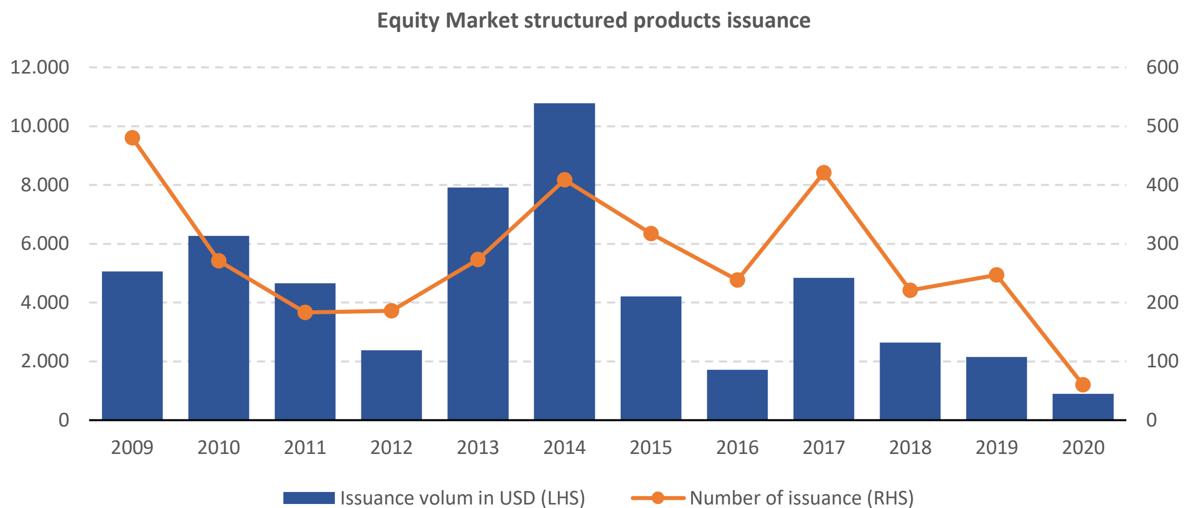
April 30th, 2020

European dividends: Upcoming opportunity?

Precedents

During the bull market from 2002 to 2008, structured notes became very popular within investment banks. Banks offered their clients the chance to participate in the equity market appreciation (we will use the Eurostoxx 50 for this report) while guaranteeing their capital. How were they able to offer such an attractive product? Thanks to high interest rates (at that time they were around 5%), of the €100 that the client invested, the bank spent €10 to buy a 3-year call option that gave the client exposure to increases in the equity market and invested €85 in a zero-coupon bond that would pay in three years the €100 that the client had invested. The other €5 were profit for the bank.

This product was very profitable for banks and brought a lot of income for many years. Then came the 2008 crisis and with it the massive drop in interest rates. Banks were no longer able to offer the same terms, so they started offering the exact opposite product: a note that would provide yield in an environment where nothing did. The client would receive a very high interest (around 8%) as long as the Eurostoxx did not drop below a certain threshold (normally a 30% drop). When that line was crossed, the client would lose as much as the index fell.



It is important to remember that investment banks are prohibited from speculating on the evolution of equities. So, after selling a structured product to a customer, banks neutralize their position to remove the risk from their balance sheet. In the case of the first structured note that we have discussed, the bank was actually selling a call option to its client, so it only had to buy a call option on the Eurostoxx with the same terms in the derivatives market.

However, the note that was being sold from 2008 onwards was more complicated. In this case it is the customer who is selling a put option to the bank, but an exotic put option that is only activated if a certain barrier is crossed. Since there is no liquid market for these types of options, banks actively manage the risk derived from this position, buying and selling Eurostoxx futures.

If the Eurostoxx falls on a given day, the probability that the put option purchased by the bank will be exercised increases, thereby increasing its exposure to index falls. To offset this, the bank must buy Eurostoxx futures, cushioning declines. If, on the other hand, the Eurostoxx raises, the bank must sell futures, slowing the rises. This activity is known as delta hedging.

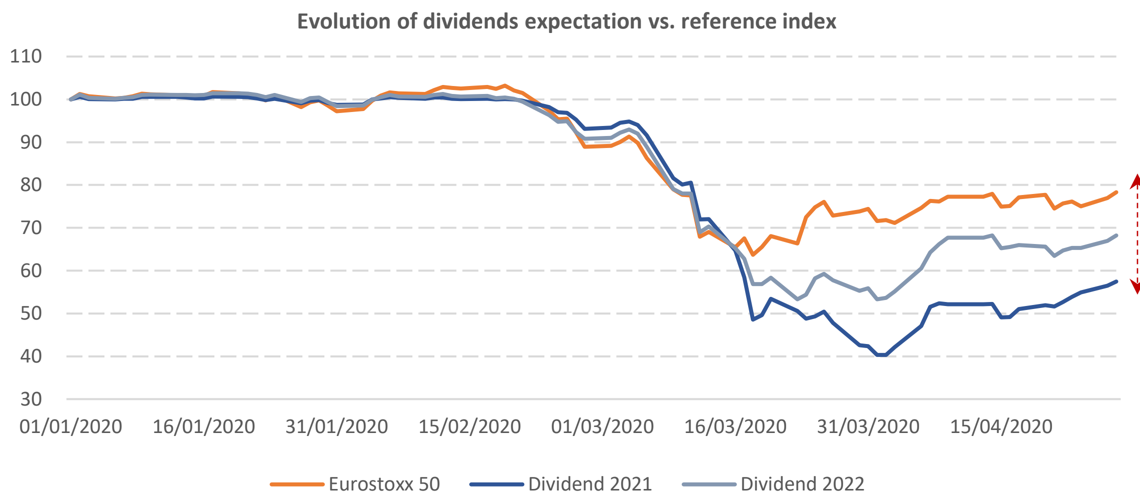
But there is another risk for banks in this product: the dividend risk. If the Eurostoxx dividend goes up, the value of the put the bank has bought goes up because when that larger dividend is paid the value of the index will go down more. But if the index dividend falls, the bank put is worth less and less.

Effects of the Covid-19 crisis

We thus arrived at March 2020. To protect the dividend risk, the banks had sold, based on their delta, dividend futures for the coming years. This market, despite not being very liquid, was able to absorb this selling pressure, and although dividend futures were trading below analyst expectations, the discount was not excessive. But then the market declines from the rapid expansion of the covid-19 began.

The delta of the puts bought by banks shot up. To neutralize their exposure, they bought Eurostoxx futures during declines. And what happened to the dividends? As deltas rose, banks' exposure to dividends rose rapidly. And to neutralize the risk, they decided to sell dividend futures all at once. The result was a stronger fall in dividend futures than that seen in the financial crisis.

These dividend futures are marketed to investors as a lower risk product than equities since dividends are usually very stable, especially for the 50 largest companies in Europe. Well, the Eurostoxx has fallen 30% from its highs, but dividend futures have fallen more than 60%. Even for years when the effects of the covid-19 should already be behind us, the impact has been brutal.



Analysing individually the 50 components of the Eurostoxx and seeing how their dividends behaved in 2008-09, we believe that there is an interesting buying opportunity. In fact, during the worst months of the last crisis, these same dividends suffered falls like those we have seen, and then recovered most of the lost ground in an equally rapid escalation.

Trade risks

This investment has of course many risks, among which the most important we think are:

1. **Market risk**. Even though most of the impact of bank sales as a result of structured notes has already passed, it can lengthen even further in time and take the dividend future price even lower. Some of these structured products were sold with barriers of 40% and 50% - and we have not yet reached those levels of declines.
2. **Political risk**. The 2008 crisis brought with it anger of the working class against the privileged class. Banks continued to pay exorbitant bonuses to their managers after being bailed out with public money, sowing the seeds of populist movements that would come years later. It could be, therefore, that in the coming months we see a pressure increase on companies to limit their dividends in a period when so many people are having a hard time. One way to mitigate this risk would be to buy the dividends of years furthest away in time - 2022 and 2023 for example.
3. **Paradigm shift risk**. Although it is a more diffuse risk, we cannot rule out the possibility that this crisis is much deeper than that of 2008, and the levels of dividends that we have seen in recent years take decades to come back. A crisis like the crash of 1929, for example, had such a large effect on the American economy that it would take almost 20 years to recover. We hope that this is not the case.

To end this report, we believe that the risk/reward that European dividends offer us today seems very attractive. There are very important risks, but after the falls we've seen, we believe that a large part of these risks is already priced in. If those risks were to materialize, we believe that the rest of risk assets have a lot more downside until they price the apocalyptic scenario that European dividends now pose. Finally, knowing that we would be buying these dividends from insensitive forced sellers adds to our margin of safety.

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