Hedge Funds find opportunities in CME FX Futures and Options

By Tina Lemieux, Managing Director, Hedge Funds and Broker Services, CME

As liquidity has grown in the CME FX electronically traded markets, so has participation by hedge funds and Commodity Trading Advisors (CTAs). These high volume FX traders are discovering that CME FX offers the liquidity they want in addition to a number of other benefits: anonymity, tight bid-ask spreads, around-the-clock global electronic access, price transparency, central clearing and guaranteed counterparty performance.

“At IKOS we like to transact in highly liquid electronic markets with total price transparency,” says Dr. Martin Coward, chief investment officer at London-based IKOS Partners, which has $2.5 billion in assets under management. “CME FX Futures give us just that.”

Growth is the operative word for CME FX. CME is the largest FX market outside the cash market, and the largest futures exchange in the United States. Since the introduction of electronic FX at CME, volume has grown swiftly and geometrically, with about 90 percent of all FX trades electronic. In 2005, electronic CME FX volume increased by 65 percent over the previous year.

This past August, electronic volume in FX futures increased by 45 percent and by 114 percent in FX options, compared to the previous year. Notional value of electronic CME FX futures and options volume was $897 billion in August 2006, up 35 percent compared to August 2005, with average daily notional value for the month at $43 billion.

All this adds up to a liquid alternative to the FX cash market, supported by a large market-making community.

Open, fair and anonymous trading environment

The CME Globex electronic trading platform offers an open, fair and anonymous trading environment, including direct electronic access to all traders for all products. The top five bids and offers are posted for everyone to see. All prices and fees are public, and there are no hidden costs. Spreads are consistently tight, and are the same for all customers. Fund managers, individual investors and professional traders all enjoy equal access to the markets.

“Being fully systematic, we need to be able to observe all the information in the market,” says Coward of IKOS, which also is a participant in the CME Hedge Fund/CTA FX pilot program. “We are able to do that with our FX trades on Globex.”

IKOS trades 10 currencies – the G-7 as well as the Australian dollar, New Zealand dollar and Swiss franc – in its IKOS Currency Fund.

“The fund can maintain all its positions in U.S. dollars on the CME and convert the proceeds to the various currencies we use,” Coward says.

CME futures markets are supported by automated trading systems that supply continual pricing feeds from global FX market makers. Since these pricing feeds are real-time, dealing quotes, CME is able to provide exceptional market liquidity and a dynamic trading venue for a large pool of FX fund managers, interbank spot FX traders, international asset managers, multinational corporations, speculators, day traders and retail investors. CME Globex also supports extensive options functionality, including streaming actionable quotes from CME-designated market makers for European-style options on CME Euro FX, Japanese yen, British pound, Canadian dollar and Swiss franc futures contracts.

“We have high frequency trading models, and therefore it helps to have deep, liquid, electronic markets like CME eFX,” says Coward. “This is significant for us as we like to have as little impact in the market as possible when we trade.”

The size and flexibility of the CME FX marketplace serves Euroption Strategic Fund well. CME provides something of a currency hedge for the fund, which is denominated in euros.

“Trading on the Globex platforms allows us the freedom of being either a taker or a provider of liquidity, which means the fund captures some of the price spread that historically would have been the edge of the market maker,” adds Coward. “We like that Globex is electronic. This is a significant advantage in executing strategies and trades. Human intervention is not efficient or effective for us.”

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those to euros in the same moment of trading, meaning almost no currency risk,” says Paolo Compagno, who operates the fund along with partner Stefano Scattolon. Since its inception in January 2006, the fund has returned 27.64 percent, with monthly returns of 1 percent to 5 percent. “We are now considering opening another fund denominated in U.S. dollars that trades only CME products.”

Another benefit – no counterparty risk
FX traders prize the efficiency of CME’s central counterparty model and the anonymity of execution. All CME FX trades are backed by the financial strength of CME Clearing, which eliminates the need to establish and administer bilateral credit relationships. The safeguards in place protect traders from the possibility of default by the counterparty to any trade. This type of clearing guarantee generally is not matched on OTC eFX trading venues.

Euroption Strategic Fund also likes CME for its innovative margin requirements, Scattolon, trading manager of the fund, points out, because the requirements decrease as the contracts approach expiration and/or go deeply out of the money.

“This increases liquidity in the market overall and allows traders to remain liquid and keep risk under control. The CME margin requirements favor all traders of options,” Scattolon says. “This is a special feature of CME compared to other exchanges.”

Special fee reduction programs
CME is currently offering two special fee reduction programs to introduce hedge funds and CTAs to the competitiveness and advantages of the CME FX marketplace. Each program enables these customers to trade CME FX products on the CME Globex® electronic platform for just 60 cents per side — less than half the current electronic trading fee of $1.60. One program is designed for hedge funds and CTAs with a minimum of $50 million in assets under management, including managed accounts and pooled funds. These participants must meet a monthly volume threshold of 125,000 sides per month to be eligible for the reduced rates. The other program targets larger funds, with assets under management of more than $2 billion, and has no monthly trading minimum.

“The hedge fund fee programs make it more worthwhile to trade on the exchange,” says Winton’s Settle. Winton Capital Management participates in the Hedge Fund/CTA FX Pilot Program, and the Winton Futures Fund has a CME 106H membership, a special membership category that provides reduced clearing fees and performance bond rates for companies that are proprietary traders.

As more hedge funds, CTAs and currency overlay managers discover the value of transacting their FX business electronically, the way they execute their daily currency trading is changing. They are increasingly attracted to the competitiveness and advantages of CME FX. What we offer can benefit the entire FX marketplace.

Futures Prices in Spot Terms
Since some FX futures are quoted differently from the cash markets (with prices given in terms of U.S. dollars per other currency), CME has developed a special, free tool to make trades easier for customers more familiar with OTC transactions. Offered on the CME Web site, CME E-equivalents displays the top five bids and offers on all currency pairs, in real-time spot equivalent terms, as well as forward rate quotes in six major currencies from ICAP, the world’s largest interdealer broker.

This product is available at www.cme.com/e-equivalents. CME now offers European style options on its euro, yen, pound, Canadian dollar and Swiss franc contracts. The site also displays quotes on these options.

CME FX Product Line-up
CME offers futures on 19 currencies paired against the U.S. dollar as well other currencies — a total of 41 futures contracts and 31 options contracts overall. In addition to major world currencies — the euro, yen, British pound, Swiss franc, Canadian dollar, Australian dollar, New Zealand dollar, Norwegian krone, Swedish krona, and South African rand — CME products include currencies of emerging markets including the Chinese renminbi, Korean won, Russian ruble, Mexican peso, Czech koruna, Hungarian forint, Polish zloty, Brazilian real and Israeli shekel. CME’s FX futures were the world’s first financial futures.

During the FX market turmoil leading up to the initial revision of the U.S. dollar “gold peg,” CME leadership championed the idea of futures contracts for foreign exchange. On May 16, 1972, CME’s International Monetary Market opened for business, listing seven foreign currency futures contracts: British pounds, Canadian dollars, Deutsche marks, French francs, Japanese yen, Mexican pesos and Swiss francs.