May 22: Market Risk – FT Says Derivatives Activity Linked to Market Declines

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The recent sharp falls in stock markets appear to have been exacerbated by an unusual wave of derivatives activity on the part of hedge funds and big banks, according to an article in last week's Financial Times.

"Several banks and big investors appear to have been forced into selling large amounts of equity futures because they have been taking large, leveraged bets on the direction of stock market volatility in recent months and these bets are now unraveling because the equity markets have recently fallen sharply. This forced selling has triggered falls in equity market futures prices and has hurt the value of the stock markets," the article was quoted as saying. "This is an incredibly sensitive topic but it looks as if some big investors are being forced into big moves because they need to hedge these [derivatives] positions," one senior trader said on Thursday.

It is impossible to track this type of derivatives trading with accuracy since the investors and banks engaged in these markets keep their positions private. However, one factor that suggests the market is experiencing some unusual dislocations is that there have been sharp falls in the European equity futures market after 4 PM each day. "This is the time when many banks and other large investors reassess their trading positions and then rebalance their books by buying or selling assets, if necessary, to ensure that their exposure to risk complies with their internal rules," the Financial Times reported.

Another factor is that these sales appear to have occurred across the board in the futures market rather than hitting specific sectors or stocks, suggesting that they reflect a pattern of forced sales. "These market movements could just be program selling, but the timing suggests that something else is going on," said a senior derivatives trader at a major bank. The issue that is believed to be triggering this is an instrument called a "variance swap". This is a type of derivative that has become very popular among hedge funds in recent months since it allows placing bets on the direction of stock market volatility in a leveraged manner. The banks that have been writing the derivatives contracts with these hedge funds have apparently been trying to hedge these positions by making large trades in conventional equity options.

During the past year it has been relatively easy for the banks to manage these positions, without exposing themselves to large levels of risk. "However, now stock markets are becoming more volatile again, they are suddenly being forced to readjust these positions to comply with their internal risk management rules. What makes this process particularly pernicious is that the speed at which they need to adjust their books increases as equity market volatility rises. Moreover, the sheer fact of selling makes the markets more volatile and thus increases the need to adjust positions," the article reported.

Some observers believe that these movements are temporary and will quickly correct themselves after a few days. However, others believe that the self-reinforcing nature of these trends could create serious market problems.
