Corporate Bond Index Futures – a new asset class emerges

The first listed futures tracking Eurozone credit open up significant possibilities in a changing market.

An interview with Lee Bartholomew, Head of Fixed Income & FX Product R&D and Jan-Carl Plagge, Head of Applied Research at STOXX.

Lee Bartholomew
Head of Fixed Income & FX Product R&D, Eurex

Jan-Carl Plagge
Head of Applied Research, STOXX

The introduction this month of the Corporate Bond Index Futures on Eurex, the first listed futures covering the Eurozone's corporate bond market, creates a new asset class and novel possibilities in exchange-traded derivatives.

The futures track the performance of the EURO STOXX 50® Corporate Bond Index, made up of debt issued by the highly capitalized companies selected into the Eurozone's well-known blue-chip index EURO STOXX 50®. The contracts offer the security and transparency of a cash-settled, centrally cleared instrument at a time when demand for fixed income products is growing.

A new solution in times of significant change

Record-low interest rates are driving demand for high-yielding corporate debt, prompting more issuers to come to the market. Trading volumes in European corporate bonds have further benefited from the European Central Bank's asset-purchasing program. At the same time, however, new European regulatory requirements have forced investment banks to re-evaluate their business model and focus their trading activities, which has led to reduced market liquidity.

All these changes are creating a need for new and efficient instruments to hedge and manage portfolios in the credit market, according to Lee Bartholomew, head of fixed income and foreign exchange product development at Eurex.

"European credit markets are undergoing significant change, and traders and investors are likely to welcome the advantages that having exchange-traded futures brings," said Bartholomew. "Additionally, the bond-index futures will benefit from their direct link to a well-established benchmark such as the EURO STOXX 50® Index."

A blue-chip benchmark for Europe's credit market

The EURO STOXX 50® Corporate Bond Index includes investment-grade, euro-denominated bonds issued by EURO STOXX Index members and their subsidiaries. All eligible bonds must have a remaining maturity of at least 15 months and a minimum nominal amount outstanding of EUR 750 million, improving investability. Only fixed- and zero-coupon issues are included. Subordinated debt is excluded.

The index is weighted by market capitalization, and has a unique capping methodology to avoid concentration risk or bias: any constituent issuer is capped at 20%, while the weight of single industries is capped at a maximum of 40%.

"The Corporate Bond Index follows the rules-based and transparent philosophy that is common with all STOXX products," said Dr. Jan-Carl Plagge, Head of Applied Research at STOXX . "The index methodology aims at offering investors access to the Eurozone corporate bond market while being very mindful towards issuer- and industry diversification."

"A key edge of the EURO STOXX 50® Corporate Bond Index over individual bonds is the availability of real-time pricing," Plagge added. The Corporate Bond Index is calculated based on by-the-minute continuously evaluated prices, which allows for high quality price determination of the index portfolio.

A hedging and trading alternative

Eurex had corporate bond desks, portfolio managers, risk desks and traders of exchange-traded funds (ETFs) in mind when designing the new contracts. "With the EURO STOXX 50® Corporate Bond Index Futures, Eurex new corporate bond index future provides buy- and sell-side participants with a versatile hedging instrument to manage their credit risk exposure and replicates some of the exposure within their portfolios", said Bartholomew.

"Through the Corporate Bond Index futures, money managers can gain exposure to a single basket of the region's most liquid and representative bonds issued by blue-chip companies," Bartholomew added, "eliminating the cost and heavy due diligence incurred in the selection of individual debt instruments." The contracts also offer banks that sell bespoke and structured products an efficient hedge.

The Corporate Bond Index futures – which have a quarterly expiry – represent an alternative to existing benchmarks, i.e. credit default swaps (CDS), which carry an inherent counterparty risk and potentially larger tracking error relative to bond markets.

A plug-and-play product

"The trading community appreciates that these are straight-through processed, cash-settled, standardized futures that match existing parameters for products such as the EURO STOXX 50® or German Bond futures," said Lee Bartholomew.

The centrally cleared and cash-settled nature of the futures means there are no settlements or deliveries to be monitored and no daily closing prices to be checked as opposed to holding bonds.

"As they have the structure of a standard Eurex index future, the new products can be easily added to existing infrastructure," Bartholomew added. "They do not require any additional effort, for example, from the back office.

A portfolio optimization tool

Bartholomew points out that the futures are also a valuable trading instrument that gives leveraged access to generate alpha in the European credit market. This can be achieved via a portfolio overlay, making the addition or removal of bond exposures in portfolios a seamless process.

"Sharing a common structure means the EURO STOXX 50® Corporate Bond Index futures and their equity index equivalent can easily be combined to develop multi-asset strategies and portfolios," Bartholomew said.

There are also unique opportunities in relative-value trading with the possibility to trade the yield spread between Eurozone corporate debt and futures on European Sovereign Debt. This is also supported by T7 Entry Services for block trading and EFP transactions on Eurex.

Further possibilities ahead

While the EURO STOXX 50® Corporate Bond Index has a family of sub-indexes tracking maturity buckets, industries and credit ratings, Eurex is for the moment focusing on introducing futures on the main index and is set to extend the offering to other bond indices.

A milestone for change in fixed-income markets

The introduction of a versatile trading and hedging vehicle for the Eurozone credit market is a positive development at a crucial time in the market's supply-and-demand balance. New trading regulations that will come into force in 2018 are likely to tilt fixed income volumes further towards on-exchange transactions, complementing the market's traditional reliance on over-the-counter liquidity.

Bartholomew draws a comparison to the evolution in the European fixed income periphery markets, and says the introduction of the Corporate Bond Index futures is a milestone that could transform the region's credit market.

"Adoption of futures, generally speaking, brings direct benefits," he said. "But also increasing use of derivatives can have a high impact. They can play a very big role in the development and stability of, as well as confidence in, fixed-income markets."