by Rohit Kumar

THE ADVANTAGES OF SPREAD TRADING STRATEGY

Calendar spreads provide an opportunity to exploit any relative miss-pricing between various contracts of same commodity.

Spread trading involves building opposite positions simultaneously in two different contracts. Calendar spread is a variant in spread trading where the traded contracts belong to same commodity or asset in the same proportion but of different maturity months. Inter-commodity/asset spreads between related commodities/assets where opposite positions are taken in different commodities of same expiry but of varying proportions is also a common strategy.

Calendar spreads provide an opportunity to exploit any relative miss-pricing between various contracts of same commodity. Generally calendar spreads follow a mean reverted process, which means prices tend to move towards the mean. This attribute makes calendar spreads more predictable and range bound, thereby making trading in spreads easier and less risky than its outrights.

From the Fig 1, it can be observed that the Spread price for a defined time period moves within a range and exhibits a reverted movement across the mean.

Additionally, trading in calendar spreads also enables efficient fund utilization as the commodity exchanges provide margin benefits for trading in spreads. (In case of NCDEX, margin charged is 1/2 of higher value outright (leg) which effectively turns out to be approximately 1/4th of overall spread position).

In the financial year 2013-2014 NCDEX has launched Spread Limit Order functionality, which allows participants to enter and exit into opposite positions in two calendar month contracts of same commodity by just quoting the price difference. With this functionality NCDEX has become the first exchange in Asia to provide such an advanced and user friendly spread entry system.

Spread Order functionality launched by NCDEX, provides market participants with Spread limit order. On execution this results in separate trades in outright contracts. Spread order matching strictly follows price time priority simultaneously conserving the price time priority in the outright futures contracts as well.

Some of the unique features are listed below:
-Display of spread order book and depth.
-Provides Spread order – Spread order match, thus

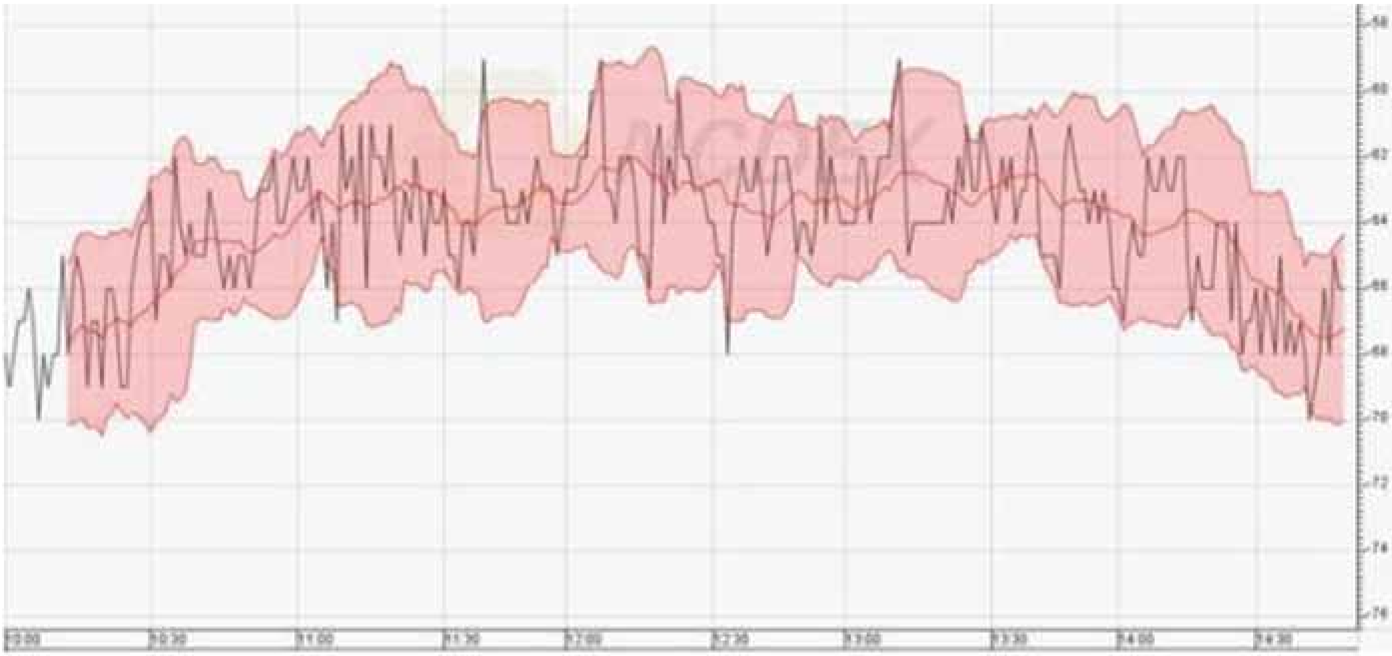

Fig 1: Castor Seed Intraday Near-Next Spread price on 25th Aug.

improving the Order fill frequency.

-Provides easy and effective roll-overs.

-No leg-risk, exchange guarantee - execution of both legs at the desired price differential.

-Spread trades result in trade in outright futures contracts.

-Spread orders are valid for a day and can be viewed/modified/ cancelled any time during the day.

-Help participants to control order to trade ratio in a significant manner.

Besides this, Spread functionality empowers participants to efficiently work on various strategies like Scalping, Rollover, and Butterfly spreads etc. The utility of this functionality has grown over the months, and today it reached to an extent where on an average nearly 20-25% of the exchange orders and trades are routed through this system. It has been adopted and appreciated equally by several sections of the market, which largely comprises of Jobbers, Hedgers and Retail traders.

Currently this functionality is enabled on all major trading platforms including Tradex, Odin and Omnesys; and available for trading in commodities like Soyabean, Soyaoil, Chana, Castor, Dhaniya etc. In the coming days, with availability of more spread combinations across all commodities; spread trading is expected to grow further and contribute a major share of daily trades.

(The author is Asst Manager, Quant and Market Structure at NCDEX)