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"STOCK INDEX FUTURES AT THE MERC"

By
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Swiss Commodity Industry Association
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STOCK INDEX FUTURES
CLAYTON YEUTTER

GOOD MORNING AND THANK YOU FOR INVITING ME TO ADDRESS THIS GROUP. LAST YEAR, WHEN I TALKED TO YOU AT THE SCIA ANNUAL MEETING IN BURGENSTOCK, I TOLD YOU OF THE DYNAMIC GROWTH THE FUTURES INDUSTRY WAS UNDERGOING. I AM HAPPY TO REPORT THAT THAT GROWTH CONTINUED IN 1983. THE CHICAGO MERCANTILE EXCHANGE HAD ITS SEVENTH CONSECUTIVE RECORD-BREAKING YEAR, TOPPING 1982 TRADING VOLUME BY MORE THAN 13 PER CENT. SINCE 1972 WE HAVE SEEN OUR ANNUAL VOLUME GROW FROM 4.5 MILLION CONTRACTS TO 38.1 MILLION CONTRACTS--A TRULY PHENOMENAL RECORD!

I ALSO TOLD YOU ABOUT AN EXCITING NEW FUTURES INSTRUMENT THAT HAS PACED OUR GROWTH--THE STANDARD AND POOR'S 500 STOCK INDEX FUTURES. WE NOW HAVE A "FAMILY" OF STOCK INDEX PRODUCTS WHICH INCLUDES S&P 500 FUTURES, BEING USED BY MORE AND MORE INSTITUTIONAL INVESTORS; S&P 100 FUTURES, AIMED PRIMARILY AT THE INDIVIDUAL INVESTOR; AND S&P 500 OPTIONS, WHICH GIVES INSTITUTIONAL USERS THE CHANCE TO CHOOSE BETWEEN OPTIONS AND FUTURES CONTRACTS FOR RISK PROTECTION. WE WILL SOON ADD AN S&P ENERGY SUB-INDEX (AND OTHER SUB-INDICES LATER) GIVING OUR EXCHANGE AN EXTENSIVE RANGE OF THESE VALUABLE NEW INVESTMENT TOOLS. OUR S&P PRODUCTS NOW ACCOUNT FOR NEARLY 70 PER CENT OF INDUSTRY-WIDE STOCK INDEX VOLUME.

IN LESS THAN TWO YEARS, S&P 500 FUTURES HAVE BECOME ONE OF FIVE MOST HEAVILY USED FUTURES PRODUCTS. AND VOLUME CONTINUES TO GROW ASTRONOMICALLY. IT TYPICALLY TAKES ABOUT FOUR YEARS BEFORE A FUTURES INSTRUMENT REACHES AN ANNUAL VOLUME OF THREE MILLION CONTRACTS. WITH THE S&P 500 -- LAUNCHED IN APRIL 1982 -- VOLUME

CLAYTON YEUTTER IS PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE CHICAGO MERCANTILE EXCHANGE. HE IS A FORMER ASSISTANT SECRETARY OF AGRICULTURE AND SERVED AS DEPUTY SPECIAL TRADE REPRESENTATIVE DURING THE FORD ADMINISTRATION.

FOR THE FIRST FULL YEAR WAS MORE THAN EIGHT MILLION CONTRACTS. CLEARLY, STOCK INDEX INSTRUMENTS ARE ONE OF THIS INDUSTRY'S ALL TIME SUCCESS STORIES.

I THOUGHT IT MIGHT BE HELPFUL TODAY IF I WERE TO DESCRIBE THIS NEW INVESTMENT TOOL IN MORE DETAIL AND TELL YOU HOW IT IS BEING USED TO TRANSFER INVESTMENT RISK. EACH DAY WE HEAR REPORTS OF OTHER FUTURES EXCHANGES AROUND THE WORLD WHO PLAN TO INTRODUCE STOCK INDEX FUTURES--HERE IN EUROPE, IN THE FAR EAST, AND EVEN IN LATIN AMERICA. THOUGH THESE PROPOSED NEW CONTRACTS ARE DESTINED TO SPREAD STOCK INDEX FUTURES WORLDWIDE, I MUST CONFESS THAT FUTURES CONTRACTS ARE PROBABLY THE MOST MISUNDERSTOOD OF ALL FINANCIAL INSTRUMENTS. THE STEREOTYPE OF A FUTURES EXCHANGE IS A MARKETPLACE WHERE ONLY SPECULATION OCCURS AND "WILD-EYED GAMBLERS" DRIVE PRICES UP AND DOWN.

NOTHING COULD BE MORE FALLACIOUS. FUTURES MARKETS DO NOT CREATE RISK. THEY MERELY TRANSFER IT -- FROM INVESTORS, BUSINESSMEN, AGRICULTURAL PRODUCERS AND BANKERS TO PROFESSIONAL TRADERS WHO ARE WILLING TO ACCEPT THAT RISK IN THE HOPE OF MAKING SUBSTANTIAL PROFITS. THIS IS THE VITAL ECONOMIC FUNCTION OF FUTURES MARKET. IT IS WHAT THEY ARE ALL ABOUT.

UNTIL 1972, THIS TRANSFERRAL OF RISK WAS AVAILABLE ONLY IN THE AGRICULTURAL SECTOR. BUT IN THAT YEAR THE CHICAGO MERCANTILE EXCHANGE LAUNCHED THE ERA OF FINANCIAL FUTURES WITH TRADING IN THE INTERNATIONAL CURRENCIES. AS A CONSEQUENCE, IT IS NOW POSSIBLE TO TRANSFER INTEREST RATE RISK, EXCHANGE RATE RISK AND, WITH STOCK INDEX FUTURES, STOCK PORTFOLIO RISK TO THOSE WILLING TO ACCEPT IT.

WITH THE ADVENT OF ENORMOUS STOCK PRICE VOLATILITY IN THE 1970s, THE VULNERABILITY OF INSTITUTIONAL PORTFOLIOS BECAME QUITE APPARENT TO INVESTMENT MANAGERS. THIS MADE THE S&P 500 ESPECIALLY ATTRACTIVE WHEN IT BECAME AVAILABLE. IN LESS THAN TWO YEARS, S&P FUTURES HAVE BECOME A MAJOR NEW TOOL IN EQUITY PORTFOLIO MANAGEMENT.

THE MARKETPLACE IS STILL THE BEST PROVING GROUND FOR A NEW PRODUCT, SO LET'S LOOK AT SOME OF THE USERS OF THESE INSTRUMENTS AND THE STRATEGIES THEY HAVE DEVELOPED.

SEVERAL LARGE CORPORATE PENSION FUNDS, INCLUDING EXXON AND WESTINGHOUSE ELECTRIC USE STOCK INDEX FUTURES AS HEDGING VEHICLES. HARVARD UNIVERSITY USES THEM IN THE MANAGEMENT OF THE VARIOUS FUNDS IT CONTROLS. THE UNIVERSITY HAS FOUND THAT IT CAN REDUCE THE MARKET RISK ASSOCIATED WITH LARGE ENDOWMENTS AND INCREASE THE RATE OF RETURN ON ITS INVESTMENTS. THE PRUDENTIAL INSURANCE COMPANY USES STOCK INDEX FUTURES IN THE MANAGEMENT OF THE PRUDENTIAL BACHE OPTION GROWTH FUND. TRAVELERS INSURANCE AND CITIBANK USE STOCK INDEX FUTURES TO ASSIST IN THE MARKET TIMING OF THEIR INVESTMENT FUNDS.

LET'S WALK THROUGH A HYPOTHETICAL CASE WHERE A MULTINATIONAL CORPORATION WANTS TO USE STOCK INDEX FUTURES TO HEDGE ITS STOCK PORTFOLIO. LET US SAY THAT THE CORPORATION HAS A TWO MILLION DOLLAR DIVERSIFIED PORTFOLIO OF STOCKS THAT CORRELATES CLOSELY WITH THE GENERAL MARKET. THE PORTFOLIO MANAGER BELIEVES THE MARKET MAY BE VULNERABLE TO A DECLINE AND WISHES TO PROTECT HIMSELF WITHOUT

HAVING TO SELL INDIVIDUAL SECURITIES. WHEN THE S&P 500 INDEX IS PRICED AT 160.00, HE DECIDES TO HEDGE TWO-THIRDS OF HIS PORTFOLIO BY SELLING SEVENTEEN S&P 500 FUTURES CONTRACTS WHICH ARE TRADING AT 160.40. WHEN THE S&P INDEX THEN FALLS FROM 160.00 TO 150.00 AND THE FUTURES CONTRACT FALLS FROM 160.40 TO 150.10, HE WILL CLOSE OUT HIS POSITION. BY HEDGING, HE HAS LIMITED THE DECLINE IN HIS PORTFOLIO'S VALUE TO 1.8 PERCENT. HAD HE NOT HEDGED, THE DECLINE WOULD HAVE BEEN 6.25 PERCENT. AND HAD HE DECIDED TO HEDGE HIS ENTIRE PORTFOLIO INSTEAD OF TWO-THIRDS, HIS DECLINE WOULD HAVE BEEN TOTALLY ELIMINATED. IN FACT, HE WOULD HAVE PROFITED BY \$3,750.

OF COURSE THERE ARE A NUMBER OF OTHER STRATEGIES THAT CAN BE DEVELOPED AROUND STOCK INDEX FUTURES. FOR EXAMPLE, THEY CAN BE USED TO SHIFT THE MIX OF AN EQUITY PORTFOLIO. THEY CAN BE EMPLOYED TO CAPTURE A RISK-FREE RETURN WHILE HOLDING ON TO EQUITIES. THE CME MARKETING DEPARTMENT CONSTANTLY HEARS OF NEW STRATEGIES THAT THE MARKETPLACE HAS DEVISED FOR THESE CONTRACTS.

YOU'LL REMEMBER THAT I REFERRED EARLIER TO THE POPULAR MISCONCEPTION THAT FUTURES MARKETS ARE GAMBLING DENS POPULATED ONLY BY SPECULATORS. NOW OBVIOUSLY, THE SPECULATOR IS A VERY IMPORTANT PART OF THE MARKET. WITHOUT THE SPECULATOR--WHETHER HE BE A FLOOR TRADER OR AN OUTSIDE CUSTOMER--THE MARKETS WOULD HAVE NO LIQUIDITY. WITHOUT LIQUIDITY, THE MARKETS WOULD DRY UP AND DISAPPEAR. SO, THE SPECULATOR IS IMPORTANT.

BUT WHEN YOU CONSIDER WHAT I'VE JUST BEEN TELLING YOU ABOUT LARGE INSTITUTIONAL USE OF OUR MARKETS AND THE INVESTMENT STRATEGIES THAT HAVE BEEN DEVELOPED, YOU REALIZE THAT THERE ARE NUMEROUS LEGITIMATE HEDGING APPLICATIONS FOR FUTURES MARKETS. TYPICALLY, WHEN WE INTRODUCE A NEW CONTRACT THE MARKET IS FIRST USED BY BLOCK TRADERS AND THE SPECULATOR UNTIL VOLUME BUILDS TO A CERTAIN LEVEL. THEN AS BANKS, CORPORATIONS, PORTFOLIO MANAGERS, INVESTORS AND OTHER MARKET PARTICIPANTS LEARN HOW TO USE THE NEW CONTRACT, THE HEDGER COMES IN. ONLY THEN DOES A MARKET TAKE OFF--THE WAY THE S&P 500 HAS "TAKEN OFF," FOR EXAMPLE.

OBVIOUSLY, WE SEE A BRIGHT FUTURE FOR STOCK INDEX PRODUCTS. S&P 500 FUTURES COULD SOON BE THE NUMBER ONE FUTURES CONTRACT IN OUR INDUSTRY. THE S&P 100 IS DOING WELL, AND S&P 500 OPTIONS SEEM READY TO ADVANCE TO HIGHER TRADING LEVELS. AND NEW SUB-INDICES WILL PERMIT INVESTORS A MUCH WIDER RANGE OF STRATEGIES. THAT'S THE BEAUTY OF STOCK INDEX PRODUCTS--AS WE LAUNCH NEW PRODUCTS, WE BRING NEW BUSINESS TO ALL THE OTHER MEMBERS OF THE INDEX AND OPTION "FAMILY."

IF ONE LOOKS AT THE NUMBER OF POTENTIAL USERS OF STOCK INDEX FUTURES, THE NECESSARY CONCLUSION IS THAT POTENTIAL GROWTH IS VIRTUALLY UNLIMITED. SOME STUDIES INDICATE THAT THERE ARE ABOUT 350,000 PERSONS WHO ACTIVELY USE FUTURES MARKETS. THIS COMPARES TO ABOUT 35 MILLION PERSONS WHO HOLD SECURITIES. STOCK INDEXES OBVIOUSLY ARE A REVOLUTIONARY NEW PRODUCT THAT WILL CONTINUE TO SPUR GROWTH IN FUTURES MARKETS FOR MANY YEARS TO COME.

CERTAINLY, WE AT THE CHICAGO MERCANTILE EXCHANGE SEE THESE AND OTHER INDEX FUTURES AS A STRONG FACTOR IN OUR ONGOING PLANS FOR THE YEARS AHEAD.