

# Mind Matters

## Asset fire sales, depression and dividends

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As regular readers will know I have been trying to construct a portfolio around three basic ideas. Firstly, cash (as a deflation hedge), secondly deep value opportunities (in both fixed income and equity markets), and finally sources of cheap insurance (such as TIPS and gold). A new opportunity has arisen: dividend swaps. In Europe, the UK and Japan these appear to be priced for an environment worse than the great depression! Dividend swap prices imply a decline of over 60% peak to trough in dividends and then no recovery at all! They may also act as an inflation hedge. As a neophyte to this market, I fear I may be missing something, but it sure looks like an asset fire sale to me.

■ A client recently suggested that I looked at dividend swaps from a deep value perspective. As I have often remarked, in the words of Winnie the Pooh, "I am a bear of little brain and long words bother me", so it was with some trepidation that I embarked on some research into these assets.

■ However, I was pleasantly surprised. Dividend swaps are relatively easy to understand (at least they appear to be – but I may have missed something!). Effectively this market allows investors to trade dividends separately from equities. As such they can also provide us with an insight into the market's view of the future path of dividends.

■ The picture they paint isn't a pretty one. On current pricing, dividends are expected to decline peak to trough by over 60% in the UK, Europe and Japan. To put this in context, during the great depression, US dividends fell 55% peak to trough.

■ Not only are dividends expected to collapse (not beyond the realms of possibility) but this market pricing implies they will remain depressed pretty much forever. For instance, following an implied 66% decline in European dividends over the next three years, the market then expects them to grow by a mere 2% p.a. for the subsequent four years! This looks excessively pessimistic to me.

■ In addition, dividend swaps may be of use as a cheap source of inflation insurance. As I have regularly stated I am seriously torn in the deflation/inflation debate. But if the Fed wins out and manages to reintroduce inflation, then earnings and dividends are likely to pick up (as a nominal series).

■ All of which begs the question of why dividend swaps are priced as they are? The only reason I can think of is that a combination of forced selling and oversupply has driven prices to excessively low levels. Whenever one sees forced selling or a supply-demand imbalance, the potential for a deep value position is created. I am at my happiest when I am buying from people who are selling regardless of value!

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## Asset fire sales, dividends and depression

As regular readers will know, for most of last year, we were happy to sit on cash (or be short). However, towards the end of last year the market began to offer us some opportunities in two arenas. Firstly, deep value opportunities split between debt and equity. Our view was that each time the market presented deeply discounted value opportunities we would deploy cash into them, building up positions slowly.

Of course, if we had perfect foresight we would only buy at the bottom. Sadly we don't possess such a useful skill, so we are forced to deal with our limitations by adopting a slow but steady deployment of cash in the face of Mr. Market's depressive phases. This remains our aim.

The second element of our strategy involved searching for assets that offer a cheap insurance policy to cover our ignorance. In particular, I have confessed to being torn in the debate over whether we are likely to experience deflation or inflation next. Thus I have attempted to seek out assets which offer potential returns in either scenario.

At the top of the list was US TIPS, with a sizeable real yield if the Fed wins the deflation battle, but a principal floor if it doesn't. Then came gold, of which I have always been slightly leery as I have always been confused over a clear way of valuing it. However, in a world in which competitive devaluation and inflation are a risk, it made (and still makes) sense to me to hold gold as the one currency that cannot be devalued. Alternatively, if the world does go into deflation on a global scale, a financial Armageddon will ensue – so having a hard real asset could be a winner in this scenario as well.

### Dividend swaps: priced for worse than depression!

A client recently suggested that I look at a third asset group that potentially fits both the deep value opportunity and the cheap insurance policy baskets – namely dividend swaps. Now as I have said on many occasions my favourite (and potentially most apposite) quotation comes from Winnie the Pooh, "I am a bear of little brain and long words bother me". So it was with some trepidation that I began to explore the wonderful world of dividend swaps.

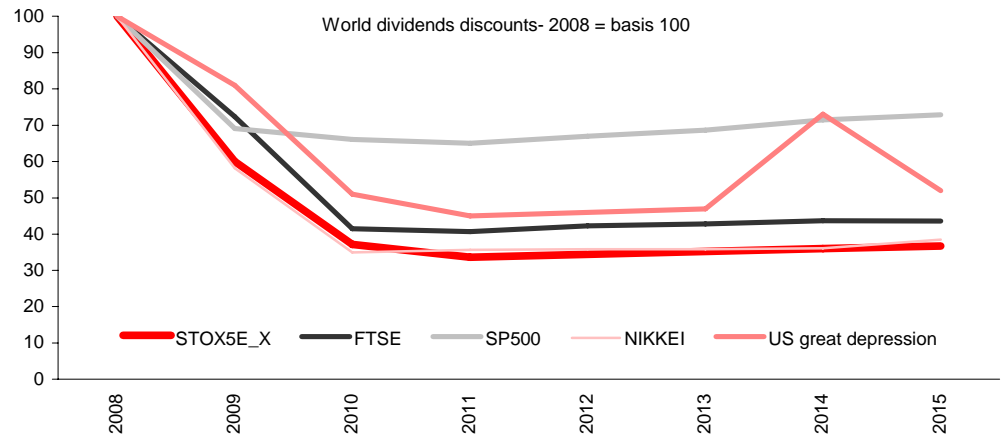
For those of you who understand these instruments, forgive me for teaching grandmothers to suck eggs. For those of you who don't. Here is a five-line primer. Investment banks and the like end up being long dividends as a direct result of the structured products they create. Effectively, when you see products such as capital guaranteed bonds which offer exposure to the upside of equity markets, they are written in terms of capital gains, which results in the issuers being long the dividends. Institutions have taken to swapping these dividends in the same way as a plain vanilla rate swap.

This market allows investors to trade dividends independently of the market. This gives us the opportunity to explore the market's implied future dividend path. For markets outside the US it isn't a pretty picture. As the charts below show, the Stoxx50, the FTSE100 and the Nikkei are all pricing in an environment worse than that experienced by the US in the great depression.

For instance, European dividends are priced to decline by 40% in 2009, 38% in 2010 and a further 10% in 2011 – representing a total decline of 66% from peak to trough compared to a 55% decline in US dividends during the Great Depression!

Roughly speaking, the 2011 swap is pricing in a situation where only telecoms and utilities pay the same level of dividend they do today, while oil and gas stocks pay only 50% of their current dividend! All of this makes it look to us as if dividend swaps are another of those assets that are pricing in revulsion (i.e. for depression) – much like corporate bond spreads.

**Dividend levels and implieds (2008=100)**

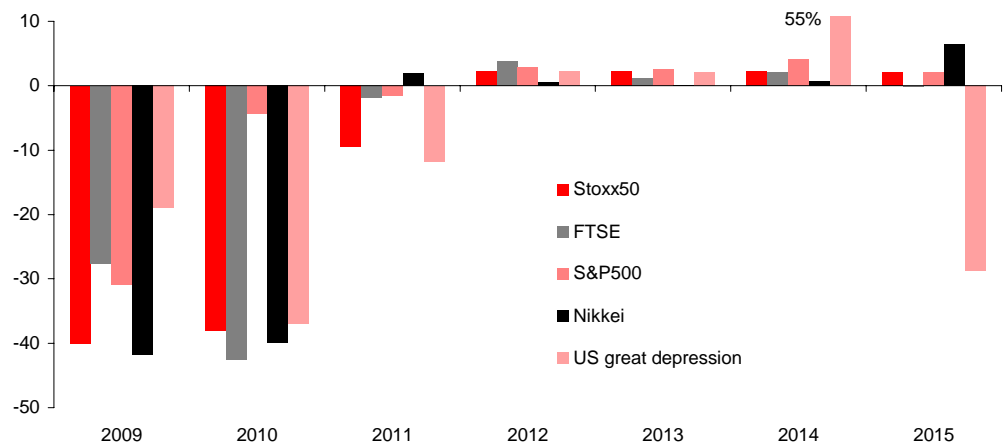


Source: SG Global Strategy Research

Not only are dividends in Europe, the UK and Japan expected to collapse (not beyond the realms of possibility I agree), but they are also forecast to remain depressed pretty much forever! For instance, following the 66% decline over the next three years, European dividends are expected to grow by just 2.2% p.a. over the following four years!

A similar story can be found in the UK, a 60% decline peak to trough, and then a mere 1.7% p.a. growth over the subsequent four years! Even in the great depression, once a floor was found, dividends grew by more than 4% p.a. (and that includes the sharp slump in dividends as the economy weakened once again in 1937 – if we take it up to end 1936, dividends grew at a rate of more than 17% p.a. for three years)

**Year by year growth in dividends (implied)**



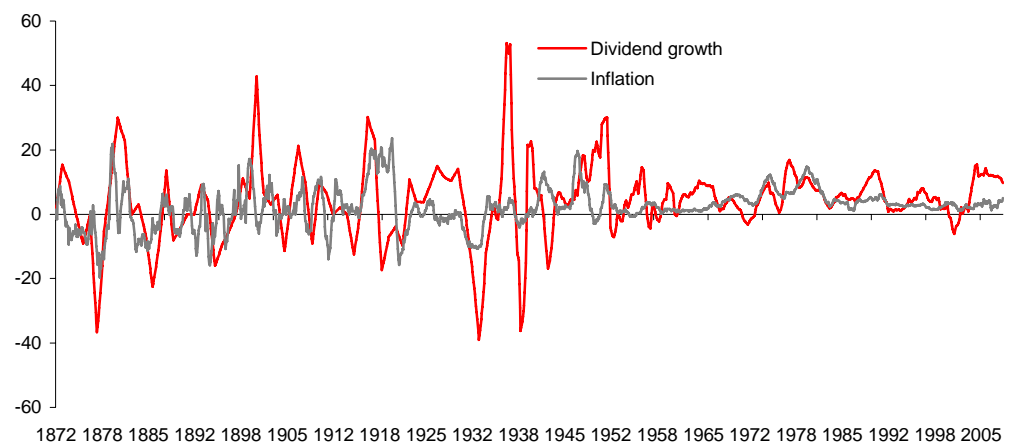
Source: SG Global Strategy Research

## Dividends as an inflation hedge

As I mentioned above, not only are dividend swaps priced for a situation worse than the great depression (making up a part of our deep value opportunities basket), but they are also potentially another form of cheap insurance against a return of inflation.

In theory, earnings and dividends are nominal concepts, and thus should generally keep pace with the inflation environment. If the Fed (and it may be a big if) is successful in engineering the return of inflation, then dividends should see a rise in nominal terms. As such dividend swaps may prove to be another good source of cheap inflation insurance.

### US dividend growth and inflation



Source: SG Global Strategy Research

## Forced sellers and oversupply

All of this begs the question of why dividend swaps are priced as they are? The only explanation I can come up with is that this is an asset fire sale, caused by a combination of forced sellers and oversupply. This, of course, is the very source of a good opportunity.

Whenever a forced seller can be found, an opportunity is potentially created. The forced seller by their very nature is selling regardless of value. As such, providing that I have a longer time horizon than the forced seller (which given this is me we are talking about, it is likely to be the case), then I can exploit their short-term need for liquidity, and in the process acquire an asset that is potentially very attractive.

Of course, I should conclude by reminding all that I am very much a novice in this area, I am sure there are much smarter people than me who deal with this kind of asset all day every day. So maybe I am missing something really obvious, if so I look forward to someone sending me an email pointing out my stupidity. If not then it looks to me like dividend swaps are trading on prices that should be considered asset fire sales.

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