The Many Uses of Single Stocks

The mark of any great idea is when you look at it after the fact, slap your forehead, and wonder why you never thought of it. Financial engineers frequently are guilty of ignoring this KISS (Keep It Simple, Stupid) principle. Buy low and sell high. Everything else is a footnote.

More to the point: After a little education and some pointing in the right direction, a product has to sell itself. Sponsoring giant cocktail parties at industry gatherings may generate goodwill for an evening – many things do – but will they trade your contracts tomorrow? Think of your life's epiphanies, such as learning how to ride a bicycle or drive a car. Someone helped you get started, but then no further marketing was necessary.

Single stock futures (SSFs) are going to fit into this category. They're new, or are going to be new – look for a launch in March 2002 – and they're a little bit different. Yes, they're joined at the hip to those common stocks we know and love so well, but they still are futures contracts. This professor knows from experience that new futures traders need to adjust to forward delivery, different concepts of margin, different tax and regulatory regimes, different market structures, and so on. But, adjust you will. You'll quickly shed such quaint notions that futures markets predict the future, that futures are riskier than their underlying asset, that evil speculators run the show, and that the real use of SSFs will be for garden variety hedging. By the way, I've been in this business for 20 years, and when I meet a true hedger, I'll let you know.

Futures traders will have fewer adjustments to make than will stock traders. They are equally comfortable going short on markets as they are going long. As a result, they're going to be amazed at the abuses stock traders have endured at the hands of market and regulatory structures that practically demand you say mother-may-I before you can trade the short side of the market. To a futures trader, the stock market is asymmetric and therefore is incomplete. That's going to change, and there's nothing anyone can do to stop it.

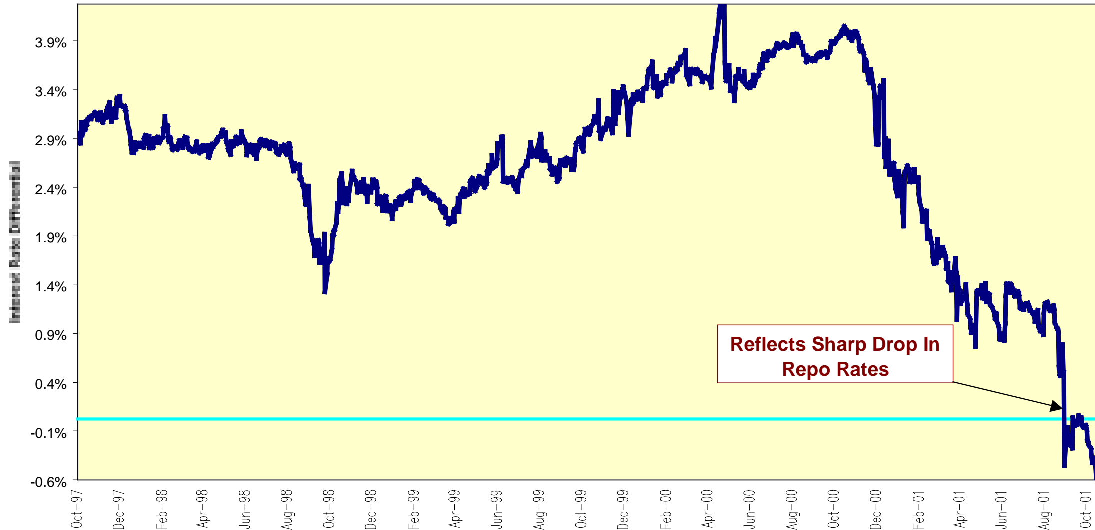
Who Wants To Save Money?

This is a trick question. We'll all say we want to save a few bucks, but then we'll turn right around and pay more just out of habit. Let's look at the present awkward construct for going short. First, you have to borrow the stock. You pay a healthy premium for doing so. The so-called broker loan rate, much like a credit card rate, carries a very healthy premium to other short-term interest rates. Ca-ching!

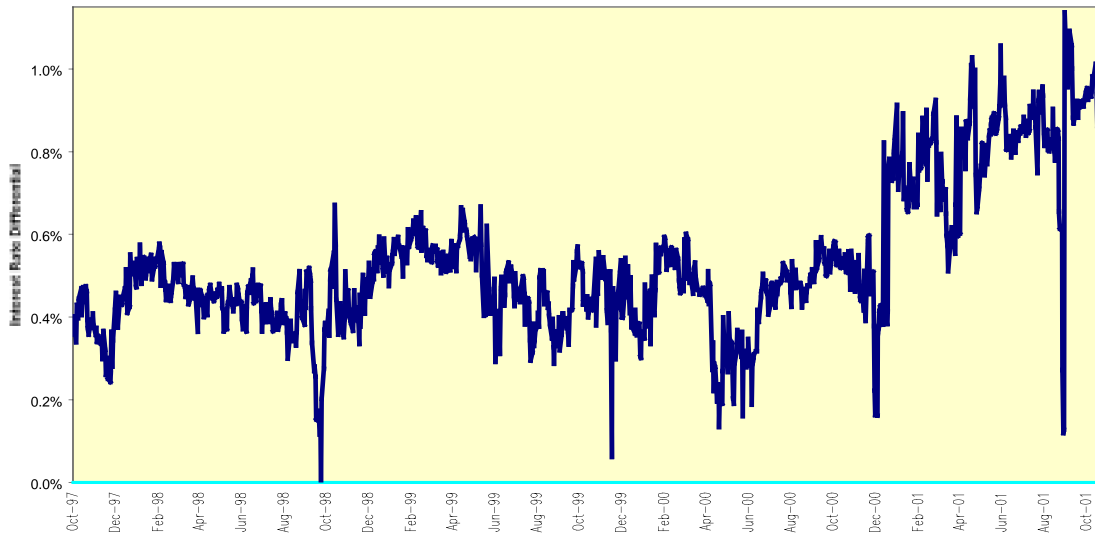
What if no one will lend you the stock or if all the stock available for lending has been lent already? The dreaded short squeeze then arises; prices can surge higher without limit as those who have borrowed the stock and are trying desperately to buy it back find that no one else really cares. Short squeezes are common in new issues with a relatively small number of shares outstanding or in thinly traded issues undergoing enthusiastic promotion by an, ahem, small coterie of committed salespeople.

With SSFs, all you'd have to do is sell a future. The supply of futures, its open interest, can expand indefinitely, and you cannot be squeezed. This obligates you to deliver the stock at expiration, but you can offset this obligation by buying the future back. They'll settle at the same price as the stock on the last trading day. You can roll your short position forward into another delivery month if you wish.

But, and here's the good part, you'll save money while you're having an easier time getting the short position you wanted. How, you ask? In the absence of a special situation related to a short squeeze, and in a topic we'll go into another day, a SSF will trade at a basis over the stock equal to the repo rate minus the future value of the expected dividend. That means you'll earn money at the rate of [repo-dividend] on your short sale. The short seller of a stock will pay the broker loan rate and any dividends due. However, the seller will receive the proceeds of the short sale, and these funds can earn interest. If we net all of these out, we see that a real advantage for selling short via SSFs would have existed over most of recent history. The recent collapse of the repo rate in the aftermath of the Fed's aggressive rate cuts has shifted, temporarily no doubt, the advantage back to the short sale of stock.



We can perform a similar analysis for the SSF's advantage for the buyer. A long SSF position is paying the broker repo rate and receiving the dividend. A stock buyer facing the 50% margin of Regulation T (proposed margins for SSFs are 20% of the value of the underlying stock) will be borrowing at broker loan over this portion; the margin deposit can be in interest-bearing securities.



You Ain't Seen Nothing Yet

Once stock traders get liberated on the short side, a world of possibilities opens up for various trading strategies. Let's look at one you're going to be trading a lot of, the matched-pair spread. A matched-pair simply is two stocks in the same industry. Over time, one tends to acquire competitive advantages over the other, and as a result the spread between them forms a definite trend. A good example of this over the past decade has been the relationship between Coca-Cola and Pepsico, neither of whom has offered your always-thirsty correspondent the endorsement contract he so richly deserves.

Coca-Cola - Pepsico: Can You Spot The Trend?

As Milton Friedman once said, one person and the truth is a majority. One product whose time has come will revolutionize financial markets to the extent that one day it will be inconceivable to you that you didn't think of it first.