Chicago Sun-Times

Turns out Treasuries had a future here

August 22, 2002

BY DAVID ROEDER
BUSINESS REPORTER

Twenty-five years ago today, the Chicago Board of Trade introduced a new kind of investment, futures on U.S. Treasury securities, and savvy investors were puzzled.

Soybean and pork belly contracts--these investors understood. You can touch and store the underlying product. But a Treasury future whose value fluctuates with interest rates?

In 1977, Richard Sandor was the CBOT's chief economist and promoter of new ideas. "I tried to sell the idea of interest-rate futures, and I got thrown out of every major bank and investment bank in New York," said Sandor, now the chairman of Environmental Financial Products LLC.

Sandor said the bankers told him, "Hey kid, interest rates don't fluctuate, and we don't need to hedge." He found their reaction reasonable. "The Board of Trade was a backwater. We were a bunch of grain traders from Chicago. What did we know about financial futures?"

Enough, as it turns out, to invent the whole business, secure Chicago's place in worldwide financial services, and help American consumers all in the same step. Chicago pushed the old commodity-based business into the complex age of derivatives, with global capitals everywhere emulating the trading methods first tried here.

"Derivatives" is still a dirty word, inviting mention of huge corporate collapses tied to bad investments. But CBOT Executive Vice President Bernard Dan said the exchange has made Treasury trading more fair and efficient. Deals made through the CBOT also are guaranteed by an agency with a AAA credit rating.

Sandor said the creation of Treasury futures "helped to significantly internationalize" Chicago. "It's flowered 75 derivatives exchanges around the world, and put the name of Chicago on people's lips, whether you're hedging the South African rand or the Singaporean dollar," he said.

Studies have estimated that Chicago's exchange community supports 100,000 to 150,000 jobs.

For consumers, an active Treasury market lowers borrowing costs. CBOT Chairman Nickolas Neubauer recalled that in the market's infancy, the "spread," the difference between the high and low prices offered on the same contract, was $125 on each $100,000 transaction. Today, the spread is usually about $16. The reduction is a cost the investors, such as banks that issue mortgages, don't have to pay.

Trading in the 30-year bond future began Aug. 22, 1977. By the early 1980s, rapidly rising interest rates and inflation--the prime rate at one point hit 21.5 percent--proved the value of hedging financial risk. Insurance companies, pension funds, corporate money managers and the like were hooked.

Over the years, the CBOT added to its Treasury complex, offering options on the bond contract and futures and options on the shorter end of the yield curve with the 10-year, 5-year and 2-year notes and the

30-day Fed Funds rate. The exchange created lower cost classes for memberships for people who wanted to trade the Treasury contracts exclusively, just drawing a larger pool of market participants.

The Treasury business has come to account for about 65 percent of the CBOT's annual volume. About 1.8 billion futures contracts on the bond and notes have traded, some 846,000 on Wednesday.

The CBOT's success, coupled with the Chicago Mercantile Exchange's launch in 1981 of Eurodollar futures, made Chicago the nation's center for risk capital, an honor equal to New York's status in investment capital and San Francisco's in venture capital.

What's next in futures? Sandor, recognized in these parts as the father of financial futures, said the business will go where wealth is created. In the 21st century, he expects much of that will shift to the information industries, where content is the product and the source of financial risk