ETFs and Futures

In a second article in our series of five, Ashley Fagan looks at how pension funds can use exchange traded funds (ETFs) as well as index futures contracts to access equity indices

In the last few years, there has been a significant move from fully-funded Futures positions into ETFs.

Since 2014, we have recorded more than $9 billion switch trades globally from equity Index Futures into iShares ETFs[1]. In June 2015, the Futures roll traded 'rich' (compared to their fair value) for the 12th consecutive roll across main exposures:

- EURO STOXX50 Futures Roll Traded 47bps rich[2]
- DAX Futures Roll Traded 17bps rich[2]
- FTSE 100 Futures Roll Traded 39bps rich[2]
- S&P 500 Futures Roll Traded 19bps rich[2]

Equity index futures and ETFs – what are the similarities and the differences?

Equity index futures and ETFs are both financial instruments that aim to replicate a given index, net of fees. They can both be traded on stock exchanges and offer intra-day liquidity. There are differences between them, however. Futures expire on a monthly or quarterly basis (depending on the contract) so investors have to 'roll' their positions, by exiting the contract close to expiry and then entering into a new one, while ETFs, in general, have no defined maturity. Buying an ETF requires investing the full notional exposure, so it is a fully-funded instrument. Index futures, however, can be partially-funded as well as fully-funded – an investor only requires a small fraction of the notional exposure that they wish to gain, i.e. the initial margin. The balance can be put into risk-free assets (e.g. money market instruments) creating a fully-funded use, or used for leverage.

How can pension funds use futures and ETFs to gain exposure to indices?

Investors use futures to gain exposure to selected market indices across equity, fixed income and commodity markets. Uses include implementing tactical overlays, portfolio completion and to obtain leverage. Institutional investors are now using ETFs for a broad range of strategies. This was evidenced by the recent Greenwich Associates 2014 survey of European institutions, which revealed that 61 per cent of pension fund managers interviewed agreed that ETFs were replacing other products in their portfolios[3] . This includes considering ETFs where perhaps before they would have more frequently used index futures.

What are the benefits of using ETFs instead of index futures for index exposure?

Index futures remain a key financial instrument for large and sophisticated investors such as pension funds. However, for certain such investors, other index vehicles, such as ETFs, can sometimes be cheaper.

Over the last two years, investors using equity index futures have experienced higher costs of ownership (often referred to as the future 'trading rich', compared to its fair value). We believe this is a direct consequence of the implementation of regulatory frameworks such as Basel and the Volcker rule[4]. These new regulatory frameworks increased the cost of capital for banks, the traditional provider of 'long' futures positions to their clients. Now, when banks manufacture futures, they incur a higher cost of the capital. Ultimately, this cost is transferred to the investor and this is resulting in the futures contract tracking the benchmark less efficiently and being more expensive to hold.

Meanwhile, the ETF product set has grown exponentially and now include equities, fixed income, commodities, property and factor investing. This has led to increased liquidity and lower ETF trading costs, in fact, on-exchange bid-offer spreads have decreased by 30 per cent since 2012[1]. As a result of these trends, since 2014 we have experienced investors moving over $9 billion from futures to iShares ETFs. Investors will need to carry out thorough due diligence to identify the most efficient beta vehicle for their needs so they can find the most efficient instrument through which to implement their beta exposure.

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[1] Source: BlackRock ETP Landscape, data as at 30 June 2015 except for bid-offer data which is as at 31 July 2015 [2] Gross annualised in basis points [3] Source: Greenwich Associates 2014 European Institutions.
[4] Part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.