International Financing Review: Futures Roll Hits Six-Year Low

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Balanced positioning drives down costs versus exchange traded funds

The cost of rolling futures contracts on the S&P 500 fell to its lowest level in more than six years in March, throwing cold water on a long-held theory that regulatory changes hitting bank balance sheet capacity could permanently increase the cost of synthetic equity exposure.

Investors paid an average of 28bp below Libor to roll from their March maturing contracts into new June expiries, enabling them to extract premiums relative to their benchmark cost of funding.

It is the lowest roll cost for the contracts since 2009, according to CME data, and represents the third quarter in a row that the contracts have rolled at sub-Libor levels. Last September's roll, averaging Libor minus 10bp, brought an end to 11 quarters of costly rolls that peaked in December 2014 when investors paid 51bp over Libor to move into new contracts.

The shift comes as a result of a renewed bid for bearish bets following last August's turbulence that saw the US benchmark shed 11% in the space of a week.

"There has been a change in the dynamics of the long and short sides of the market with the recent return of volatility," said Tim McCourt, head of equities at CME Group.

"The first-quarter move down in stock prices has brought new participants into the market, and we're moving more to a state of equilibrium with the return of leveraged shorts, rather than the long bias that dominated the bull market."

Short S&P 500 futures positioning by institutional investors stood at 195,000 contracts in late April, according to the latest CFTC Commitments of Traders report, while long positions totalled 272,000 contracts. Leveraged funds displayed a more bearish view with 134,000 short contracts compared with just 92,000 long positions.

That is a stark change from December 2014, when asset managers held 310,000 long contracts compared with 129,000 shorts.

Dislocations in equity repo rates, which threw roll costs into Libor-plus territory starting in December 2012, were widely viewed as a direct result of new capital rules that forced banks to streamline balance sheets.

"Over the last three years, everyone on the Street has been describing the dynamic with a focus on the supply side, with dealers cutting balance sheet capacity as a result of Basel III. There hasn't been enough attention paid to the demand side," said Anand Omprakash, equity and derivatives strategist at BNP Paribas.

"If asset managers don't need so much long exposure, the cost of that balance sheet is going to go down."

The reversal, which got under way last September, raises questions about an expected shift from futures into exchange traded funds. ETF issuers had begun to see some institutional investors switching out of futures positions and into ETFs in an attempt to mitigate the rising roll costs.

"The debate [futures versus ETFs] is most relevant for investors using futures to track an index where they don't require the leverage," said Omprakash. "If you need leverage, it's usually more efficient, and less operationally burdensome, to buy futures than it is to borrow money to buy ETFs."

In addition, ETFs are not entirely immune from higher futures roll costs as liquidity providers typically hedge their exposures in the futures market.

"All equity products, whether futures or ETFs, are affected by moves in the equity repo lending rate," said CME's McCourt. "When the implied financing is at a premium to Libor, there can be benefits to the fully funded instruments, but when the roll cost is at sub-Libor levels, you can only get that benefit from futures."

He also notes that futures are around seven times more liquid than their ETF counterparts so remain the product of choice for investors coming in for large end-of-day trades. Average daily volume in CME's E-mini S&P 500 futures contract stands at US$170bn while the SPDR S&P 500 ETF trades an average of US$25bn each day.

Large moves in implied financing costs have driven some investors to take a more dynamic approach to product choices, taking into account futures roll costs, ETF management fees and market impact costs.

"Investors are nowadays more mindful of the pros and cons of each product and many have set themselves up to be diversified between futures and ETFs in their equity exposure. This has allowed them to take advantage of the relative pricing advantages that might exist between the two markets," said Omprakash.