



STUCK ON THE RUNWAY

It's three years since futures contracts were first listed on the NZX 15 Index. But, despite some initial interest, this instrument has failed to take off.

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Stock index futures are known to boost a market's efficiency and reduce its volatility. They also enable investors to hedge their positions and minimise their risk.

That's why stock exchanges in just about every major developed country have launched stock index futures and why the New Zealand Exchange (NZX) signed a deal with the SFE Corporation (SFE) in September 2003.

This deal was expected to enable the NZX to provide a range of futures and options contracts to New Zealanders by listing the equity on the Sydney Futures Exchange.

It wasn't New Zealand's first attempt at creating a futures and options market. The New Zealand Futures and Options Exchange had been active in the 1990s but disappeared in the late 1990s.

However, with many New Zealand investors still trading futures and options in international markets, the NZX

considered the alternatives available to it at the time.

"We didn't have the expertise to build our own platform," observes NZX products group manager Geoff Brown.

Indeed, for the NZX, the deal with the SFE was a way of avoiding the significant investment required to build its own market infrastructure and of gaining instant access to SFE's global participant base.

"We would also expect, as has occurred in nearly all other markets with liquid futures and options, that liquidity in the underlying instruments will improve," the NZX said at the time the deal with the SFE was announced.

SO WHAT WENT WRONG?

"It proved extraordinarily costly for organisations in New Zealand to connect to the SFE from a technical perspective. Only one organisation did it," says Brown.

"Also, if you look at the options market in most parts

of the world, if you want to invest, you can use scrip as collateral. The SFE didn't allow that. You must put cash up as a security."

Brown says these factors proved to be major hurdles.

"Brokers have said that it's too hard [to use this instrument]. Many do invest in the Australian Securities Exchange's (ASX's) futures and options market and have said the NZX 15 Index is just too difficult. After all, a lot of New Zealand stocks are dual listed on the ASX," he says.

But Brown notes: "We have a five year contract with the SFE which ends next year and when it does, we will look at

But he adds: "Liquidity in the Top 10 stocks has generally been increasing, but if all stocks in the underlying basket of stocks aren't liquid, the NZX 15 Index just can't work."

For his part, Brook Asset Management managing director Mark Brighthouse notes: "Retail investors would normally be attracted to the leverage that a futures contract gives, but in New Zealand retail investors are more interested in leveraging real estate than leveraging financial assets. This reflects the tax benefits they see from leveraged real estate whereas futures contracts would be taxed as financial arrangements.

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our alternatives. At this stage, we can't resolve the problems in the short term."

Goldman Sachs JBWere director of derivatives Greg Boland notes that his company did some early trades on the NZX 15 Index and was a market maker at one stage, but decided not to continue because there wasn't enough volume.

"You have to rely on multiple users. The speculators looked at it and did a few trades, but the fund managers in New Zealand didn't take it up," he says. "If you want to be in futures and options, you need multiple products and this is just one product. You wouldn't want to set up a business on one trade."

Boland notes that many New Zealanders do trade in bank bill futures, index futures and other products overseas. "So it's definitely not a case of New Zealanders lacking understanding in this area," he says.

SO WHY DID THE NZX 15 INDEX FAIL TO LAUNCH?

According to ING head of equities Amanda Smith, one problem is that the market in New Zealand has historically been hampered by unusual securities lending rules which result in tax liabilities for those trading in derivatives.

ING chief investment officer Philip Houghton-Brown agrees, noting that recent tax changes will not be helpful for derivatives either.

"They've improved the tax for Portfolio Investment Entities, but derivatives will continue to be taxable. So they are not being put through a level playing field with the physical stocks that we are trying to hedge."

More specifically, Smith observes: "The NZX15 is really a small market. Once you get out of the big companies, you have liquidity issues and there are liquidity issues even with the Top 15."

She points to a lack of stock lending in the market which could have otherwise helped investors and market makers secure a position in the underlying securities to offset the derivatives.

"Theoretically, institutions like ourselves are planning to lend out stock to see if it will help the market," she says.

Similarly, Houghton-Brown notes: "We would like to see more liquidity driving markets across the board. That would help us. Hopefully over time, the level of stock lending will pick up. We intend to be a participant in that area."

"Institutional equity managers also don't have a major requirement to either equitise their small cash balances or hedge any of their market risk."

TO THE FUTURE

Looking ahead, Brighthouse believes that improved volumes and liquidity will come as the investment industry in New Zealand grows.

"The problem lies with the lacklustre growth in active equity investing generally in New Zealand over the past 15 years due to the favourable tax treatment of passive strategies," he says.

"Australia has seen far greater growth in the size and depth of both its physical and derivative equity markets and this is in a large part due to its superannuation industry and growth in active equity management firms."

Brighthouse expects the derivatives market in New Zealand to evolve gradually.

"It will develop as investment strategies become more active in nature and new products include aspects of market risk management in addition to security specific risk," he says. ▀

