Cboe® iBoxx® iShares® Corporate Bond Index Futures

CLIENT USE CASE

CLIENT: INTERNATIONAL ASSET MANAGER

CHALLENGE: NON-US BASED FUND LOOKING FOR HEDGED EXPOSURE TO US CORPORATE BONDS

BACKGROUND

Corporate bond portfolios are vulnerable to both interest rate risk as well as default risk. This use case explores how a US high yield bond portfolio manager may be able to hedge these risks with corporate bond futures compared to trading credit default swaps or ETFs.

APPROACH

For international investors, tax and regulatory concerns are additional considerations when deciding on the investment vehicle.

For example, foreign investors are typically subject to a withholding tax on dividend payments by US corporations, including fund distributions paid out by US-listed ETFs. The base withholding rate is 30%, which means a foreign holder of a US-listed ETF will only be receiving 70% of the gross dividends available to US investors. In contrast, futures contracts do not pay dividends. In this case, dividends are already incorporated in the underlying total return index on which the Cboe® iBoxx® iShares® Bond Index futures are based.

Additionally, for many European funds, UCITS compliance is another consideration. US-listed ETFs are typically not eligible investments for European UCITS funds, whereas index futures are typically eligible.

On the options side, for investors (regardless of domicile) looking to hedge US high yield exposure, one obstacle to using US-listed ETF options, particularly longer-dated options (3M+ tenors), is the uncertainty around the associated borrowing cost and dividend payments. As a result, despite potential abundant US-listed ETF option liquidity, most of the volume i could be concentrated in the front 2-month tenors, as the volatility around the forward makes trading longer-dated options difficult. In contrast, Options on Cboe® iBoxx® iShares® Bond Index futures are based on the total return of the underlying index, which includes dividends. Additionally, the ability to hedge longer-dated options with futures helps reduce the uncertainty around the borrow cost of the underlying. As a result, options on futures may enhance liquidity in the longer dated vol market for high yield bonds.

SOLUTION

For foreign investors, the Cboe® iBoxx® iShares® Bond Index futures may offer a cheaper alternative to trading ETFs as dividends are included in the total return of the futures whereas ETF dividends are subject to a withholding tax. Additionally, the index futures are typically UCITS compliant whereas US-listed ETFs typically are not, which is an important consideration for many European funds. By reducing the uncertainty around dividend and borrow cost, options on the corporate bond futures may also help enhance the liquidity in the longer dated vol market for corporate bonds.

For more information about Cboe® iBoxx® iShares® Bond Index futures and options on futures reach out to Cboe at Sales@Cboe.com.