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ALTERNATIVE MARKET BRIEFING

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TRF - the right product at the right time (part 2)

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 1 here.)

View from the banks

The view from the bank perspective on TRFs is a little bit the same as the view on dividend futures, where the shift from OTC products or OTC swaps to dividend futures brought a lot of volumes and more liquidity in the market, says **Antoine Deix**, head of dividend and repo solutions at BNP Paribas, the largest French banking group.


Antoine Deix

On top of the appetite for transparency and fungibility to foster liquidity, TRFs also aim at mitigating the concerns over the introduction of the bilateral margining on non-clear OTC swaps.

TRFs bring in the benefits of Euro STOXX 50 Futures, such as exchange trading, liquidity, transparency, fungibility, no counterparty risk, and so on, as well as the benefits of Euro STOXX 50 TRS, that is, no quarterly roll risk, no dividend risk, and lock in financing for more than three months. It is the best of both worlds.

TRFs also provide a listed solution to access the repo parameter, notably through a calendar spread to benefit from the TRF financing spread curve.

Repo as an emerging asset class

There is a demand from banks' structured product business for forwards and the repo directly parameterises how cheap or expensive that forward equity exposure is, **Natasha Sibley** explains. That reflects the supply-demand and it is something investors can use to generate returns. One of the key components of the repo is the carry.

In this chart, Janus Henderson Investors looked at a short five-year TRF vs. a long one-year TRF and the repo differential between those two-term rates.

Source: Bloomberg, Janus Henderson Investors analysis, as at August 2021.

"It's quite remarkable that you can have a trade where the curve hasn't moved in your favor at all, but you have this really strong carry profile coming from the static carry of the headline repo rate and also the roll down as the total return futures move closer to expiry," she says.

"One of the reasons (repo) is such an attractive asset class for investors is because you have this really strong carry signal that can offset volatility that you might see in the repo rates themselves."

The difference between TRS and TRF

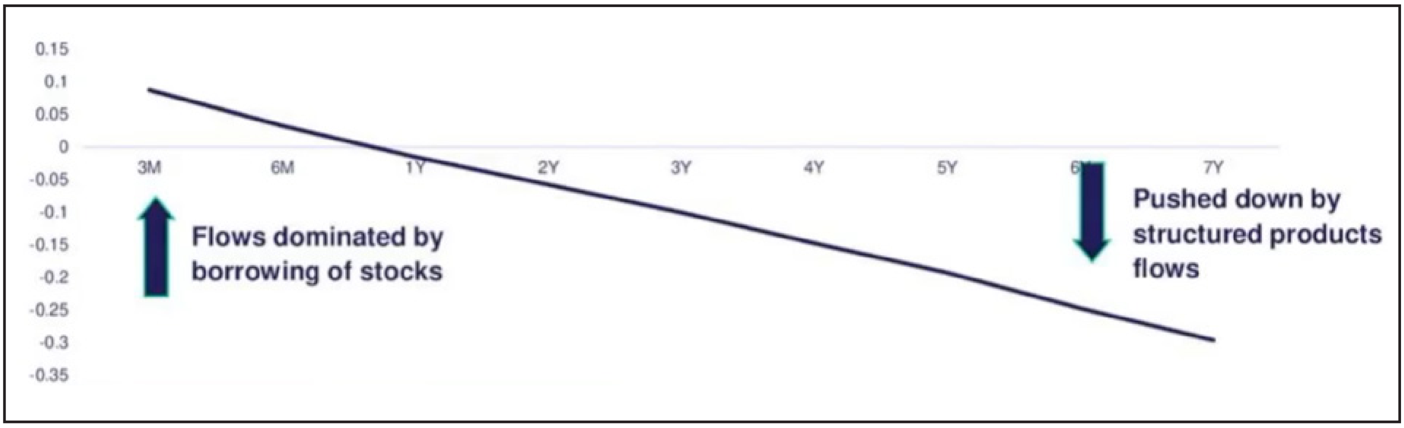
Buy-side investors use TRFs for two types of trade; the first one is carry-trade, where one takes a relative value position between two points on the term structure, the other one is a simple beta replacement trade, says Natasha Sibley.

TRFs have some differences in price return features. The main one is that investors get dividend exposure with price return futures, but not with TRFs. That became clear in 2020 when we witnessed massive changes in the dividends expected to be paid in the next three months. This "is a reason why investors might want to use TRFs as a beta replacement."

Furthermore, when it comes to the differences between the swaps and futures, one of the key differences is the ease of trading, she adds.

The drivers of the repo term structure

Short-term flows are dominated by stock borrowing and lending and appetite for collateral, says Antoine Deix. Long-term flows are dominated by structured products issuance where the pressure is rather on the downside.



Source: BNP Paribas

"Opposite flows on the short and long-term are structurally steepening the Repo curve and when the market is weakening, we see an even steeper curve. That is what is bringing the attractiveness in the TRF's financing spread."

Systematic risk of TRFs

One of the key benefits of this product is the clearing side - on top of the trading and distribution side, says **Stuart Heath**, director of equity and index product design at Eurex.

Antoine Deix

Eurex built the futures product around the clearing capacity but didn't change the market structure per se. "So a TRF is still traded as a swap quoted in basis points but now it's a future that's cleared." This reduces systematic risk in that it avoids the liquidity adds-on and the additional margins that one might get from outsized positions, whereas "a centrally cleared product does the exact opposite." Furthermore, "we can manage the risk because we see the risks at all points along the curve not just in the underlying delta."

Innovation and outlook

As the structured products market evolves, there are going to be different places where we see opportunities in the repo rate mirroring the markets for structured products, according to **Natasha Sibley.**

"The FTSE 100 is a really good example because this is an index that we have traded repo on in the past using swaps. It was difficult to exit that trade at the best level because it looked like that was going to have to be a novation."

Nobody was keen on having to novate a swap - that's a lengthy process. And exiting in times such as March 2020 would have been difficult. In contrast, during that same time, TRFs saw a lot of trades in terms of volume. "Broadening the product suite to move into new markets as structured products move around, that's really helpful to the buy-side," she adds.

Aside from the FTSE 100 TRF done in collaboration with FTSE Russell, Eurex has also introduced the Euro STOXX Banks TRF and the Euro STOXX Select Dividend 30 Index TRF, says **Stuart Heath**. "These are more aimed at recycling the supply of implied repo hedging that's out there."

Now that the product is embedded in the operational processes of a lot of institutions, it gives Eurex more development chances, he adds. One new development might be a beta replacement product.

"In the dividend market, we are increasingly seeing investors looking in single names and basket of single names, so TRFs could allow to fine-tune the exposure single names that are the most used in structured product baskets and thus could display steeper repo curves," says **Antoine Deix**. "We are not there yet but that's an area to explore in the next year."

Part 1 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**