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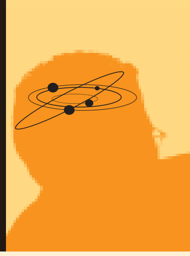

EQUITY DERIVATIVES

ONE PRODUCT, SO MANY USES FOR THE WEALTHY INVESTOR

Whichever way they are put to work, and at whatever level, derivatives have an important role to play in any investment portfolio

Equity derivatives are the multi-purpose tool for the high net worth investor. They can be used speculatively, for risk management or to provide an extra boost to income. They are cheaper to trade than stocks.

And they just got better. Thanks to changes at the exchange level, end users can reap the benefits of more efficient trading – bringing with it more cost effective products – as well as a standardisation and simplification that inevitably reduces risk.

USAGE

As a speculative tool, derivatives offer a cheap, efficient way to enter markets, and to get out of them again. A swift "in-out" trade on index futures is an obvious example. Because anyone can participate on the bid or the offer (rather than having to take the price of the market maker), bid-offer spreads are cut and costs brought down.

The cost savings are a strong attraction – a cost of around €3 to €7 to trade a stock futures contract, compared with at least €15 for an equity transaction. And then there's stamp duty: investors in the UK market can save themselves another 0.5 per cent as stock futures, unlike UK shares, do not attract stamp duty. With electronic trading, access is fairly straightforward.

But arguably the main use for derivatives – indeed, the one they were set up for in the first place – is to control risk across sizeable portfolios, whether single stock risk or the risk of the whole portfolio against the index.

For example, if the shares in the portfolio are European, some kind of insurance is provided through trading a FTSE Eurofirst 80, a futures contract on the top 80 European names.

RISK CONTROL

Risk can be controlled by taking short positions, by using options to adjust the profit or loss of the portfolio, by holding cash and being long in call (buy) options, or, traditionally, by buying put (sell) options against holdings. This can be done either on a single-stock level or for the index as a whole.

The most likely way for a wealthy investor to access this kind of insurance is by investing in derivative-based funds, most obviously hedge funds, although they could also do it directly through a broker.

The third way in which derivatives could be useful to the HNWI – and a very popular use for them – is as a way of boosting income from a portfolio. If an investor holds shares, he gets income from dividends. He can boost this income, and protect against the downside – although at the cost of some upside – by writing a call option against his holdings.

This is an option for another party to buy at a fixed price, which is generally higher than the current price. The investor gets a premium from the other party – which increases his income, and so slightly protects against the downside. For some wealthy investors, where a steady, maximised income is what matters, this is a reasonable

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trade-off against the lost advantage of a potential sharp rally in the share price.

Equity derivatives, then, have an important role to play in an investment portfolio. And now, with a new, standardised, more flexible model developing at the exchange level, they can be traded more efficiently, more simply and with minimised risk. This can only be good news for the investor.

SIMPLIFICATION

Historically, the options markets in Amsterdam, Brussels, Lisbon, London and Paris all had their own idiosyncrasies. They were all very domestic-focused, and so each market developed along its own (slightly different) lines.

An options contract in London, for example, would expire on the third Wednesday of the month, in Paris it would expire at the end of the month and in Amsterdam on the third Friday of the month – something guaranteed to confuse anyone who wanted to be involved in more than one market. Now, options contracts are starting to be standardised.

Moreover, a single policy is being negotiated on adjustments for corporate action and can be expected in the near future. And consultation is currently being carried out on trading procedures, for example on block trades. Centralised policy should bring benefits in terms not only of efficiency and ease of use, but also of keeping execution risk to a minimum.

FLEXIBILITY

Flexible trading is an essential step up from the traditional model of short-dated, standardised contracts. Allowing counterparties to tailor contracts to their own requirements, and giving them both price certainty and reduced execution risk, it is a means of dramatically improving exchange-traded products.

This new approach is now available for some UK equity options – FTSE 100 Index Options and major blue-chip individual options – and the plan is to expand to other European markets. Rather than sticking to a preset contract, users can choose exercise prices and expiry dates, the latter up to a maximum of three years away.

Price certainty is achieved because trades are executed at prices pre-negotiated between the counterparties (say, an investment bank and a fund manager) and partial order fills are avoided, which minimises execution risk.

MATCH TRADING

Counterparties can now get the best of both worlds in terms of on- and off-exchange trading, by pre-negotiating bilateral trades in a new wholesale market segment. In other words, they keep outside of the central order book but use the exchange to give them the certainty of execution.

After the negotiation, which sets the price, the parties come to the exchange and present their trade for validation, confirmation, post trade administration and clearing. They have 100 per cent matching of buy-side with sell-side, no interruption or breakage of trade and no execution risk.

In match trading, which is very attractive to fund managers, counterparty and credit risk is reduced by daily calculation and management of marked-to-market and variation margins by the clearing house, and, because the clearing house acts as central counterparty, the contract has the security of an exchange-traded product.

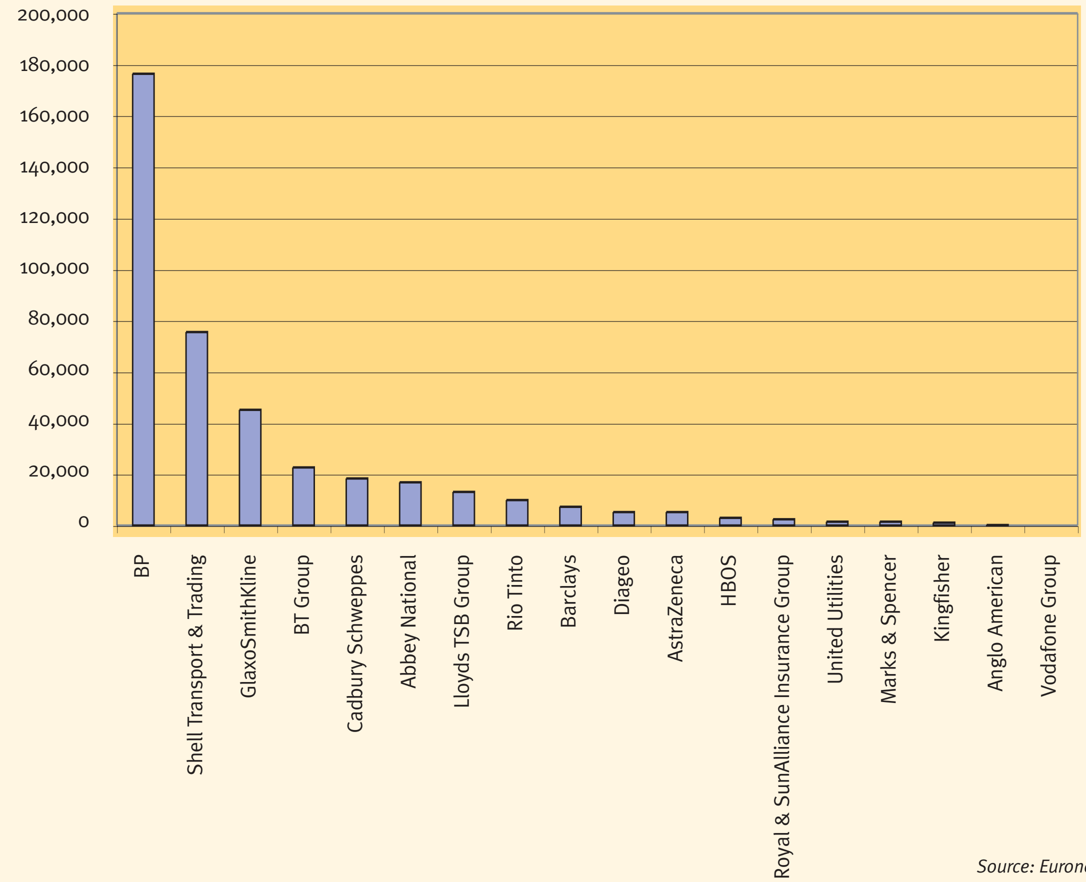
OTC FACILITY

This latest development, in particular, will make life easier and more secure for hedge funds – and so, of course, for their users, including those high net worth individuals anxious to reap the benefits of equity derivatives in their overall portfolio.

Traditional over-the-counter (OTC) business tends to be more expensive to administer than exchange business, involving copious amounts of legal documentation for every transaction. But a new facility for confirmation, administration and clearing of OTC option trades means considerable economies of scale, and allows OTC traders to access the risk management process of an exchange-traded product.

Starting in the UK, with a similar facility for Dutch individual equities, the service should expand in time to other European markets. It allows users to retain the anonymity of OTC trading – price, volume and time of individual trades are not published, and there is no obligation for counterparties to be given names when an inter-dealer broker is used.

However, trades are confirmed there and then, sparing users the risk and uncertainty of trades left unconfirmed, 1



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'In match trading, which is very attractive to fund managers, counterparty and credit risk is reduced by daily calculation and management of marked-to-market and variation margins by the clearing house, and the contract has the security of an exchange-traded product'

and they are rendered fully fungible with equivalent exchange-traded contracts. Post-trade administration is provided, including corporate action adjustments, and users have the chance to exit OTC positions with alternative counterparties.

MORE BENEFITS

Moreover, by allowing users to net positions if they have both exchange and OTC trades, the facility reduces the collateral required – either as margin at the clearing house or maintained against the OTC book.

With much of the European market thus standardised and rendered flexible, and with its benefits expanded to OTC trades, the appeal of equity derivatives can only be boosted by the futures and options market of the future.

Jonathan Seymour, head of equities, Euronext.liffe

CORPORATE STATEMENT

Euronext.liffe is the derivatives business of Euronext, formed after Euronext's purchase of the London International Financial Futures and Options Exchange at the end of 2001. Euronext.liffe is the world's leading electronic exchange, trading more business by value on its electronic platform LIFFE CONNECT™ than any other exchange. Euronext.liffe was the first to launch Universal Stock Futures in January 2001. The list of 115 Universal Stock Futures now listed on Euronext.liffe covers 13 countries.

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