AN END-USER PROFILE:

Russell Investments

Lisa Cavallari, head of derivatives trading at Russell Investments, discusses liquidity in equity index futures, the need for standardizing transaction costs and the CDS market split.

RUSSELL INVESTMENTS is an active user of listed derivatives as a tool for helping its clients meet their investment objectives. In 2018, the Seattle-headquartered asset manager traded more than $1 trillion in futures and options, primarily in equity and fixed income contracts, on behalf of its institutional clients and its own funds. In the following interview, Lisa Cavallari, the company's head of derivatives trading, describes the purpose of its trading and the benefits for Russell Investments' clients. Cavallari and the trading desk she oversees primarily serve three types of accounts: pension plans that need help with the implementation of their investment policy decisions, Russell Investments' own funds, and so-called transition management clients, which are typically pension plans that are in the process of changing managers. Cavallari also talks about several industry-wide issues: the increase in the liquidity of certain types of equity index futures, the need for a standardized approach to transaction cost analysis, and the bifurcation of the credit default swap market.

By Charles Wallace

Charles Wallace is a New York-based financial writer who has written for *Fortune* and *Institutional Investor.*

MV: How big is Russell's use of derivatives?

LC: In 2018 we traded over a trillion dollars' worth of listed derivatives in transaction volume. Around 61% of our trading volume on the listed derivatives side is in the U.S. and Canada, followed by about 22% in the developed markets Europe region, 12% in developed markets Asia, and then 6% in emerging markets.

MV: How would you break it down by asset class?

LC: Asset class is, not surprisingly, dominated by equity and fixed income. The equity portion is about 60% of our volume, and fixed income is about 38%. Then the remaining percentages are comprised of commodities, volatility products and currency. Currency needs a bit of an asterisk because Russell Investments trades over $1 trillion in FX forwards. Our clients that utilize foreign currency exposure, typically third-party accounts and the Russell Investments funds, need to obtain that exposure via the forwards market versus the currency futures market due to the size of the exposure required. As a result, currency futures are a very small portion of what my desk trades because we have an FX team that specializes in and indeed trades a large volume of FX forwards.

MV: How many people work on Russell's derivatives desk?

LC: All of our derivatives traders sit on the desk in Seattle. I manage a team of seven listed derivatives traders. We provide nearly round-the-clock coverage for six days a week.

MV: How does Russell use derivatives?

LC: There are three primary constituencies that we serve on our trading desk. We trade for third-party pension plan clients. We trade for Russell Investments funds. Then we also trade derivatives as part of transition management events. Those transition management events occur when large defined benefit plans remove a manager and hire another, so Russell Investments fills that void and manages the transition. Those three constituencies provide all of our derivatives flow.

Our global assets under management as of March 31, 2019 was $290 billion, and $82 billion of that was specifically derivative overlay. In the context of our third-party pension plan clients, they are sometimes looking for specific asset allocation moves at the plan level and an overlay manager can step in and provide those asset allocation movements via the use of derivatives. Frequently a client is looking to adjust their asset allocation and provide coverage and exposure in areas where they might not have exposure or where they want to gravitate towards. It could be strategic asset allocation or tactical asset allocation. Listed derivatives are a useful way of obtaining exposure quickly, in a timely manner, and in a liquid and cost-effective way.

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> **Lisa Cavallari**
> Russell Investments

When it comes to hedging, the hedging is going to be more specific. It depends on the particular client. In some cases we have clients that require specific exposure that they would like to hedge either short term or long term, or they're looking to tailor a combination of exposures to provide them with a partial hedge. Though futures are standardized, we can create baskets of futures to sharpen desired exposures. For example, baskets of equity index futures can be combined to track a benchmark equity index. On the fixed income side, baskets of bond futures and credit default swaps can be quickly compiled to target the effective duration of a fixed income benchmark index.

MV: In terms of the asset allocation moves that you just mentioned, are portable alpha strategies an example of that type of use?

LC: Absolutely, yes. In fact, with portable alpha, whether you're looking for alpha as part of a tactical asset allocation decision, or you're looking for beta exposure, listed derivatives are a cost-effective way of achieving that goal. The most common approach is to buy equity index futures as a proxy for the beta [market tracking] component. Then an active manager can be tasked with the alpha generation. Our team continually assesses, in the context of this example, whether buying equities, ETFs, index futures or a bilateral OTC index swap is the best route to establish the beta.

MV: Let's talk about liquidity. What trends are you seeing?

LC: It really depends on the asset class and the product. One of the things I have noticed over the last five years is the increasing use of the emerging markets equity index futures. One particular contract, the MSCI emerging markets index future, continues to gain in popularity. The flexibility that it provides is very robust, you can trade it electronically virtually any time of day, and what you are starting to see is liquidity popping up in more periods of the day, not just during U.S. trading hours. The emerging markets futures, and also the MSCI EAFE futures on ICE, have evolved. The more recently launched MSCI Europe and World [contracts] on Eurex are also gaining traction.

Any time that you have something that meets a strong need, it becomes more cost effective. Five or six years ago people would have heard of the MSCI contracts and asked us many questions, but their demand far outstripped what the market could handle. As the growth continues in these types of contracts, we are able to utilize them to capture many types of exposures. In the example I provided earlier, where baskets of equity futures are created to replicate benchmark exposure, that can be replaced with a single contract based on an index as long as the contract is liquid. Another potential bonus is that the MSCI contracts are denominated in a single currency, whereas a comparable basket of equity futures contracts would be denominated in different currencies.

Another area that we've been receiving questions, both internally and externally, is for sector futures. I'm talking utilities, energy, healthcare, and even real estate. Those contracts have been around for a while, but they are growing in popularity. We're closely watching the open interest of those contracts. We think they're an effective way to get sector exposure. We would expect to see those products experience growth similar to what we've seen for the MSCI contracts.

MV: So the liquidity is still pretty thin in those?

LC: We continually assess volume and open interest. We look at mandates where it's appropriate based on size to engage with those contracts. I think the important thing to keep in mind is that we have a preference for keeping below a certain percentage of open interest or daily trading volume. In the past, when we see contracts achieve that sort of tipping point [in liquidity], we have worked with the exchanges and the clearinghouses to say 'Can you please consider re-evaluating the limits you have on aggregate ownership of these contracts? Can you re-examine tick size? Can you look at block size?' In other words, you want to see those elements [in place] to keep pace with growth in the contract.

MV: How do you see liquidity conditions changing over the course of the day? Do we actually live in a world where markets operate 24/7, or is that just an illusion?

LC: It's not an illusion, it's becoming more and more of a reality. We've done some analysis internally about the flows that we've received over time. Keeping in mind that we're on the west coast and this is speaking only for listed derivatives for our business needs, there's very little flow that was traded between 3 a.m. and 5 a.m. Pacific time. If you think about that in the context of the global trading day, that's the middle of the day for Europe, while North America isn't yet open and Asia's already closed. We do see clusters of activity around different regional opens and closes. It means that people in Seattle are working a variety of different hours, and I like where we are situated from a time zone perspective. The team arrives in the morning before Eurodollar futures open in Chicago [Editor's note: 7:20 a.m. Central, 5:20 a.m. Pacific] and when I leave it's just after the Asia open, which is a long day, but there are periods of activity when markets are open at the same time. Europe and North America overlap for several hours at a time, which is super helpful for our trading.

MV: Eurex recently extended its hours into the Asian trading day. Is that something that creates more opportunities for you?

LC: It does. Because clearing houses and exchanges are important partners in our business, we meet regularly with them and we always encourage product cycles that cater to a global marketplace. Once those exchanges do that, like Eurex has done, and I know TMX within the last six months has done the same with their Canadian contracts, we observe the liquidity to see how it is developing in those new hours. We're very supportive of that concept and we do participate as appropriate.

MV: What issues are affecting your derivatives trading? What about transaction cost analysis? Are there certain things that clearing firms and exchanges could do that would make it easier for Russell to analyze trading costs in real time?

LC: That is definitely a growing area where a lot of people are focusing attention: how to examine transaction cost analysis in a very specific way. It reminds me of what Russell Investments developed with the T-standard in 2003 for transition management. The goal of the T-standard was to create a framework that removed ambiguity and gave clients a consistent measurement standard during portfolio transitions. In the same way, there needs to be consistency in nomenclature and cost measurement in the derivatives space.

The time is really ripe for that to come to the futures space. If you think about it, it's very logical. People have a certain number of FCMs [futures commission merchants], and they are trying to provide services to their clients. What is less obvious to the outside world is the fact that it's not all unified under some standard umbrella and we're not all speaking the same language. It's without a doubt a goal that we're moving towards collectively as an industry. But right now it seems to be fragmented. The FCMs provide the data they can about your flow, and firms are left to look at what they can build internally as well as what they can get from external third-party providers to fill in the gaps and provide some of that unification. It's a very interesting time to be in listed derivatives. People are sharpening their pencils.

MV: Is there something that an FCM could do that would help you?

LC: Because they all have their own individual business models, I can't point to anything specifically other than standardization of terms and language so that apples-to-apples comparisons can be made across multiple FCMs. I think you have FCMs racing towards that intellectual property, trying to concentrate their resources and provide the best data and algorithms to clients. The challenge is that Russell Investments uses more than one FCM and more than one prime broker. That means that we are left to assemble and analyze this disparate data.

MV: Explain what happened on the transition management side.

LC: The challenge in the transition management space was that there were no industry standards on how to measure the costs of a transition and providers tended to deliver the client a variety of benchmarks that lacked consistency. Essentially, the T-Standard is time-weighted investment returns capturing the difference in returns between the transition portfolio, with all costs included, and the target portfolio, assuming you could instantaneously gain the return. When people use the same methodology, then you can start speaking the same language and really make robust comparisons.

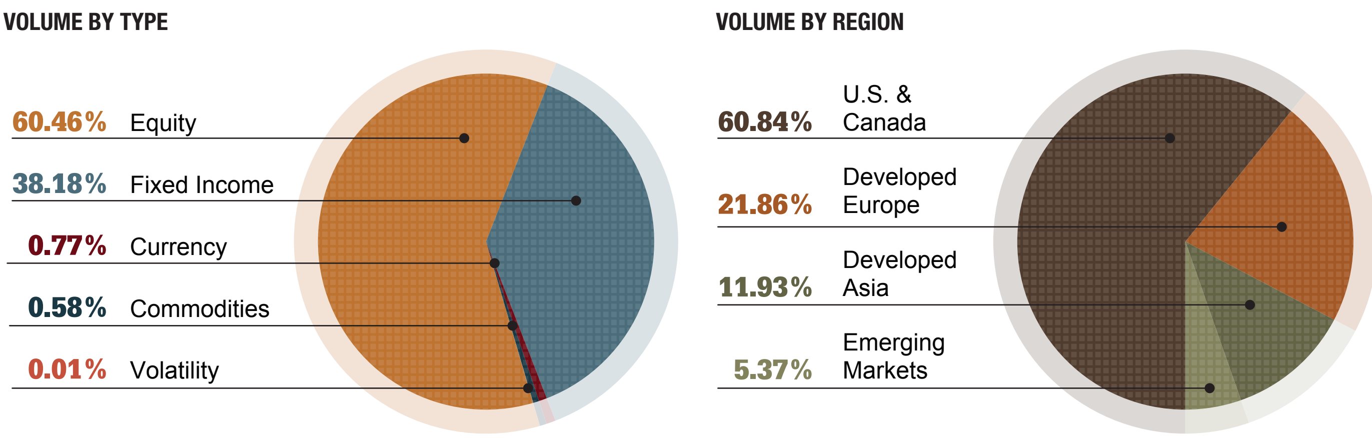
MV: How is the best execution requirement in the EU's Markets in Financial Instruments Directive affecting the industry's ability to perform transaction cost analysis?

LC: That is an excellent question. Taking a step back [from MiFID], occasionally regulators are looking for information that is not common in the marketplace. When the industry is pivoting towards meeting a regulatory need, sometimes those needs are not translatable into the way that we use data on a day-to-day basis. I believe that the cross-border nature of these global regulations makes it very difficult to get consistent definitions and again speak that common language.

With regard to what's happening in MiFID surrounding best execution, as we look at the definition of best execution, it reminds me of the word leverage. It means different things to different people, and it depends on how you define it. From a policy standpoint, we all want better transparency surrounding costs and I believe that's what drove some of those rules and regulations. But the industry is now struggling to reconcile the data that we have and the variables at our fingertips. My preference would be to make that data consistent so that it can be used in other meaningful ways. In other words, I regret that in some instances with regulation, you're trying to satisfy a specific regional standard. I want to take that broadly and more globally, as idealistic as that sounds, and I don't think I'm alone in that.

WHAT DOES RUSSELL TRADE?

In 2018, Russell Investments recorded derivatives trading volume of just over $1 trillion in notional value. Here's how the firm's trading breaks down across asset classes and geographies.



MV: Let's turn to some of the issues within the industry that you've been working on. For example, I know you're interested in the average pricing question. Can you walk me through this? Why is that an issue? Is there a lot of money at stake?

LC: It is low hanging fruit. It's not necessarily that there is a lot of money at stake. These are robust, efficient, low-cost markets, so when you have a specific product that cannot be average priced, why does it matter? It matters because if I have a large order that I need to trade across 150 accounts, I want to know that I can allocate pro rata based on an average price of that product. That's a very simple math problem, but depending upon the contract, how it's constructed, which clearinghouse supports it and which FCM supports the account, it's not as easy as it should be. Over time the industry will get there, but it's an example of these small issues that we have yet to resolve. If those types of problems can be removed from the operational burden, we'll get some consistency, and it will just make it all the easier to obtain the growth and depth of the markets that we need.

MV: Another concern is single name credit default swaps. Can you walk me through that issue? How does the execution of single names differ from the execution of index products?

LC: The SEC [Securities and Exchange Commission] is the regulatory body in the U.S. that governs single-name credit default swaps. However, the CFTC [Commodity Futures Trading Commission] has power over index products like the CDX and the iTraxx products. Because the SEC has not finalized the rules surrounding single-name credit default swaps, there's an artificial bifurcation of a marketplace that used to be quite integrated.

I'll provide an example. Suppose we had a client who really liked the investment grade CDX, which is traded via a swap execution facility and is a cleared instrument. What if they didn't like a particular name in the index and they wanted to overweight or underweight that particular single name? Well, it used to be that they'd have to trade a bilateral OTC instrument. That's cumbersome. Why wouldn't you want to support something that clears and offsets exposure in a more seamless way?

In late 2015, the buyside, through the SIFMA Asset Management Group, requested that the dealer community move to provide voluntary clearing. The industry wanted it, and I believe the cleared community on the clearinghouse side and the FCM side were supportive. They came up with a way to have single name CDS voluntarily cleared. The vast majority of the liquid instruments that make up the individual constituents of those indices are now accepted for clearing.

It would be wonderful to see the SEC adopt a similar framework that the CFTC has. The industry and more broadly, regulators and policy makers, are intellectually similarly aligned. We're on the last mile. Let's get over that finish line.

Then, there are also issues with—this is really getting into the weeds—cleared swaps have a different method [than futures] of segregating the collateral that's posted. It's legally segregated but operationally commingled. It would be great when the rules are finalized to essentially have harmonization so that LSOC applies to single-name CDS and index CDS officially.

MV: I noticed that ICE, the leading clearinghouse for CDS, has several hundred single names listed as available for clearing.

LC: That's right, and we strongly encourage clients to clear. If it's clearing eligible, we clear it. It is a risk-mitigated way of looking at this exposure. I'm not entirely convinced that I can obtain competitive quotes in the bilateral OTC space for single-name credit default swaps anymore. The dealer community wants clearing too. From their own [perspective], the way they determine risk and the way they have to hedge the other side of trades, they are also incented to clear. ▦