growth of the U.S. economy. Additionally, new exchange-traded financial instruments like stock options and stock index options and futures have been created to help manage the risks of stock ownership and to take advantage of stock market moves.

Now changes in federal regulations have paved the way for the introduction of single stock futures (SSFs). This new instrument provides a link between two kinds of financial markets—securities and futures—and makes it easier to hedge portfolios and capture market opportunities.




NEW PRODUCT, NEW EXCHANGE

A new wholly electronic futures exchange, Nasdaq Liffe Markets (NQLX), was created to trade this unique hybrid instrument.

The two partners in Nasdaq Liffe Markets offer expertise from each of the worlds that single stock futures bring together. The Nasdaq Stock Market, the world's largest electronic equity market, has become synonymous with the most exciting and promising component of the U.S. economy. The London International Financial Futures and Options Exchange (LIFFE), the premier international electronic derivatives exchange, brings its own experience in trading stock futures and provides NQLX with LIFFE CONNECT™—a trading system that is market-tested, functionally rich, and robust.

The goal of NQLX is to build on the strength of its parents to attain its own vision of an accessible electronic marketplace for a wide range of financial instruments.



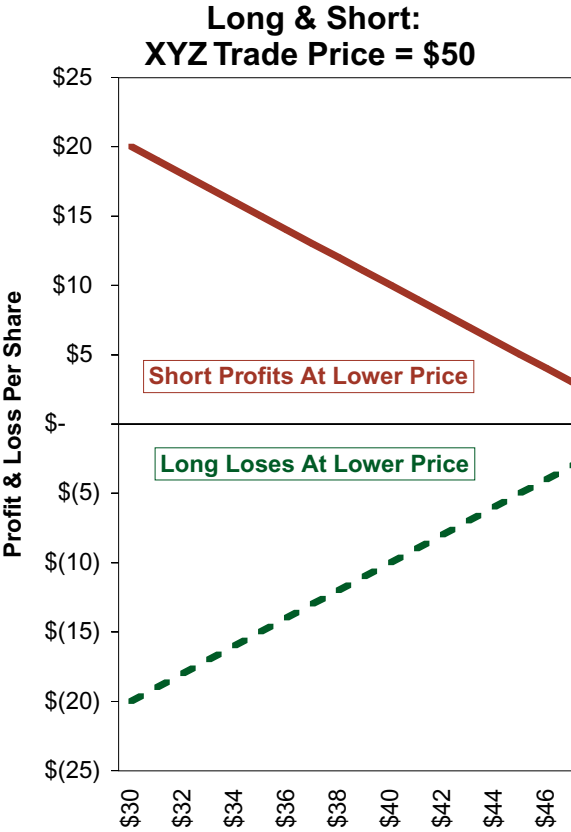
SINGLE STOCK FUTURES: WHAT ARE THEY?

A SSF contract is simply a standardized agreement between two parties to buy or sell 100 shares of a particular stock in the future at a price determined today. Futures contracts are bought and sold on federally regulated exchanges, and for SSFs, regulation is by both the Securities and Exchange Commission and the Commodity Futures Trading Commission.



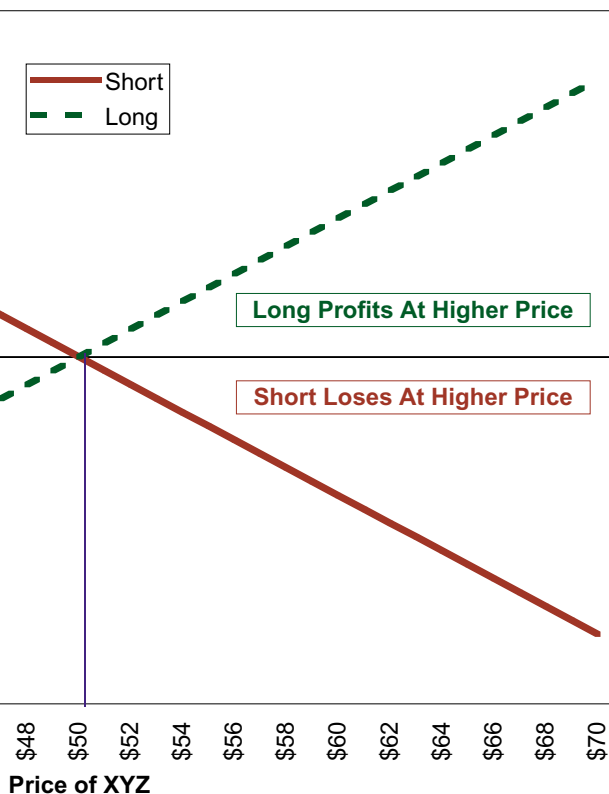
On NQLX, SSF contracts are available with expirations for the first five calendar quarters (expiring in March, June, September and December) and in the first two non-quarter calendar months. For example, on July 1st, SSFs would be offered that expire in July, August, September, and December of the current year, and in March, June and September

of the next year. By taking a position in a SSF, you can lock in a price today at which you'll buy and sell stocks as much as 15 months from now. The minimum price fluctuation, or "tick" size, of NQLX SSFs is one cent per share, or \$1 per contract.



THE MECHANICS OF SSFs

The mechanics of trading SSFs are fairly straightforward. If you believe that the price of a particular stock will go up, you buy or "go long" a SSF contract. If you think the price is headed down, you sell or "go short" the futures contract (and in futures trading, you don't have to wait for an uptick as you might have to when shorting stocks, so going short is as easy as going long).



As an example, let's say you bought an April futures contract on XYZ Company at a price of \$50 during the first week of February. This gives you the obligation to buy XYZ at \$50 when the future expires on the third Friday of April unless you sell the futures contract first. In other words, you can end your agreement to buy XYZ by selling the April futures contract at any time before the contract ceases trading. If XYZ's price at the time is greater than \$50, you make \$100 for each dollar it is higher, and you lose \$100 for each dollar it is lower.

The procedure for selling is just the opposite. You can offset your obligation at any time on a short contract by buying it back before you would need to deliver XYZ shares. If XYZ's price at the time is less than \$50, you'll make \$100 for each dollar it's lower, and you'll lose \$100 for each dollar it's higher. (SEE CHART PAGE 4 & 5)



PROFITS AND LOSSES

As the graph on pages 4 & 5 shows, if you sell a futures contract at a higher price than you bought it, you'll make money. If

you sell it for less than you bought it, you'll lose money. It doesn't matter whether you first went long or short.

The formula is the same:

$$\begin{aligned} & [\text{Price Sold} - \text{Price Paid}] \times 100 \text{ shares} \times \text{Number of Contracts} \\ & = \text{Profit or Loss} \end{aligned}$$

Let's say you went long (i.e., bought) 5 contracts of XYZ futures at \$50 and sold them one month later at \$55. Your profit will be:

$$[\$55 - \$50] \times 100 \text{ shares} \times 5 = \$2,500$$

If, however, you went short 5 contracts of XYZ at \$48 and bought them back at \$57, your loss would be:

$$[\$48 - \$57] \times 100 \text{ shares} \times 5 = (\$4,500)$$

These calculations don't include commissions paid to your broker. As in stock trading, the cost of commissions are subtracted from your profits to determine your net profit or added to your losses to determine your total loss. You should also be aware that futures brokers may calculate commissions on a round-turn basis—that is, commission covers both the cost of opening and closing a position. Stock commissions are typically calculated separately for each side of a transaction.

SIMILARITIES AND DIFFERENCES

As the graph illustrates, SSFs have the same price and risk profiles that are familiar to stock traders. But there are differences. The most important difference is that you are separating the pricing of the stock from the time when you actually buy or sell it. As a result, the mechanisms for accounting for gains and losses and for assuring that the parties involved pay for those losses, are different in futures trading than in stock trading.

In futures trading, whether you take a long or a short position, you'll be asked to post some funds with your broker. This, however, is not for the purpose of paying for or receiving payment for the stock; if you have a long position, you haven't bought anything yet, and if you have a short position, you haven't sold anything yet. You will be asked to post a sum of money known as "initial margin"--a good faith deposit that provides assurance that you can meet your obligations if your futures position moves against you. The minimum initial margin level is set by government regulations, but your brokerage firm may ask for more than the minimum if its own risk analysis requires it, or to provide more cushion before a margin

call is triggered. Exchanges can and do raise and lower margin levels in response to market conditions.



Gains and losses are posted to your account every day—gains in the case that you are long and the price of the stock goes up; losses when you are long and the price of the stock goes down. The short position has the opposite gain and loss profile.

Again, to assure that you can meet your obligations, you may be required to post additional margin should the value of your account fall below a pre-determined maintenance level. If your account falls below the minimum maintenance level, you will be asked to bring your account all the way back up to the initial margin level, rather than simply up to the maintenance level.

Trading on margin in the stock market is different than in the futures market. When you buy stock on margin, you are borrowing from your broker in order to purchase the stock and using the stock you purchase as the collateral for the loan. You also pay interest to your broker for the loan. When you short a stock, you are borrowing stock from your broker, and you pay your broker the broker loan rate plus any dividends due. But the futures trader has not borrowed to buy stock nor has borrowed stock to sell. There is no interest on a loan involved. In the world of futures, the margin obligations of buyer and seller are the same: to deposit funds in order to ensure that their obligations can be met.

Single stock futures are different than stock options and are considered by many traders to be easier to understand. If the stock price goes up, the futures price will go up, except in extraordinary circumstances. Options, on the other hand, exhibit non-linear behavior over time, price, and volatility. What that means, simply speaking, is that there are many considerations that go into pricing options, and many options traders have had the experience of watching options positions head in a direction opposite to what

they might expect, or not move at all. For additional information on the differences, see the NQLX website at www.nqlx.com.

MARGINS AND LEVERAGE

Whatever the initial margin level is at any given time, remember that margin can be your best friend or your worst enemy. For the sake of example, let's assume an initial margin level of 20% in our examples of: 1) going long a single stock futures on ABC Company at a \$50 trade price and closing your long position at \$55, or 2) going short a single stock futures contract on ABC Company at a \$48 trade price and closing your short position at \$57. The margin level represents 20% of the value of the contracts traded for calculating the return on initial margin in these two trades.

- Example of going long at \$50 and closing the position at \$55:

Initial Margin at \$50: $[20\% \times \$50] \times 100 \text{ shares} \times 5 \text{ contracts}$
= \$5,000

Gain on position if closed at \$55: \$2,500

Return on margin: $\$2,500 / \$5,000 = 50.0\%$

- Example of going short at \$48 and closing the position at \$57:

Initial Margin @ \$48: $[20\% \times \$48] \times 100 \text{ shares} \times 5 \text{ contracts}$
= \$4,800

Loss on position if closed at \$57: (\$4,500)

Return on margin: $(\$4,500)/\$4,800 = (93.75\%)$

The importance of this illustration cannot be emphasized enough: In futures trading, you can lose more than your initial margin deposit. Never base the number of contracts you trade on the level of the initial margin. If you have not traded futures before, consult your broker or financial advisor about the risks involved.



EXAMPLE:

HEDGING YOUR STOCK POSITION

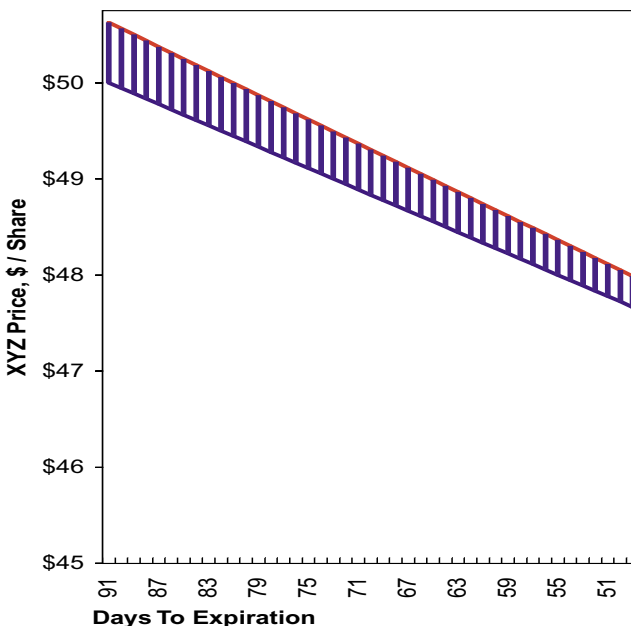
Let's go back to our example of XYZ Company trading at \$50 per share. Let's say you do not expect XYZ stock to pay a dividend before the futures contract goes to delivery. If you are concerned about XYZ stock declining in price over the next three months, you can sell a single stock futures contract that expires 91 days from now.

What price could you expect? If, for example, interest rates for this time period are 5%, the theoretical "fair value" of the futures contract can be calculated in this way:

$$\begin{aligned} & \$50 \times 1.00 + (.05 \times 91/365), \\ & \text{or a price between } \$50.62 \text{ and } \$50.63 \end{aligned}$$

Fair value roughly indicates that there is no particular advantage to being long or short and, theoretically, there should be no arbitrage available. But "fair value" is calculated in different ways for different traders, because not everyone's cost of funds or trading costs are the same and, so, fair value is only a rough calculation in this case. And, of course, depending on market conditions, derivative instruments don't always continuously trade at "fair value."

Hedging XYZ In A Price Decline



If XYZ declines in price toward \$45 in a straight line over the next three months, normally the futures contract would decline at a similar rate. (SEE CHART ABOVE)

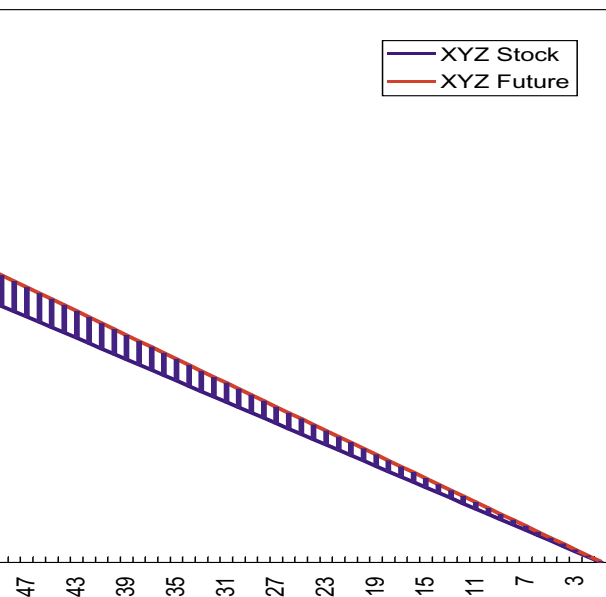
What was your profit and loss at the end of three months?

Own XYZ @ \$50.00 => \$45.00: Loss of \$5.00 in stock value

Sell 3-month XYZ futures @ \$50.62 => \$45.00,
a gain of \$5.62

Either: Deliver XYZ stock @ \$50.00

Or: Buy back short XYZ futures @ \$45.00 and retain stock



We can reverse the price movement and get the same net results:

Own XYZ @ \$50.00 => \$55.00: Gain of \$5.00 in stock value

Sell 3-month XYZ futures @ \$50.62 => \$55.00,
a loss of \$4.38

Either: Deliver XYZ stock @ \$55.00

Or: Buy back short XYZ futures @ \$55.00 and retain stock

In either case, you have a combined gain of \$0.62 per share before trading costs. This corresponds to the interest rate gain on the basis. On a percentage basis, $\$0.62/\50.00

over 91 days is an annualized rate of return of 5%, which raises the question...




SHOULD YOU HEDGE?

This is an issue of personal financial planning -- one that involves your risk tolerance and investment horizon. Two questions arise:

1. Do you like the stock as a long-term investment or not? If the answer is not a strong "yes," then no amount of trading is likely to turn a mediocre stock into a good investment.

2. Do you want stock exposure or a rate of return that will, at best, be a money market return for a non-dividend paying stock?

These are difficult questions, and the availability of SSFs will not necessarily make them easier to answer. What SSFs can do, however, is to give you one more trading tool to execute your risk management strategies quickly and efficiently. Experienced traders understand the importance of discipline, and sometimes there's no better use of futures than as a pre-existing order, or as a "stop" designed to take you out of a position.



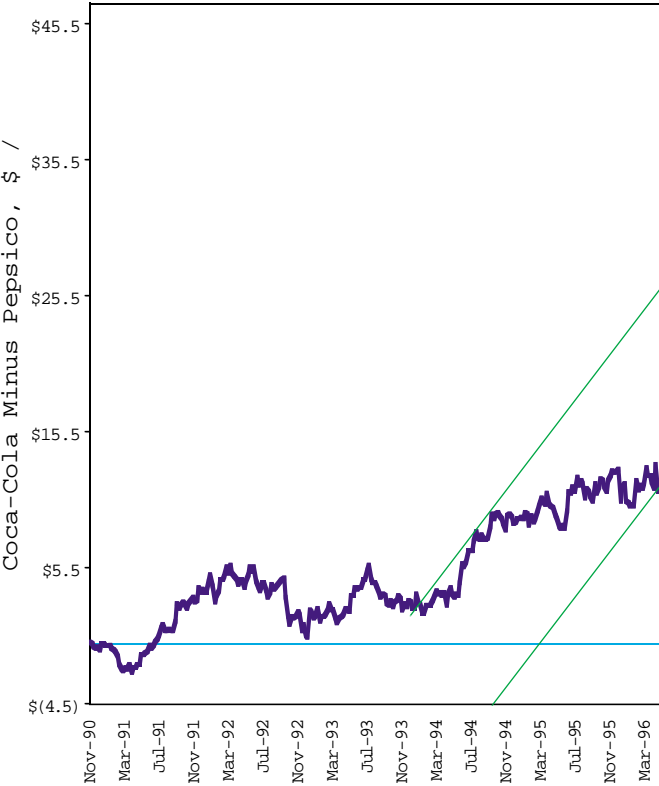
OTHER USES FOR SINGLE STOCK FUTURES

It's impossible to predict all of the strategies that will be employed in the market for single stock futures — uses for successful futures contracts tend to evolve as the market gets more sophisticated. However, index fund management and pairs trading may be two strategies that emerge in trading single stock futures.

As popular as indexation is, it can be a difficult strategy to adhere to all of the time.

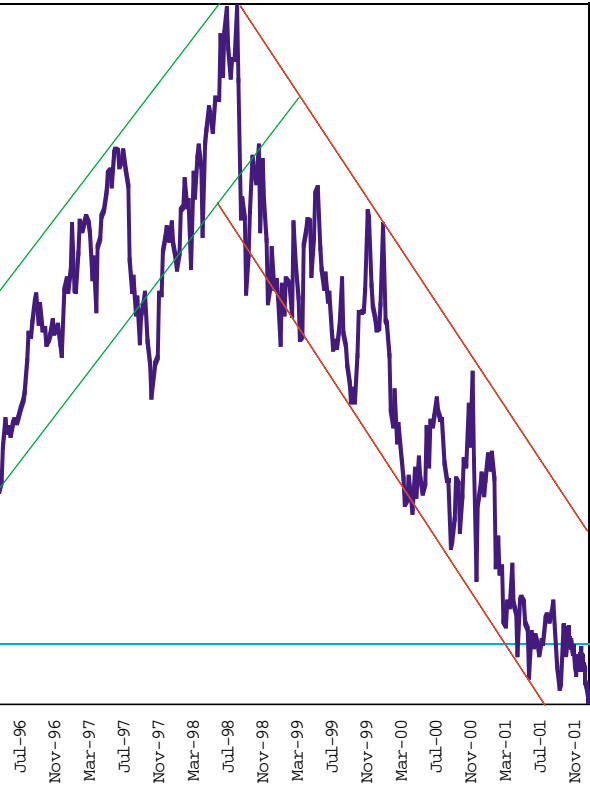
SSFs offer the opportunity to "delete" a stock or group of stocks from an index. Think of it as turning the Nasdaq 100™ into the Nasdaq 99 by selling a SSF on a stock in an index to which you don't want to have exposure. On the flip side, buying a single stock future on a stock in an index can be used to add additional exposure to that stock.

Coca-Cola - PepsiC



Another significant use may be trading the spread between two stocks. This so-called "matched pair" trade makes sense from a fundamental point of view: Every can of Coca-Cola sold is one not sold by PepsiCo, and vice-versa. As one firm in an industry starts to gain or lose a competitive advantage, this trend has a tendency to persist. (SEE CHART)

Co: A Matched



MAKE YOUR MOVE

Whether you want to hedge against price changes on your individual stocks or take advantage of the price moves in the market, Nasdaq Liffe Markets' SSFs expand your range of trading alternatives. For more information, call your broker or Nasdaq LIFFE Markets, at 312-553-4800.



This brochure is for informational purposes only and does not constitute investment or legal advice. Please be aware that trading in futures or options is not for everyone. It can be risky. Before you invest in futures or options, you should assess a number of issues, including: First, you should consider your financial experience, goals, and financial resources and assess how much you can afford to lose beyond your initial payment. You should understand and assess your exposure to risk and other aspects of trading these instruments. Second, as with all contracts, you should understand the futures and option contracts you enter into and your obligations under those contracts. Third, you should review the risk disclosure documents provided to you by your broker. If you have any questions, we can be reached at www.nqix.com



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