TRF - the right product at the right time (part 1)

B. G., Opalesque Geneva:

Eurex, an international derivatives exchange and a member of the Deutsche Börse Group, has been churning out its pioneering Total Return Futures (TRF) since 2016. In a recent webinar, we learned about the nature of TRFs, their history, the way they are used by the buy-side and the banks, their risks, repo as an emerging asset class, the broadening of the TRF product suite and other innovations. Here are some of the most salient points. (*Part 2 will be published tomorrow.*)

What is a TRF?

"In short, total return futures (TRFs) on the EURO STOXX 50® index were introduced in December 2016 to provide a listed alternative to the existing €100 billion OTC total return swap (TRS) market," explains **Nicolas von Kageneck**, senior equity and index sales specialist at Eurex.

Nicolas von Kageneck

TRFs were structured to replicate in a cost-efficient way the net pay-out profile of the index TRS. When you buy a TRF, you get an exposure to the underlying index at the trade date assuming you hold this position to expiry. So buyers of TRFs receive the performance, whether positive or negative, of the EURO STOXX 50 price return index plus 100% of the realised dividends. In return, the buyer will pay to the seller of the TRF the benchmark funding rate €STR* (euro short-term rate) plus a spread known as the equity financing rate.

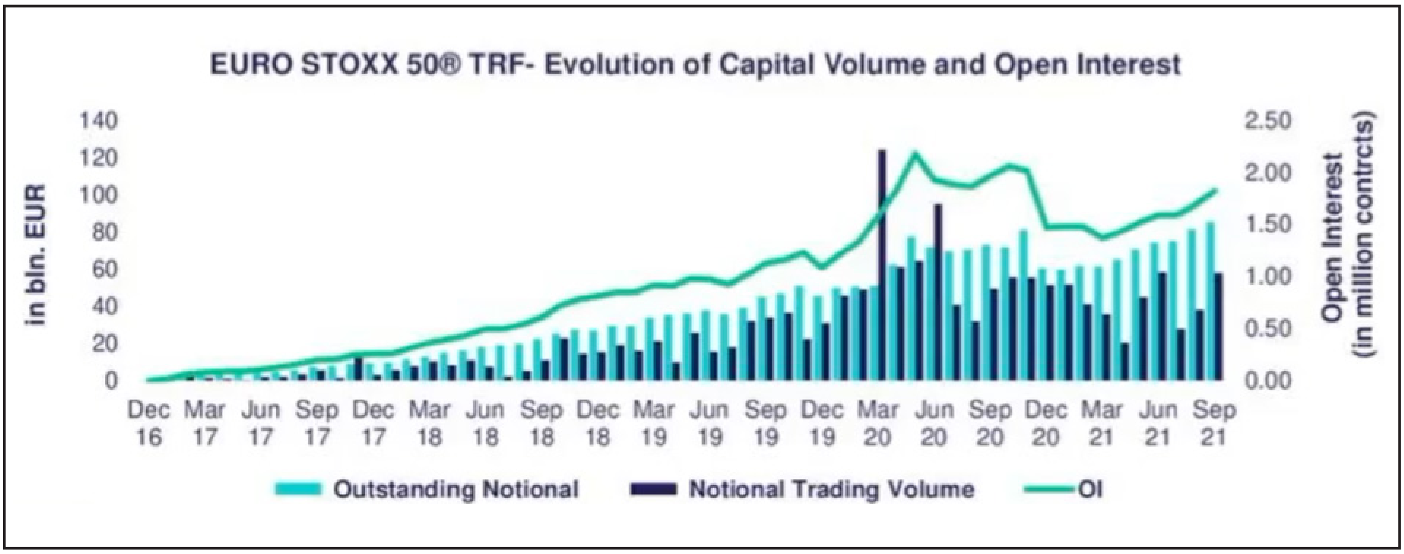
"When an asset manager buys a TRF from a dealer, the dealer hedges the trade by buying physical shares," von Kageneck continues. "He will then lend these physical shares out to the market and extract an income from it, which is the repo rate. So he passes this extra income to the buyer with a lower TRF spread. In essence, the higher the repo, the lower the TRF spread and vice versa. This is a very important point to understand."

The equity financing rate provides investors with unique investment opportunities, both from a carry perspective and in terms of cost optimisation, he adds.

TRFs were introduced as a result of dealer banks being massively affected by a lot of restrictive regulations since the financial crisis of 2008. One of the most significant regulations was probably the introduction of Uncleared Margin Rules (UMRs)** for non-centrally cleared OTC derivatives. Banks expressed interest in the futurisation of the TRS market to, first of all, reduce counterparty risk but also to mitigate the capital, collateral, and balance sheet pressures that they were facing.

Asset managers who have not been subject to the UMRs so far will be so in the next years. They "will probably adjust their trading strategies and move away from the pure bilateral exposures to either centrally cleared swaps or exchange-traded derivatives," he says.

TRF growth since inception



Source: Eurex

2020 was an exceptional year because of the dividend uncertainty. A lot of investors rolled their positions out of the price index future into the TRFs for the December maturities.

View from the buy side

Janus Henderson Investors, a global asset management group, started trading repo via TRSs in 2009. At that time there were no total return futures and they could only use the OTC market. But when they decided to trade more systematically, TRFs made a lot of sense.

Natasha Sibley

"We were quite opportunistic in our trading then and tried to put exposure on when we felt the levels were really quite stressed," portfolio manager **Natasha Sibley** explains. "But what we wanted to do was build a framework to enable us to trade repo slightly more systematically, that is, a framework that enables us to make quick consistent decisions across the various repo opportunities and to risk-manage those decisions. In 2016, we started trading much more systematically on repo and that would have been really quite painful to do if TRFs hadn't existed. We trade relatively actively now and we can be in and out with different banks because we can trade on the exchange. We have standardisation across different products, so not just TRFs but options, regular price return futures, and dividends."

Part 2 here.

To watch the whole conversation, you can replay the webinar here:
Total return futures: The Great Migration - How hedge funds and active strategies profit from new instruments on regulated exchanges

Notes:

* €STR is a benchmark interbank rate published for the first time on 2 October 2019, based on the methodology of the European Central Bank (ECB). It will progressively replace the EONIA interbank rate.

** UMR (uncleared margin rules), which went live in 2016, aims to reduce the risk of derivatives exposures. If a firm has an aggregated notional exposure greater than €50m, then it is in scope to compute an initial margin using ISDA's SIMM (Standard Initial Margin Model) methodology, which can be costly. Since UMR went live in 2016, only a small number of firms have been impacted by Phases 1-4. However, by September 2022, an estimated 1,000+ additional entities will be subject to UMR for initial margin (IM).