



FORUM FOR THE FUTURE

Russell index futures provide liquidity benefits.

GARY KNAPP *Quantitative consultant, New York Board of Trade, for CIBC Mellon.*

With the increased prevalence of Russell indices as a primary institutional benchmark, the introduction of futures and options on them by the New York Board of Trade (NYBOT) gives institutional investors more options and flexibility to better manage style tilts and alpha overlay strategies. The NYBOT has begun listing futures and options on the Russell family of equity indices covering large cap and small cap as well as value and growth subsets. The use of the Russell indices has grown to the point where the amount of actively managed assets using a Russell benchmark is nearing the amount managed to an S&P benchmark. The Frank Russell Company published a study in June 2004 which shows actively managed assets of US\$1.39 trillion benchmarked to Russell indices versus US\$1.52 trillion benchmarked to an S&P index. Of particular note is the large amount of assets benchmarked to the Russell 1000 Value & Growth Indices versus the S&P/Barra Value & Growth Indices. The relatively small amount of assets benchmarked to the S&P Value & Growth may explain the lack of interest in these futures contracts. By listing the Russell 1000 Value & Growth index futures, the NYBOT has provided a derivative tool for the large amount of assets that are managed to these benchmarks.

Futures are a cash-efficient way to passively index, implement a tactical asset allocation overlay or add alpha through style and cap timing overlays. During the run-up to the bull market top in early 2000, growth substantially outperformed value. A long Russell 1000 Growth/short Russell 1000 Value spread had a compounded return of more than 50% from June 1995 to March 2004. This is about half the gain from being long the Russell 1000 over the same period. One of the benefits of the spread position during this period is that it was immune to the market shock of August 1998 precipitated by the Russian default. Had an investor with perfect foresight reversed this growth/value spread at the market

top in March 2000 to be long value/short growth, the spread position would now have a compounded return of over 120% through June 2004. This compares to the Russell 1000 return of about 75% from June 1995 through June 2004.

Futures and options trading in the Russell indices are still in the early stages of development. Trading volumes and open interest are growing but are still small compared to the S&P 500 index futures and options. To facilitate liquidity, the NYBOT employs a designated market maker whose responsibility it is to provide continuous bid and offer prices at a regulated maximum spread for a regulated minimum size. This provides a liquid market in the futures regardless of the level of participation by other investors. The liquidity of the underlying securities of the index and the commitment of a designated market maker to perform the arbitrage between the cash and futures provides liquidity to the futures and options market.

The current market environment offers little absolute return in any vehicle. The risk-free rate is low, bond yields are low and equity returns have been negative for three of the last four years. Hedge fund returns have averaged in the low single digits since 2001. This may be a function of the impact of the demographics of the dominant investors. As the post-Second World War baby boom generation begins reaching retirement, preferences may be shifting to income-producing securities versus high growth. This suggests more capital chasing high dividend-paying equities and fixed income securities and less investment in growth stocks. The result of this demographic phenomenon may be sustained low returns for the equity markets. In such an environment it will be difficult to generate sufficient return to meet liabilities by passively indexing. Alpha will be increasingly important. Mining alpha from differential performance between value and growth, large and small cap, and sector rotation will be extremely important. ■