CPM Group

Market Commentary

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The Shift To Futures From Forwards

Institutional Investors Move To Exchange-Traded Futures And Options From OTC Forwards, Swaps, And Options In Metals

There has been a major shift among institutional investors away from over the counter forwards and options toward listed futures and options in precious metals. This move to listed derivatives, cleared, standardized, and more regulated markets has been underway at least since around 2000. It has accelerated in recent years and become a major factor in precious metals markets.

It must be noted that this shift is in line with similar moves across financial markets, and that it is inextricably bound with other major transformations underway in national and global financial markets. While much of the shift that has occurred in interest rate markets has been triggered by government mandates, the shifts in the precious metals markets primarily have been driven more by the liquidity and other benefits offered by CME Group listed precious metals futures and options.

CPM Group undertook a two-pronged study of precious metals market participants – primarily institutional investment managers – attitudes and practices toward the relative advantages of trading listed futures and options compared to over the counter forwards, swaps, options and, to a lesser extent, exchange traded funds and products. Additionally, we conducted interviews with 14 managers at 11 different hedge funds, commodities trading advisors, commodity pool operators, and generalist fund managers.

CPM's recent work has confirmed that there already has been a major shift toward listed futures and options, especially among institutional investors, and away from OTC forwards, swaps, and options. This migration to listed instruments has been on-going for years. It started slowly after some legal and regulatory changes related to hedge funds and to listed products in 2000, accelerated during and immediately after the Global Financial Crisis of 2007 – 2009, and has continued to move quickly over the past four years.

Charts 1 and 2 below illustrate this. Meanwhile, there has been a simultaneous reduction in the average trade size in the London OTC market as intrabank and institutional trading have shifted and declined over the past two decades, as shown in Chart 3 on the next page. Charts 4 and 5 show the recently released data on London trading volumes, which are much smaller than the size some market participants and observers had suggested in their market reports before the London Bullion Market Association started publishing this data in November 2018. Some market observers had stated in reports over the past several years that London OTC volumes might have been as much as twice the size the newly released data reports.

This trend reflects the coming together of a number of issues, including regulatory changes in major markets, the need for credit and clearing arrangements, counter-

Chart 1
Gold Futures Volumes Have Risen Tenfold Since 2000

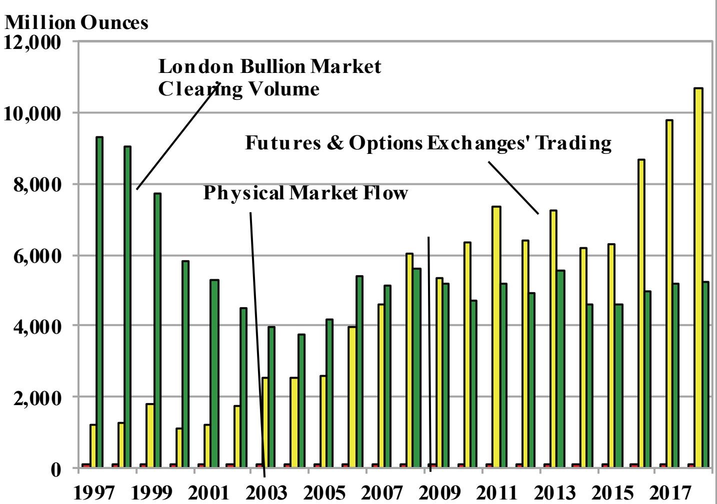


Chart 2
Silver Futures Volumes Also Have Soared, Dominate Market

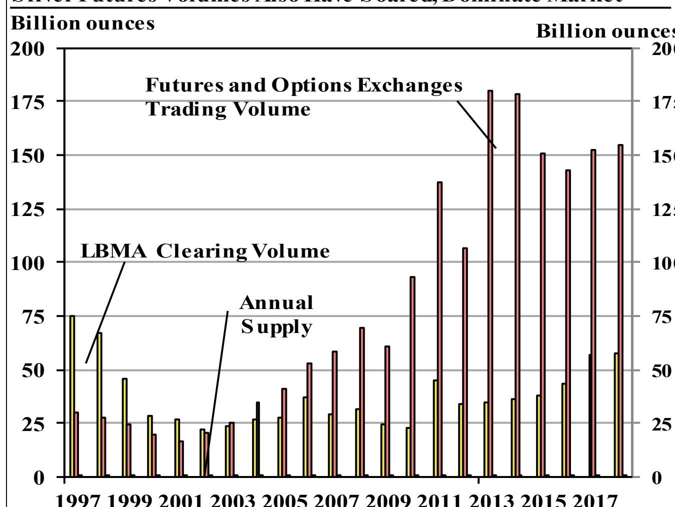
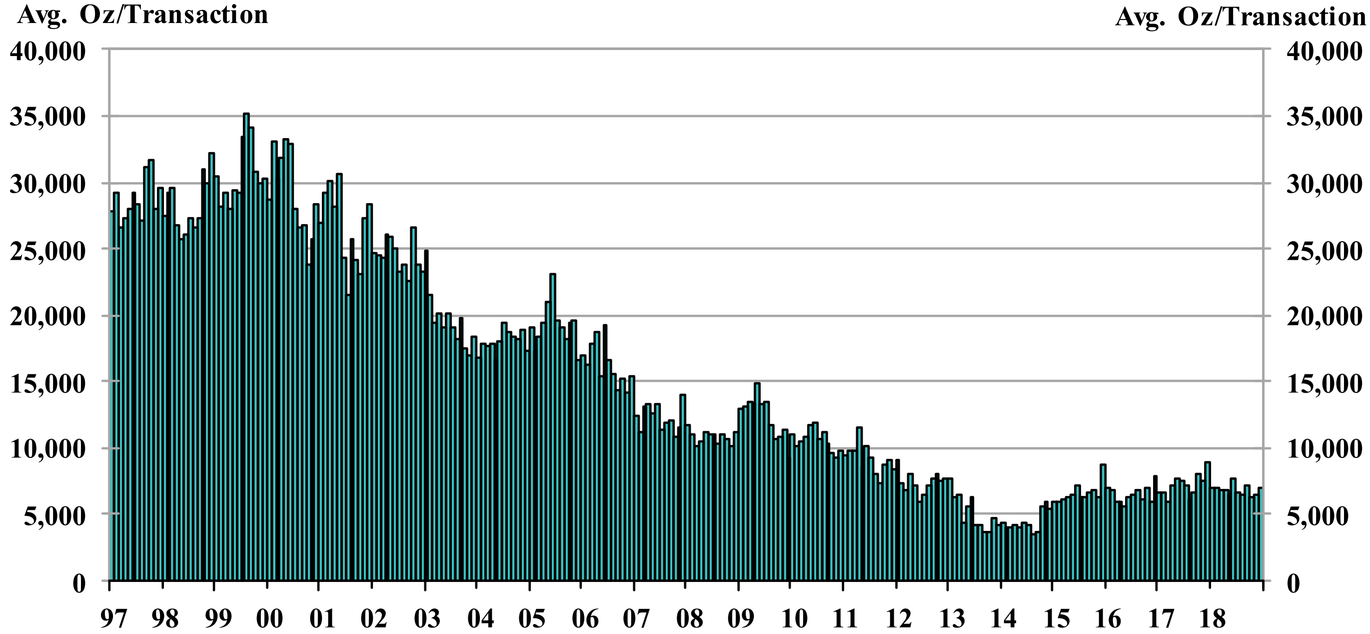


Chart 3

London Buillion Market Association - Average Trade Size

Ounces of Gold Transferred Divided by Number of Transfers



party risk issues, increased difficulties in opening and maintaining OTC trading lines and arrangements, **but most importantly greater liquidity, ease of use, and transparency in listed derivatives**.

It is clear from the analysis, surveys, and institutional investor interviews that CPM undertook in compiling this report that listed futures and options, specifically those on CME Group exchanges, has seen higher volumes relative to OTC markets in terms of trading by institutional investors. Investors have preferred and focused on listed futures and options at the expense of OTC markets. Meanwhile, the volumes of trades on gold and silver exchange traded funds remain small compared to listed futures and OTC markets.

Institutional Investors Already Have Shifted To Futures From OTC Markets

- Most of the institutional investment managers said they are more inclined to trade listed futures and listed options than OTC or ETF products.
- Data comparing London gold and silver clearing volumes to futures trading show the large increase in futures and options volumes compared to relatively flat London OTC clearing volumes.
    - For gold, Chart 1 shows futures volumes at 10.7 billion ounces in 2018 are more than double the 5.2 billion ounces of London clearing volumes. This compares to London clearing volumes of 4.5 billion ounces in 2002 and futures volumes 1.8 billion in 2002. While London volumes have risen 16% since 2002, futures volumes have risen 494%.
    - Silver, Chart 2, shows a more dramatic shift to futures from London OTC. In 2002 the two volumes were close to each other: 20.2 billion ounces of silver trading of futures exchanges and 21.9 billion ounces in London OTC clearing volumes. By 2018 futures volumes were nearly three times the London OTC cleared volumes. Futures had risen 664% to 154.4 billion ounces in 2018, while London OTC cleared volumes had risen 164% to 57.9 billion ounces.

Key Determinants

- Overwhelmingly both the interviewees and survey respondents stated that the primarily factors determining whether they used listed traded futures and options instead of OTC or ETF instruments were not driven by transactional fees or other financial costs.
- The primary factors cited in determining whether to use futures rather than OTC or ETF products were as follows.
    - **Liquidity (Most Important Factor)**
    - **Transparency**
    - **Clearing**
    - **Ease of Use**

A study of the spreads in Comex gold and silver futures trading across lot sizes shows that the bid/ask spreads in 2018 were roughly half the size they had been in 2010.

The average bid/ask spread in a representative sample of gold trades in September 2018 was 55.7% less than the spreads in September 2013. Improvement in the bid/ask spread led to approximately a $1,956 decrease in execution costs, including all transaction fees and costs as well as the spread, for a 5,000 ounce trade on average during this time.

For silver the average spread was down 37.6% between 2014 and 2018. The narrowing spreads are directly attributable to the increased liquidity in the Comex futures markets for gold and silver during this time.

Related to these reasons given for using listed futures and options instead of OTC, the following points were made by many if not most of the interviewees and respondents.

1. Greater **liquidity** in futures, especially in the first 12 months where most of the trading occurs. This greater liquidity was cited as one of the most important advantages of listed derivatives, if not the most important, by most of the fund managers interviewed or surveyed.
   a. The greater liquidity clearly is reflected in better pricing and thus lower actual transactional costs.
2. The increased 'pain' in terms of increased paperwork, cost, time, and management of setting up OTC ac counts and trading and margin lines with OTC counterparts has become too cumbersome.
3. The lack of cross margining in OTC is a big negative, positive for futures.
4. Compliance demands in OTC are more onerous.
5. Futures have central clearing. Even the advent of OTC cleared trades does not make the OTC clearing system as perceived to be reliable and effective. The view is that the well-established clearinghouse for futures exchanges was stronger, better set up, more liquid, and more secure than the OTC clearing arrangements.
6. Institutional investors do not need credit and do not have the sorts of banking needs that commercial market participants have, so they see reduced value of having a 'trading relationship' with a bank or trading company.
7. Hand in glove with the liquidity was the transparency of the futures markets, which allows them to see the liquidity of the months and instruments in which they are investing an calculate their position in the market. This is lacking in the OTC markets.

Most of the investors interviewed expressed opinions that the OTC forwards market was more the place where commercial hedgers, producers, processors, and fabricators, were likely to trade through banks. The fund managers said they felt this reflected the greater potential for

Comex Gold Bid/Ask Spreads

cents per ounce

	Contract Volume Size (lots) 5	10	25	50
2013	14.12	23.52	39.65	58.82
2014	12.19	12.44	24.04	36.73
2015	13.15	13.15	23.96	35.30
2016	10.96	10.96	19.55	28.91
2017	10.45	10.45	12.53	21.49
2018	10.27	10.27	10.74	19.71
Percent Change				
2013 - 2018	-27.2%	-56.3%	-72.9%	-66.5%
Average				-55.7%
Change in cents per ounce				
2013 - 2018	-3.85	-13.24	-28.91	-39.11
Average				-21.27

Comex Silver Bid/Ask Spreads

cents per ounce

Silver	Contract Volume Size (lots) 5	10	25	50	100
2014	0.56	0.56	1.10	1.64	2.60
2015	0.58	0.58	1.10	1.64	2.58
2016	0.52	0.52	0.86	1.28	2.15
2017	0.51	0.51	0.51	0.98	1.55
2018	0.51	0.51	0.51	0.70	1.14
Percent Change					
2013 - 2018	-10.2%	-10.2%	-54.1%	-57.4%	-56.2%
Average					-37.6%
Change in cents per ounce					
2014 - 2018	-0.06	-0.06	-0.60	-0.94	-1.46
Average					-0.62

commercials to use other banking services and thus to be more tied in with banks and trading companies than are institutional investors. Additionally, they expressed the opinions that commercial traders were perhaps less familiar with trading, seeing it as adjunct to their major responsibilities, and consequently less comfortable with trading futures and options directly. (All of these opinions are in line with commercial and investor (non-commercial) attitudes observed by CPM in its work with these entities.)

It's Not About The Money

- Almost universally the interviewees and survey respondents said that the relative explicit transaction costs were not a determining factor in whether they traded listed instruments or OTC or ETF products. Many professed not even knowing the transaction costs and cost differentials.
- Total transaction costs, including fees, commissions, and spreads, have fallen in both the futures and OTC

markets. The decline seems greater in percentage terms in futures and listed options, increasing the competitive advantage or value proposition of listed products.

- In the interviews several fund managers said they pay more for OTC trades than for futures. They explained that they tended to trade OTC positions only when arbitraging with futures markets.
- Two-thirds of the respondents said they did not pay any additional fees for London Precious Metals Clearing Ltd. Clearing services, assuming the fees were imbedded in the OTC spreads.
- One third of the respondents to the survey stated they needed to post margin for OTC trades now.

Options

In gold and silver options, too, the majority of trading occurs in Comex listed options. Comex listed gold and silver options are two to three times larger than London OTC volumes. Trading volumes on London OTC options have only begun to be reported since the middle of November 2018. Taking March 2019 as a sample, there were 114.7 million ounces of gold options traded on the Comex during March, more than double the 50.4 million ounces of gold options in London. For silver Comex March 2019 options trading volume totaled 610.0 million ounces, 2.7 times more than the 222.5 million ounces of London OTC options.

Precious Metals Options Volumes, March 2019

Million Troy Ounces

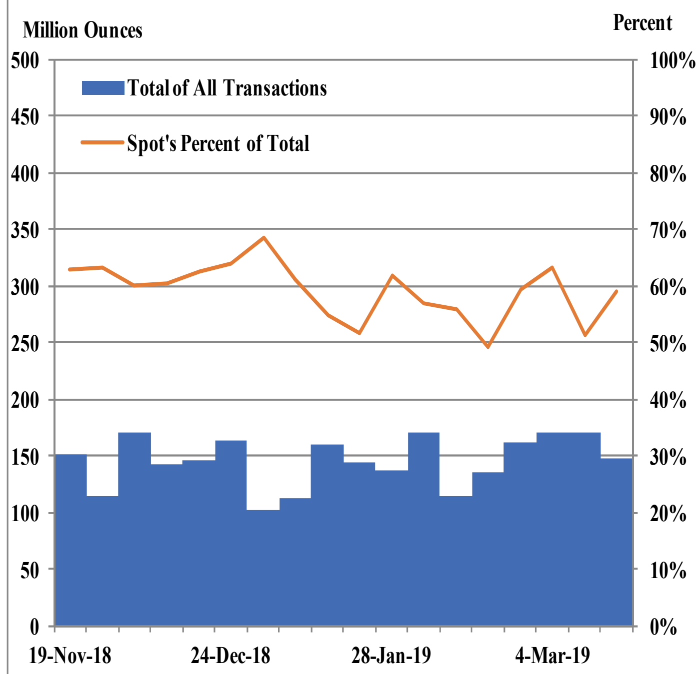
	Gold	Silver
Comex	114.7	610.0
London OTC	50.5	222.5
Comex/London	2.3	2.7

The results of the interviews provided anecdotal information pointing to the preference to listed options over OTC options, with the same set of factors cited by fund managers as related to futures versus forwards: greater liquidity, ease of transaction, transparency, and price discovery. Additionally, the interviews made clear that the preference of listed derivatives options over OTC options has grown over the two decades since 2000, with the shift accelerating since the Global Financial Crisis.

Regarding ***options*** trading, all of the companies interviewed trade options as well as futures.

Chart 4

London Gold OTC Trading Volumes



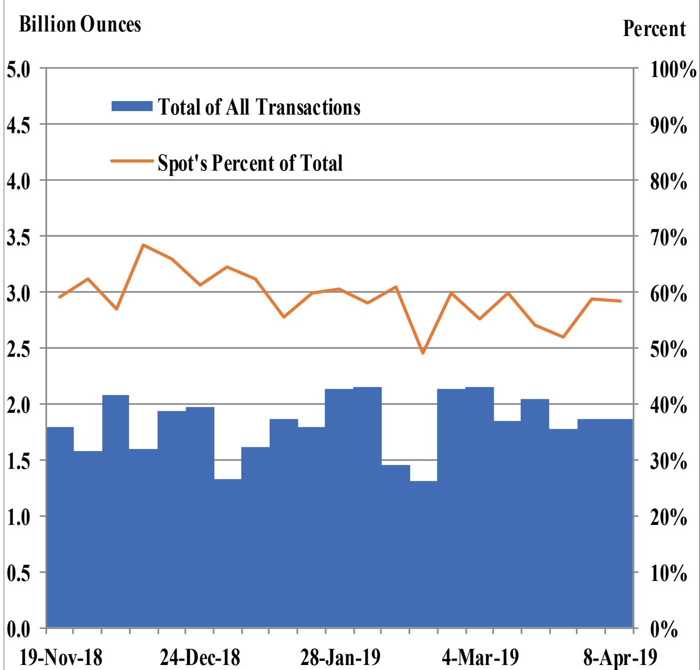
Conclusions

This study was undertaken to gather data and anecdotal evidence related to fund manager, institutional investor preferences between listed futures and options and OTC forwards, swaps, and options. Across all sectors financial markets are under-going massive transformations. As part of these changes, there is a common perception that there has been a shift in this direction over the past two decades, and CPM sought to quantify this as much as possible.

Additionally, we sought to determine the motivations behind such shifts. We wanted to know how much of this was related to comparative transaction costs and liquidity, how much reflected regulatory changes, and how much had to do with non-monetary or regulatory changes and preferences on the buy side of the market.

It was clear from the data we collected on markets, the survey we undertook, and the interviews we conducted with large and small fund managers that participate in the precious metals investment markets that **there clearly is a strong and growing preference for listed derivatives.** This shift has been underway for a long time, since around 2001, although it clearly has accelerated in the past several years. **It looks likely to continue, as institutional fund managers prefer listed futures and options. Liquidity benefits seem likely to continue to be one of the major, if not the single most important, factor driving this on-going shift.**

Chart 5
London Silver OTC Trading Volumes



The preference has more to do with liquidity, anonymity, ease of trading, transparency, pricing, and the existence of a well respected and long-established third-party clearinghouse.

The **ease of use** in futures and listed options, with the ability to trade more readily and rapidly, without many of the ancillary back-office and other additional tasks related to OTC trading is a key factor in the minds of many institutional investors. It always has been, but as trading across financial markets has become more automated and computerized, ease of trading considerations are that much more obvious in the minds of portfolio managers and traders at fund management companies.

So, too, is **pricing and execution transparency**. With the steady and dramatic increase in volumes traded on the exchanges since around 2001 liquidity has improved. Changes from the increased volume and move toward electronic trading has improved anonymity, as have changes in the nature of both buy and sell side institutions. The stability of the clearinghouse and the overall way in which exchanges have moved in line with changing regulatory regimes also is seen as beneficial to investors.