acuiti management intelligence

Solving the Investment Trilemma

Custom Basket Forwards and the Rise of Thematic and ESG Investing

IN ASSOCIATION WITH

Nasdaq

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Introduction

Since the Global Financial Crisis, regulators have pushed for derivatives market frameworks that have increased the cost and complexity of trading in over-the-counter (OTC) products. This has been a long process, from Dodd-Frank and Emir to the Uncleared Margin Rules (UMR) that are now fully in place.

At the same time, new investment trends have emerged that require innovative products to execute. ESG and climate investing is becoming an increasingly sophisticated market, while thematic investing is in the early stages of what looks set to be a meteoric rise.

Exchanges have responded to these trends by developing new products that provide investors with listed exposures to execute their ESG, climate and thematic investment strategies. In addition, they have launched products designed to provide listed alternatives to OTC contracts, such as total return futures, allowing investors to access the benefits of OTC markets with the regulatory and capital efficiency advantages of trading a listed and centrally cleared product.

To date, however, investors have faced a trilemma when it comes to adopting products that meet the demand for ESG and thematic investing. They are looking for capital and margin efficiency, low cost and operational complexity and customisability. Currently the available products on the market, from listed to OTC to ETFs, can meet two of the three of these requirements but no product can meet all three.

In conjunction with the launch of its new Custom Basket Forwards, Nasdaq commissioned Acuiti to conduct a study exploring how asset managers and the sell-side see the opportunities in ESG, climate and thematic investing and the challenges they are facing in accessing exposures through OTC markets, the current listed products on offer and ETFs.

For this study, Acuiti surveyed or interviewed Europe-based senior executives actively involved in equity derivatives markets at 67 firms comprising asset managers and sell-side firms.

The key findings are:

- Asset managers are looking to continue reducing OTC exposures for equity products over the next three years
- The cost and complexity of ISDA agreements and capital efficiency are the major factors driving demand for listed alternatives among asset managers
- ESG and thematic investing is increasing the need for customisable products for both asset managers and the sell-side
- Investors currently face a trilemma in their demand for tailorable products, with none offering capital and margin efficiency, low trading costs and customisability
- Custom basket forwards solve the trilemma, enabling asset managers to develop capital-efficient, bespoke products and sell-side firms to engage new clients and expand their offerings

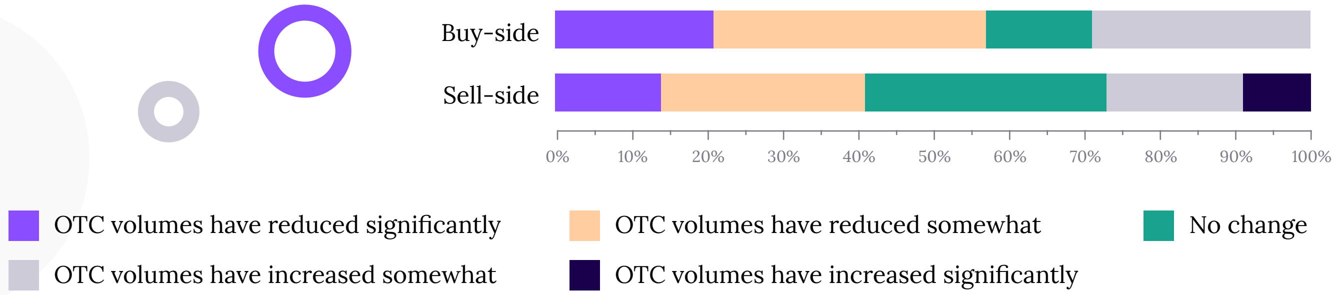
OTC's position in a changing landscape

Post-crisis financial reforms were designed to reduce counterparty risk in OTC markets. From Dodd-Frank and Emir to the Uncleared Margin Rules, a swathe of new regulations have been designed to encourage both the transition of OTC trading into listed markets and increase the volume of cleared OTC derivatives as opposed to those traded bilaterally.

In addition, concerns around counterparty and credit risk have remained since 2007/8. These concerns have been reinforced by the withdrawal or retreat of several major prime brokers from the market over the past decade. All of these trends have increased the attraction of listed alternatives to the buy-side and bank execution and trading desks.

OTC contracts still play an important part in financial markets, though. While survey data shows that a majority of survey respondents had reduced their exposures over the last three years, over a quarter had increased their volumes.

How has the level of OTC trading changed over the past three years?



Respondents to the survey that increased OTC volumes cited the flexibility these products offer. Some respondents also reported being able to access better pricing. However, favourable pricing is often dependent on the size of the firm and the products in which they trade.

OTC trading can carry considerable operational costs, however. Indeed, the complexity and cost of trading under an ISDA agreement was cited as the main driver for reducing OTC exposure, well above the impact of UMR.

WHAT HAS DRIVEN A REDUCTION IN OTC VOLUMES?

1. Overall complexity and cost of trading under ISDA agreements
2. Counterparty risk concerns
3. Desire to increase capital efficiency
4. Impact of UMR on trading book
5. Increased availability of suitable listed products
6. Lower costs in the listed market

While having ISDA agreements in place guarantees many advantages, for smaller firms the cost of signing and maintaining agreements with multiple counterparties can become excessive. As well as being the main reason for firms reducing their exposures to OTC, the cost and complexity of ISDA agreement was the main reason firms that do not trade in OTC markets gave for not doing so at all.

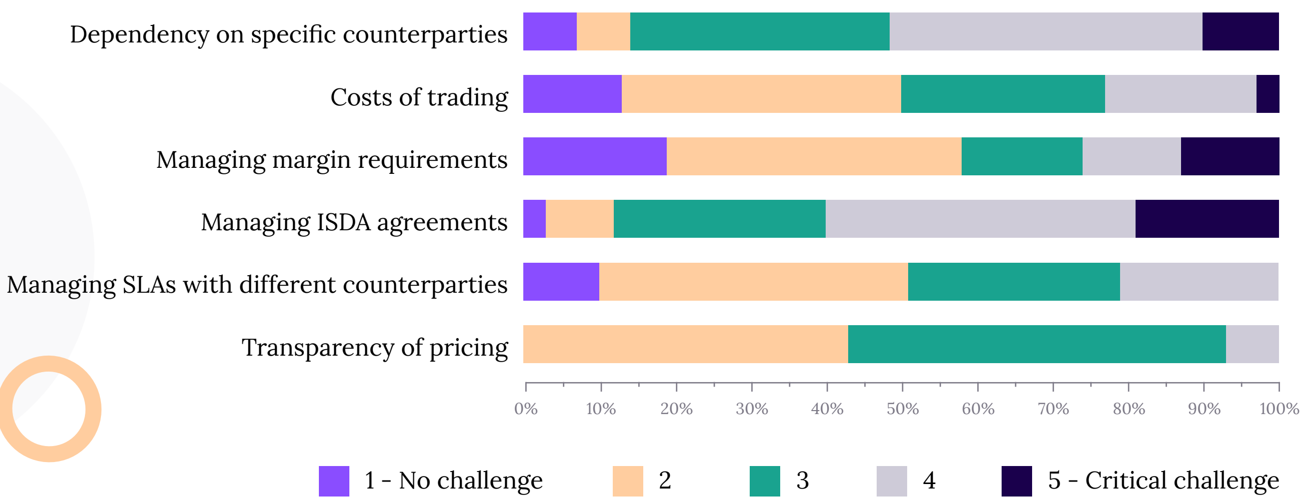
WHY DO FIRMS NOT TRADE OTC?

1. Overall complexity and cost of trading under ISDA agreements
2. Not required by our trading strategies
3. Counterparty risk concerns
4. Margin implications

ISDA agreements constitute the greatest challenge for OTC market participants, but survey respondents also reported challenges in meeting margin requirements and concerns over dependency on specific counterparties.

For buy-side respondents, managing SLAs and ISDA agreements were the biggest challenge in the OTC markets. For banks, dependency on specific counterparties and managing margin requirements were the top challenges.

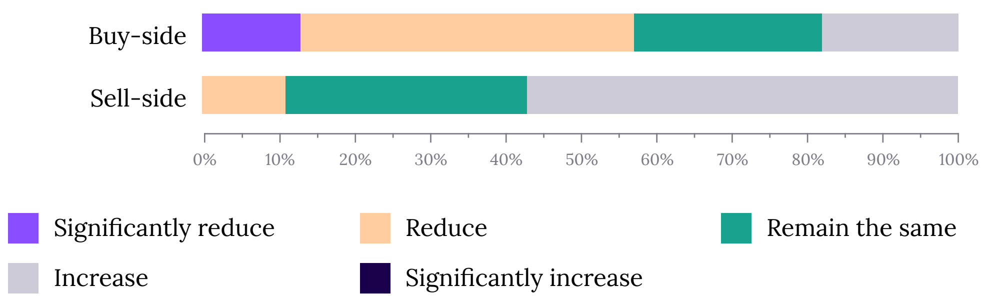
In terms of your engagement with the OTC markets, how much of a challenge do you find the following:



In part as a result of these challenges, over half of buy-side respondents to this study said that they expect the volume of OTC trading to decline over the next three years. For sell-side firms there was a split, with larger firms tending to expect volumes to grow while smaller, regional banks had typically reduced OTC exposures over the past three years and were planning to remain at current levels.

This trend will be driven by the factors listed above, but also increasing competition from listed markets, as exchanges increase the sophistication of their offerings. The growing offering of exchange traded products designed to marry the benefits of the OTC with the listed market come at a time when two related themes are growing significantly in adoption among the buy-side: thematic investing and ESG.

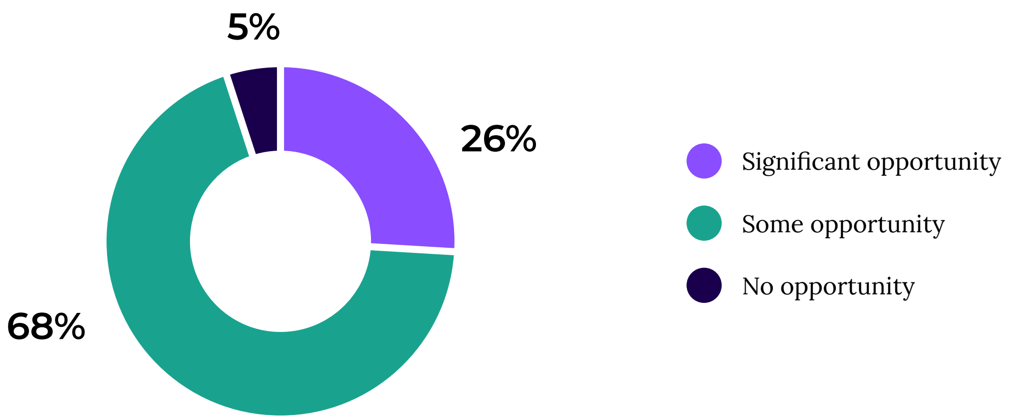
How do you expect the volume of OTC trading as a percentage of overall business to change over the next three years?



Choosing the right products for ESG and thematic investing

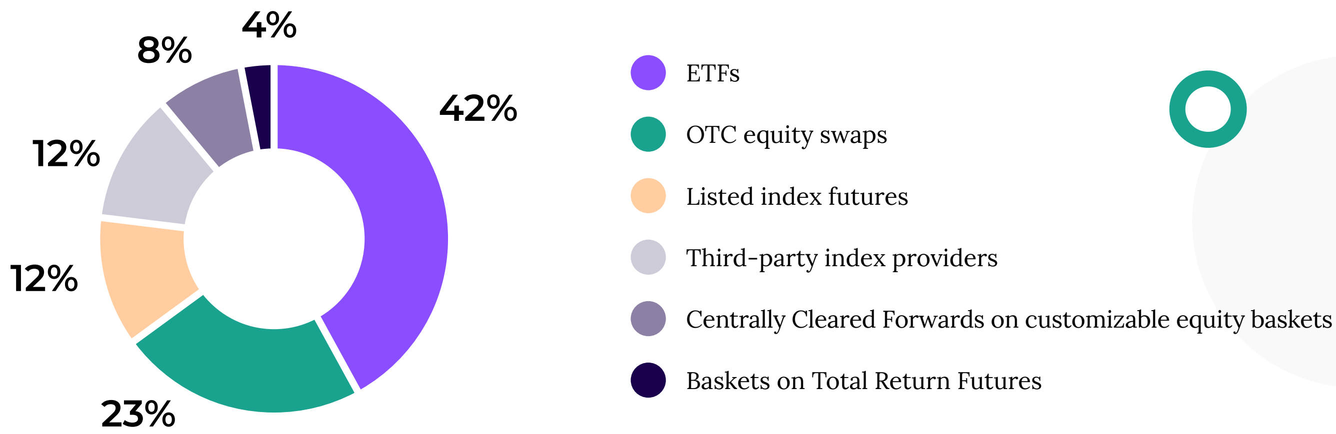
One of the major shifts in investment taking place today is the rise of thematic investing. Asset allocators are increasingly demanding indices and products that allow them to gain cost-effective exposure to global trends such as AI or future mobility. Most survey respondents saw opportunity in this trend, while some sell-side trading desks have reported seeing daily turnover in the hundreds of millions for thematic products.

How much of an opportunity does thematic investing pose for your business?



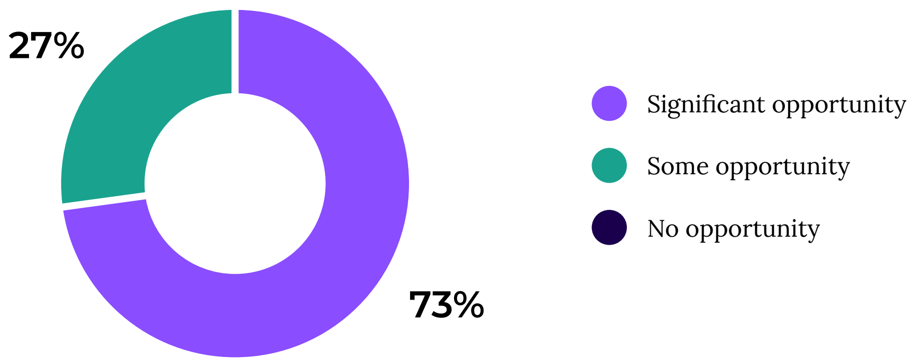
Up until now, ETFs have been the main investment vehicle for creating exposure to themes (see chart on next page). ETF providers have been effective at product creation and liquidity development around themes. Interviews for this report suggest that there has been little migration from OTC basket trade swaps into ETFs though, with portfolio managers appreciating the simplicity of trading a single line item with a swap. Swap users can also benefit from financing services from their prime brokers.

Which instrument would you see as the most optimal for your business when building thematic indices?



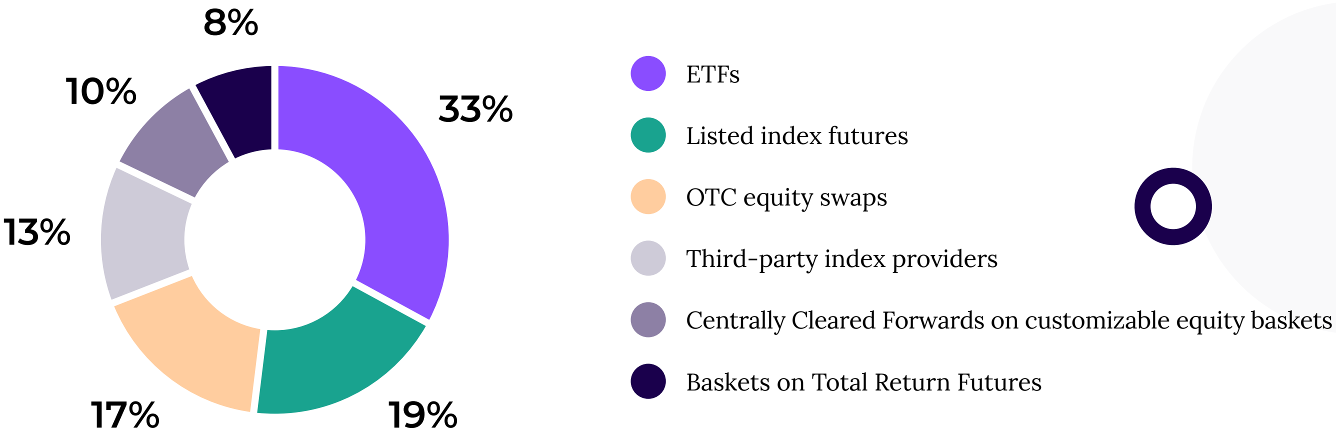
ESG and climate investing is a related area of investing in terms of portfolio construction and a more established trend among investors. All respondents to the survey said that ESG provided an opportunity for their business, with three quarters saying it provided a significant opportunity.

How much of an opportunity does ESG pose for your business?



Again, ETFs were seen as the most optimal product for ESG investing, with listed index futures and OTC swaps also favoured. Over the past five years there has been significant growth in both the breadth of products and liquidity in listed derivatives contracts on the market that cover ESG themes.

Which instrument would you see as the most optimal for your business when building ESG indices?



"Nasdaq has developed Custom Basket Forwards to address the demand for a simpler and more efficient way to manage tailored equity exposures and can be seen as a futurization of equity swaps.

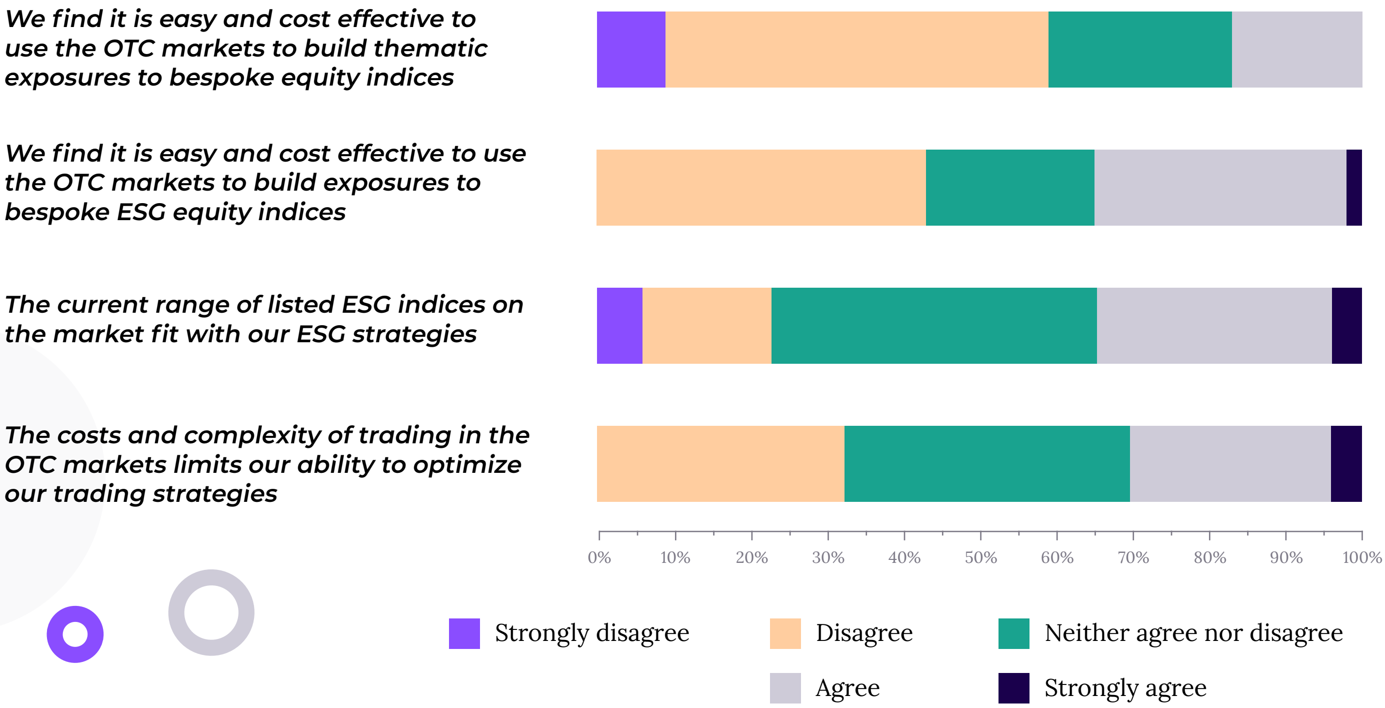
"CBFs tackle market challenges for firms finding equity swaps increasingly difficult due to pressure of regulations, bilateral risk and complexity and costs of maintaining ISDA agreements. It combines some of the bespoke elements of OTC-derivatives with the benefits of a standardized contract traded on a regulated market and centrally cleared."

Alessandro Romani
VP, Head of European Derivatives, Nasdaq

The product trilemma

Despite recent growth in listed products and ETFs, a key issue for asset managers and banks today is that no product perfectly fits their needs when it comes to thematic and ESG investing.

Do you agree or disagree with the following statements:

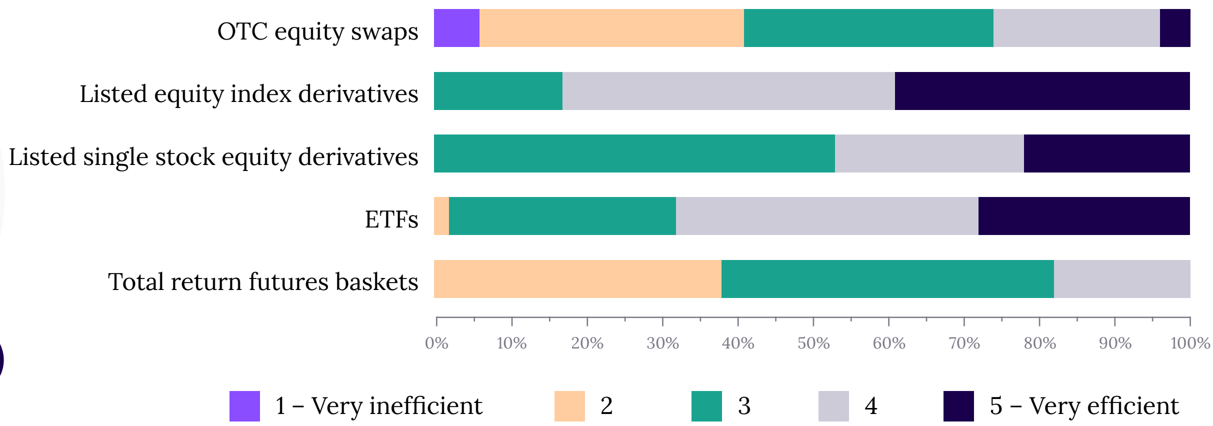


As outlined above, OTC markets offer flexibility and, for some, cost effectiveness, but come with an operational and, frequently, a margin burden. ETFs and listed equity indices offer capital efficiency and lower costs, but that comes at the expense of customisability while the costs and complexity of building portfolios using single stock equity derivatives often outweigh the benefits that they bring in customisability.

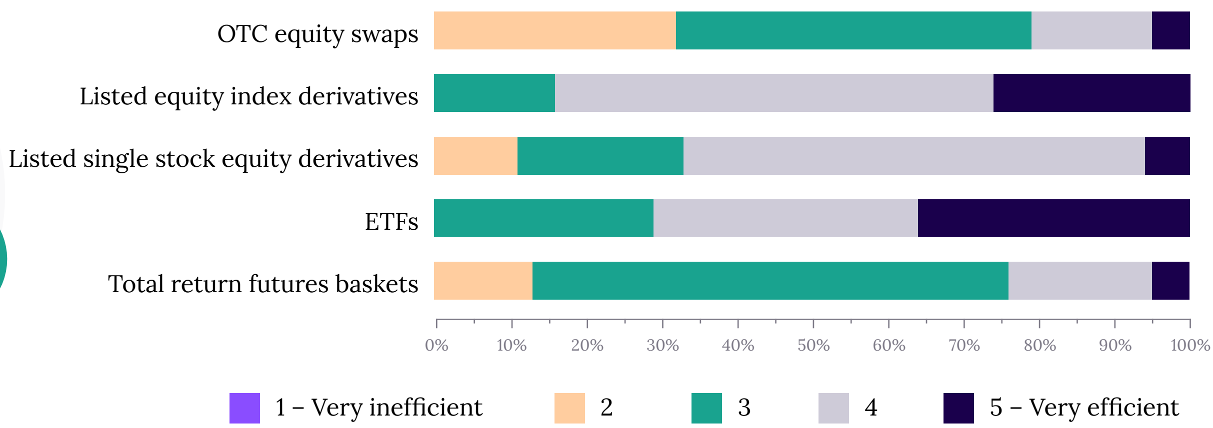
This is important for asset managers and the sell-side providers that serve them, as the expertise they bring to the market is in stock and portfolio selection. While asset managers increasingly use ETFs in their portfolio construction and for hedging purposes, they are by their nature active managers and require the ability to customise products to reflect their specific views on market trends.

Today therefore, investors face a trilemma when it comes to portfolio construction. Of the core requirements of asset managers – capital and margin efficiency, low costs and simplicity of trading and customisability – the current products on the market can only be two of the three.

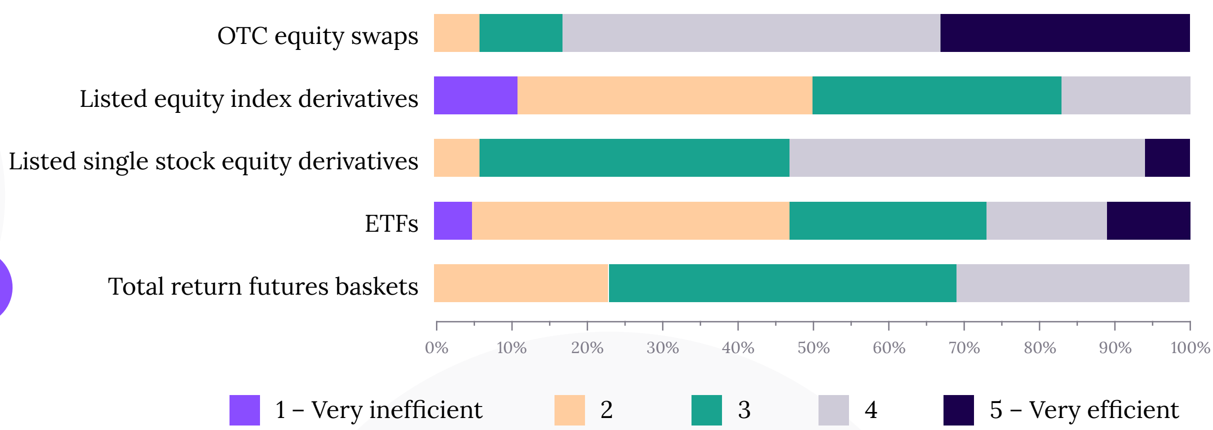
How do you rate the following products when it comes to capital and margin efficiency?



How do you rate the following products when it comes to the costs of trading?



How do you rate the following products when it comes to customizability?



Solving the trilemma

Among the rising number of products being used for thematic investment, basket trading has emerged as a highly popular tool. This has developed rapidly in the OTC markets, where baskets are executed through swaps, but listed alternatives are also starting to come online.

However, to date, most listed products have been aimed at the major sell-side banks. An increasing number of hedge funds, macro funds, multi-asset managers and some long-only funds are using basket trades to go long or short on a theme, but doing so in OTC markets.

Basket trading is also finding use among funds running overlay strategies, who construct baskets that eliminate factors or risks that they want to hedge out of their portfolios. Instructions can be as specific as excluding corporate actions from indices and optimising for minimum liquidity or market size parameters.

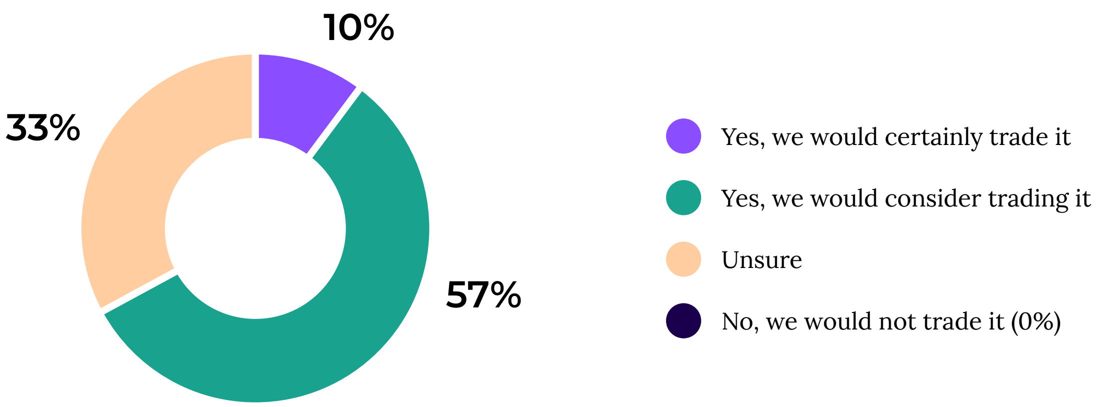
End users prize the high degree of customisation on offer in the space, as well as being able to trade the basket on a single line item. The pace of innovation has been rapid, with some tier one banks boasting a highly sophisticated technological offering to clients. These platforms have automated much of the basket creation process and are able to get customised products to market very quickly.

However, these services are mainly available to larger clients that can manage the ISDA agreements and complexity of running swap books on the baskets. This is locking many small to mid-sized firms out of the market.

For these types of firms, the required specialist back-office operations, collateral management systems and inhouse expertise are often too costly to run OTC basket trading strategies.

Being able to effectively outsource post-trade processes to clearing brokers and custody banks, as can be done with more standardised, exchange traded instruments, would significantly reduce the costs of basket trading.

Were an exchange to offer Custom Basket Forwards (CBFs), which would allow you to create a cash settled forward contract on a customized equity basket, combining tailored and bespoke elements with the benefits of CCP clearing and trading on a regulated market, would you be interested in trading it?



Survey responses clearly show that market participants are open to trading products that combine customisation with the cost-efficiencies of CCP clearing. As end investor interest in thematic investing grows and the sophistication of strategies and products tied to it does too, so will demand from a broader spectrum of buy-side firms to access cheaper and less onerous derivatives. It may also be the case that as thematic investing grows its user base, liquidity concentrates around more common themes, such as AI, where higher levels of standardisation are more acceptable to end users.

TOP BENEFITS OF CBFs ACCORDING TO THE BUYSIDE

1. No need for an ISDA agreement
2. Lower counterparty risk
3. Capital efficiency
4. Reduce OTC exposures

TOP BENEFITS OF CBFs ACCORDING TO BANKS

1. Capital efficiency
2. No need for an ISDA agreement
3. Ability to engage new/more clients
4. Ability to offer new products to clients

For the sell-side, adoption of exchange traded baskets can enable them not only to gain the benefits of capital efficiency and the absence of an ISDA agreement but also the ability to engage new clients and offer new products to existing clients. The latter two were cited as key benefits that an exchange traded basket offering would bring by sell-side respondents.

Larger firms among the sell-side saw more potential in offering new products to clients than engaging new clients, which is a stronger benefit for smaller, regional banks. However the capital efficiency and elimination of the need for ISDA agreements were shared benefits across the sell-side.

The path towards the futurisation of the OTC markets, long anticipated following the regulatory response to the 2008 financial crisis, has been long. However, as exchanges innovate and leverage technological advancements to bring more products to market, the rise of listed alternatives to OTC products is likely to accelerate.

Custom Basket Forwards solve the trilemma facing investors — enabling them to achieve capital and margin efficiency, low costs of trading and customisability on a listed and cleared environment that mitigates counterparty risk and reduces OTC exposures.

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