Equity derivatives move to the mainstream

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The latest research by Greenwich Associates into North American and European usage of equity derivatives reveals that these products have moved into mainstream, commonplace usage by institutions on both sides of the Atlantic.

European institutional investors and banks that long ago embraced the lucrative business of selling structured equity derivatives products into the retail market are now integrating equity derivatives into their own investment strategies as an efficient means of obtaining desired exposures.

The results of Greenwich Associates' 2007 European Equity Derivatives Investors Study reveal large increases in the number of European institutions and banks using equity derivatives, the number of derivatives products used by individual institutions and banks, and the volume of trades executed in these products each year.

'While banks remain heavy users of the structured derivative products they on-sell to their high net worth and retail clients, money managers and hedge funds have adopted options and other highly liquid derivative products as 'access products' with which to create virtual positions in some securities or markets that are outside their specific mandates,' says Greenwich Associates consultant Jay Bennett.

Of the 201 European institutions and banks participating in Greenwich Associates' 2007 study, nearly 80 per cent use structured/securitised equity products or exotic OTC products, and almost 90 per cent use highly liquid 'flow' equity derivatives products such as listed options, index futures, swaps, and exchange-traded funds.

In the 12-month period covered in the research, notional trading in structured/securitised equity products rose by more than two-thirds to an estimated USD230bn across the entire universe of 258 accounts, with 86 per cent of that total originating in continental Europe.

The amount of commissions paid by participating institutions and banks on options trades rose to an estimated USD465m as well. 'European institutions and banks are probably the world's most evolved users of equity derivatives, particularly on the structured side,' says Greenwich consultant John Colon.

The on-selling of structured equity derivatives has become an increasingly important revenue stream for both banks and investment managers in recent years, with approximately 75 per cent of participants in each category reporting that they engage in the business. More than 45 per cent of European institutions and banks say they purchase these products with the intent of on-selling rather than holding them in their portfolios; another 15 per cent say they on-sell some products while holding others.

The most active re-sellers of structured equity derivatives products are found in France, Germany, Spain, and the Nordic countries, followed by Switzerland and the Benelux countries, with UK institutions and banks on-selling the smallest percentages of their holdings.

'There's a huge and profitable business selling products with all sorts of nuances: they can feature anything from hedge fund-linked returns to oil and gas plays,' Bennett says.

Eighty percent of European institutions and banks now trade single-stock options, up from 75 per cent a year ago, with three-quarters of volume in listed options deriving from UK and continental European underlying assets. The usage of other highly liquid 'flow' products is also on the rise. The use of index futures increased modestly to 78 per cent of study participants in 2007, and 33 per cent of institutions and banks now use single-stock futures, up from 25 per cent.

Use of variance swaps on indices and single stocks doubled to 19 and 15 per cent respectively, with hedge funds and French institutions and banks reporting the highest levels of use. While use of single-stock and index swaps declined slightly to 31 per cent, the notional amount of equity swaps traded by institutions and banks participating in the Greenwich Associates' study rose 15 per cent over the past 12 months, to an estimated USD85bn.

Last year Greenwich research revealed a surprising, and on the surface at least, counterintuitive finding: institutions in Europe and North America continue by far to favour 'high-touch' broker execution for futures and options rather than electronic trading platforms. Three quarters of all options trades and more than two thirds of futures trades in Europe are still communicated to brokers via the old-fashioned telephone.

Bennett attributes the reliance on traditional high-touch trades to the growing use of an increasingly sophisticated slate of equity derivatives products as well as the size of trades. 'Due to the volatile nature of derivatives trades, institutions and banks do not want to trust their positions to electronic systems, they want somebody to take over the position as quickly as possible,' he says.

North American equity derivatives: specialised products become commonplace tools

Once regarded as specialised tools, equity derivatives today are used by North American institutions as a routine method of obtaining desired exposures and hedging positions.

The results of Greenwich Associates' 2007 North American Equity Derivatives Research Study, which targeted more than 200 active investors in the US and Canada, reveal that it is becoming common practice at North American institutions for cash portfolio managers to work in conjunction with traders and equity derivatives specialists to achieve investment goals.

As equity derivatives move into the mainstream, the use of liquid 'flow' products like options, futures and exchange-traded funds has become ubiquitous among US institutions. In addition, the universe of equity derivatives investors is expanding as a growing number of hedge funds enter the market. In 2007, Greenwich Associates interviewed 80 hedge funds.

'The 'flow' or highly liquid equity derivatives business is surging,' Bennett says. 'Last year, the institutions targeted in our research generated an estimated USD420m of commissions for brokers on options trades - over the past 12 months that amount jumped to an estimated USD775m.'

Although the use of structured/securitised equity products is much less common among North American institutions, it too is on the rise. Forty-two percent of study participants in 2007 say they use structured equity derivatives, up from 34 per cent in 2006. The institutions targeted in the Greenwich Associates study traded an estimated USD35bn notional in structured/securitised equity products in the 12 months covered in the research. More than three quarters of these institutions use single-stock or basket-based products, and about 40 per cent use index-linked products. Smaller proportions use hedge fund and mutual fund-linked contracts.

'The structured equity derivatives business continues to boom in Europe because of strong demand from high net worth and retail investors who purchase these products from banks and other institutions,' Colon says. 'That demand does not exist in North America, so the business is growing at a much slower pace.'

Institutional investors are increasingly relying on their cash portfolio managers and traders to make decisions on equity derivatives trades. The proportion of North American institutions saying that decisions regarding equity derivatives are the exclusive province of derivatives specialists fell to 21 per cent in 2007. 'Futures and options have become standard tools such as 120/20 and 130/30 investment strategies - we expect equity derivatives use to continue its rapid rise,' Colon says.

Nearly 85 per cent of North American institutions trade single-stock options, up from 81 per cent last year, while nearly 80 per cent trade index options, up from 74 per cent. Hedge funds remain the most active users at 93 and 86 per cent respectively.

The Greenwich Associates report documents the following additional trends in product usage:

• The use of futures fell from 65 per cent in 2006 to 61 per cent in 2007. Just more than half of the hedge funds participating in the research describe themselves as active users of futures.

• Institutional use of exchange-traded funds slipped from 70 per cent in 2006 to 65 per cent in 2007. Although hedge funds are the market's most active users of ETFs, the share of hedge funds reporting use dropped to 71 per cent from 81 per cent year-to-year. Conversely, use of ETFs increased sharply among mutual funds.

• Use of single-stock or index-equity swaps decreased from 38 per cent of study participants in 2006 to 33 per cent, reversing a trend observed last year.

• Nearly a quarter of institutions say they use variance swaps, up from less than 20 per cent in 2006. Between 14 and 20 per cent of institutions report using dividend swaps, dispersion/correlation trades, sector swaps, portfolio swaps and access products. Hedge funds drive activity in most of these categories.

• On the structured equity product side, 54 per cent of institutions that use these instruments said they were active in products with less than one year's duration, while only 5 per cent were active in products with duration greater

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