Gearing up for end of 2017

After the success of its first issue, the LSEG derivatives newsletter returns with a new graphic format. Thank you very much to all readers who provided feedback and suggestions.

Q4 will be a very busy quarter, with the release of our MIFID II compliant trading systems on 13 and 27 November for LSEDM and IDEM respectively.

We also have a number of public engagements which will see our teams involved in events in Chicago, London, Milan and Lugano. It is also worth mentioning this year’s Trading Online Expo at Palazzo Mezzanotte in Milan with already 2,000 attendees signed up.

In this issue of the newsletter we publish an article focusing on the successful extension of trading hours for our FTSE MIB futures products on IDEM. We also host our first external contribution, the derivatives team at BCS Global Markets sharing their experiences in trading Russian DR derivatives on our London derivatives market.

We hope you enjoy the newsletter.

Yours,
Nicolas Bertrand
Global Head of Derivatives and Commodities
On July 3rd, 2017 the IDEM market extended the trading hours for FTSE MIB futures and FTSE MIB mini-futures to 8:30 pm CET. This represents a strategic development for the Italian market, as it provides international investors - particularly those based in the U.S., including traditional and quantitative asset managers - with additional trading time and opportunities on the Italian benchmark futures. It is also an important initiative to address the growing demand from private investors and the online brokerage community, which is very active on both products.

The continuous trading phase on IDEM now includes the following sessions:
— a day session, ending at 5:50 pm (5:49:59) CET
— an evening session, from 5:50 pm to 8:30 pm CET, where only FTSE MIB futures and FTSE MIB mini-futures are traded

The transition between the traditional trading day and evening sessions takes place without interruption: orders entered during the day session, if not yet executed or partially executed, may conclude in the evening session. Moreover, the contracts concluded during the entire continuous trading phase (day session and evening session) will form a single contractual position and will be cleared on the trading day. Importantly they will be margined on the basis of the daily settlement price, calculated as the quantity-weighted average of the last 5% of the contracts concluded until 5:38 pm CET.

The opportunity to trade FTSE MIB futures and FTSE MIB mini-futures in the evening session responds to retail clients’ need to hedge their positions in the After Hours market (closing at 8:30 pm CET) or in the MTA (the main Italian cash equities market, closing at 5.42 pm CET).

With this move, Borsa Italiana intends to further boost the strong growth experienced by its flagship index futures. Indeed FTSE MIB futures and FTSE MIB mini-futures have been amongst the fastest-growing equity index derivatives in Europe in the last three years, growing by 60% and 70% respectively in terms of contracts traded. Both listed products have seen record all-time-high volumes in 2016, trading around €4 billion on a daily basis. Both products enjoy a significant diversity of order flow, strong contribution from private investors, full support from several liquidity providers, and deep and tight order book liquidity - with more than 95% of contracts traded on screen.

Traders have responded very positively to the extension of trading hours, taking advantages of new opportunity offered by Borsa Italiana since launch. During July and August, 2% of FTSE MIB futures and FTSE MIB mini-futures contracts were traded in the evening session, with significant peaks above 5% of a day’s total volume registered in numerous sessions. The record day since launch date was September 5th, which saw 2,000 lots traded in the extended hours, representing 4.5% of FTSE MIB futures and as much as 10% of FTSE MIB mini-futures.
The contracts concluded during the entire continuous trading phase (day session and evening session) will form a single contractual position and will be cleared on the trading day.

IDEM is among the top European equity derivatives exchanges and as a result is attracting more and more interest from international investors who want to diversify their portfolio. Derivatives on FTSE MIB can be negotiated also in the U.S. in accordance with the terms of the No-Action letters from the CFTC and SEC.

Regulatory and Technical References
(Links below)

— Borsa Italiana notice n. 12358 of 15 June 2017
— CC&G notice about the extension of trading hours and closing prices
— Initial Margins applied to Equity Derivatives Section
— IDEM – Borsa Italiana website
— Options Disclosure Document
Why should derivatives be used?

1. Take advantage of expectations in the stock’s behaviour can be capitalised upon, even when the direction of the move is difficult to foresee. Options allow investors to benefit from a stock move, irrespective of the direction – this is particularly useful when deciding the optimal portfolio strategy when catalysts are approaching, such as earnings.

2. Tailor the risk/reward profile of a long stock position that is more suitable for a certain investment environment. A fundamental change in the fund management industry has been the proliferation of investment styles, moving away from balanced benchmark dominated mandates. This naturally leads to strategies that range from ultra-cautious to highly-leveraged and from absolute to relative benchmarks. A long only stock position may not be the most efficient way to match these requirements. Additionally, the large growth of passive funds has put pressure on active managers to find alternative sources of alpha, or uncorrelated risk premiums. The use of derivatives addresses this problem and we have seen a large growth in call overwriting and put underwriting funds.

3. Map the investment return profile to the investment view, with regards to target prices or probability weighted returns. Investors can enhance returns if they believe in their target prices, by giving away any further upside potential beyond the levels analysed. A more sophisticated strategy is to calibrate exposure based on a probability weighted set of potential price targets.

4. Protection against potentially extreme short-term catalysts that may not be relevant for a long term investment case.

Fund managers looking to include emerging markets in their equity portfolio tend to look primarily at cash markets as source of returns. BCS global markets believe that there is a good opportunity to open up the area of equity derivatives to a wider audience. Derivatives have historically been viewed with scepticism due to the significant levels of jargon and complexity.

With this article we hope to unravel some of this jargon which may be of interest to Russian cash focused investors who are considering entering the world of derivatives. There is a range of possible option strategies that could be combined with a long equity position, that could create attractive risk adjusted returns for certain investors and we hope to explain how they can be used.
Derivatives are typically viewed as tools for short term or event driven investors. A long term fundamental investor who has a long term view but is aware of short term ‘turbulence’ can also take advantage of these tools. For example, buying short dated put options can protect their position in case of an exaggerated negative reaction.

5. Increase leverage of a position given the same level of investment

In the search for outperformance, active managers can take advantage of the leverage on offer using options, when there is high conviction on a stock. The outlay in purchasing a call option clearly offers much greater leverage for example, than the outright purchase of a stock.

Who uses derivatives in general?

In the previous section we have outlined the main reasons portfolio managers should use derivatives. In the diagram above we list the types of investment styles that can benefit from incorporating derivatives strategies to manage risk or shape specific portfolio profiles.

Derivatives misconceptions

1. They are risky instruments. Some may argue that the availability of leverage increases risk – but this is not the case if handled with adequate risk controls (you should not be selling naked puts with leverage). In most cases they help to limit the downside, or lock in some profits.

2. They are complex. Exotic options, as the name suggests, are quite complex. But we would argue that vanilla derivatives (calls & puts) are no more complex than evaluating the price target on a stock. The latter will involve knowledge of the macro environment, the relative power of clients versus suppliers, competitive pressures, political change, the potential for innovation and this is all before valuing the resulting earnings stream!

Options allow investors to benefit from stock moves, irrespective of the direction.
Taking note of the below considerations, there is ample opportunity for investors coming from cash equity backgrounds, to use options. Indeed it is important to make a distinction between derivatives traders and cash investors, as in the latter case implies the increased likelihood of holding options positions until maturity in conjunction with a long or short equity cash position, and having less relevance to the mark-to-market exposure. It also means that downside protection is typically the primary consideration as it is these trades which are often the primary steps into the derivatives world. In order to effectively structure a derivative strategy, it is important to consider the following:

- Current position in the stock (Underweight, neutral, overweight)
- Short term investment view (Bearish, neutral, bullish)
- Attitude to risk (Protection, reduce volatility, increase leverage)
- The richness/cheapness of volatility

In fact, it is the first 3 points which are of primary interest and the 4th makes a slight adjustment to the trade structure based on the price of options, versus its history (this is due to the mean reversion characteristics of volatility).

In Fig.2 we summarize how different market views and level of risk appetite can be mapped to standardized options strategies.
What does it all mean?

So far in this article we have explained some key factors that come into play when investment managers decide to use equity derivatives products in their portfolios. BCS have developed a competence in advising their clients on how to translate these theoretical elements into practical, executable transactions.

In Fig. 3-4 we analyse how the opportunity created by a structural change in a global benchmark and some fundamental short term triggers, can be turned into a simple long call strategy. The trade is decided by looking holistically at all the factors influencing the stock:

- The inclusion of the stock in a benchmark is a bullish signal therefore beneficial to investors holding a position in MMK.
- Nevertheless the stock is trading at a 5 year high and might have limited upside potential.

BCS research reiterates the short term character of the trigger.

- The earning announcement might create short-term volatility.
- The long term view remains positive due to strong steel prices and is supporting the stock thus limiting its potential downside.

Considering all the factors above and mapping them against all the available derivatives strategies above, it seems reasonable to use a call option to replace the existing cash position.

This would allow the investor to maintain the same exposure to the upside of the stock with limited notional risk and to benefit form any potential pick up in volatility. At the same time the downside risk is known as it is limited to the premium paid for the option.

**Fig. 3 - MMK - Inclusion in MSCI Russia to become a major trigger**
- You currently hold a long-term position in MMK.
- MMK is currently trading at its 5yr highs.
- BCS Research release a note, identifying a bullish short term catalyst.
  - There is another catalyst in end-October with Q3 earnings results.
  - Steel prices continually rising and global demand is expected to strengthen.

**Chart 2: Expected MSCI Russia index weight of MMK**

<table>
<thead>
<tr>
<th>Year</th>
<th>MMK</th>
<th>NLMK</th>
<th>Severstal</th>
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<tbody>
<tr>
<td>2016</td>
<td>0.8%</td>
<td>0.8%</td>
<td>1.0%</td>
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<tr>
<td>2017</td>
<td>1.0%</td>
<td>1.0%</td>
<td>1.2%</td>
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<tr>
<td>2018</td>
<td>1.2%</td>
<td>1.2%</td>
<td>1.4%</td>
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<td>2019</td>
<td>1.4%</td>
<td>1.4%</td>
<td>1.6%</td>
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Source: BCS
Fig. 4 - Stock Replacement

This strategy suits investors who believe in an appreciation of the underlying, although they feel they would like to lock in some profits because of near term catalysts.

The performance is less driven by fundamental factors – take profits on the position whilst maintain some upside exposure through re-investing a small amount of profit.

— The investor is long the underlying stock position as a core holding within a portfolio
— The stock has had a strong run and there is a risk the stock suffers weakness in the near
— However, the fundamental story remains intact and it is still desirable to have upside exposure to the stock

We hope to have given some brief ideas of why it is crucial to consider derivatives to optimise risk-adjusted returns when investing with a fundamental point of view.

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London Stock Exchange Derivatives markets offers trading and clearing of futures and options on Russian* Depositary Receipts with dividend adjusted single stock futures and fully transparent dividend futures also available to trade.

Participants benefit from both the onscreen order book and the flexibility offered by our cleared only service.

For any further information please contact the LSEDM Sales Team on +44 207 797 3833 or at lsedm.sales@lseg.com

<table>
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<tr>
<th>LSEDM Russian based derivatives available on order book</th>
<th>LSEDM Russian Derivatives Volume and OI 2015-17</th>
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<tbody>
<tr>
<td></td>
<td>Options</td>
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<td>SBERBANK</td>
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<td>SURGUTNEFTEGAZ</td>
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<td>XS RETAIL GROUP NV</td>
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</tbody>
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*derivatives are also available for trade reporting on selected other IOB names
Statistics
— IDEM Equity
— LSEDM

Events and initiatives
The group derivatives markets will attend/organize the following events:
— FIA EXPO 2017 – Chicago
  17/19 October 2017
— Borsa Italiana Trading Online Expo – Milan
  26/27 October 2017
— FOW Trading Milan – Milan
  8 November 2017
— Lugano Fund Forum – Lugano
  20/21 November 2017
— FOW Derivatives World London:
  the debate 2017 – London
  6 December 2017

News
— IDEM extends Future and MiniFuture trading hours
— Derivatives now available for trade reporting on Polyus PJSC
— Additional IOB underlyings available to trade on order book
— Borsa Italiana welcomes ICAP as first Non-Executing Broker on IDEM

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