Friday Night ´Lights

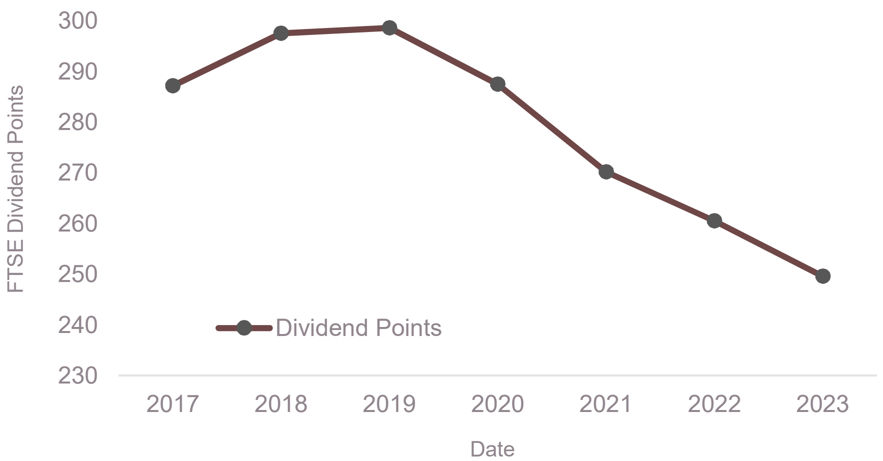
27th October 2017

Dividends - Have we got "Samhain" special for you

Over the last year, we've spoken a great deal about potential opportunities that exist because the constraints under which the banks must operate do not necessarily align with the views of long term investors. Disparities exist in well covered topics such as implied vs realised volatility and less well covered elements, such as the cost of perfect hedges on foreign currency investments and how expensive that is. Dividends are yet another example of these. As an isolated asset class, they have become an increasingly well utilised financial instrument as transparency, liquidity and understanding have grown, and a large futures market now exists. The cost of near term future dividend streams does tend to be similar to realised levels, and as such little divergence exists. However, over the medium to longer term, disparities can and do occur where the costs of buying future dividend streams may be at odds with where historically realised levels have been and where analysts' predict those dividends will mature. i.e. the value of longer dated future dividend streams may trade at a discount to their future values. So why is this?

Well, the primary driver of this is now relatively well known. By selling options on capital return indices, banks are left long dividends. As such, they tend to err on the conservative side of estimates, marking them down, both to reduce risk and also in order to shift them on to the savvier investors amongst us. This has little to do with real world investment views. 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 Rates – Expected Dividends), making the options they write more expensive. Thus for banks it is a zero sum game.

FTSE 100 Futures Curve (Dec '17 - Dec '23)*



Longer dated dividend futures trade at a discount to historical levels & analysts estimates

Markets this week:

Rates (bps)		
	Current	Week Chge
GBP 1yr	68.200	1.80
GBP 3yr	94.300	2.30
GBP 5yr	110.700	2.60

Equity Indices (%)		
FTSE 100	7,504.36	-0.25%
S&P 500	2,560.40	-0.58%
Nikkei 225	22,008.45	2.57%
Eurostoxx 50	3,667.05	1.72%

5yr Credit Spreads (bps)		
Citigroup	49.54	3.93
Credit Suisse	64.19	-0.90
Deutsche	88.37	-1.55
GS	63.27	3.47
HSBC	21.63	-2.82
JPM	45.14	1.97
Soc Gen	35.97	-0.58
Santander UK	46.16	-0.15
MS	56.99	2.22

Commodities & Currencies (%)		
Gold	1293.95	1.35%
Oil (CLA)	51.39	4.26%
GBPUSD	1.3091	-0.75%
GBPEUR	1.1252	0.50%
GBPJPY	149.214	-0.34%

5yr Implied (vol pts)		
FTSE 100	16.64%	0.07%
S&P 500	18.42%	0.04%
Nikkei 225	17.82%	-0.56%
Eurostoxx 50	17.99%	-0.16%

**Source Bloomberg / Partner Banks*
Data as at 27th October 11.00am

We have discussed previously, and will again when the opportunity exists, the potential gains to be made by purchasing those dividends as an isolated asset class. However, there's an opportunity available right now. What if a bank were willing to price their options more in line with the prevailing returns of dividends? This would therefore make the underlying elements of your beloved structures (i.e. the derivatives) inherently cheaper, effectively reinjecting those savings back into your payoff.

There is an anecdote concerning a young child and their mother, preparing a ham for dinner. As the mother cut both ends off the ham, the child asked why. Mum replied that her mother had always done it that way. When the child still insisted on knowing why, a quick call to grandma revealed the reason: "Because the pan was too small." It is human nature to stick to what you know. It is safe, familiar and well-rehearsed. Opportunities however, will always exist for those willing to adapt. In the case of defined return investments, it is more important than ever with lower yields and historically low volatility to think a little more out of the box to ensure you're making the most out of that metaphorical structured ham.

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"See first, think later, then test. But always see first. Otherwise, you will only see what you were expecting. Most Scientists forget that." – Douglas Adams

Please see below for a reminder of historical yields and current futures levels:

Historical Dividend Yields	
2017 (current)	4.22%
2016	3.99%
2015	4.42%
2014	4.65%
2013	3.64%
2012	3.95%
2011	3.93%
2010	3.17%
2009	3.47%
2008	5.38%
2007	3.36%
Mean Average	4.02%

Dividend Futures		
Year	Dividend Points	Yield*
2018	297.50	3.99%
2019	298.60	4.00%
2020	287.50	3.86%
2021	270.20	3.62%
2022	260.50	3.49%
2023	249.60	3.35%

**Yield calculated from FTSE Spot Level of 7,457.50 at 4pm 26/10/2017*

So, what does this do for pricing? Well…

Pricing Comparisons	**Standard Underlying**	**Fixed Div Underlying**
FTSE 100 6yr Stepdown Autocall with 60% EKIP	6.14%	7.15%
FTSE 100 6yr Flat Autocall with 60% EKIP	9.20%	10.80%
FTSE 100 6yr Supertracker with 60% EKIP	258%	310%

As you can see, it certainly makes a difference. Tune in next time or call us for more information on this idea and more, to make sure you're getting most out of that structured pricing!

Disclaimer

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