FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

Dividends as an isolated asset class

30th September 2016

Dividends, as an isolated asset class, and dividend futures have become an increasingly utilised financial instrument as transparency, liquidity and understanding have grown. Whilst the cost of buying near term future dividend streams tend to be similar to realised levels, so little opportunity for growth and therefore gains, over the medium to longer term, disparities can occur where the costs of buying future dividend streams may be at odds with what analysts' predict those dividends will be. i.e. the costs of buying future dividend streams trade at a discount to analysts' forecasts.

The primary driver of this is now relatively well known; that is, banks being left long dividends from the options they write, mark them down in order to shift them on to the savvier investors amongst us. At this point it is worth noting that when banks mark down their future dividend estimates this increases the forward for that underlying (Forward = Spot + Interest – Expected Dividends), making the options they write more expensive. Thus for banks it is a zero sum game.

For investors in dividends though, it provides an opportunity to gain equity like returns, albeit arguably with more defensive features as invariably dividends tend to remain relatively more stable over the short to medium term as corporate board rooms try to maintain or indeed grow dividends, despite probably more volatile earnings and share prices. That said, no company can accommodate macro-economic shocks such as the financial crisis or company specific as with BP and the Gulf of Mexico oil spill.

Opportunities

Currently we believe that the area for greatest opportunity is where future dividends are trading at a significant discount to both analysts' future dividend forecasts and in some cases for longer dated future dividends, even at a discount to prevailing realised dividend levels, is with regards to the Eurostoxx 50. The table below summarises where the dividend futures for the Eurostoxx 50 dividend index points are currently trading and analysts' forecasts out to 2019. Beyond 2019 we have assumed zero growth as analysts' tend not to go beyond three years in their estimates.

	2017	2018	2019	2020	2021
Analysts' Forecasts	124.8	128.49	137.00	137.00	137.00
Futures Price	114.50	110.20	103.10	97.60	89.70
Investment Return	9.00%	16.60%	32.88%	40.37%	52.73%
Annualised Return	7.37%	7.19%	9.26%	8.38%	8.46%

Source Bloomberg, Data as at 29th Sept
Current 2016 dividend futures trading at ~119 index points

Evidently from the table above, dividend futures beyond 2016 are trading at a discount to current realised levels and the further out you go the more discounted the futures become. Indeed, since the end of 2015, the discount has actually increased, as the chart below illustrates. i.e. the term structure has steepened.

Indicative Levels – 6yr	Participation
Topix GBP Supertracker 65% EKIP	180.0%
Topix GBP 85/125 Booster 65% EKIP	200.0%
Topix GBP 100/140 Booster 65% EKIP	315.0%

Rates (bps)	Current	Week Chge
GBP 1yr	48.20	1.60
GBP 3yr	42.10	-0.10
GBP 5yr	46.80	-2.00

Equity Indices (%)		
FTSE 100	6837.06	-1.05%
S&P 500	2151.13	-0.63%
Nikkei 225	16449.84	-1.82%
Eurostoxx 50	2938.31	-3.10%

Currencies (%)		
GBPUSD	1.2955	-0.08%

5yr Credit Spreads (bps)		
Citigroup	88.43	10.03
Credit Suisse	143.20	11.03
Deutsche	248.16	22.87
GS	104.86	9.52
HSBC	76.73	8.18
JPM	68.87	7.60
MS	101.41	9.59

Commodities (%)		
Gold	1325.70	-0.89%
Oil	47.15	6.00%

3m Implied (vol pts)		
FTSE 100	14.29%	0.39%
S&P 500	13.86%	0.41%
Nikkei 225	19.29%	-0.70%
Eurostoxx 50	21.50%	1.62%

5yr Implied (vol pts)		
FTSE 100	19.44%	0.15%
S&P 500	20.94%	-0.20%
Nikkei 225	19.59%	0.05%
Eurostoxx 50	20.08%	0.26%

Source Bloomberg / Partner Banks
Data as at 30th Sep, 10.00am

Upcoming events	
6th Oct	ECB minutes released
7th Oct	UK Trade Balance
7th Oct	US Non-Farm Payrolls

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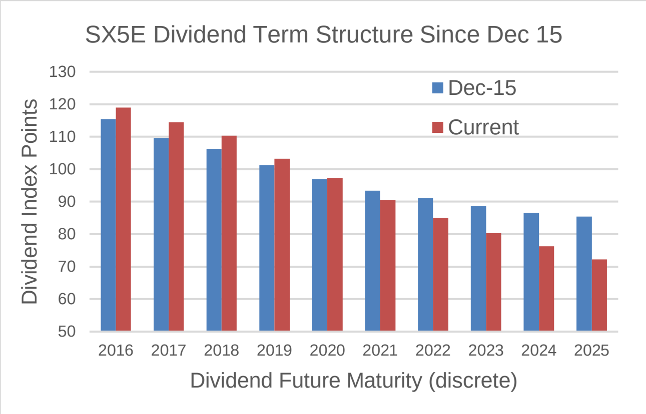

Chart 1
Source Bloomberg, Data as at 29th Sept

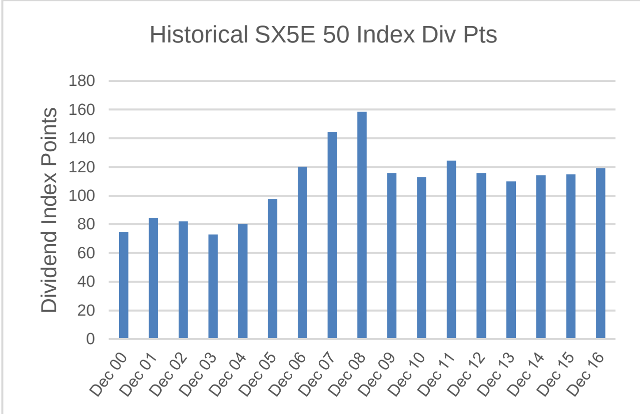

Chart 2
Source Bloomberg, Data as at 29th Sept

Based upon the table outlined above and the dividend term structure, it would seem that greatest opportunities arise from around December 2019 dividend futures onwards. This takes advantage of both the discount to analysts' forecast and indeed the further discounting of the longer dated dividend futures since the end of 2015, whilst it would seem nearer dated futures and investor sentiment seem to have improved.

Looking at 2019 dividend futures specifically, these can be picked up currently at around 103.10 index points, which is well below the current realized levels of around 119 index points for 2016 and represents an entry point last seen in terms of realised levels going back to 2005 (see chart 2 above). Assuming dividends realised a level consistent with analysts' forecasts, you'd realize an annualized return in in excess of 9.20% and assuming no growth from current levels of 116 index points, you'd still realize an annualized return close to 5%, with arguably reasonable downside protection.

For the more adventurous amongst you, you may believe that longer term European major caps will see dividend growth continuing beyond 2019, and would therefore want to take exposure further out along the curve, taking advantage of both growth expectations and the current significant discount.

Previously dividends have only really been accessible as either a direct investment in the future itself, leaving you with EUR|GBP exposure and requiring futures execution and margining, or via quanto tracker securities that track the future but hedge out entirely the EUR|GBP exposure. These are still available on a bespoke basis, however, we have developed new structures with our partner banks that allow you to go long the future, whilst also benefiting from contingent downside protection. The example below illustrates how we can now provide more tailored exposure around dividend futures.

6 Year GBP Supertracker on Eurostoxx 50 2021 Dividend Futures	
Format	EIS Note (CGT)
Maturity	Dec 2021
Underlying	Eurostoxx 50 Index (BB: SX5E <Index> / SX5E 2021 Dividend Future (BB: DEDZ1 <Index>)
Contingent Capital Preservation	Triggered if at maturity only SX5E is below 65% of initial strike. If triggered capital eroded on 1:1 basis from current SX5E levels
Upside participation	100% participation in any appreciation of the 2021 dividend future from current futures levels

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