Dividend derivatives look to the future

Architects of trusted markets EUREX

Dividend derivatives look to the future

During the first Covid-19 outbreak in 2020, the European dividend futures market had to endure its greatest challenge since its inception – the sweeping cancellation of company dividends. New volatility, triggered by Russia's invasion of Ukraine and prolonged by global inflation fears, continues to roil markets. Yet, it has not posed the same existential challenge to the market. Instead, attractive entry points emerge as market participants look forward to a period of product expansion and structural changes.

As volatility continues to hit markets through 2022, opportunities open up in dividend derivatives. These products have been traded in Europe since the early 2000s. The dividend swap market initially grew from banks' needs to manage their dividend exposure in structured products and the appetite from hedge funds to take on that exposure.

"In 2008, Eurex was the first exchange to list dividend futures", affirms Paul Beck, Executive Director, Equity and Index Derivatives at Eurex. "EURO STOXX 50® Index Dividend Futures were then quickly established as a benchmark for the market. Today, market participants trade a wide range of index and single name dividend derivatives that are listed on various exchanges worldwide."

While 2020 was a shock for all markets, it presented unique challenges for dividend derivatives. The pandemic forced many companies to cancel dividends that had already been announced. This crisis was then amplified by restrictions that the ECB imposed on European banks, which suspended any dividend payments until later in 2021.

This created turmoil in the dividend and structured product markets, putting dividends at the forefront of financial markets. Market participants were now dealing with a serious and previously unconsidered risk.

That moved the market to adapt. During the exceptional market conditions of 2020, Eurex provided market participants with guidance for the treatment of dividends. As the market recovered, trading shifted focus to shorter-term risk horizons.

"The events of 2020 steered more attention to the short end of the curve," says Lorena Dishnica, product manager at Eurex. "Usually, the riskier part of the curve was the mid or long term. However, in 2020, that was the part of the curve which was more affected with drops – from about 120 where the index had usually traded, down to a low of 50."

"That then led us bringing in the shorter maturities, moving more short-term from the annual expires that we had initially. We brought the semi-annuals in for the index and the quarterlies in for the single-name business. That was our response to the markets' need to better hedge and to get a position against the short-term risks."

"The events of 2020 steered more attention to the short end of the curve, which was more affected with drops – from about 120 where the index had usually traded, down to a low of 50.

Lorena Dishnica
Product Manager, Equity & Index Product Design, Eurex

> **During Covid, we were discovering a new world where announced dividends were canceled and companies were receiving external pressure to either cancel or reduce these payments. That is something we haven't seen during the Ukraine conflict.**

Antoine Deix
Head of Dividend and Repo Solutions, BNP Paribas

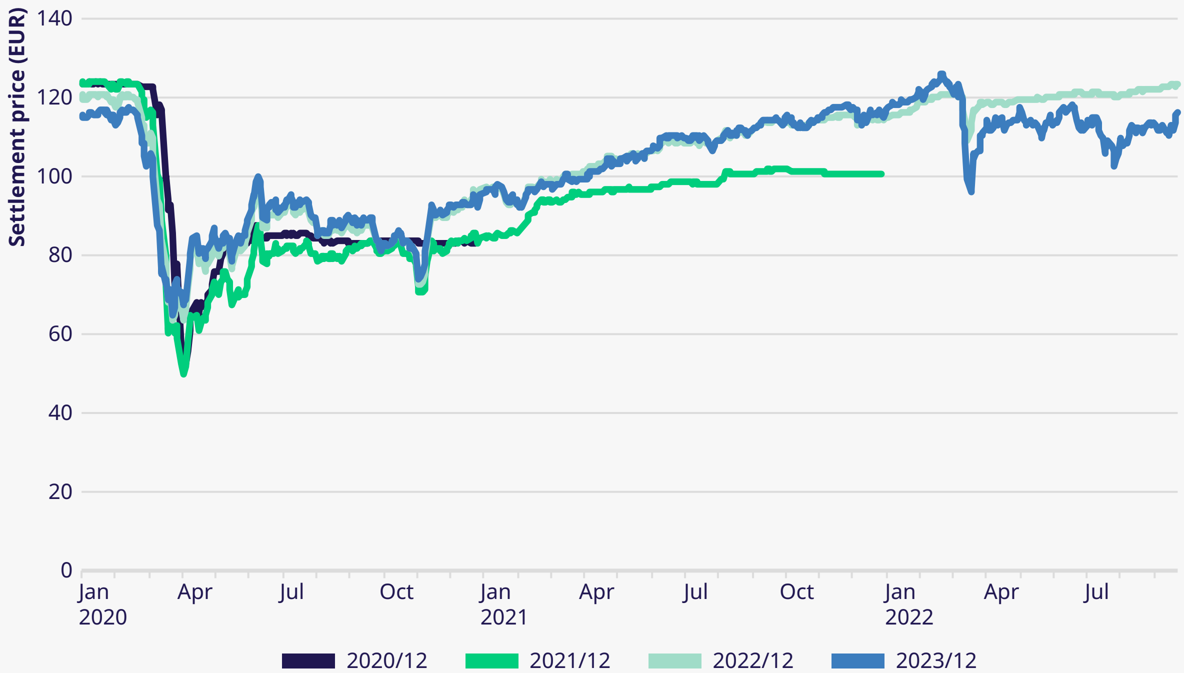
Interest building

Fast forward to 2022, when Russia's invasion of Ukraine became the next major volatility event to hit financial markets. Dividend derivatives were hit along with other asset classes, but the implications for the asset class were much less far-reaching.

"During Covid, we were discovering a new world where announced dividends were canceled and companies were receiving external pressure to either cancel or reduce these payments," says Antoine Deix, head of dividend and repo solutions at BNP Paribas. "That is something we haven't seen during the Ukraine conflict."

While this impact and continued volatility stemming from global inflation and monetary tightening was not as broad, they have still created buying opportunities. Structured products still exert considerable influence on dividend futures, with issuers' selling exacerbated during market drawdowns as they hedge their positions. This has opened entry points for investors with the market knowledge to take advantage of the forced selling of futures.

EURO STOXX 50® Index Dividend Futures – Settlement price development by expiry



❝ It's still essentially a direct play on the earnings, and that's unique in the very nature of this product. It's listed and fairly simple to understand. In a year like this, there are definitely opportunities. We will eventually get to a price level where there are decent returns to make.

Antoine Porcheret
Director, Equity Trading Strategy, Citi

"It's still essentially a direct play on the earnings," says Antoine Porcheret, Director, Equity Trading Strategy at Citi. "And that's unique in the very nature of this product. It's listed and fairly simple to understand. In a year like this, there are definitely opportunities. We will eventually get to a price level where there are decent returns to make."

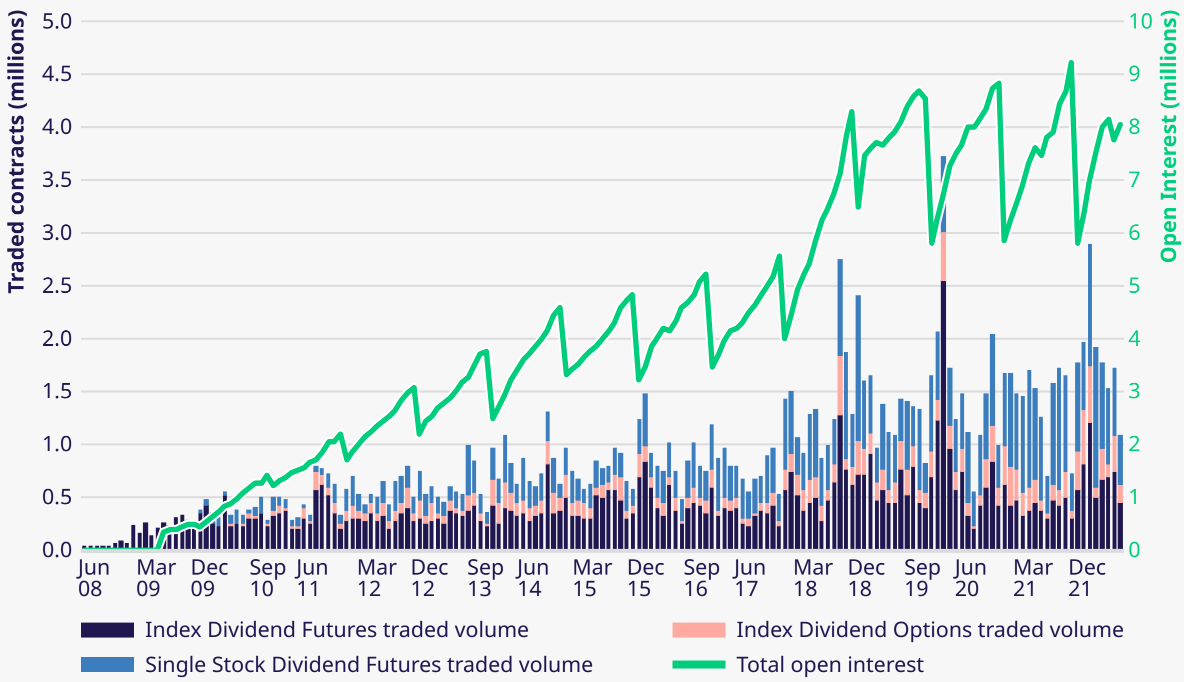
"That's especially so when the direction is one way; you can see the pain points where the issuers supplying dividend risk become forced sellers. This is exactly what you're looking for when you have cash and are looking for opportunities."

This year's volatility has already presented entry points for investors in another part of the Eurex dividend derivatives ecosystem. Traders have already been able to profit in Eurex's EURO STOXX 50® dividend options, which saw flow following the sell-off triggered by the Ukraine invasion.

As dealers moved to hedge pre-invasion call positions, some investors took long dividend positions, including long call spreads, and benefited from the heightened upside volatility.

This kind of opportunity first appeared in the futures market in 2009. Back then, investors had the opportunity to buy a 2010 EURO STOXX 50® dividend future at 50 points in March and settle at 115 a year later. That chance to buy the dip seems unlikely to reappear, though. Since then, more buyers have entered the market and gained the expertise to opportunistically spot attractive buying levels.

Eurex Index and Single Stock Dividend Derivatives



"We are not seeing distortions of that magnitude anymore because the market is more mature, we see less downside sensitivity from structured products and there are more participants ready to step in," says Deix. "But that period shed light on the dividend market, and many investors saw opportunities and value there."

"Over time, we saw a great many investors entering the market. That included fast money and real money – pension funds, asset managers and, of course, hedge funds."

"We saw a democratization of the dividend market, compared to the concentrated market that existed before listing EURO STOXX 50® dividend futures in 2008. Back then, only a few hedge funds were trading against the banks."

"But now we have seen many investors actively looking at the dividend market and trading it. Some investors are also passively looking at it, only entering when there are market weaknesses that they know are opportunities – when there are big market moves because of these hedging needs."

Porcheret says that recent interest has come from private bank clients, who have started to trade exotic products that go long on dividend futures. While this hasn't massively boosted demand, it still represents welcome new liquidity that can absorb risk in the market.

"We saw a democratization of the dividend market, compared to the concentrated market that existed before listing EURO STOXX 50® dividend futures in 2008.

Antoine Deix
Head of Dividend and Repo Solutions, BNP Paribas

The rise of decrement indices

Another consequence of the 2020 turmoil in dividend markets has been the rise of decrement indices. These are causing fundamental changes to the way that European issuers construct structured products like auto callables. This structural shift has implications for the dividend futures market, for which these products are a central supply source. In the long term, this development could change flows and how the market is traded – alongside an increasing diversity of products.

Decrement indices have changed the calculation of structured product creation by reducing issuers' hedging needs. A decrement index is a synthetic total return index that deducts dividend payments from its forward price by fixed amounts. This removes dividend risk for issuers, who can set dividend payments in advance. With dividend exposure cut, so is the need to sell dividend futures to cover issuers' positions.

Cutting hedging costs has obvious benefits for issuers but also for their clients, who get the savings passed on in the form of greater yields or higher protection from their products. While proponents for the indices faced skepticism from banks in the products' early days, the 2020 dividend scare has greatly enhanced their appeal. Since then, adoption has spread across Europe, with interest also developing in Korea and Canada and less developed structured product markets like the U.S. and U.K.

"Decrement indices have been ground-breaking for the structured-products industry," says Armelle Loeb, Managing Director in EMEA Sales at Qontigo. "As often happens with innovation, some issuers and banks were slow adopters at first. But once they felt comfortable with them, the indices truly reinvigorated the market."

"Of all the indices that Qontigo designs for structured products, more than three quarters now have an embedded decrement formula."

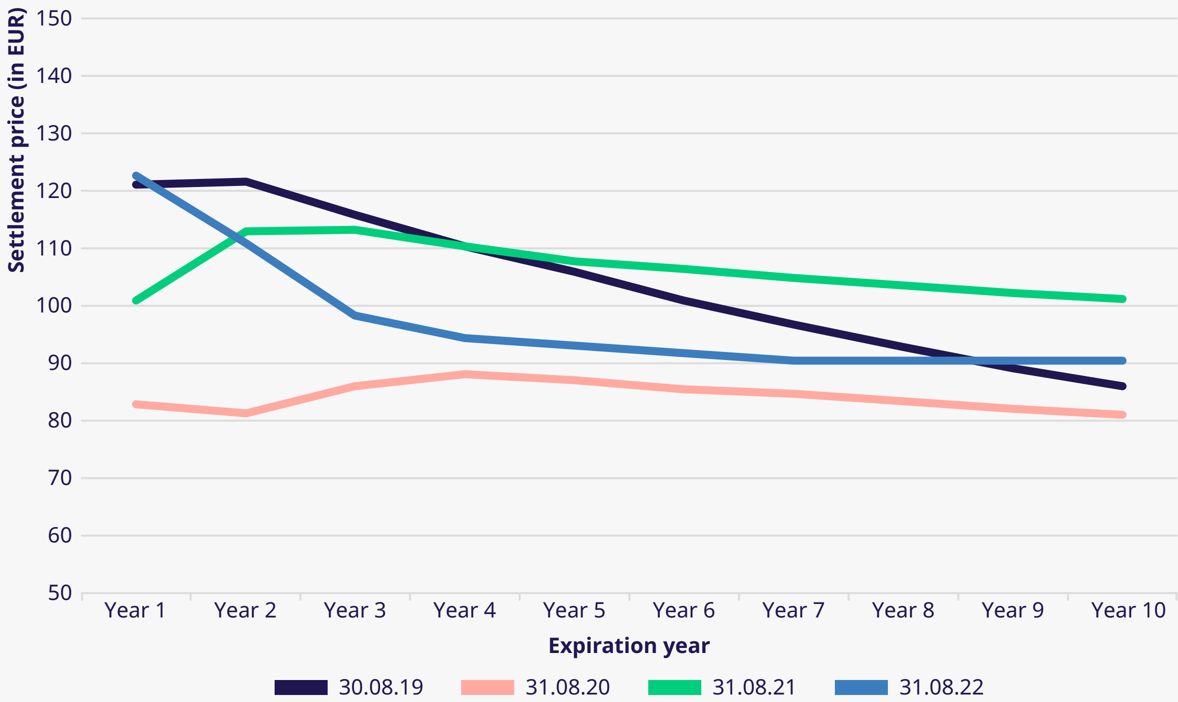
Decrement indices have been ground-breaking for the structured-products industry. As often happens with innovation, some issuers and banks were slow adopters at first. But once they felt comfortable with them, the indices truly reinvigorated the market.

Armelle Loeb-Darcagne
Managing Director, EMEA Sales, Qontigo

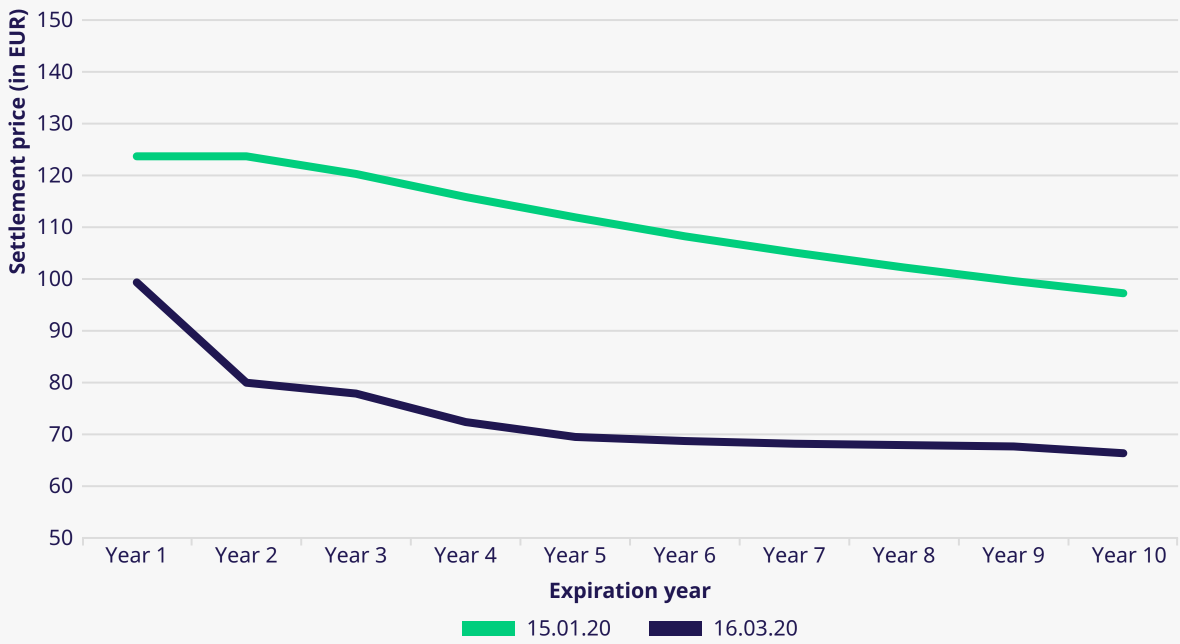
So far, this evolution has largely been an index trading story, contributing partly to lower issuance of products like EURO STOXX 50® auto-callables. Decrement indices are increasingly being used in single-name products. Still, their influence hasn't been as noticeable on volumes in this corner of the market yet.

For the dividend futures market, the rise of decrement indices reduces a structural source of supply from structured product desks. This has even temporarily eased backwardation in the spot dividend curve.

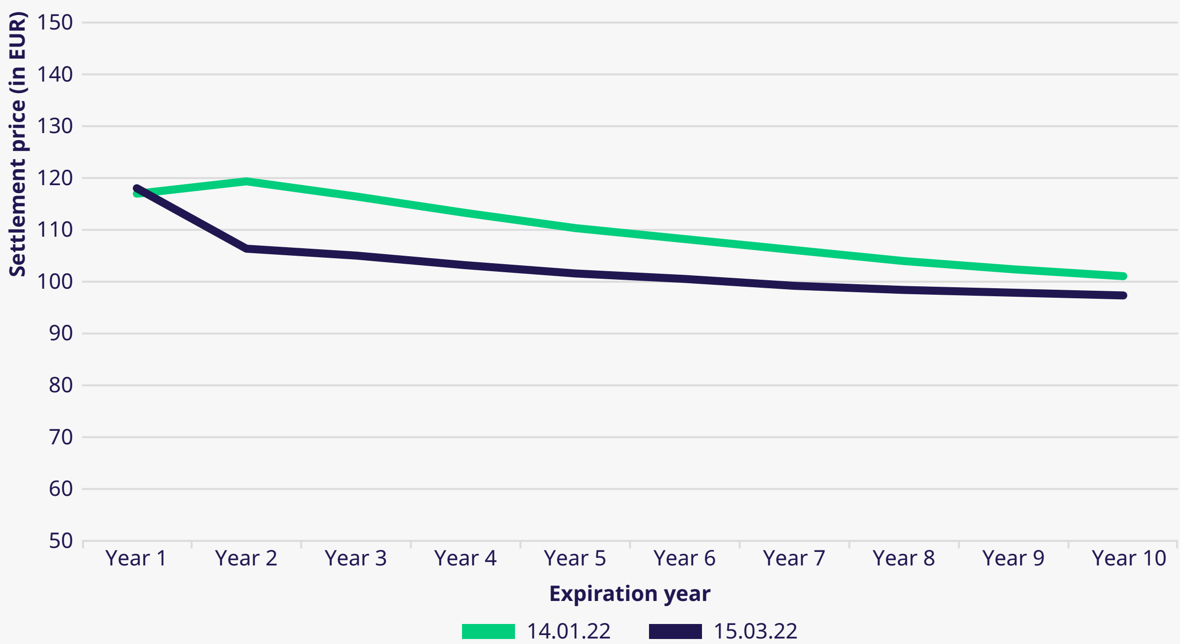
EURO STOXX 50® Index Dividend Futures term structure, last day of August



EURO STOXX 50® Index Dividend Futures term structure, pre-Covid vs after



EURO STOXX 50® Index Dividend Futures term structure, pre-Ucraine vs after



> **“ This change has been happening quite dramatically since last year. The consequences are pretty simple for dealers – this completely removes structured products’ dividend risk.**

Antoine Porcheret
Director, Equity Trading Strategy, Citi

"This change has been happening quite dramatically since last year," says Porcheret. "The consequences are pretty simple for dealers – this completely removes structured products' dividend risk."

"When they trade these products with retail, they no longer have any dividend risk on their book. That means that you naturally have less dividend risk supply from exotic dealers. Not only when they trade but also when the market goes down. You don't have this additional supply. This has supported the dividend curve since 2021."

The market dynamic that Porcheret refers to is forced futures selling. Structured product desks have historically had to sell into dividend future market falls, increasing the weight of market drawdowns.

This is one symptom of the complex interdependency between structured products and the dividend futures market since its creation in 2008. It also points to a future in which decrement indices, while depressing supply short-term, could have long-term positives for the market.

Structured products and their hedging needs have been essential to the growth of European dividend futures, creating a robust supply stream for the market. But as outlined above, their significant presence can distort market movements by accelerating sell-offs. Easing that influence could lead to a market that is less vulnerable to volatility.

"We see the decrement space evolving with structurers looking to incorporate newer features, such as financing costs and rolling futures, reflected in index methodologies.

Aye Soe
Global Head of Core and Multi-Asset Product Management, S&P Dow Jones Indices

"We might see lower downside convexity in the dividend market because of the lowered need from structured product issuers to hedge their dividend exposure when the market is going down," says Deix.

"All else being equal, with decrement indices, the need to sell dividends in a market downturn should be much lower than in the past."

"The dividend futures market should absorb hedging flows more easily in those situations. That could make downside moves less extreme than we were used to seeing in the past."

"That is one of the main takeaways from the rise of decrement indices: it should bring less downside convexity to the dividend futures market."

While the growth of decrement indices has been rapid and impressive, the product still faces challenges. Some market participants find the need to maintain standards that stop issuers and index providers from making decrement calculations too bullish. Decrements calculations should be in line with historical and expected dividend payments and safeguards that ensure this may be needed to protect the industry's credibility.

Should these next steps in the product's evolution be done correctly, decrement indices seem set to grow and diversify as index providers create more fine-tuned offerings for clients.

"Our decrement indices are often used as underlying benchmarks for structured products in several markets in Europe, the U.S., and Asia," says Aye Soe, Global Head of Core and Multi-Asset Product Management at S&P Dow Jones Indices. "In addition to strong demand for our market cap-weighted indices, we see demand in areas such as ESG, climate, thematic, sectors, multi-asset and factor indices."

"We see the decrement space evolving with structurers looking to incorporate newer features, such as financing costs and rolling futures, reflected in index methodologies."

Back to basics?

The challenge for the market now is to build on the buy-side interest described above, attract new sources of liquidity, and encourage their more lasting presence in dividend derivatives. As Porcheret says, the investment proposition for the market can be very straightforward.

These are products that reward good company research. The right cash flow, revenue, and net profit analysis, as well as good dialogue with companies, can produce accurate dividend estimates. This can open up investment opportunities that cut out a lot of market noise by focusing on dividend payoffs alone.

If the rise of decrement indices reduces the aggression of future sell-offs, the market could be driven towards being settled by fundamentals rather than by technicals. That could create more two-way flow and highlight investment opportunities beyond buying the dip.

This could include the product's use as a portfolio hedge in a macroeconomic environment of high inflation.

"Dividends have a lower beta than stocks and tend to rise with inflation," says Beck.

"Many companies prefer to keep a stable dividend policy and are reluctant to cut dividends, even in a bad year. But that's not always reflected in the dividend futures market, because structured product issuers need to hedge their dividend exposure, especially during market downturns."

"However, as the dividend market is structurally changing with the rise of decrement indices and likely less forced selling by structured product issuers, there should be less volatility in the dividend futures market going forward. This should result in a higher Sharpe ratio, making dividend derivatives a more attractive proposal for traditional buy-side clients."

> **"As the dividend market is structurally changing with the rise of decrement indices and likely less forced selling by structured product issuers, there should be less volatility in the dividend futures market going forward. This should result in a higher Sharpe ratio, making dividend derivatives a more attractive proposal for traditional buy-side clients.**

Paul Beck
Executive Director, Equity and Index Derivatives, Eurex

Options expand

Another attraction for prospective investors is the expanding number of instruments on offer in Eurex's dividend derivatives ecosystem.

Eurex has recently added to the tools that investors can use to capture dividend exposures, launching EURO STOXX 50® Banks Index Dividend Options in June. Liquidity providers are actively making markets for the product, and momentum has been building, with 6,000 lots traded since inception.

This adds to already attractive liquidity in futures, with about 15–20% of EURO STOXX 50® Banks Dividend futures liquidity showing on-screen.

Now, with rising interest rates reversing a decade of life in negative territory for European banks, the new bank options are opening more sophisticated exposures to this sector of the market. Banks recently enjoyed their best quarter for net interest income in years. Furthermore, 2022 has been the first time in 15 years that banks have executed new business at a wider spread than assets already on their balance sheets.

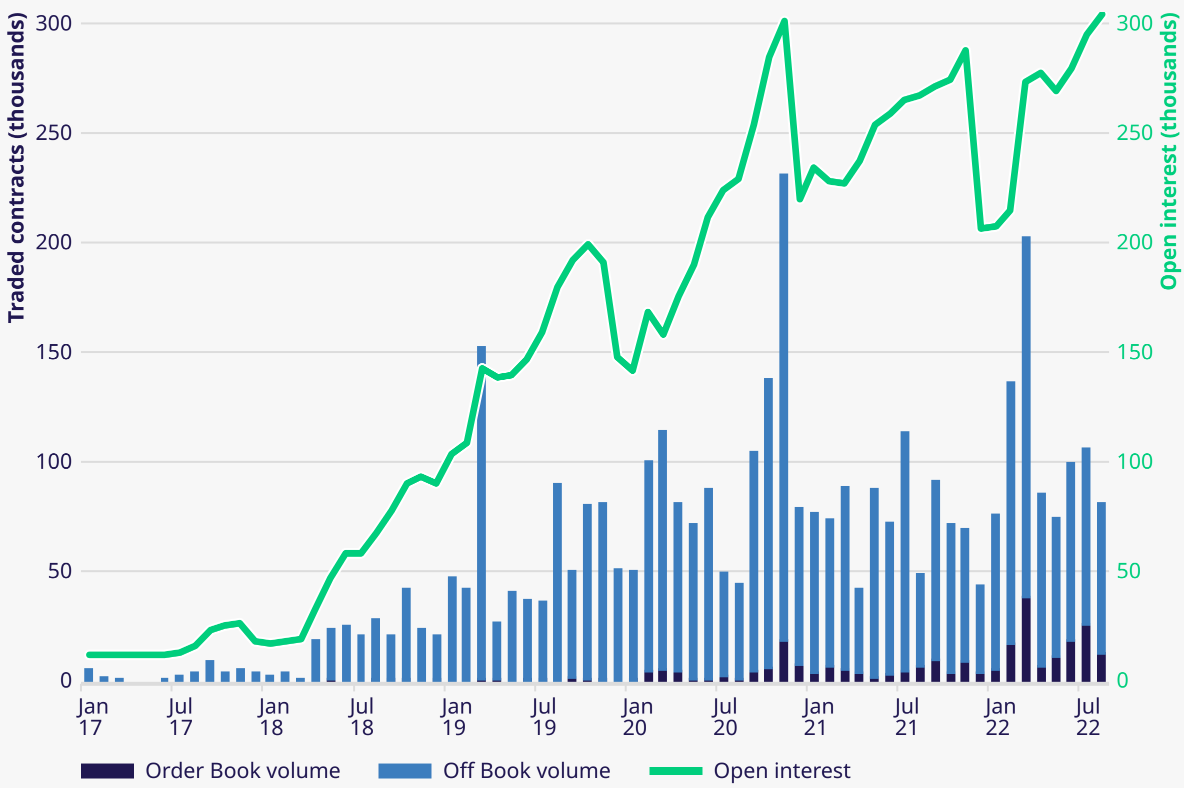
Even if the economic slowdown continues, hitting bank volumes and cost of equity, lenders should be buffered by improved net interest margin. Another buffer to protect dividends is the option to cancel share buyback programs.

There is still a great deal of uncertainty in the outlook for the sector and the economy in general. This makes developments such as the finetuning of futures and expansion of the options suite all the better timed. Investors will need to position as accurately as possible, in as mature a market as possible, for any potential surprises in the future.

“It is really interesting when you start to have the full scope of products available on an underlying, as it truly means that it has become a real asset class,” says Deix.

“You don’t just have futures; you also have options. So, you are able to hedge, overwrite and really take exposure on the volatility and the underlying.”

EURO STOXX® Banks Dividend Futures – Volume and open interest



Interviewees

Antoine Deix

Antoine Deix is currently Head of Dividend & Repo Solutions for BNP Paribas. Over his career, he has developed unique expertise in global repo and dividend derivatives. Antoine joined BNP Paribas in 2003, and before joining the Sales team as a product specialist, he was Senior Equity & Derivatives Strategist for Global Markets based in Paris. Having been based in New York from 2004 until 2009, Antoine first headed the Dividends and Indices Analysis team before taking up responsibility for fundamental research within the Forward Trading team.

Armelle Loeb-Darcagne

Armelle Loeb-Darcagne is Head of Index European Sales at Qontigo, in charge of promoting and distributing innovative STOXX and DAX index solutions to the entire range of institutional clients. Armelle has more than 20 years of experience in investment banking and asset management. Prior to joining STOXX Ltd. in 2015, she held different senior positions in the ETF industry with iShares, as Head of Swiss Sales and then HSBC and Credit Suisse ETF as Head of Sales. Armelle started at Lehman Brothers before joining Deutsche Bank in Fixed Income Sales and Trading. She then joined Morgan Stanley Capital International, which became MSCI, where she was responsible for the French-speaking market.

Antoine Porcheret

Antoine Porcheret is a Senior Equity Trading Strategist at Citi. His role is to lever fundamental content and derivative parameter dislocations to express trade ideas and cross-asset views at index, sector, and single stock levels. He designs investment solutions for directional, arbitrage and hedging purposes. Before joining Citi, Antoine spent four years at BNP Paribas in a similar role. He started his career in 2006 at HSBC, where he held a number of roles in equity derivative trading, including Europe flow trader, head of CCEEMEA equity derivative trading, and co-head of single stocks exotic trading.

Aye M. Soe

Aye M. Soe is Managing Director, Global Head of Core and Multi-Asset Product Management at S&P Dow Jones Indices (S&P DJI). Aye heads up the Product Management Group, which has global responsibility for the commercial success of S&P DJI's product lines: U.S. Equity, Global Equity, Fixed Income, Commodities, Real Assets, Multi-Asset, and Custom Indices, as well as Data. Prior to this role, Aye headed up the Americas research team. The group is responsible for conceptualization, research, and design of core and quantitative equity, fixed income, commodities, volatility (VIX® futures based), multi-asset, environmental, social, and governance (ESG), and alternative asset strategy indices. She also regularly publishes in a number of headline S&P DJI publications and research papers related to capital markets and investment concepts.

Eurex Contacts

EUREX SALES
Paul Beck
T +352-2 43-3 61 42
paul.beck@eurex.com

EQUITY & INDEX PRODUCT DESIGN

Stuart Heath
T +44-20-78 62-72 53
stuart.heath@eurex.com

Lorena Dishnica
T +44-20-78 62-72 42
lorena.dishnica@eurex.com

Published by
Eurex Frankfurt AG
Mergenthalerallee 61
65760 Eschborn
Germany

www.eurex.com

ARBN Number
Eurex Frankfurt AG ARBN 100 999 764

Find out more online at
www.eurex.com/div