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Funds fuel the global derivatives boom

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Many hedge funds have benefited richly from the recent surge in corporate activity surrounding the exchanges sector. For example, hedge funds are thought to have been among the big winners as shares in the New York Mercantile Exchange surged from USD59 to as high as USD152 at one point during the stock’s first day of trading on the New York Stock Exchange.

They have also sought to cash in on the merger of the Chicago Mercantile Exchange and the Chicago Board of Trade, the competition between the NYSE and Deutsche Börse for Euronext, and the succession of bids from other exchanges and private equity firms that have more than doubled the share price of the London Stock Exchange in less that two years, culminating in the recent hostile bid from Nasdaq.

But arguably any profits earned by funds from these transaction are fair reward for their contribution to making derivatives exchanges one of the hottest niches in the global financial industry. Many exchanges and traders say hedge funds can account for anything up to half of all total trading volumes and are driving growth in the value of outstanding derivatives in the order of 50 per cent over the two years to mid-2006.

For example, the CME and CBOT, which are aiming to complete their merger in the first half of 2007, attribute much of their...
combined 25 per cent growth in trading volume over the past year to activity by hedge funds. The CME has established trading incentives for hedge funds in a bid to capitalise on the continuing strength of capital flows into alternative funds from institutional investors.

Not only do hedge funds’ trading benefit the derivatives exchanges through the fees they pay, they make the marketplace more attractive to all participants by increasing the pool of liquidity. Last July the Mercantile Exchange formalised this effort by creating a dedicated team with a brief to attract more hedge funds to become customers, and the organisation says it has already had some success in convincing more funds to become members of the exchange. The CBOT is also active in marketing directly to hedge funds.

The growth of institutional investment has intensified competition and contributed to driving down returns in the traditional hedge fund investment fields of equity and fixed income instruments, boosting the attractiveness of the commodity markets and other types of derivative as a source of alpha.

According to traders active in the markets, the influence of hedge funds can be seen in patterns such as a tenfold spike in the trading of gold futures and options at CBOT over the year to October, catapulting the exchange into the position of leading US market for listed gold futures. They are also viewed as responsible for a surge in Eurodollar trading on the CME.

The expanded horizons of hedge funds have had a positive impact on the business of the New York Board of Trade, but their influence on the organisation’s activity extends back beyond the past decade, according to Joe O’Neill, NYBOT’s senior vice-president for product development. He notes that both the establishment of the exchange’s financial instruments business, Finex, and its expansion to Europe through the establishment in 1994 of a Dublin trading floor, were prompted in part by hedge funds.

“We’re getting more and more involvement from hedge funds,” he says. “The whole Finex initiative was launched by a couple of hedge funds back in 1984, and the Dublin effort was to make sure we got round-the-clock exposure, which was also to meet the needs of some hedge funds that wanted to be able to access the market more than just in US hours.”

O’Neill argues that while important to the growth of NYBOT, which has just completed the merger it agreed last year with the Intercontinental Exchange, hedge funds do not necessarily represent the largest share of its trading. “I wouldn’t say they are driving our markets,” he says. “Hedge funds are important, but trade is still a very important part, especially of our agricultural markets. It accounts for around 50 per cent of our markets, while hedge funds are probably a good proportion of the other 50 per cent.”

Eric Bolling, an independent energy trader for the past 19 years on the New York Mercantile Exchange, believes that hedge funds are particularly attracted to energy markets because of their role as a driver of inflation. “There’s been a huge influx of hedge fund money into all the commodity markets, but especially the energy markets. Over the years hedge fund managers have come to realise that the best way to protect their equity portfolios from higher inflation is to be long on energy, and the best way to do that is through energy futures.”

He says that 2002 saw a “perfect storm” for energy prices as the US prepared to invade one major oil producer, Iraq, tensions grew with another, Iran over nuclear development and the war against terrorism,
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The current surge in corporate activity surrounding the world’s leading derivatives exchanges can be viewed as an eloquent reflection of their increasingly prominent role in the global investment industry, not least as hedge funds employ a range of derivatives in ever more complex strategies. Over the two years to mid-2006, the notional value of interest rate, equity-based and credit derivatives rose by almost 50 percent to USD283.2tn, according to the International Swaps and Derivatives Association (ISDA).

Greater ease of product access, cost-effectiveness, price transparency and especially liquidity are incentives for managers to employ exchange-traded derivatives. These factors are growing in importance as increasing competition between funds and lower volatility in traditional asset markets puts pressure on managers to develop new techniques for delivering returns to their investors.

Once a little-remarked feature of the global financial system, derivatives exchanges are now enjoying the spotlight. Over the past decade the sector’s traditional leaders in Chicago have found themselves under increasing challenge from the market models and trading technology offered by European rivals, led by Eurex, which is operated jointly by Germany’s Deutsche Börse and SWX Swiss Exchange, and LIFFE, the London-based subsidiary of the Euronext exchanges group. And the current round of IPO and merger announcements in the United States can be considered as a reflection of the growing competitiveness of the market.

During the 1990s, Eurex has become the world’s leading futures and options exchange by leading the way on fully electronic operation, and now has about 400 members in 19 countries worldwide. It offers a broad range of international benchmark products and operates the most liquid fixed income markets. During 2006 more than 1.5 billion contracts were traded, confirming the efficiency of the Eurex market model and its superior liquidity.

A key benefit that distinguishes Eurex is its integrated structure, which lowers costs and increases transparency for its participants. The integrated clearing house provides central counterparty services for instruments traded on Eurex, as well as the Eurex Bonds and Eurex Repo trading networks, the Frankfurt Stock Exchange and the Irish Stock Exchange.

To understand the needs of the marketplace, Eurex has developed close relationships and open communication channels with its users, both through direct dialogue and its membership of organisations such as AIMA. It has also helped to promote research of value to the alternative investment industry.

Eurex’s ability to provide participants with huge pools of liquidity through an efficient structure and at competitive cost has made it a key player in the global success story of the derivatives industry, and it’s always looking to the next challenge to meet customer demand.

At the beginning of 2007, following the trend of hedge funds increasingly demanding direct exchange access, Eurex introduced volume discounts for exchange-based transactions and launched a technology roadmap to meet the challenge of growth driven by algorithmic trading. Hardware and software improvements in areas such as processing performance and storage will reduce system response times substantially and boost the throughput of the system to more than one billion quotes a day.

Eurex’s innovation can also be seen in the launch on March 27 of the world’s first exchange-traded credit derivatives contract, a future based on the iTraxx Europe five-year index series. With the global credit derivatives market expanding from USD11tn in 1996 to USD20tn a decade later, the ability to list these instruments will improve operational efficiency, risk management and market access in this fast-growing area.
and for the first time oil prices surged past its long-time high-water mark of $40 a barrel. That convinced hedge fund managers that the long era of cheap energy was over and the time was opportune for investment.

“They began to realise they’d better get involved in the energy markets, and as the markets started to rally, more and more money went into it,” Bolling says. “These things took shape in 2002, and the pool of money flowing into the energy markets has consistently got bigger and bigger over the past four years.”

For hedge funds active in the energy market, the advantage of exchanges is their liquidity. Says Bolling: “Hedge funds are getting involved using the electronic platforms, but exchanges are still the way of entry. There are exchange-traded funds based on the price of crude oil, but there’s no ETF that will protect them in a natural gas spiking environment, at least not one that’s liquid enough to trade, so they have to come here.”

The involvement of hedge funds in the energy markets is visible, he says, through an exaggeration of existing trading trends. “We’ve seen that whatever move is happening for fundamental reasons because of demand or supply disruption, the swings are becoming bigger and the volatility is becoming greater, because there’s more money chasing similar products. In addition, hedge funds’ market behaviour is different from that of traditional players. They’re very price-driven, whereas traditional players such as energy producer and refiners tend to be very fundamentally driven.”

Bolling believes that upsets such as the Amaranth Advisors collapse, which stemmed from risky bets in the natural gas market, may prompt investors to demand a switch from off-exchange trading. “Bringing some of that trading to the exchange would make it more accountable and transparent. Had Amaranth been trading on an exchange like NYMEX [the blow-up] probably wouldn’t have happened, because they would have had to post so much margin, and red flags would have been raised left and right.

“If I were a regulator or an investor I would definitely push for hedge funds to put this stuff on the exchange, where prices are reported and positions are reportable. Managers may not want the scrutiny and transparency, but I would have a tough time arguing that to the Amaranth investors. If hedge funds came under CFTC oversight through trading on an exchange, that would benefit everybody.”
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True professionals can make a difficult task look easy, but this is not the case for currency traders. Over the past two years, the performance of six widely-followed indices for currency-only money managers – the Barclay Currency Traders Index, the BTOP FX Index, the Center for International Securities and Derivatives Markets asset-weighted index, the CISDM equal-weighted index, the Parker FX Index and the AFX index – has been either negative or insignificantly positive, with the exception of the CISDM equal-weighted index over 24 months (up 7.82 per cent).

However, professional traders can make life unnecessarily difficult for themselves by getting lost in all of the interlocking factors, including macroeconomic fundamentals, geopolitics and each country’s yield curve, that affect the $2trn-a-day global currency market.

Of an estimated 8,000 hedge funds and 1,800 currency commodity trading advisors, only 124 – about 1.3 per cent – can be described as currency-only funds, who approach the markets across more than 30 commonly traded currency pairs and with targeted trade durations from minutes to months. Some are discretionary traders, while others hew to rigidly constructed quantitative systems. The majority are trend-followers, but many short-term quantitative traders adopt countertrending or mean-reverting strategies.

Many longer-term traders rely on interest rate ‘carry’ strategies to earn more in the currency lent than in the currency borrowed, and the most sophisticated construct both plain-vanilla and exotic option strategies to achieve narrow return targets. But one reality remains: the low proportion of currency-only traders is either a tribute to the virtues of inter-market diversification or evidence of just how difficult it is to reside only in the currency markets.

Alexander the Great was a terrific simplifier who, according to legend, solved the intractable puzzle of the Gordian knot by cutting it with his sword. Currency traders can duplicate this solution by replacing a wide array of currency pairs with the simple dollar index (DXY). Nearly all traders, whether they choose to admit it or not, really bet on whether the US dollar will rise or fall, and search out vehicles with which to express this opinion.

The DXY is a basket of six major currencies: the euro, yen, sterling, Canada dollar, Swedish krona and Swiss franc. Each currency is liquid and has a reliable structured interest rate market; collectively they create an index that represents the directional flow of the USD globally with tight, efficient low cost bid-ask spreads. Futures and options on the DXY trade at the New York Board of Trade, the primary marketplace for price discovery. DXY spreads are 2-3 pips wide, far narrower than could be achieved by trading each currency individually.

Just as traders can over- or underweight stocks in an index, they can over- or underweight currencies in the DXY, and more active investors can even arbitrage the member currencies against the DXY. In addition, currency managers with multiple cross-rate exposures can use the DXY futures and options as a hedge.

Sceptics may say the DXY is little more than the euro, whose weighting is 57.6 per cent, in disguise, but in fact there have been long periods of divergent performance between the euro and the DXY since the former’s introduction in January 1999. A singular focus on the euro will result in a USD-focused trader missing large moves in, say, the Canadian dollar or Japanese yen.
The flip side of the surge in the global hedge fund industry since the turn of the millennium is the dramatic expansion of the world’s derivatives markets. By the middle of 2006, according to the International Swaps and Derivatives Association, the value of outstanding value of interest rate, equity and credit derivatives had grown to more than USD280trn, half as much again as two years earlier, and there is no sign of the pace slackening.

The parallel expansion of hedge funds and derivatives is no coincidence. The growth of hedge fund investment over the past decade has been accompanied by a massive diversification of strategies away from the traditional approaches of long/short equity and global macro in which derivatives have played a crucial role. Once obscure instruments such as credit default swaps have become everyday features of the alternative investment management industry.

Derivatives exchanges have moved to centre-stage along with the instruments traded there. Institutions such as the Chicago commodities exchanges, not so long ago viewed by the outside world as somewhat arcane appendages to the US agricultural industry, are now acknowledged not only as important trade centres for trade dealers but as the playground for hedge funds seeking out inefficiencies and opportunities in an ever more bewildering range of markets.

And valuable assets in their own right, too. The past couple of years have seen derivatives exchanges become coveted and increasingly highly valued assets amid the growing free-for-all that has followed demutualisation of many of Europe’s leading stock exchanges - and in which hedge funds themselves have played no small part. An early indication was the acquisition of the London International Financial Futures Exchange (Liffe) by Euronext (itself created...
from a merger of the Paris, Brussels and Amsterdam stock exchanges), snapped up under the nose of the London Stock Exchange.

The second half of 2006 has seen an acceleration in the appreciation of derivative exchanges’ value following a series of transactions, bids and financial operations on both sides of the Atlantic, starting with the announcement in September that the Intercontinental Exchange (ICE), an Atlanta-based marketplace for energy products, would acquire the New York Board of Trade for around USD1bn in shares and cash.

The transaction, which was completed at the end of January, brings together NYBOT’s activity in commodities including cocoa, coffee, cotton, ethanol, orange juice, wood pulp and sugar, as well as currency and index futures and options, with the ICE’s global marketplace for futures and OTC energy contracts based on crude oil and refined products, natural gas, power and emissions.

The deal marks another step in the gradual disappearance of mutually-owned institutions, of which NYBOT was one, but a key attraction for its members is access to the ICE’s commodity trading technology, which will sit alongside the New York institution’s traditional open-outcry trading. Says NYBOT senior vice-president for product development Joe O’Neill: “We are part of the process that is leading to increasing consolidation in the sector.”

Arguing that this approach is necessary for institutions seeking to serve the maximum range of customers with the widest range of products, he adds: “It certainly improves your product mix, and in our case it also provides us with an electronic trading platform. We have the history in the products we trade and the trade support, so we’ll continue to serve our customers, whether they be trade customers, hedge funds or speculators.”

As with many of the exchange link-ups now being proposed or examined, there is an important international dimension to the ICE-NYBOT merger. ICE conducts its futures markets through a regulated London-based subsidiary, ICE Futures, and it also has offices in Calgary and Singapore (as well as Chicago and Houston), while NYBOT has had a trading floor in Dublin’s International Financial Services Centre, FINEX Europe, since 1994.

O’Neill expects this process of international diversification to take advantage of opportunities in other geographical regions and time zones to continue following consummation of the merger with ICE. He says: “We’ll probably see more interesting ventures in Asia, to add a third time zone. We have memorandums of understanding with the Singapore Commodity Exchange (SICOM), with the Zhengzhou Commodity Exchange in China, and with the Tokyo Grain Exchange. We are working to develop our relationships in that part of the world.”

The ICE-NYBOT deal was followed last October by the announcement of a merger between the Chicago Mercantile Exchange and the Chicago Board of Trade, creating a
combined organisation with a market capitalisation of some USD25bn, and with an average trading volume of nearly nine million contracts per day, representing a notional value of approximately USD4.2trn.

What the participants promise will be the world’s most extensive and diverse global derivatives exchange aims to provide its customers with global access to a wide array of benchmark exchange-traded derivatives based on the US interest rate yield curve, equity indexes, foreign exchange, agricultural and industrial commodities, energy and alternative investment instruments such as weather and real estate.

The deal has been widely interpreted as a riposte by the Chicago exchanges to the challenge posed by the leading European derivatives exchanges, Euronext Liffe and Frankfurt-based Eurex, which was created by a merger of the German and Swiss derivatives exchanges and is jointly owned by Deutsche Börse and SWX Swiss Exchange.

The adoption by the European exchanges of electronic trading gave them a competitive advantage as the Americans initially clung to open outcry, and Eurex even took on the Chicago exchanges on their home turf by opening for business in the Windy City in 2004, although making major inroads into the US market has proved a tough proposition.

Meanwhile, the share price of the New York Mercantile Exchange, the world’s leading marketplace for oil and energy contracts, surged by around 125 per cent on the first day of trading following its initial public offering in November. From an issue price of USD59, the seven per cent of NYMEX shares floated on the New York Stock Exchange soared as high as USD152 before closing at USD132, giving the 134-year-old exchange a market capitalisation of USD11.6bn.

While market participants believe there is still room for further consolidation among derivatives exchanges - for example, adding the Chicago Board Options Exchange to the CBOT-CME merger - in some areas the point appears close to being reached where the market efficiency benefits start to be outweighed by the disadvantages of diminishing competition.

For example, one of the (several) factors that eventually forced Deutsche Börse to withdraw its bid to merge with Euronext, leaving the field free for the pan-European exchange group to link up with the New York Stock Exchange, was the prospect of the European Commission ordering a full competition enquiry into the implications of Eurex and Euronext Liffe falling under common ownership.

Liffe chief executive Hugh Freeburg had called on London market players to reject the proposed Deutsche Börse-Euronext deal not only because of the potential threat to London’s derivatives market were Liffe to be controlled by Eurex in Frankfurt, but on account of the market domination that would be exerted by a combination of the two exchanges, which would control 92 per cent of the European derivatives market. With Euronext now apparently set to complete its merger with the NYSE, the continent’s derivatives duopoly seems safe for the foreseeable future.