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PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

UNIVERSAL STOCK FUTURES

PRODUCTS PROVIDING FLEXIBILITY

Private wealth managers may be shying away from putting USFs to use because the concept takes some figuring out. But the results are worth the effort

Launched by Euronext.Liffe in January 2001, universal stock futures (USFs) were initially utilised predominantly by institutional players. Although some private wealth managers have been using the product selectively since its inception, USFs are starting only now to find their way into private portfolios, despite limitations imposed by management mandates and regulators. In particular, those managers seeking to control equity risk more organically and add flexibility to equity portfolios are now looking at these products as a viable tool.

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Max Butti, Euronext.liffe

What makes USFs so useful

Some specific aspects are worth highlighting:

- **They are cash settled – they do not imply physical delivery of the underlying**
- **They can take short positions, allowing managers to take advantage of both sides of the market – this makes them an ideal tool for directional trading**
- **They can be used to achieve tax savings – for instance being cash settled, UK stocks don't attract stamp duty**
- **They can be used for dividend enhancement and dividend tax credit arbitrage**
- **The tax margining system makes them suitable for cash management in portfolios**
- **They can be employed by portfolio managers looking for a convenient way to generate alpha**
- **They allow risk management and hedging of individual portfolio components without disturbing the make-up of the portfolio or being forced to crystallise losses**

Growing trading volumes (see Charts 1 and 2) and the increasing number of contracts on offer are giving more confidence to users who have kept "a wait and see" attitude in the past three years. In 2003 trading volume increased by 61 per cent to 6.35m contracts and the addition of further contracts brought the total of companies on which USFs are listed to 143. During 2004 volumes have been so far positive, with a 117 and 207 per cent year on year increase in January and February respectively. The contracts now cover all the components of the FTSEurofirst 80 Index and the main European local benchmarks.

KEY ADVANTAGES

Universal stock futures were designed to provide flexibility. However, their value proposition based on low cost, simplicity and efficiency may be of interest to private wealth managers who do not necessarily have access to an extensive global execution network or to stock borrowing and lending facilities in order to short a single stock.

With the exception of restrictions on the use of derivatives in private portfolios imposed by specific mandates or regulators, the main reason why private wealth managers have not been systematically using USFs is probably due to unfamiliarity with the product.

Universal stock futures are relatively simple instruments. However, as it often happens with simple tools, they lend themselves to rather sophisticated uses, and they involve a rather steep learning curve for both client and manager.

In the examples below we try to explain how these

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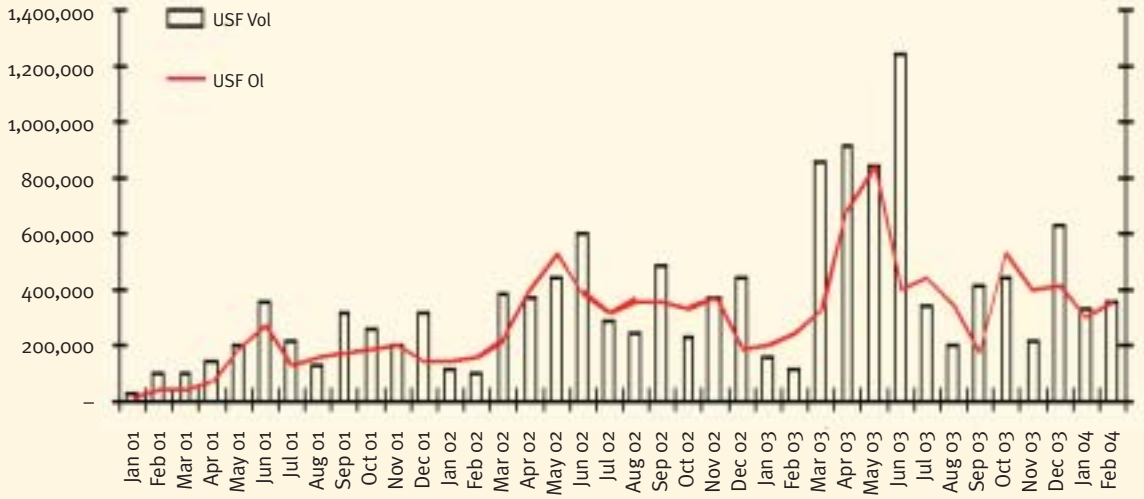
Trading update



Source: Euronext.liffe

instruments can be easily used in very simple situations to achieve a variety of objectives.

EXAMPLES

Universal stock futures are a suitable tool to hedge specific stocks without changing the make-up of the underlying portfolio or being forced to crystallise a loss. A very simple way to achieve this is to sell short a USF against the existing single stock position in the portfolio to "neutralise" the downside.

Let's take a portfolio benchmarked to the FTSEurofirst 80 Index that contains a position of 500 shares in Volkswagen established when the stock was at €45.75 in September 2003. On 5 January 2004 the stock is trading at €44.34. The stock outlook is negative in the short term but the portfolio manager doesn't want to sell it at the current price as he would materialise a loss. He decides to sell short five contracts (one contract = 100 shares) of Volkswagen in the corresponding March USF at €44.43 in order to neutralise any further potential downside in the stock.

The prediction was correct and Volkswagen shares did indeed decline and on 19 February were trading in the cash market at €39.64, posting a loss of 10.59 per cent over the period.

However, the loss was offset by the gains made in the future position as the Volkswagen March USF has also declined and is now trading at €39.70. The calculation is as follows.

Loss on long stock position

- €44.34 – €39.64 = €4.7 x 500 = –€2350

Gain on short USF position

- €44.43 – €39.73 = €4.70 x 5 x 100 = €2350

In addition, to illustrate how USFs can be used to hedge an individual stock position, this example also highlights the relationship between the price of the stock and the corresponding future.

A trading strategy that is gaining more popularity as a way to generate alpha in equity portfolios is the relative value trades between single stocks and their benchmark index.

This can be achieved by combining USF positions with an equity index futures position. If an individual stock is expected to outperform the market, the strategy would be to buy futures on the stock and sell futures on the market index. Futures are normally traded with equivalent underlying notional value.

As an example, take an investor who expects MMO2 plc shares to outperform the FTSE 100 Index over a period of one month. Market prices are as follows:

2 February 2004

- MMO2 plc share: £83.75
- MMO2 plc USF March 2004: £84.50
- FTSE 100 Index*: 4388.80
- FTSE 100 Index Future March 2004: 4365.5**

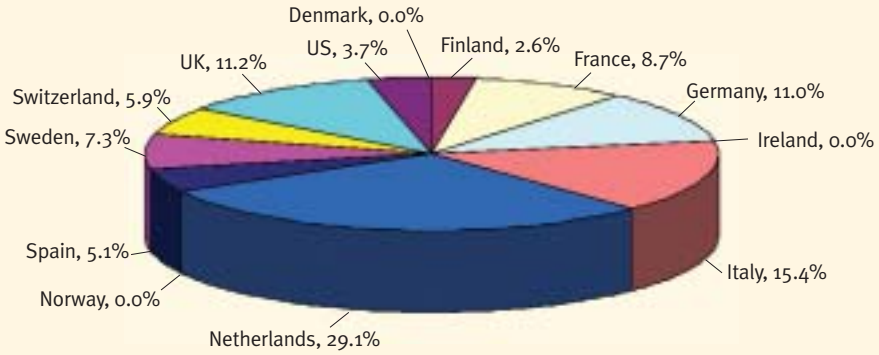
(* The FTSE 100 Index is not quoted as a market – there are no bid or offer prices; ** the FTSE 100 Index future price is below the index cash level because of dividends)

- The investor buys MMO2 USFs at £84.50 and sells FTSE 100 Index futures at 4365.5.
- The trade is for approximately £100,000, therefore the number of contracts traded is £100,000/(0.8375 x 1000) = 119 MMO2 futures and £100,000/(4388.80 x 10) = 2 FTSE 100 Index futures.

On 1 March 2004 the markets are as follows:

- MMO2 plc share: £105.82
- MMO2 plc USF March 2004: £106.00
- FTSE 100 Index: 4522.40

Underlying country of origin – volume distribution



VOLUME GROWTH Y-O-Y (MIL LOTS)

2001	2002	2003
2.29	3.93 (+71.5%)	6.35 (+61%)

Source: Euronext.liffe

FTSE 100 Index Future March 2004: 4502.0

- MMO2 shares are up 26.35 per cent whilst the index is up only 3.04 per cent. The gain on MMO2 USFs is (1.06 – 0.8450) x 1000 x 119 = £25,585, whilst the loss on the Index futures position is (4365.5 – 4502.0) x 10 x 2 = £2730, leaving a net profit of £22,855.

PREFERENCES

Private investors have preferences for the form in which investment returns are accrued – ie a preference for either income or capital gain. With conventional equity investment, this preference will lead the investor to focus on high yield or low yield shares. Universal stock futures can allow the investor to shift the balance between income and capital gain within a portfolio whilst widening the range of equities which the investor can consider using.

Futures contracts do not pay dividends. An investment in futures can be used as an alternative to investing in high yielding shares. Holding an equivalent cash balance will ensure that the overall return will be the same – capital gains will form a greater proportion of the total. A cash deposit is maintained to ensure that the futures position and the potential stock position are equivalent, ie additional gearing is not introduced into investment, which will affect the return on capital. Income in the form of interest will come from the cash deposit. Reducing the amount of cash on deposit will reduce the interest income, but will also increase the gearing of the strategy to movements in the share price.

The same structure described above can be used to increase portfolio income. As an alternative to buying shares which pay no dividends, depositing cash and buying futures contracts will result in an interest income being generated, and a lower capital gain. Total return on this strategy will be the same a holding the shares – the futures ensure that the exposure to share price movements is maintained.

In essence, USFs are derivatives instruments that are simple to explain and simple to understand. They can be used in a wide range of situations, adding more sophistication to the management approach without necessarily introducing more complexity in portfolios.

Max Butti, product manager, universal stock futures, Euronext.liffe

Contract specifications

- **Currency: local currency of the underlying**
- **Unit of trading: contracts based on shares of Denmark, Finland, France, Germany, the Netherlands, Norway, Spain Sweden and Switzerland – 100 shares. Contracts based on shares of Italy and the UK – 1000 shares. Contracts based on shares of US – 100 shares**
- **Delivery months: nearest two of March, June, September and December, plus nearest two serial months such that the nearest three calendar months are always available for trading**

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. LIFFE is the world's leading electronic exchange, trading more business by value on its electronic platform LIFFE CONNECT™ than any other exchange. LIFFE was the first to launch Universal Stock Futures in January 2001. The list of 143 Universal Stock Futures now listed on LIFFE covers 12 countries.

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