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TalkingPoints

A Practical Look at Index Liquidity in Asia

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What role does index liquidity play in helping market participants in Asia participate in the U.S. equity ecosystem during Asia's trading hours?

1. What are the key differences between the S&P 500® and Dow Jones Industrial Average® (DJIA®) and why do liquidity and trading volumes that are tied to these indices matter?

Izzy: The S&P 500 and DJIA are widely used gauges of U.S. large-cap equity performance. They contain many of the largest companies in the world, and the indices also underlie many of the investment products like exchange traded funds, index funds and derivatives, futures and options.

One key difference between the two indices is the weighting approach. The Dow® is price weighted, whereas the S&P 500 is the market-cap weighted. The number of constituents is also significantly different—30 for The Dow versus 500. Note also that there are no utilities or transportation companies contained in The Dow, as they are tracked separately by the Dow Jones Utility Average and Dow Jones Transportation Average.

I think we often hear about how much assets have been growing, tracking passive product index profiles in the news or media. However, there is little transparency and emphasis on the liquidity and trading volume of these products. This is unfortunate, because volume can give us a good indication of how well these products are policed by arbitrages.
For example, when buying and selling, investors rely on arbitrages to make sure that ETFs are in line with the underlying index members.

When there is a market sell-off and liquidity becomes a big issue, will an ETF still be able to be sold with a price close enough to the underlying stock members? And this is when market efficiency becomes important and why indices with large ecosystems and liquidity are especially relevant. Both the S&P 500 and DJIA have a decade-long record of attracting liquidity, and they have proved of interest to arbitrages and media.

2. How do our indices tracking the S&P 500 and DJIA futures compare with other Asian headline indices underlying futures contracts? For Asian investors, why are those differences important to consider?

Izzy: The key potential advantage of having U.S. benchmark futures trade during Asian hours is for investors to transact in local time zones. The potential use case is for investors to react

to market news as it happens and hedge against events that happen during Asian hours. They could also potentially adjust their positions ahead of economic releases and announcements. To achieve these potential benefits, the liquidity and bid-ask spread during Asian hours is important.

We have also done our own research in comparing the S&P 500 and DJIA versus Asian equity indices. From the angle of futures trading, we found the Asian hours liquidity of S&P 500 futures has been growing at a 13% 10-year CAGR. For The Dow, the growth rate is even higher, at 17%. Just to compare, the liquidity of S&P 500 futures has also been close to futures on the Nikkei and Hang Seng Index, which speaks to the potential use case.

The co-movement between the U.S. and Asian markets is another interesting point to consider. Co-movement is measured by correlation, with close-to-close daily return as its basis. However, such an approach may underestimate correlations between the U.S. and Asian markets because there is a difference in the trading hours. With futures trading now almost 24 hours a day, we are able to measure correlation with the same cut-off time during the day. If we do correlation in this more correct way, we see that the futures on U.S. benchmarks had meaningful correlation with Asian benchmarks, especially during crisis periods.

3. How do you define liquidity and what role does liquidity play in helping you to manage your own strategies?

Jean-Francois: Liquidity can indeed play a critical role in investors' portfolios. Looking at ETFs for example, there are several layers of liquidity available to institutional investors. The first one would be the liquidity on exchange, where investors can trade against each other. In that case, large trading volumes as well as low bid-ask spreads would be indicators of good on-exchange liquidity.

The second and third layers of liquidity for ETFs relate to the ability of investors to trade OTC and to leverage the underlying liquidity in the market by benefiting from the creation/redemption mechanism of ETFs. For example, if an investor were to purchase a large amount of ETF units in one trade, and they don't find enough depth available on an exchange, they may still be able to trade OTC against specialized counterparties. These specialized counterparties, sometimes authorized participants, then meet this outsized demand by creating additional ETF units in the primary market. In short, ETFs are always at least as liquid as their underlying market, which is why the index they track really matters in terms of the overall liquidity.

If the primary market is liquid, then it helps to increase the liquidity in the secondary market. In addition, we have also seen synergies between different vehicles like ETFs and futures tracking the same indices when sophisticated market participants are leveraging the liquidity of ETFs and futures for their arbitrage activities.

4. How are Asia-based investors using indices to help track potential opportunities in U.S. markets?

Jean-Francois: We see through ETFs a number of different usages. Especially last year during the period of increased volatility in the U.S. with the beginning of the COVID-19 pandemic, we saw a number of investors doing tactical trends and sometimes overnight trading, trying to benefit from discrepancies and market movements between Asian hours and U.S. market hours. While we have seen that type of activity happening, we also see the classic buy and hold within the traditional asset allocation framework used by institutional investors in the region. So really, the usage in terms of ETFs tracking the S&P 500 or the DJIA is broad.

Of course, I'm talking about traditional buy-side investors, but there is also an entire crowd of index arbitragers, market makers and liquidity providers that use these ETFs for other purposes. The second part that I think is also important to highlight is we see more and more investors trading during Asian hours. There is a potential time risk by waiting for the U.S. to open, so they make use of the ability to trade ETFs tracking the S&P 500 and the DJIA during Asian hours in order to not be caught by market movements overnight.

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