TEN YEARS TO LEARN TO MANAGE RISK IN THE FUTURES MARKET

How Chicago came of age

BY JEREMY STONE

GROWTH of trading on the Chicago Mercantile Exchange continues to set the standard for volume and diversity, **Mr Leo Melamed**, special counsel to the Chicago board, told a Financial Times conference on World Financial Futures in London yesterday.

Mr Melamed, founder of the International Monetary Market, said it was only 10 years ago that he and his associates went through the pains of creating the IMM, a move designed to vault a group of pork belly and cattle traders into the centre of the world's financial markets.

In the first eight months of 1982, financial futures volume on the IMM totalled 12.6m contracts, 40 per cent ahead of the same period of 1981 and only 2m contracts short of the total for 1981, which was a record year.

A direct consequence of the IMM's success, Mr Melamed said, had been the meteoric rise in exchange membership prices over the years. IMM seats were originally sold to the public at $10,000, but of late it has taken well over $250,000 to purchase a membership. The IMM's growth has helped push full Chicago Mercantile Exchange seats as high as $380,000.

The IMM has tried hard to strike a balance between those who wanted more and more futures instruments and those who feared that innovation would strain the exchange's capabilities. In the last year that capacity to manage innovation was stretched to the limit by three new types of contract – the 90-day certificate of deposit contract, the 90-day Eurodollar deposit, and the Standard and Poor's 500 Index contract, which opened in April.

Mr Melamed said that the IMM's certificate of deposit contract gave a good example of answering a market need. The CD contract reacted like that in T-Bills to daily factors such as Federal Reserve policy moves and economic news generally. But the specific need to hedge interest rate risk on bank debt – rather than U.S. Government instruments – created a need for the CD futures contract.

After just one year, Mr Melamed said, the price spread between CD and T-Bill futures had become a key barometer of investor confidence, and a measure of the "flight into quality." Major financial pressures – banks' exposure to Latin America loans, and the failures of Penn Square and Drysdale – had been first detected in a widening of the CD/T-Bill spread.

It was important to note, Mr Melamed said, that the IMM had always recognised that the financial futures concept was global. One of the IMM's first steps to widen its horizons had been to open a London office in January 1980. Steps are now being taken to develop, and link up with, a futures exchange in Singapore.

In the IMM's view, the success of Liffe (the London International Financial Futures Exchange) would benefit all markets. A better understanding and greater depth in all markets were the expected results.

Mr Junius Peake, president of the International Futures Exchange (Intex), spoke about the use of automated trading facilities to create a world-wide 24-hour trading capacity. He was confident that Intex offered a cost-effective trading arena which could link markets in cities such as London, Chicago, Tokyo, Hong Kong, and Singapore.

Trading and clearing members of Intex will deal from remote computer "trading stations" linked to the Intex system – centred in Bermuda – by means of dedicated telephone lines. From his trading station, a sophisticated mini-computer, the member will have access to the market in any contract and enter into trading.

The Intex market will offer direct access to a futures market to financial institutions in areas – such as Scandinavia and the Middle East – which at present have to deal through intermediaries. And even for those with immediate access the computer – which now stops at the entrance to the trading pit – can be brought into closer control of actual trading.

Mr Steven Resnick, senior investment strategist at Merrill Lynch, analysed different investment demands for futures instruments.

Individual speculative demand was satisfied by the greater volatility of futures markets (compared with the primary market) and by the high gearing which resulted from the smaller front-end commitment. On the equity side, low transaction costs enhanced the appeal of futures markets versus cash stock markets and options markets.

Although this might sound economically unproductive, the extra liquidity which such speculation could generate provided greater hedging capacity to companies and governments, enabling many interest-related aspects of business to be conducted normally even when balance sheets were stretched and the economic environment volatile.

Mr John Sandner, chairman of the Chicago Mercantile Exchange, described the CME's recently introduced contract based on the Standard and Poor's 500 Index, an instrument which links futures trading with movements in the stock market.

Mr Sandner believed that the contract was well on the way to becoming "the most successful effort in the annals of the futures industry." Chicago's daily trading in this contract, only five months old, now tops the combined turnover of its competitors in New York and Kansas City.

"Locking in" a set of known prices can eliminate risk from transactions where – because trust-funds are involved – market exposure is inappropriate. An example recently occurred in New York where a broker was given the job of transferring $400m of the city's pension fund investments between pension fund managers, accounting for nearly a third of that day's trading on the stock exchange. The use of stock index futues guaranteed the transfer prices.

At the same time, Mr Sandner said, investors could now limit their risk during a general market decline without selling their stocks, losing dividends, or changing their tax position; they could simply take a short position in the S & P futures.

Dr John Blin, of the New York Financial Futures Exchange, presented a case study in the development of financial futures, focussing on his own market.

Mr Robert McKnew, of Continental Bank, gave a U.S. banker's view of how banks will use futures to help customers, and to protect their own position. **Mr E. R. Potter**, of National Westminster Bank, provid a UK counterpart to Mr McKnew. He thought that the UK clearing banks now had the greatest vested interest in Liffe's success; the banks' futures broking operations will have themselves as their biggest customers.

He thought that financial futures were "the missing part of the financial jigsaw" and that corporate treasures should take the trouble to use the new market directly; the banks' experience of Chicago markets had been profitable and there was no reason why the non-bank sector should not benefit in much the same way.