

EUREX

The future of equity derivatives Perspectives for UK equities and dividends

Managing equity and dividend risk today requires new trading strategies and products. In a webinar convened by *Risk.net* and hosted by *Eurex*, three experts discuss what's next for the UK and European markets

It has been a bumpy ride for European equity markets this year, with prices and dividends buffeted by macro events such as the Covid-19 pandemic and Brexit, as well as more market-based events such as the uncleared margin rules (UMR) and the collapse of Archegos Capital. These events continue to influence trading strategies and the use of structured products, as well as changing the types of actor in the market.

To manage risk in this new world, firms are increasingly turning to markets, such as decrement indexes, or newer products such as total return futures (TRFs). In a webinar hosted by *Risk.net* and *Eurex*, experts from FTSE Russell, Natixis and *Eurex* discussed the emerging equity derivatives landscape in the UK and Europe post-Covid-19 recovery, and looked at how trading behaviour and products might develop.

In an audience poll conducted at the start of the proceedings, the majority of respondents said they expect UK dividends to return to pre-Covid-19 levels by the end of 2022. Arie Boleslawski, deputy head of global markets at Natixis, noted that the Euro Stoxx futures curve showed a similar pattern, with dividends seen rising throughout 2022 and into 2023 before decreasing.

He also noted that the Covid-19-related turmoil in dividends markets this year – which resulted in many firms not paying dividends – had little macroeconomic impact, but has had huge repercussions on how equity derivatives products are structured. “[It] triggered a lot of changes in the way banks try to protect themselves against dividend moves – in particular, in promoting indexes with reinvested dividends,” he said.

It also changed the flows of structured products, the shape of the market and the actors involved. “There used to be a lot of alternative funds paying dividends – especially in risk premia strategies,” Boleslawski said. “This has been massively hurt now with some defaults in the last year, so the market might potentially be less liquid of these instruments ... and it will take time before it becomes as liquid as it used to be, especially on the long-term part of the term structure.”

However, Boleslawski and Alexandros Severis, smart beta and smart sustainability product manager at FTSE Russell, were optimistic on the outlook for UK dividends.

Severis commented that, in 2020, dividends in payments from FTSE 100 companies dropped by almost 50% compared with 2019. This was largely due to banks and energy firms – which make up a large part of the FTSE 100 relative to other European and US indexes – coming under regulatory and governmental pressure to stop or decrease dividend payments.

THE PANEL

Stuart Heath, Director, Equity and Index Product Design, *Eurex*

Alexandros Severis, Smart Beta and Smart Sustainability Product Manager, FTSE Russell

Arie Boleslawski, Deputy Head of Global Markets, Natixis

Moderator: Stella Farrington, Head of Content, *Energy Risk*

“The Covid-19 pandemic actually hit [dividend paying stocks in] the FTSE 100 Index particularly hard as it has exposure to cyclical value stocks and is lightweight on tech sector exposure,” Severis said. “Things picked up towards the end of 2020 into early 2021 when the vaccine roll-out kicked in, the economy began to recover and value stocks saw strong growth. Although there are fears of an interest rate rise and creeping inflationary pressures, the UK has fared well in terms of recovery, and now looks attractive in terms of dividends,” he said, noting UK equities dividend yield is around 3.5% compared with 2.5% in the eurozone and emerging markets.

Severis believes the decision of the UK Prudential Regulatory Authority to ban banks from paying dividends in 2021 “helped these banks fortify themselves and really improved their capital positions”.

While the UK has seen a lot of inflationary pressure recently, GDP growth in real terms is set to be around 7% in 2021 and 6% in 2022, Severis said. “Even though the FTSE 100 may not have performed as well as other regional indexes, what we are seeing is that earnings are actually quite strong and better than expected.”

This may not yet be reflected in prices and could mean there is some rallying to do within the FTSE 100, he added, but cautioned that a major determining factor would be what central banks decide to do with interest rates in the coming months.

Unsurprisingly, there has been an increased interest in hedging dividends using instruments such as dividend futures, said Stuart Heath, director of equity and index product design at *Eurex*. But, while last year saw increased interest in index dividend products, this year, he said, the focus is on single names. As a result, *Eurex* has launched quarterly dividend products on single names to help firms hedge dividend uncertainty around the timing of payouts.¹ “We’ve seen two million of those trades in the past 12 months,” he said.

Regulation and margining

The general shift from over-the-counter (OTC) trading to centrally cleared markets is creating growth in listed markets and is also reflected in business at FTSE Russell, said Severis.

Global volumes in futures and options based on FTSE Russell indexes increased by 16% in 2020 and continues to rise, he said. He hopes UMR will create more structure and transparency within the market.

Boleslawski noted that, as UMR are rolled out to larger numbers of firms, they may have a greater impact than the early roll-out to larger banks that could more easily finance collateral arrangements.

"Now [the rules] are extended to market participants with less access to cash – that could create some issues," he said, noting that the margin needing to be paid under UMR is usually much higher than the amount banks used to ask for and sometimes higher than exchange levels.

"That will, I believe, reduce the leverage of alternative funds and hedge funds, potentially impacting performance," Boleslawski said. Additionally, he noted that the collapse of Archegos and Greensill may cause banks to increase the amount of margin they ask for, even from firms not required to post under UMR.

As regulation pushes more firms towards cleared markets, Eurex is being proactive by creating products on exchange that replicate the function of existing OTC products, Heath said.

An important example of this is TRFs, which are designed to look like an OTC swap but have the benefit of counterparty risk mitigation through clearing with very robust margining and collateral rules. For example, under Eurex's FTSE 100 TRF, the buyer gets the total return on the FTSE 100 index. That includes the price return of the index itself, plus any dividend distributions. In effect, the buyer pays the seller the financing charge, which will be based on an underlying benchmark rate plus a spread. "The key is you trade this product in terms of the spread in basis points over the financing rate. That, in effect, links directly into the implied repo rate," said Heath.

Trends

The UK market is likely to be affected by some huge trends taking hold now that could impact the composition of the FTSE 100, said Severis. The energy industry has already dropped to being only 10% of the market from 20% a decade ago. The UK has traditionally been low on tech stock relative to the US – which has giants such as Amazon, Facebook and Google – but that is slowly changing, he said. In recent years, big brand names such as Darktrace and Deliveroo have listed on the London Stock Exchange. The UK's strong stance on environmental, social and governance (ESG) issues is also likely to have an impact, promoting investment in the UK clean tech sector, he said.

"I would go as far as saying that ESG has already played a key role in the transformation of the UK equity market as firms try to manage risk and [face] pressure from pension funds [that will avoid investing in firms not] conforming to net-zero goals," Severis said.

In general, there is a change in the "dividend kings" of the market, with dividends from healthcare stocks rising sharply, for example, he said. Dividend concentration has changed too. Around five years ago, the top five dividend payers provided about 40% of total dividend paid within the FTSE 100. Today this has dropped to 35% and the trajectory is pointing downwards.

A major trend Boleslawski expects is an increasing discrepancy between the UK and the rest of Europe as the economies and actors diverge.



Stuart Heath, Eurex

Product development

All of these influences are impacting the products that banks and exchanges are developing. In recent years, low interest rates have pushed clients to seek yield from so-called non-decrease or coupon products, said Boleslawski. As a result, banks developed products that helped them offload the most toxic risks, such as volatility and dividend risk, by promoting indexes with reinvested dividends. As banks were obliged to keep certain risks, in particular the repo risk, products such as long-term total return swaps or TRFs were developed to hedge the repo risks.

"The future I see is certainly a product range that is biased towards, essentially, execution risk – typically with more control mechanisms where there is no volatility risk," Boleslawski said, adding that he also sees a large focus on ESG indexes.

In terms of product evolution, Heath believes the TRF is an important addition to the toolkit of hedging products, especially for hedging repo risk, but also dividend risk. The product, first launched on Eurex five years ago, has around €80 billion of open interest. The various tenors of the product go out for 10 years, matching structured products markets which are generally longer dated.

"Interestingly, there's a term structure on TRFs that participants can play, which helps recycle the risk, noted Heath. "For example, they might be going short one maturity and long another, taking the spread out. So it's even starting to be thought of almost as an asset class in its own right." However, its primary supply is the implied repo hedging from structured products desks, he added.

Decrement indexes

Severis said decrement indexes are popular with large bank issuers and structured products desks as they allow for lower replication costs, enabling issuers to offer competitive terms to their clients.

Historically, structured products have been based on price returns and the underlying assets. "If the asset goes up, you'd get that return, but dividends payments would go to the issuer," he said. Now, in tough market conditions such as those of last year, banks were forced to buy more shares of the underlying constituent or index to hedge their liabilities from their structured products. "So, decrement indexes actually eliminate this dividend risk and it really helps the structured products desks provide more favourable terms."

This year there has been "huge interest" in single-stock decrements, Severis said, noting that FTSE Russell recently launched the first single-stock decrement indexes with Credit Suisse. Another trend he noted on decrement indexes is the demand for ESG or sustainable development goals indexes, as well as certain thematic indexes.

Heath agreed that decrement indexes make sense for structured products issuers, but noted that dividend risk is still in the system, albeit held by a different party. However, people are increasingly using TRFs as a non-dividend risk product, not just for hedging repos. There's a growing trend to just be either long or short TRFs, he said. "So, effectively having a total return exposure to the index and the reinvestment of dividends is a theme in the structured products market as well."

Heath said he expects growth in total return products. "We know there is demand for this sort of hedging out there because there are structural positions in synthetics and in longer-dated options, and [we also know] they don't eliminate the repo risk. I think we'll see a broadening of the product mix to include TRFs alongside regular futures and dividend futures," he said.

¹ *Eurex (2021)*, Undividend attention: dividend derivatives, www.bit.ly/316hYLU

>> Watch the full webinar, *The future of equity derivatives and perspectives for UK equities and dividends*, at www.risk.net/7898436

The panellists were speaking in a personal capacity. The views expressed by the panel do not necessarily reflect or represent the views of their respective institutions.