

## New Impulses for Derivative Markets

**Do investors who use derivative products benefit from pension system reform and related modernization of the respective asset management instruments? The article below outlines the influence, correlations and strategies of new pension concepts on exchange-traded derivatives.**

Pension reforms across Europe are likely to lead to increased demand for capital market and equity derivative products including those available at organized derivatives exchanges. Fund managers will not only seek new ways to ensure an adequate return for their larger investor base, but they will also be obliged to find methods by which they can effectively manage the risk of the growing assets under their control.

The full impact on the wider financial markets of the ongoing pension reforms in Germany is a subject for much debate. However, it seems certain that there will be substantial growth in the total amount of funds under management.

The growth of pension funds in the UK and Netherlands has far outstripped that seen in Germany. The more liberal regimes in the UK and the Netherlands, where fund managers are bound by the "prudent man principle" has proved preferable to the strict quantitative measures that have previously governed pension funds in Germany and in other European countries.

Not only has more money been invested in the UK and Netherlands in schemes independent from employers and government, but also these funds have tended to yield more than those in countries such as Germany. The average return on funds invested between 1984 and 1996 in countries that have adhered to the prudent man principle was 9.5 percent. The average in countries with strict quantitative restrictions has been just 5.2 percent.

Greater freedom to invest in the equity markets is one explanation for this disparity in the rates of return. Reform of the German pension system will allow fund managers more choice. However, even if the newly liberalized German pension funds do diversify their holdings, several factors have to be taken into account about how to achieve satisfactory returns.

Some estimates suggest that the flow of fresh funds into the capital and equity markets in Germany alone could grow from around EUR 5.6 billion this year, to as much as EUR 41 billion in 2008. Much of this is likely to be invested in the equity markets. But there could also be an increased demand for government bonds, particularly at the long end of the yield curve.

This will potentially lead to the same sort of pressures on the long end that has been seen in the UK over the last few years. There, demand outstripped supply to such an extent that the curve became inverted, and fund managers have struggled to obtain an adequate return from their bond holdings. If the region's equity markets were steaming along in a bull trend, this would not necessarily matter. The falling yields in the bond markets would be more than offset by strong returns from equities. But problems will clearly emerge if the equity markets trend either sideways, or worse move lower as they did throughout 2001.

When this happens, returns will inevitably come under pressure and funds may face the potential problems of liabilities exceeding assets. So the greater risk that investing in equities entails has to be effectively managed. Liquid derivatives products can help do this.

Highly liquid fixed-income and equity derivatives products are excellent tools for managing risk and maximizing returns. At times of extreme market stress, such as during the Asian crisis of 1998, the collapse of Long Term Capital Management (LCTM) in the same year or the terrorist attacks of September 11 last year, products are available that allow the swift and effective reduction or increase of exposure to key market segments.

Even though the asset management vehicles, coming to existence following the reform of German pension laws, will have various rules and regulations to consider restricting their use of derivatives, they can still benefit from using derivatives products.

The use of derivatives for hedging purposes is more or less up to the pension fund. It will be easier for the new funds to use exchange-traded derivatives than those traded over-the-counter, so the transparency of Eurex should prove a key advantage in attracting this activity.

Users of Eurex products have the advantage that all the trades are done with a secure, central counterparty – Eurex Clearing AG. This effectively removes counterparty risk, which is still a concern to anyone trading OTC, especially after the spectacular collapse of Enron.

Very simple option strategies exist that allow fund managers to scale up their returns. There are a couple of classic plays commonly utilized by funds holding underlying assets. The first is to sell upside calls (out-of-the-money calls). The fund accepts premium for selling the right to a third party to buy an asset. This is often used when markets are trending sideways or moving lower. If the market does head higher, the fund manager is covered because he holds the underlying assets. If the option is exercised, he will have to meet that call. But he will have done so at a rate that was far more attractive than the one that prevailed in the market at the time he wrote the option.

The other strategy, used when a fund manager believes the market will head higher, is to sell out-of-the-money puts. The fund manager again receives the premium, granting the right to a counterparty to sell an asset. If the market does move up, the option will expire without being exercised. If it heads lower and the put is exercised, the fund must take delivery of the shares.

There seems little reason why at least some of the new funds cannot adopt these types of strategies. Some will be able to pursue more bespoke strategies. When used properly, derivatives are extremely useful tools that can help manage and control risk to ensure adequate returns for investors.

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