Weekly Educational Topics

Introduction to Forward Contracts

"A FORWARD CONTRACT IS A MUTUAL AGREEMENT BETWEEN TWO PARTIES FOR THE DEFERRED DELIVERY OF AN ASSET."

"THE PAYOFF FOR A PARTY THAT HAS A LONG POSITION IN A FUTURES CONTRACT IS THE DIFFERENCE BETWEEN THE ASSET PRICE AT THE TIME OF DELIVERY AND THE FORWARD PRICE AGREED UPON."

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A forward contract is a mutual agreement between two parties for the deferred delivery of an asset. A contract specifies the quantity and type of asset, the delivery time and place, and the delivery price. The party buying the asset in the future has a long position and believes the asset price will go up, hence they enter into a contract that gives them the power to buy the asset for a price they believe will be lower than the expected future price. On the other hand, the party selling the asset has a short position and the opposite sentiments regarding the asset.

There is no initial cost to enter a forward contract. They do not trade on centralized market exchange. They are considered to be over the counter (OTC) instruments. The payoff for a party that has a long position in a futures contract is the difference between the asset price at the time of delivery and the forward price agreed upon. On the other hand, the payoff for a party that has a short position in a futures contract is the difference between the forward price agreed upon and the asset price at the time of delivery.

These contracts do not always result in exchange of asset for the forward price as parties sometimes agree to pay the difference between the forward price and asset price at the time of delivery. This instrument is one of the many hedging instruments that can be used to fix a price of an asset, in most cases a commodity, like oil, which is possibly associated as a major raw material and cost for the operation. This hedging method allows the party to predict the future costs and removes uncertainty.