CME Group has announced the impending launch of eight* equity index futures contracts on FTSE Russell indices. The availability of exchange traded funds (ETFs) on all of these benchmarks is a benefit to investors as it allows for the three-way arbitrage with the underlying stock portfolio which improves liquidity and market efficiency for all products.

A recent CME Group publication titled The Big Picture: A Cost Comparison of Futures and ETFs compared S&P 500 futures and ETFs across a variety of different investment scenarios and client types. Futures proved more economical in seven of eight scenarios and provided considerable additional benefits for many investors including around-the-clock liquidity, a high degree of leverage, no limitations on short sales and enhanced tax efficiency.

In general, the advantages of equity index futures over ETFs on the S&P 500 as described in The Big Picture are applicable to the FTSE Russell indices. There are, however, certain additional specific observations and benefits highlighted below.

Russell 1000, Russell 1000 Growth and Russell 1000 Value

There are over $64.5B in ETF assets benchmarked to the Russell 1000, Growth and Value indices. The iShares Russell 1000 Growth ETF (Ticker IWF, AuM $28.1B) ranks as the seventh largest ETF in the world with the iShares Russell 1000 Value ETF (IWD, $24.0B) fourteenth and the iShares Russell 1000 ETF (IWB, $11.4B) still within the top 50.

The analysis in The Big Picture showed that the only scenario where the cost of replicating the S&P 500 was cheaper with ETFs than with futures was for a fully-funded long investor with a holding period over four months. The primary reason of this cost advantage was the low management fees on the ETFs examined – ranging from 5 to 9.45bps.

For the Russell 1000, Growth and Value indices, the management fees on the associated ETFs range from 11 to 15bps, for the Russell 1000, and from 15 to 20bps for the Growth and Value versions, with over 95% of assets in the highest price funds. Compared to futures, these higher fees significantly decrease the cost efficiency of ETFs for long-term holders.

There are also European-listed ETFs on the Russell 1000 Growth and Value indices. These have management fees of 40bps and, due to their offshore domicile, only accrue 70% of the underlying dividends. With dividends yields of 1.49% and 2.48%, this withholding results in an additional 45bps and 74bps underperformance on the Growth and Value indices, respectively.

FTSE 100

In the U.S., there is only one FTSE 100 ETF, which has negligible assets, though there are a number of funds tracking the MSCI UK Index. In Europe there are ten different issuers of FTSE 100 funds with over 40 individual listings in different markets. However, as these funds are not approved under the Investment Company Act of 1940, they are not generally eligible for distribution to US investors.

Of the many FTSE 100 funds available, the largest is the iShares FTSE 100 ETF (ISF, £3.4B). Despite its low management fee of just 7bps, the ISF is actually an expensive alternative for investors looking to replicate the index due to the effect of UK Stamp Duty. When creating new shares of the ETF, the fund must pay a 50bps tax on the purchase of the underlying equities. This cost is passed back to the creating broker and, in turn, to the end investor.

As a result of Stamp Duty, the arbitrage mechanisms that keep the ISF trading in line with its underlying net asset value cannot function as efficiently and the performance of the ETF can deviate by as much as 50bps from the performance of the index without generating a trading opportunity.

The trading in equity index futures is not affected by UK Stamp Duty because the primary liquidity providers are either stamp duty exempt themselves or can execute through exempt entities. As such, the arbitrage of equity index futures functions more efficiently and provides improved tracking.

*CME Group will launch E-mini futures contracts on the Russell 1000, Growth and Value, FTSE 100 (USD and GBP-denominations), FTSE Emerging Markets, FTSE Developed Europe and FTSE China 50 indices.
FTSE Global Emerging Markets

The Vanguard FTSE Global Emerging Markets ETF is the fifth largest ETF in the world (VWO, $37.1bn). Until now, there has not been a futures contract on this benchmark, despite the fact that the fund trades over half a billion dollars notional per day. Trading global index benchmarks is a complex business, particularly in emerging markets where local market transaction costs (exchange fees, taxes, etc.) can be very high and liquidity in certain stocks quite limited. When hedging, market makers use optimized replicating portfolios to reduce their transaction costs to reproduce the underlying index. By removing the most illiquid and expensive names to trade, they take on a small degree of tracking risk but can achieve significant savings in transaction cost.

With an ETF, the fund manager requires delivery of the full replicating portfolio when creating new ETF units. The cost savings that can be achieved by clever optimization are not possible. As a result, the total cost of execution in the ETF (fees plus impact) is often significantly higher than what could be achieved with futures. Combine this with the borrowing costs incurred when shorting ETFs, and futures provide an attractive and cost-effective alternative for both long and short investors.

FTSE China 50

The FTSE China 50 index is the underlying benchmark for the iShares China Large-Cap ETF (FXI, $5.7B). While this ETF is a fraction of the size of the funds tracking the FTSE Emerging Markets or Russell 1000, Growth and Value benchmarks, it trades more than all of the others combined, ranking as the ninth most actively traded ETF with more than $1B trading per day. Compared with the other funds, the FXI also has a very high management fee of 74bps.

Transactions in the underlying securities of the China 50 index can be expensive. The FXI is a physically replicating fund and, as described above, this limits the ability of market-makers to use lower-cost hedging alternatives, which makes ETF a more expensive trading tool.

The FXI is notable for the high ratio of turnover to underlying assets (i.e. average daily trading of nearly 20 percent of total assets). As a result, the availability and cost of borrowing FXI can, at times, significantly impact the ability to express short views on the index using ETFs, and the cost of doing so. These restrictions and costs are not mirrored with futures where there is no differentiation between selling long and selling short.

FTSE Developed Europe

While the FTSE Developed Europe remains less recognized than other more pan-European index benchmarks, the index provides a broad and diversified picture of the European markets and a viable alternative to other more well-known but highly concentrated indices. Vanguard, the second largest ETF issuer globally, offers a London-listed ETF on the FTSE Developed Europe index (VEUR_LN, $359M). There are no U.S.-listed ETFs on this benchmark. The future therefore represents the only listed vehicle through which U.S. investors can access this attractive index.

Futures and ETFs provide different ways to access the same underlying index exposure. CME Group’s partnership with FTSE Russell Indexes will provide investors with new tools to trade these popular benchmarks.

Investors who currently trade FTSE Russell index exposures via ETFs may find considerable advantages and savings with CME equity index futures.

For more information on futures on FTSE Russell Indexes, visit cmegroup.com/ftserussell.