The Chicago Mercantile Exchange ("CME"), with a $53 billion market capitalization, is the largest securities exchange in the United States. Over the course of many decades, it has established dominant, near monopolistic market positions in many exchange-traded derivative asset classes, such as interest rates, currencies, agriculture, equity indexes, and metals. Importantly, these futures and options contracts not only trade on the company's Globex platform, but also clear and are settled at the CME clearinghouse. This dual profit center allows CME to operate at one of the highest margins throughout the industry, as evidenced by the most recent annual profit margin of 43% recorded in 2019 (for context, one of the most profitable companies in Corporate America, Microsoft, currently generates an after-tax profit margin of 31%).

With the exception of energy-related derivatives (which are traded and cleared predominantly by ICE), the CME, for all practical purposes, controls the balance of the U.S. futures industry. Acknowledging the historical difficulty competitors have had introducing competing or even new futures products due to the CME's size and market power, investors have generally placed a high valuation on the company, routinely in excess of 25x earnings. Even at the moment, the shares trade at a P/E ratio of 19.5x current year earnings forecasts (although these forecasts can hardly be relied upon amid the present disruption in the capital markets).

Exchanges are one of the few beneficiaries of heightened market volatility – providing, in a way, an element of countercyclicality. Over the course of the last month, the U.S. equity market has lost nearly one third of its value, and the most common measure of volatility, the VIX, reached a record level (surpassing the record attained during the 2008/2009 Credit Crisis). There are certain large industries, such as airlines, that are effectively generating zero revenue at the moment – an astonishing moment in time. Yet, the CME, among other exchanges, is reporting record trading volume – and, by extension, presumably record earnings.

For example, the company recently achieved a record in monthly trading volume for the February 2020 period – a statistic not to be taken lightly considering the over 100-year operational history of the CME. Specifically, volume increased at the following rates (versus February 2019) in these products: Interest Rate +55%, Equity Index +133%, Options +73%, and Metals +73%. In total, the 30.1 million daily contracts traded during February 2020 was an all-time record, surpassing the February 2019 level by 58%. It is not unreasonable to assume that the CME could actually realize historic profits this year, should some degree of the present volatility continue.

Despite this, the CME shares have declined by 25% since the beginning of the year, which is a complete detachment from the actual fundamental operating performance of the company. Even after this substantial loss of market capitalization, the CME is not a cheap company, as determined by most traditional equity valuation measurements. However, there is no reason to believe the CME will not be able to continue its level of market dominance long after the current crisis has passed and trading volumes subside – the company has weathered literally hundreds of crises throughout its history. The balance sheet has roughly $2 billion of net debt and $26 billion in shareholders' equity, easily demonstrating one of the strongest balance sheets of any financial sector company.

Exchanges are an eclectic and often misunderstood group of companies. This is no more evident than at the present time – shares of these companies are down 20%, 30%, 40%, if not more. It must obviously be assumed that no corporation can prosper during a public panic or economic crisis – the exchanges are clearly an extraordinary exception to an otherwise well-intended hypothesis.

Important Disclosures:

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