Janus Henderson

ALTERNATIVE PERSPECTIVES

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OUR ALTERNATIVES CAPABILITIES

JANUS HENDERSON'S ALTERNATIVE INVESTMENT STRATEGIES ARE DESIGNED TO DELIVER ATTRACTIVE RISK-ADJUSTED RETURNS WITH MODERATE VOLATILITY AND LOW CORRELATIONS TO TRADITIONAL ASSET CLASSES. SOLUTIONS CAN BE CONSTRUCTED TO CONSIST OF MULTIPLE SOURCES OF RETURNS WITH THE INTENTION OF ENHANCING DIVERSIFICATION AND LOWERING OVERALL PORTFOLIO RISK.

"One of the hardest things to do in any industry is to challenge the status quo; to move past embedded behaviour in search of new ways to think, new ways to look at data, and new ways to utilise the tools available to us. In this latest edition of our Market GPS: Alternative Perspectives, investment professionals from across our Diversified Alternatives team highlight some thought-provoking insights from our ongoing research. We believe these views are of broad interest but particularly relevant for investors evaluating or implementing diversifying strategies into strategic portfolio allocations.

Aneet Chachra and Alistair Sayer consider the potential use of liquid alternatives for those investors looking to avoid costly trading activity during periods of higher volatility. Natasha Sibley and Lucy Holden give some insight into how investors can harness the asymmetric supply/demand characteristics of dividend futures.

Andrew Kaleel, Mathew Kaleel and Maya Perone investigate some of the more interesting characteristics of trend-following strategies.

Finally, we sit down with **Mark Richardson** for some insight into the hype around machine learning. This is a critical area for investors in trying to understand the potential value (or lack thereof) of machine learning-based models within the world of quantitative finance.

We hope you find this publication of interest, and we would be happy to discuss any of these ideas in more detail. Further, we welcome any feedback you may have."

David Elms

Head of Diversified Alternatives

The Janus Henderson Alternatives platform is made up of 22 investment professionals situated in the UK, US, Australia and Singapore. The team is responsible for US\$14.3 billion* in client assets and manages a range of investment solutions aimed at delivering specific outcomes tailored to meet the needs and constraints of clients. The team brings together a cross-asset class combination of alpha generation, risk management and efficient beta replication strategies, as well as the flexibility to create customised offerings. Current solutions include multi-strategy, alternative risk premia, alpha capture and global commodities/managed futures.



TREND IS YOUR FRIEND





Can investors follow the pack and hope to outperform? In this article, Portfolio Managers **Andrew Kaleel**, **Mathew Kaleel** and **Maya Perone** investigate the characteristics of trend-following strategies and consider their potential value as part of a strategically positioned portfolio.

Source: Getty Images

KEY TAKEAWAYS

- Trend following seeks to buy assets that are rising in value and short assets that are falling in value. A simple form involves using a moving average over a time series on a given security.
- ➤ Trend-following strategies are typically implemented via liquid futures markets on regulated global derivatives. The use of futures markets allows investors to trade on margin and as a result, provides the flexibility to target preferred outcomes.
- ▶ Trend following has historically added value in times of chaos, uncertainty and macro disruption and when blended with other strategies designed to minimise left tail risk, the use of trend following could represent an attractive portfolio protection option for those investors with a positive return expectancy.

The performance of trend-following strategies (also known as 'time series momentum' or 'CTA') has come into focus over the past few years, and debate continues on their potential value as both a standalone allocation to a traditional portfolio and as part of a wider alternative asset portfolio.

In its purest implementation, trend following seeks to buy assets that are rising in value and sell short assets that are falling in value. A simple form of trend following involves the use of a moving average over a time series on a given security. A directional view (to be long or short) can be ascertained by looking at the average of the closing prices of a time series over a given time frame.

For trend-following strategies, the time horizon is typically six to 12 months. If the current price is above the moving average of the price series (see Exhibit 1), investors would be long that asset, while selling short if the current price is below the average of the time series. Therefore, trend following does not seek to predict price moves; on the contrary, it seeks to be positioned in the direction of recent movement in prices.

EXHIBIT 1: THE DISLOCATION BETWEEN PRICE AND MOVING AVERAGE INDICATES THE DIRECTION OF TREND



Source: Refinitiv Datastream, Janus Henderson Investors, Diversified Alternatives Team, January 1981 to December 2019. The moving average shown is a rolling three-year average of the S&P 500 Index. Past performance is not a quide to future performance.

TREND IS YOUR FRIEND (cont.)

TREND BETA MODEL

Trend-following strategies are typically implemented via liquid futures markets on regulated global derivatives. The use of futures markets allows investors to trade on margin and as a result, provides the flexibility to target preferred outcomes.

The mechanical nature of trend-following strategies allows for the development of models that provide an overview of the historical performance and positioning of a basic trend-following strategy.

For the sake of simplicity, we can examine long-term trends via a hypothetical trend beta model. In this example, weekly time series data is used in conjunction with a multiyear moving average to determine long and short positioning. Individual positions are scaled utilising an ex-post volatility methodology, allowing for an initial equal contribution to risk for each of the underlying positions.

Sector allocations are then re-scaled with the intent to equally allocate risk. Allocations are made across 60 markets, covering interest rates, bonds, currencies, commodities and stock indices. An assumption of 2% per annum (pa.) is allowed for implementation costs, and interest (income) received is based upon the US federal funds rate.

Finally, positions are scaled to target an ex-post portfolio volatility target of 12% pa.

TREND PERFORMANCE

The data suggests that this hypothetical trend beta model would have provided attractive long-term return to risk outcomes versus the S&P 500[®] Index, delivering a positive payoff in addition to lower drawdowns and volatility. Over this period, the strategy would have had essentially zero correlation to equities:

	Annualised return	Annualised volatility	Sharpe Ratio	Maximum drawdowns	Correlation
Trend Beta Model	13.5%	12.0%	0.70	40.1%	-0.01
S&P 500 Index	11.6%	16.2%	0.47	71.7%	-

Source: Refinitiv Datastream, Janus Henderson Investors, January 1974 to August 2019. Past performance is not a guide to future performance.

Note: Hypothetical model based on weekly time series data across commodity, bond, rate, currency and equity futures. Used in conjunction with a multiyear moving average to determine long and short positioning, rebalanced weekly and scaled to target an ex-post volatility of 12% pa. Incorporates a hypothetical 2%/year cost. See disclaimers for additional information on simulated performance.

WHAT CAUSES MARKETS TO TREND?

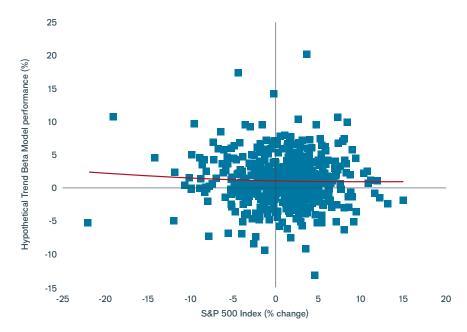
A trend will manifest in a given market or sector based upon one or more factors, including sentiment, market dislocations, changes in perceived or actual levels of supply and demand, macro drivers (such as the US dollar or oil prices), changing inflationary expectations or central bank policy.

A typical trade setup exhibits several different phases. It begins with an initial market move that determines the trend and signal, evolves into managing a position while the trend plays out, and ends with eventual exhaustion as prices react to news that runs counter to the market.

For example, a price shock or change in supply could cause prices to move away from perceived fair value. The initial move higher would result in trend strategies instigating a long position (and vice versa for a short position). As the market event progresses, this can bring new participants to the table, pushing prices higher, forming the basis of a meaningful trend. Ultimately, prices may move to a level well beyond fair value. At this point of exhaustion, momentum is lost, and prices likely revert to fair value (or beyond), thus ending the trend.

TREND IS YOUR FRIEND (cont.)

EXHIBIT 2: THE CTA SMILE INDICATES A TREND OF TAIL PROTECTION



Source: Janus Henderson Investors, monthly returns 30 November 1973 to 27 December 2019 for the hypothetical trend beta model described earlier versus the S&P 500 Index. Past performance is not a guide to future performance.

TREND FOLLOWING AS A POTENTIAL SHOCK ABSORBER

Trend following has historically been used by investors as a tool to help improve diversification and reduce risk in multi-asset portfolios. The long-term expected payoff profile of a trend-following strategy is one that exhibits a good upside capture ratio, but more importantly a material positive return in sustained bear markets for stocks and bonds.

A defining feature of the long-term return series of a trend-following strategy, when compared to the S&P 500 Index, is the 'CTA Smile', which captures the four potential outcomes when comparing monthly returns (see Exhibit 2). Returns in the top left quadrant highlight the incidence of positive returns for trend following when equities are negative. The frequency of these positive returns indicate that trend following has historically contributed to left tail protection.

MORE RECENT RETURNS FOR GLOBAL EQUITIES AND IMPLICATIONS FOR TREND FOLLOWING

More recent data for trend indices have seen lower return outcomes. Is the case for including a trend-following strategy still intact? From our analysis, the short answer is yes. Looking at rolling three-year returns of the Trend Beta Model, the data provides the following insights:

- While returns since 2008 have been low, they are not unusual relative to longer-term returns.
- Prior periods of relatively muted returns have preceded periods of positive outperformance over the following five years.

Looking at the returns from allocations to both global equities and the Trend Beta Model since the Global Financial Crisis (GFC), rolling 12-month returns on the MSCI World Index have effectively not been below 10% on the lower bound since the GFC. There is not much conjecture that central bank intervention has removed the downside risks to this point.

TREND IS YOUR FRIEND (cont.)

In our view, extended historical bear markets and recessions reinforce the argument for a defensive allocation to alternatives. The last two major global stock market shocks – the US recession of 2000-2001 and the GFC in 2008-2009 – coincided with significant positive absolute performance from the Trend Beta Model, and meaningful left tail alpha. The Trend Beta Model also benefited from extended moves in specific sectors, such as during the bond bull market of 2014.

One final observation is the case for mean reversion over a meaningful time horizon. Historically, rolling returns on global equities that exceed 25% to 30% have often reversed over the next two to three years. It is these periods in which diversifying or protective strategies could potentially add material value to a traditional portfolio.

TREND-FOLLOWING CAPACITY AND FACTOR CROWDING

Another important factor that must be considered is the constituents of widely used and quoted CTA/trend-following indices, which can be dominated by larger CTAs.

Our view on **capacity** is that there is a critical threshold for assets under management (AUM), beyond which a trend-following strategy will likely have to alter the way that capital is allocated. Beyond this level, markets with lower liquidity or capacity will by necessity receive a lower allocation, concentrating risk in fewer, larger markets.

The issue of **crowding** is a different matter. We do not believe this is likely to have a meaningful impact on potential returns. Firstly, the size of the CTA industry has remained relatively stable over the past decade, while trading volumes have increased year on year during this period. Secondly, we estimate that the total average position size of a trend-following strategy is not close to a material level where we would expect to see any significant market impact.

THE ROLE OF TREND FOLLOWING IN A PORTFOLIO

There are several indicators that, in our view, suggest positive prospects for trend-following strategies. Overall trading costs continue to decline while the technology around execution and implementation continues to improve. An increasing number of investable markets (such as the growth in emerging markets) offers the prospect of further potential diversification for trend portfolios in the future.

Elsewhere, the evolution of trend following has seen managers move into other areas of investment (OTCs and cash equities). The creation of 'synthetic' time series for prices (either at the sector level, macroeconomic level or cross-asset level), for example, offers a range of opportunities to potentially augment returns.

Trend-following strategies are also being used more thoughtfully, as part of a broader suite of protection strategies. We believe a trend-following strategy optimally sits as part of a suite of strategies that are designed to provide a shock absorber for various adverse outcomes, including known unknowns and black swans.

In summary, trend following has historically added value in times of chaos, uncertainty and macro disruption. When blended with other strategies designed to minimise left tail risk, the use of trend following could represent an attractive portfolio protection option for those investors with a positive return expectancy.

FOOTNOTES: TREND IS YOUR FRIEND

Note on simulated modelling (the Trend Beta Model): The hypothetical, back-tested performance shown in the Trend Beta Model is for illustrative purposes only and does not represent actual performance of any client account. No accounts were managed using the portfolio composition for the periods shown and no representation is made that the hypothetical returns would be similar to actual performance.

Hypothetical, back-tested or simulated model performance has many inherent limitations, only some of which are described in this article. The hypothetical trend beta model has been constructed with the benefit of hindsight and does not reflect the impact that certain economic and market factors might have had on the decision-making process. No hypothetical, back-tested or simulated performance can completely account for the impact of financial risk in actual performance.

Therefore, it will invariably show optimised rates of return, used solely here for the purpose of illustration. The hypothetical performance results shown may not be realised in the actual management of accounts. No representation or warranty is made as to the assumptions made or that all assumptions used in construction of the hypothetical returns have been fully stated. Assumption changes may have a material impact on the returns presented. This material is not representative of any particular client's experience. Investors should not assume that they will have an investment experience similar to the hypothetical, back-tested or simulated performance results and actual results subsequently achieved by any investment strategy.

MACHINE LEARNING – NO SILVER BULLET?





Machine learning has evolved rapidly over the past decade, with huge consequences across industries. But does the hype exceed its potential impact? In this article, we discuss with Portfolio Manager **Mark Richardson** the value of machine learning for the world of quantitative finance.

Source: Getty Images

A conversation with

MARK RICHARDSON, PhD Portfolio Manager

KEY TAKEAWAYS

- There is a great deal of hype around machine learning (ML), given the potential ramifications for the world of quantitative finance.
- ▶ It is too early to say with any certainty that machine learning represents a potential 'silver bullet' in the world of quantitative finance. But there are areas of interest that could be worth investigation.
- One of the more potentially credible applications of machine learning is in modelling the evolution of classical models in a time series.

Machine learning is a nascent paradigm in modern quantitative investment management, and like many industry participants, Janus Henderson has been testing the water with this developing technology. This includes looking at applying a machine-learning approach to augment existing models the team operates in the equity derivatives space. In the views of Portfolio Manager Mark Richardson, "We felt it was important to begin a systematic and dispassionate investigation of the potential scope of the emergent Machine Learning toolkit in order to assess the implications for certain aspects of our investment process".

"WE FELT IT WAS IMPORTANT TO BEGIN A SYSTEMATIC AND DISPASSIONATE INVESTIGATION OF THE POTENTIAL SCOPE OF THE EMERGENT MACHINE-LEARNING TOOL KIT IN ORDER TO ASSESS THE IMPLICATIONS FOR CERTAIN ASPECTS OF OUR INVESTMENT PROCESS".

At this point, it is too early to say with any certainty that machine learning represents a potential 'silver bullet', but there appear to be several areas of potential research interest. For example, one of the key strategies the team operates involves dynamic trading around a persistent supply and demand imbalance in Euro Stoxx 50 forward contracts, which manifests in significant, if ephemeral, price distortions. A key component of the trade involves modelling of price changes in the Euro Stoxx 50 dividend term structure relative to a given move in the underlying index.

While the Janus Henderson Alternatives team has an existing model for this that works very well, as interest in machine learning grows, they have been keen to see if there is something to be gained by applying techniques from the machine-learning toolkit. As Mark says, "Initial investigations suggest that it is difficult to beat our existing models".

"INITIAL INVESTIGATIONS SUGGEST THAT IT IS DIFFICULT TO BEAT OUR EXISTING MODELS".

MACHINE LEARNING - NO SILVER BULLET? (cont.)

Elsewhere, the team has looked at applying machine-learning techniques to help forecast volatility surface moves, one of the more potentially credible applications of the machine-learning toolkit. The question is, given a parametric specification of the previous day's implied volatility surface, is it possible to utilise machine-learning techniques to describe its time-series evolution, given the observable intraday futures move? As Mark comments, "Increasing the accuracy of implied volatility forecasts has the potential to be significantly impactful to the extent that it smooths portfolio volatility, removes subtle directional exposures, and ultimately produces more stable hedges".

"INCREASING THE ACCURACY OF IMPLIED VOLATILITY FORECASTS HAS THE POTENTIAL TO BE SIGNIFICANTLY IMPACTFUL TO THE EXTENT THAT IT SMOOTHS PORTFOLIO VOLATILITY, REMOVES SUBTLE DIRECTIONAL EXPOSURES, AND ULTIMATELY PRODUCES MORE STABLE HEDGES".

The team continues to progress its research agenda in this area. "Clients expect us to have an opinion on the efficacy of machine learning in general and the only way of developing such a view is to carry out extensive and rigorous experiments. All the while we remain open to the possibility that there could be better ways of doing things".

Machine learning has been touted as a potentially transformative technology for the investment industry. But the measure of all progress is whether that potential can be harnessed for aggregate gains on productivity or performance. While the team is approaching the idea of machine learning as a potentially useful development, they are doing so from a starting position of measured scepticism.

A necessary condition for determining whether machine-learning tools are suitable for prime-time use is getting comfortable with the trade-off that (potentially) superior solutions to trading optimisation problems come at the cost of substantially reduced model interpretability. While the team understands exactly what is going on inside their current models, it would be a significant departure from this intellectual framework to move across to what would be an essentially 'opaque' system. In Mark's view: "At this point, we do not believe that clients would be comfortable with such an abdication of understanding. It would require truly exceptional machine-learning model performance before we could 'trust the black box' and seriously consider their use in real-world trading activity".

"AT THIS POINT, WE DO NOT BELIEVE THAT CLIENTS WOULD BE COMFORTABLE WITH SUCH AN ABDICATION OF UNDERSTANDING. IT WOULD REQUIRE TRULY EXCEPTIONAL MACHINE-LEARNING MODEL PERFORMANCE BEFORE WE COULD 'TRUST THE BLACK BOX' AND SERIOUSLY CONSIDER THEIR USE IN REAL-WORLD TRADING ACTIVITY".

LIQUIDITY IN STRESSED MARKETS IS MORE EXPENSIVE THAN YOU THINK





In this article, Portfolio Manager **Aneet Chachra** and Investment Director **Alistair Sayer** consider the cost of trading when volatility spikes, and ask if liquid alternatives provide an alternative for investors to manage their portfolios during periods of uncertainty?

Source: Getty Images

KEY TAKEAWAYS

- Investors often need to sell what they can, rather than what they would like to, during periods of market uncertainty. This typically makes equities the commonly used shock absorber to meet spending requirements.
- The direct costs of trading stocks are indeed low relative to most other asset classes. But equity transactions during periods of stress are, on average, done at a steep price discount.
- ▶ Alternative investments typically are less sensitive to periods of equity market stress. However, they are often hindered by a general lack of liquidity, potentially undermining their value to investors. Liquid alternative strategies can potentially fill this gap.

According to conventional wisdom, individuals or institutions that sell stocks when volatility spikes are potentially uninformed and/or irrational. They are typically selling because they are overcome by fear, even though many believe the logical decision would be to stay the course and ride out the volatility. The implication is that sellers are potentially making poor and uninformed choices that could likely lead to worse returns.

We believe this is overly simplistic. Although behavioural biases surely play a role in investment decisions, people often transact not because they choose to, but because they need to. Even an investor with a well-structured and broadly diversified portfolio will periodically have mismatches between their inflows and their spending needs. For example, a pension plan needs to provide monthly benefits to plan members, while also potentially unexpectedly receiving capital calls from its private equity/venture capital partners. Investors typically also have other constraints, such as portfolio leverage, margin or volatility targets that force their hands, especially in stressed market conditions.

SENSIBLE DOES NOT ALWAYS EQUAL PRACTICAL

The real decision is very often **what** to sell, rather than **whether** to sell. Theoretically, an investor should consider liquidating a pro-rata slice of each holding to raise cash or avoid breaking a constraint. In practice, this is impractical. Many bonds are difficult to transact quickly, while most alternative investments, including real estate, private equity, venture capital, hedge funds, and so on, are illiquid – especially at short notice and in potentially small increments.

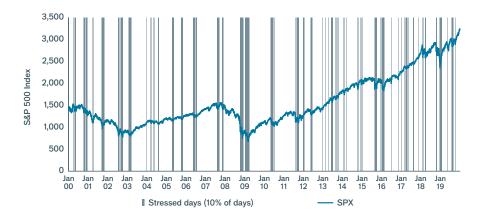
Consequently, investors often need to sell what they can, rather than what they would like to. This typically makes equities the commonly used shock absorber to meet spending requirements, change a portfolio profile, or hedge other risks. Stocks (accounting for dealing times) can be sold almost instantly and settle quickly: over US\$300 billion of S&P 500 futures transact daily with an average bid-ask spread of $<0.1\%^1$.

THE ILLUSION OF 'NEARLY FREE' TRADES

This creates the illusion that the liquidity cost of transacting in equities is nearly free. The direct costs of trading stocks – which include commissions, bid-ask spreads and other charges – are indeed low relative to most other asset classes. But equity transactions during periods of stress are, on average, done at a steep price discount. In other words, there is a large but invisible cost to selling stocks when market volatility is relatively high.

LIQUIDITY IN STRESSED MARKETS IS MORE EXPENSIVE THAN YOU THINK (cont.)

EXHIBIT 1: VOLATILITY IS AN INTRINSIC PART OF EQUITY MARKETS OVER TIME

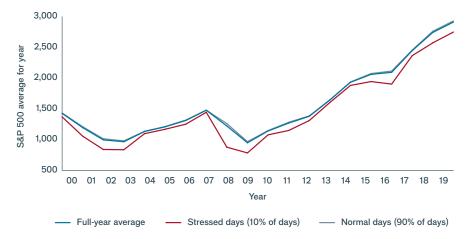


Source: Bloomberg, Janus Henderson Investors. Shows the level of the S&P 500 Index, illustrated with the 10% of days annually in which market volatility (as measured by the VIX) was highest from 3 January 2000 to 31 December 2019. Past performance is not a guide to future performance. The value of your investment may go down as well as up and you may not get back the amount originally invested.

We can illustrate this by ranking all days in each year based on the closing level of the Chicago Board Options Exchange (Cboe) Volatility Index (VIX). We label the 10% of days in a year with the highest VIX levels as 'stressed', while labelling the remaining 90% of days as 'normal'. Exhibit 1 shows the last 20 years of the S&P 500 with the days labelled stressed highlighted in gray. The most stressed (volatile) days of each year are quite spread out and occur unpredictably.

For each year, we calculate the average level of the S&P 500 for stressed days (10% of days), normal days (90% of days), as well as a full-year average (100% of days). Exhibit 2 compares the three averages. Notably, the stressed line is significantly below the full-year average, while the normal line is slightly above the full-year average.

EXHIBIT 2: INVESTORS PAY A PRICE FOR LIQUIDATING EQUITIES ON 'STRESSED' DAYS



Source: Bloomberg, Janus Henderson Investors, 3 January 2000 to 31 December 2019. Past performance is not a guide to future performance. The value of your investment may go down as well as up and you may not get back the amount originally invested.

LIQUIDITY IN STRESSED MARKETS IS MORE EXPENSIVE THAN YOU THINK (cont.)

The price discount on stressed days compared to the full-year S&P 500 average is about -8%, while the price premium for normal days is about +1%. Obviously, selling on high-volatility days is not always sub-optimal; prices can go down and volatility increase further, after all. But statistically, liquidating equities when volatility spikes is costly. Unfortunately, the need to sell in stressed markets often correlates with other negative events – i.e., worse economic conditions or other setbacks.

ARE LIQUID ALTERNATIVE STRATEGIES A POTENTIAL SOLUTION?

Other portfolio assets are unlikely to be completely correlated to equities and are therefore likely to hold up better during periods of equity market stress. Notably, alternative investments typically have a much lower beta to stocks. But investors are hindered by the general lack of liquidity in most alternatives and are often forced to sell liquid stock holdings at a discount instead.

"STATISTICALLY, LIQUIDATING EQUITIES WHEN VOLATILITY SPIKES IS COSTLY. UNFORTUNATELY, THE NEED TO SELL IN STRESSED MARKETS OFTEN CORRELATES WITH OTHER NEGATIVE EVENTS – I.E., WORSE ECONOMIC CONDITIONS OR OTHER SETBACKS."

Liquid alternative strategies can potentially fill this gap – giving investors real diversification from traditional asset classes, while providing the flexibility for investors to trade on their own terms, rather than as forced sellers. The liquid alternative sector has a host of different tools that can play an important role in portfolio construction, and potentially provide the opportunity for different investment behaviour. For example, adopting an explicit protection strategy into a portfolio can potentially enable investors to weather short-term market stresses, while positioning for potential longer-term opportunities.

DIVIDEND FUTURES – MIND THE GAP





Portfolio Manager **Natasha Sibley** and Analyst **Lucy Holden** consider the potential use of systematic and tactical approaches in seeking to take advantage of the asymmetric supply/demand characteristics of dividend futures.

Source: Getty Images

KEY TAKEAWAYS

- ▶ In markets where structured products are prevalent, such as in Europe, dividend prices are distorted by the supply of dividend exposure that must be hedged, commonly by banks seeking to hedge risk from structured notes.
- ▶ The structure of dividend futures markets lends itself to both systematic strategies designed to harvest the available risk premia and tactical strategies that seek the most attractive dividend exposures.
- While Europe is by far the biggest market for dividend futures, there is room for these securities to become increasingly internationalised.

It is possible for investors to take a view on dividends that companies will pay in the future. At a simple level, the market price for dividends is influenced by standard supply and demand factors – like all markets – so does not reflect a pure expectation of future dividends. In markets where structured products are prevalent, such as in Europe, dividend prices are distorted by the large supply of dividend exposure that must be hedged. This creates opportunities for investors willing to take dividend risk at a statistically interesting level.

As prices move and fundamentals evolve, the distribution of returns from dividend exposure changes, making the risk/reward trade-off more (or less) favourable. The long-term structural dynamic of this market is a persistent supply, commonly from banks seeking to hedge risk from structured notes, for example. Given that the focus of these trades is to hedge risk, the actual pricing of dividend futures tends to be of secondary significance, a level of asymmetry that can create a persistent risk premium.

SYSTEMATIC AND TACTICAL – TWO COMPLEMENTARY STRATEGIES

The structure of dividend futures markets lends itself to two styles of trading: one a systematic, rules-based exposure that harvests the risk premia available; the other, a more tactical strategy that seeks to tilt dividend exposures to where they are most attractive – both geographically (across the globe) and along the tenor curve (the length of time remaining before a contract expires).

On one side, designing and precisely specifying a systematic strategy is informative for tactical trading, allowing investors to benchmark trading decisions and generating a quick feedback mechanism. Conversely, an opportunistic tactical trading process, and the framework around it, helps to develop the thought behind systematic strategy design. Considering strategies from both perspectives informs results on both sides, providing the opportunity for improvement.

A systematic strategy gives insight into the true effectiveness of a hedge, providing an opportunity to question whether it is suitable, or if a more appropriate hedge is available. It could also deliver some context into past events of interest, such as the early days of the global financial crisis in 2008-2009.

DIVIDEND FUTURES – MIND THE GAP (cont.)

EXHIBIT 1: EUROPE LEADS THE ARBITRAGE OPPORTUNITY



Source: Bloomberg, Janus Henderson Investors, dividend estimated compound annual growth rate (CAGR) December 2018 to December 2027, shown as a percentage, rebased to 100 at start date. Forecasts as at 31 October 2019.

THE EUROPEAN DIVIDEND ANOMALY

We believe that the market for dividend futures on European stocks is one of the richest hunting grounds for divergence in dividend valuations. Pricing has shifted away from market fundamentals and, to us, European stock dividends seem to be trading at a level that does not reflect their real value. If we are correct, one way to benefit from a backdrop of political uncertainty would be to capitalise on the discrepancy between the price of European stock dividends and the forecasts for dividend payouts from European companies (US investors could buy dividend futures on the Euro Stoxx 50 Index, for example).

The charts in Exhibit 1 show the discrepancy between the expected growth in dividends (paid by companies in some of the world's biggest stock market indices, and the growth priced into dividend futures). Euro Stoxx 50 dividend futures are pricing in dividend cuts for the next few years, to the tune of around 3% per annum – numbers that look extraordinary when compared to analysts' expectations for corporate earnings (declines of the scale implicit in such numbers could present a significant problem for the single-currency region).

There is always a risk that companies could cut their dividends severely, meaning any trade could potentially lose money. But for those investors who believe that conditions are unlikely to be that bad, buying longer-tenor futures contracts and holding them to maturity could represent a potential trading opportunity.

DIVIDEND FUTURES – MIND THE GAP (cont.)

While this divergence is more pronounced in Europe than elsewhere in the world, it is an ongoing theme we see in the US and Asia as well. As the charts show, the gaps are far narrower than in Europe, perhaps reflecting that these types of structured notes have not been as popular in the US, for example. There is certainly room for these products to become increasingly internationalised. But dividend futures still represent a potentially valuable arbitrage opportunity for investors seeking alternatives at a time of heightened geopolitical noise.

Structured products relating to dividend futures are less common in the S&P 500 Index than in European or Asian indices. As such, there is less natural flow on the dividend market (banks don't have much exposure, so have much less need to hedge).

However, as Exhibit 2 shows, there are sometimes temporary dislocations. This example is from the summer of 2019, when S&P 500 dividends sold off somewhat, while the underlying S&P 500 Index rallied. The discount to forecast became unusually high, providing an attractive short-term trading opportunity, before the gap subsequently narrowed in October and November.

EXHIBIT 2: THE S&P 500 DIVIDEND FUTURES TRADE OF 2019



Source: Bloomberg, Janus Henderson Investors, 2 January 2019 to 19 February 2020. Chart illustrates the temporary dislocation in prices between the S&P Annual Dividend Index Futures and the S&P 500 Index. Past performance is not a guide to future performance. The value of your investment may go down as well as up and you may not get back the amount originally invested.

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