Russell Research

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Russell 2000® Index Style Futures

Futures contracts based on the Russell 2000 Growth and Value indexes began trading on the IntercontinentalExchange (ICE) on April 22, 2013. These two contracts trade alongside the existing contract for the core Russell 2000 Index, which is one of the most widely traded futures contracts in the world. The new contracts enable managers of U.S. small cap style portfolios to efficiently equitize their cash holdings and tactically hedge or further tilt their growth or value style exposures. The innovative "trade at index close" (TIC) order type and the ICE's flexible block trading capabilities allow traders to increase the effective liquidity of the new style contracts by trading relative to end-of-day cash index prices.

Investment logic

The futures contracts based on the Russell 2000 Growth® and Value® indexes provide new tools for portfolio managers, investors and traders. For small cap style managers, using these contracts is an improvement over using the existing Russell 2000 contract. First, the Russell 2000 Growth and Value indexes are more representative of small cap growth and value style managers' performance than is the Russell 2000 Index. Table 1 reports the annualized tracking error of managers in three Russell U.S. small cap manager universes.[1] Market-oriented small cap managers have the lowest tracking errors to the Russell 2000. Perhaps not surprisingly, small cap growth and value managers have notably higher tracking errors to the core Russell 2000, and are better benchmarked against the corresponding Russell small cap index. Managers' average annualized tracking error is reduced by better than 1% with the use of the appropriate style index.

[1] Based on monthly data for the period June 30, 1996 to March 31, 2013. There are 117 managers assigned to the core small cap universe, 136 to the small cap growth universe and 137 to the small cap value universe. All are managers that as of March 31, 2013 have had eight consecutive quarters of history, or 12 quarters total.

Table 1 / Small cap manager tracking error
June 30, 1996 – March 31, 2013

Manager Universe	Average TE to Russell 2000 Index	Average TE to Russell 2000 Growth Index	Average TE to Russell 2000 Value Index
Core	7.04%	8.82%	8.12%
Growth	9.76%	8.69%	12.77%
Value	8.44%	11.27%	7.38%

Source: Russell Indexes

For managers benchmarked to a style index, equitizing money to the core index is a direct source of tracking error. The ability to equitize with an instrument directly linked to the benchmark is thus of obvious practical value. Table 2 shows that the annualized monthly tracking error between the Russell 2000 and both the Russell 2000 Growth and Value indexes is approximately 7% per year over the period June 30, 1996 to March 31, 2013. All analyses in this paper are based on performance over the period from June 30, 1996 to March 31, 2013.

Table 2 / Annualized Russell 2000 tracking error
June 30, 1996 – March 31, 2013

Tracking Error	Russell 2000 Growth Index	Russell 2000 Value Index
Annualized monthly	6.59%	7.29%
Average 45-day	4.30%	4.38%
Median 45-day	3.40%	3.29%
Maximum 45-day	17.67%	21.99%

Source: Russell Indexes

This tracking error varies over time, much as does equity volatility. The average 45-day tracking error is substantially less, at about 4.3%.[2] The median 45-day tracking error is still lower. However, the annualized maximum 45-day tracking error is in the area of 20%. The data shows that although the typical tracking error between small cap core and style indexes may be, on average, moderate, it can become quite large during volatile market periods.

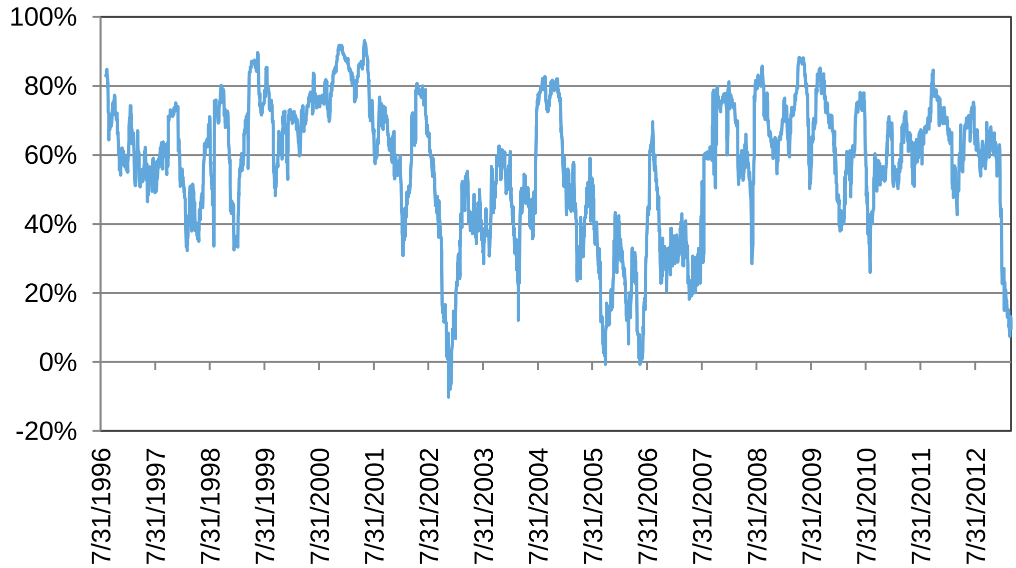
Investors will be able to use these new contracts to implement overlays and small cap style tilts consistent with their beliefs about market direction. This should be of particular benefit to investors with views on the direction of the small cap valuation style spread.[3] The ICE futures contracts based on the Russell 1000 Growth and Value indexes do not serve this purpose well, because the relationship between large cap and small cap valuation premia varies significantly over time. The average correlation between these premia, based on monthly data, is 82%. This falls to 71%, based on daily returns; but more to the point, rolling correlations are much more variable: the average 45-day rolling correlation is 57%. Figure 1 charts rolling 45-day correlations. The pronounced medium- and longer-term trends in the

[2] The 45-day window was the smallest that yielded a distinct pattern.

[3] "Valuation style" refers to the growth/value dimension of style. The spread is the difference between the value and growth returns and is also referred to as the" value premium."

rolling correlations shown in Figure 1 suggest significant scope for strategies that differentiate large cap and small cap style spreads.

Figure 1 / Rolling 45-day correlation between large cap and small cap valuation style spreads, June 30, 1996 – March 31, 2013



Source: Russell Indexes

Implementation

The contract months the ICE listed at the launch of the two new futures contracts were June 2013, September 2013, December 2013 and March 2014. The contracts are available on the ICE platform, and all major vendors are set up to provide access to them. They are also included in the Exchange Member Incentive programs that are in place for existing Russell Indexes contracts. These programs are designed to increase liquidity in the new contracts. The ICE also provides two tools for trading all Russell futures contracts – tools that may be of particular interest for institutional users: block trading and trade at index close (TIC).

Although trading Russell futures contracts on the ICE electronic order book is the most straightforward avenue for gaining benchmark exposure, lower contract volumes and open interest – which are typical in nascent products – could cause managers to consider other instruments despite higher relative tracking error. A manager may wish to consider using the ICE block trading facility to implement larger positions while minimizing both market impact and tracking error.

Block trading

The ICE block trading facility can be an effective way for managers to execute larger trades while minimizing market impact. A block trade is a privately negotiated transaction in which both parties agree on quantity and price ahead of the actual execution. The minimum quantity requirement for a block trade in all Russell futures contracts is 20 contracts. Block trades are reflected in the daily volume and open interest on the exchange, once they are executed.

The potential advantage of using the ICE facility is in the block trades' minimal direct impact on futures market prices. Utilizing the ICE block function allows a manager to trade the listed future while tapping into the underlying liquidity via a market maker or broker/dealer. In a block trade, a dealer who takes on market risk will assess the cost of hedging its potential exposure. Dealers generally hedge via a basket of stocks, ETFs or other solutions. It is important to note that there is no additional charge for executing a Russell block trade on the ICE. Other exchanges often charge additional per-contract fees for block trades.[4]

Trade at index close (TIC)

Trade at index close (TIC) is an innovative order type conceived by Russell and introduced by the ICE that allows a manager to place a bid or an offer for any Russell futures contract during the course of the trading day at a price expressed as a differential to the closing price of the underlying index (in this case, the closing index value of either the Russell 2000 Growth Index or the Russell 2000 Value Index).[5] For Russell contracts, the ICE will accept TIC orders in the first two listed contract months.

A TIC bid or a TIC offer is expressed as a positive or negative differential (or no differential) to the closing value of the underlying index as the reference point. Similarly to other regular orders, TIC bids and offers are matched on a first-in, first-out basis in the order book. Additionally, TIC orders can be agreed upon via a block trade. After a TIC trade is completed, the trade will receive a price equal to the agreed-upon number of index points (.01s) above or below the day's closing price of the respective index. The actual trade price will not be assigned until the closing value of the underlying index is determined and the agreed-upon differential is applied. Determination of the closing value of the underlying index is generally made at around 5:00 p.m. ET.

The TIC order type can help managers limit tracking error to the underlying index value, which may be especially helpful in the equitization of cash positions. A TIC block trade would be the recommended route for managers seeking larger-size trades benchmarked to a specific time of day, such as the close, because it eliminates the basis risk of a divergence in the futures from the index returns (i.e., divergence from fair value) and assures a completed order at the prespecified time. In the first month of trading, more than 5,000 Russell contracts have been traded with the TIC order type on the ICE.

The Russell family of contracts trading on the ICE

With the addition of the Russell 2000 Growth and Value contracts, there are now six Russell equity futures contracts trading on the ICE that cover the traditional style options of large cap and small cap, growth and value. Table 3 shows trading information for all of these contracts, including the ICE trade ticker and the Bloomberg and Reuters codes for trade data and real-time index pricing.[6] These contracts offer managers an unprecedented opportunity to shape the equity style exposure of a futures position. Combined with the fixed income, currency and commodities contracts that trade on the ICE, these contracts offer futures traders new opportunities to execute multi-asset-class strategies on a single trading platform.

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[4] For a detailed discussion of block trading in Russell Indexes futures contracts, please see "Block trading: Unlocking the underlying liquidity for the Russell 1000 Future," by Brandon Abang, *Russell Research Practice Note*, February 2012.

[5] Detailed information about TIC can be found in "Trade at Index Close," by Kelly Haughton and Joseph Smith, Russell Indexes, August 1, 2008, www.theice.com/publicdocs/futures_us/Trade_at_%20Index_Close_808.pdf.

[6] At this time, Reuters does not have a month-to-month spread code for the Russell 2000 Value contract.

Table 3 / Codes for Russell futures contracts trading on the ICE

		Bloomberg			Reuters		
Contract	ICE ticker	Mini contract	Mini TIC order	Real-time price index	Mini contract	Month-to-month spreads	Real-time price index
Russell 1000	RF	RMA	RMTA	RIY	0#RMF:	0#RMF-:	.RYY
Russell 1000 Growth	RG	RGAA	RGTA	RLG	0#IRG:	0#IRG-:	.GGY
Russell 1000 Value	RV	RVBA	RVTA	RLV	0#IRV:	0#IRV-:	.VVY
Russell 2000	TF	RTAA	RTTA	RTY	0#TFS:	0#TFS-:	.TOY
Russell 2000 Growth	G2	RWAA	RWTA	RUO	0#GHH:	0#GHH-:	.GHY
Russell 2000 Value	V2	RXAA	RXTA	RUJ	0#VB:	---	.VBY

The Reuters month-to-month spread code for Russell 2000 Value is unavailable as of this writing.
Source: Russell Indexes

Conclusion

The new ICE Russell 2000 style futures contracts give small cap managers, investors and traders new tools to efficiently manage exposures to the small cap growth and value styles and to the small cap valuation style spread. These exposures are shown here to be more reliably achieved with the use of the new Russell Style Futures contracts than with the existing Russell 2000 contracts. The market-maker incentive programs and block and TIC trading structures provided by the IntercontinentalExchange increase effective contract liquidity and allow traders to more effectively limit basis risk.

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