

MSCI exchange-traded derivatives in today's market structure

Part 1: MSCI exchange-traded derivatives

June 2018

MSCI exchange-traded derivatives

MSCI ETDs are an important subset of the broad ETD market described in the preceding section. Below, trends and challenges related to MSCI ETDs are detailed.

Growth of MSCI ETDs continues as investors employ passive trading strategies and benchmarking.

MSCI ETDs are tied to some intriguing statistics, as shown by Figure 7. Over 79.4 million MSCI contracts were traded in 2017. MSCI reports that US\$ 3.774

trillion of MSCI index-based futures and options were transacted in the year, a 45% increase over 2016.⁷ The impressive sustained period of growth has been linked to the general trend of passive investing, as funds tied to a benchmark must track their respective performances. Over US\$ 12.4 trillion is currently benchmarked to MSCI indices on a worldwide basis.⁸

Figure 7: MSCI ETDs 2017 snapshot



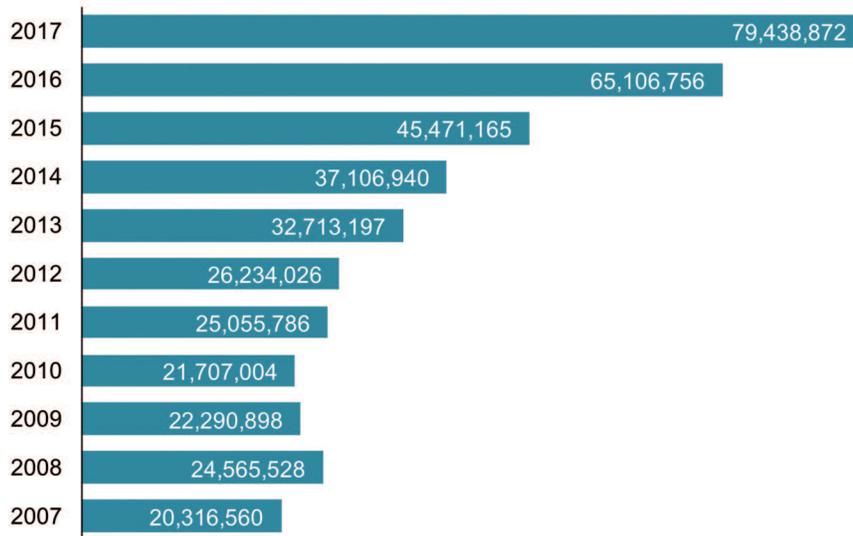
Source: MSCI

⁷ "Listed Futures and Options Based on MSCI Indices," MSCI Inc., Q1 2018, accessed March 1, 2018, <https://www.msci.com/documents/1296102/1360895/msci-LFO-cfs-en-+-+Q4.pdf/cf8ea018-3d55-4a77-8951-113bc8ec919b>.

⁸ "Index Licensing," MSCI Inc., accessed March 1, 2018, <https://www.msci.com/index-licensing>.

Figure 8: MSCI ETD annual volume edges higher.

Total annual ETD volume, 2007 to 2017



*Figure does not include options on ETFs that track MSCI indices

Source: FIA

A broad range of financial products are based on or use MSCI indices, including ETFs, mutual funds, insurance products, structured products, OTC derivatives, and listed futures and options. MSCI ETDs have been growing in popularity and volume over the past 10 years, as shown by Figure 8.

When liquidity and fragmentation are the new normal, relationships matter.

Although a debated concept, liquidity is often described as the ability to transact an instrument at a reasonable cost across a wide variety of market conditions. Market participants will often make decisions about when and where to trade based on anticipated liquidity levels. When trading costs are low, participants can enter and exit positions without significant price impact. According to a recent Commodity Futures Trading

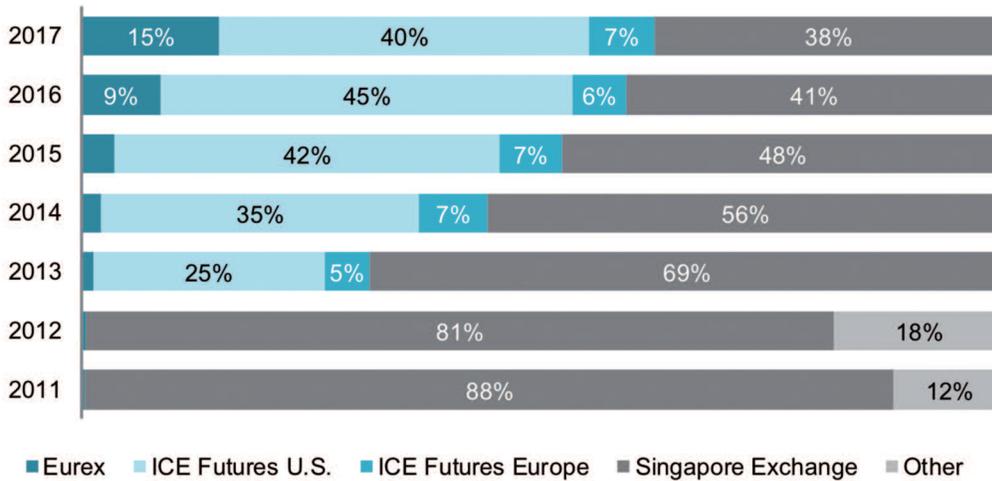
Commission white paper, changes in market structure, regulation, and participation in recent years, which may negatively influence liquidity levels in listed derivatives, have been stable in a low-volatility environment.⁹

MSCI ETDs have unusual characteristics and trade in a fragmented market, which limits liquidity to individual investor pools. Rather than being licensed on an exclusive basis, MSCI ETDs are currently spread across seven exchanges: Eurex, ICE Futures U.S., ICE Futures Europe, Singapore Exchange, and others (CBOE, JSE, and DGCX). As Figure 9 highlights, the 2017 market share picture has become more dispersed than it was at the beginning of the series. While the majority of trade count is presently linked to the Singapore Exchange (38%) and ICE Futures U.S. (40%), other venues have begun to occupy a larger slice of the pie. For example, Eurex accounts for 15% of market share and has been increasing its activity in MSCI ETDs since 2013.

⁹ Nicholas Fett and Richard Hayes, "Liquidity in Select Futures Markets," February 1, 2017, accessed January 9, 2018, http://www.cftc.gov/idc/groups/public/@economicanalysis/documents/file/occe_liquidityfuturesmarkets.pdf.

Figure 9: MSCI ETD market share of volume is fragmented.

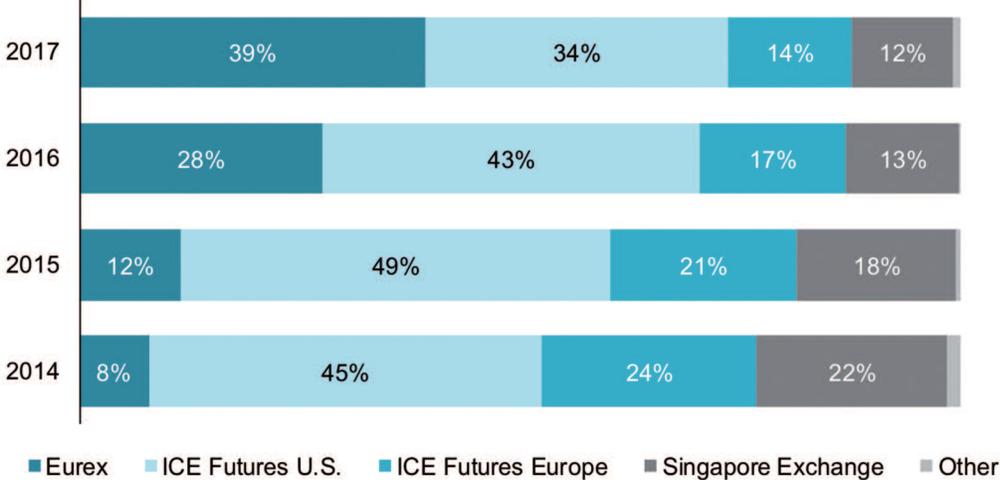
Percentage of trading of MSCI ETDs by exchange, 2011 to 2017



Source: FIA

Figure 10: MSCI ETD OI by exchange tells a different liquidity story.

Percentage of open interest of MSCI ETDs by exchange, 2007 to 2017



Source: FIA

Contracts traded and OI are both measures of liquidity; however, in the case of MSCI ETDs, these metrics differ significantly by exchange. The percentage of open contracts spanning the past four years is represented in Figure 10. At the end of 2017, the majority of OI resided at Eurex (39%). This result differs significantly from the volume metrics highlighted in Figure 9, in which the exchange held the third-highest percentage of volume at that time.

Venues have responded to the growing need to trade listed futures and options rather than OTC derivatives by offering carbon copies of the same product. For example, the MSCI World Net Total Return Index can be found in its U.S. dollar version on ICE Futures U.S. and Eurex. Likewise, variants of the same index are popping up – the euro-denominated version of this same index is also available on Eurex. As a result, managers have to consider not only which specific

index is best for their investment goals but also the advantages of transacting on a particular exchange given the full suite of products and margining practices – a topic that will be discussed in depth in the following section.

While the typical liquidity metrics used by market participants (OI, notional ADV, and trade count) are quite useful for identifying trends in the listed markets, investors rely on relationships with the broker community as one of the most important determinants when sourcing liquidity in a fragmented ETD market, according to a recent Aite Group survey. Intuitively, this makes sense given the sheer breadth of offerings: MSCI has licensed some 250 futures and options to seven exchanges.¹⁰

“*(Liquidity is) not a point of OI or trades which print on the screen. It's more about relationship – speaking to each broker and making sure they are aware of the interest or order coming through the pipe. Are they willing and able to quote?*”

Stefan Thomsen, senior trader,
Union Investment Privatfonds GmbH

Low screen volume linked to certain contracts means “hidden” liquidity must be unearthed through market-makers and/or by using exchange tools that ease execution. For example, end-of-day auctions and block trading help investors trade large sizes without market

“*The visible on-screen liquidity for most Asian contracts remains low at the moment. However, buy-side investors can rely on the liquidity provided by banks and market-makers (that) stand ready to quote blocs on these contracts.*”

Amaury Lacourte, Asia Delta One Index trader,
Société Générale

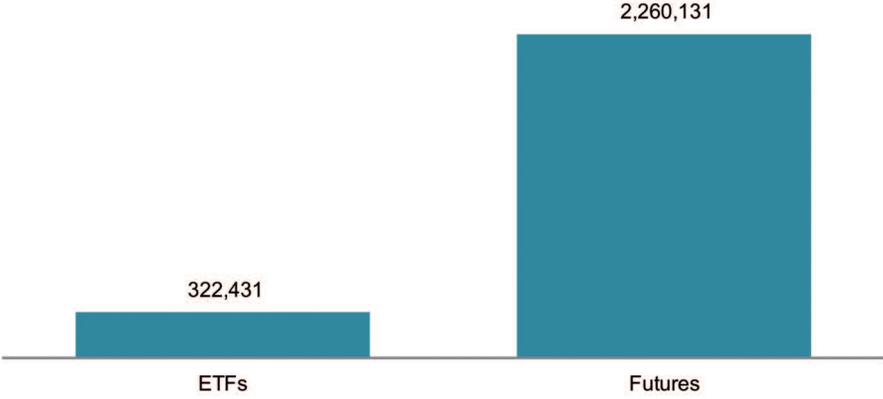
impact. Access to a range of global futures and options through a single venue – particularly those approved for U.S. investors – also attracts flow. (This is evident in Figure 10, as Eurex has the broadest offering of global products while other exchanges are more regionally focused.) Thus, even though the OI or the number of contracts traded may be larger on one exchange than on another for a particular contract, these solutions can result in identical liquidity, and investors are able to trade the same size for the same cost.

As mentioned earlier, there is a relationship between ETF, futures, and cash markets. Often when screens are thin for one product, liquidity can be sourced from a related market. As Figure 11 shows, MSCI global futures ADV was about 2.3 million contracts during the first quarter of 2018, while 322,431 MSCI ETF shares are traded each day, on average, over the same period. While ADV is much larger for MSCI futures, trading activity is concentrated, as only 41% of futures were traded (88 out of 216 listings) compared to 92% of ETFs (843 of 920 listings) during this time.

¹⁰ Listed Futures and Options Based on MSCI Indices” MSCI Inc., Q4 2017, accessed March 1, 2018, <https://www.msci.com/documents/1296102/1360895/msci-LFO-cfs-en+-+Q4.pdf/cf8ea018-3d55-4a77-8951-113bc8ec919b>.

Figure 11: 2018 MSCI ETF and futures ADV

ADV of global MSCI ETFs vs. futures, Q1 2018



Source: Thomson Reuters, MSCI

Conclusion

Buy-side participants:

- Because screen liquidity is often fairly light, buy-side survey participants suggest their relationship with a market-maker is vital to trading ETDs. These participants are most concerned that off-screen liquidity will be there when they need it.
- In addition to market-makers, **tools to enhance liquidity, such as block trading and end-of-day auctions, are key to choosing a venue in which to trade MSCI ETDs.** One buy-side participant mentions that some technologies are too restrictive and that more flexibility is needed when using trading platforms.
- Finally, in addition to liquidity, one of the most important factors in choosing an exchange is the margining agreement. Market participants who trade client portfolios across multiple ETDs, for example, note that a portfolio-based margin system, such as PRISMA, is the optimal choice given its netting benefits.

Sell-side participants:

- Sell-side participants, such as banks, are keen to address the importance of off-screen liquidity. They suggest that while open interest may be an indication of market depth, MSCI ETDs that trade on multiple exchanges may be traded in the same size and at the same price, even if liquidity metrics vary.
- **One sell-side firm emphasizes exchange risk as a strong focal point for banks over the last few years. Segregation rules and the waterfall structure of developed exchanges (in the event of a counterparty default) are carefully scrutinized since unused cash must be left at the exchanges.**
- Finally, the type of margining program is again mentioned by sell-side firms. Simply stated, the more portfolio margining possibilities, the better. Cost considerations are paramount to the margin discussion.

About Aite Group

Aite Group is a global research and advisory firm delivering comprehensive, actionable advice on business, technology, and regulatory issues and their impact on the financial services industry. With expertise in banking, payments, insurance, wealth management, and the capital markets, we guide financial institutions, technology providers, and consulting firms worldwide. We partner with our clients, revealing their blind spots and delivering insights to make their businesses smarter and stronger. Visit us on the [web](#) and connect with us on [Twitter](#) and [LinkedIn](#).

Author information

Audrey Blater, Ph.D.
+1.617.261.7137
ablater@aitegroup.com

Contact

For more information on research and consulting services, please contact:

Aite Group Sales
+1.617.338.6050
sales@aitegroup.com

For all press and conference inquiries, please contact:

Aite Group PR
+1.617.398.5048
pr@aitegroup.com

For all other inquiries, please contact:

info@aitegroup.com

