

INVESTING

Structured products

By James Rutter

There are plenty of investors in equities who will be wishing they had bought a simple capital-protected note at the start of the year. Then there are those unfortunate investors who bought just such a note issued by Lehman Brothers, the collapsed US bank, and are sitting on a virtually worthless asset.

As in many other sectors, the financial crisis has concentrated minds in the structured products market and cruelly exposed the losers. However, when the dust settles the outcome could be positive, suggests Frédéric Dawance, head of marketing, products and solutions at Swiss private banker Lombard Odier Darier Hentsch. "A crisis like the one we are experiencing opens the eyes of managers to the possibilities of structured products," he says. "The fact is that structured products are not an asset class but a tool that enables you to tailor your views more precisely."

VALUE

Getting the most out of such tools is something that few wealth advisers, and therefore their clients, get right. Incessant pitches for products from private banks and wealth managers is a common complaint from clients. They suspect the motivation for advisers to push products is the fee attached, and the hefty commission their brokerage arm receives, rather than the suitability for their portfolios.

Many in the industry concede clients have not been well served by structured product providers, particularly in the retail market where fees are notoriously high. "As much as 80% of the structured products world doesn't deliver good value to investors," says Chris Taylor, chief executive of Blue Sky Asset Management, a specialist UK-based structured products provider set up last year. "But everyone accepts that 80% of the traditional mutual fund world also fails to deliver."

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Volumes of structured products in the European retail market have grown markedly over the past couple of years, rising 38% last year to €261bn, according to data from StructuredRetailProducts.com. "It is not the case that the proportion of structured products in the average client portfolio is increasing but that more clients are using them," says Dawance. "Whereas five years ago it might have been only 10% of clients, today it is more like half."

Taylor believes dissatisfaction with actively-managed mutual funds, which can charge high fees while failing to beat market indices, will drive more investors to use structured products so long as providers can deliver better value.

Edward Hamilton-Ely, head of structured products at Schroders Private Bank, says the high fees prevalent in the retail market can be avoided when private banks take control of structuring themselves. "The fundamental difference is that we don't price in distribution fees. We want clients to have a good experience and come back. While products designed for the independent financial adviser market might charge fees of between 4% and 7%, we normally price in fees of up to 1% a year, depending on the underlying, and sometime much less."

Taylor says there is no reason why a structured product shouldn't compete on cost with other forms of asset management. This year, a private office asked Blue Sky to structure a portfolio for a client who had seen a £1bn fortune built during the dotcom boom reduced to £200m by the subsequent bust. Having seen his net worth recover last year, the client wanted to remove as much risk as possible from the portfolio while retaining exposure to rising equity markets. Blue Sky replicated the asset allocation model of the private office and reduced the downside exposure by a ratio of one-to-four, so losses would be capped at 25%. If the equity portfolio increases in value, any rise is magnified seven



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times up to a return of 70% over six years, with unlimited one-for-one returns beyond that point. The fee for the structure was 35 basis points a year, including the initial set-up, trading and administration costs.

Importantly, in this structure the client was still exposed to the risk, albeit reduced, of equities declining in value. As Taylor says: "You cannot beat the risk-free rate of return without introducing risk." Which is, perhaps, the single most important consideration to keep in mind when assessing a structured product.

RISK

Even if a product has a full capital guarantee, it carries significant risk. To receive back 100% of your capital at maturity will in real terms amount to a hefty loss, given the impact of inflation over the life of the investment and the opportunity cost of not having the money invested elsewhere or on deposit at a bank.

Thinking in this way helps focus attention on where it is most needed: the underlying investment strategy.

A structured product is simply a way of getting access to an investment idea. For the product to deliver real value, the idea needs to be right. "If you are wrong on the underlying strategy then there is no way of making money with a structured product," says Alexandre Zimmermann, head of investment advisory at private bank SG Hambros. "Using structured products is all about the investment rationale."

Increasingly, private banks and wealth managers appear to be embracing this fact. Credit Suisse, for example, periodically promotes big investment themes it believes will deliver returns over three years or longer. It uses a structured product as one way of gaining access to the theme – direct equity exposure, buying an index or bonds might be the others. Assuming an investor believes in the theme, they then have a choice of how to access it which might be influenced by tax issues or regulations as well as an assessment of the risk and returns of the different options.

Hamilton-Ely says his team plays a similar role



at Schroders Private Bank: "We are plugged into the investment process and it is our job to see if there is something we can do with an idea that might provide a better risk-return profile for clients than the alternatives."

Ryan Rogowski, head of Harewood Solutions, the UK structured products arm of BNP Paribas, puts it another way: "The goal should be to deliver products that serve a purpose within asset allocation."

He cites Harewood's Enhanced Property Recovery fund, launched in March, as an example. The fund, quoted on the London Stock Exchange, doesn't have capital protection so investors are fully exposed to any declines in the European Public Real Estate index over its six year life. The structure gives investors entry to the market at the index's lowest level over the first two years. As long as the index is higher than that level when the product matures in 2014, investors will get their initial capital plus either a 70% return or the performance of the index if it is greater. Buying the product is effectively a way of timing entry to the European property market at its low point over the next two years.

LIQUIDITY

The fact that the product is listed and BNP Paribas commits to provide liquidity is an added attraction, says Rogowski: "The client can sell out if the market rebounds and they feel the product has done its job."

Zimmermann at SG Hambros says the private bank has used a similar structure for clients who want to invest in equities but see significant short-term risks. The product does not have full capital protection but so-

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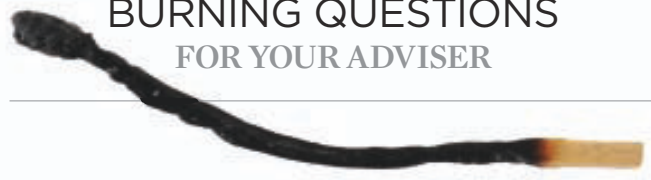
called "soft" protection, which means the original investment is protected as long as the index does not fall more than a certain amount. The investor gets full exposure to an underlying equity index over three years, with an entry level that is the lowest point during the period. If the index falls by 50%, the client gets switched into the equity market. "But you don't need a positive return over the three years," says Zimmermann. "If the index goes down 20% then recovers 10%, the client gets a 10% return. It is not fully capital protected but for a client who wants to take equity risk, it is great pay off."

David Weller, a partner at Cheviot Asset Management who oversees its structured product investments, says this type of so-called auto-callable structure starts to look more attractive as the equity market declines. "A FTSE 100 index structure being issued at today's levels with a soft protection at the 50% level would require the market to be trading back at levels last seen in 1992 before the capital protection is compromised. At the start of 2008, the 50% level was closer to the 2003 low."



Rogowski: liquidity matters

BURNING QUESTIONS FOR YOUR ADVISER



UNDERLYING STRATEGY

Does it fit within your asset allocation?

A structured product is simply a wrapper for an underlying investment idea. If you wouldn't consider it a good idea as a standalone, then the wrapper shouldn't sway you. How did the provider come up with the investment idea? Chris Taylor, chief executive of Blue Sky Asset Management, says: "We think too many issuers of structured products first and foremost identify cheap derivatives and then try to add or work a research story around them. We employ research to identify the investment opportunity first."

Is there another, more effective or less costly way of accessing the investment? Equally, is there an investment idea you have that could be implemented via a structured product? Specialists and private banks with their own structuring capability will often create a bespoke product for investments upwards of €1m.

RISK AND RETURN

What is the probability of the product delivering a return above cash and how much risk are you taking to achieve it?

What is the worst-case scenario? What type of capital protection, if any, is included? This might be so-called "hard" protection, which offers a minimum level of return regardless of the performance of the underlying asset, or "soft" protection, which provides a minimum level of return as long as the underlying asset does not breach a pre-set barrier. Investors often overlook the fact the valuation of a product could be volatile during its life and will be affected by changes in interest rates, market volatility, the time to maturity of the product as well as the performance of the underlying asset.

The maturity of the product can have a big impact. Frédéric Dawance at Lombard Odier Darier Hentsch says: "Maturities have been getting shorter and virtually all the products we arrange have a maturity of between three months and three years. A product with a five-year or seven-year life has a much greater sensitivity to interest rates and other factors, which makes it harder to keep the performance in line with the underlying exposure the client wants."

LIQUIDITY

How easy will it be to sell the product?

Ryan Rogowski, head of Harewood Investments, says: "It is important that investors know they can get out of the product if they want to but also that they understand that capital protection only applies at maturity." Does the provider make a commitment to provide liquidity in the secondary market? How wide is the bid-offer spread on other products it has arranged? Is the product listed and traded on an exchange?

CREDIT RATING

What is the financial strength of the issuer behind the structure?

A string of bank failures has focused attention on credit risk in structured products. Lower ratings might enable potentially higher returns but the investor is taking more credit risk. David Weller, partner at Cheviot Asset Management, says: "If capital protection is the reason for buying a product then the capital protection element should be as strong as possible, perhaps even using gilts or segregated cash."

FEES AND COSTS

How transparent is the structure in terms of its fees and costs?

Andy Halford, head of structured products at private bank Kleinwort Benson, says: "A big issue for some clients is that the fees often get charged upfront. Because a product is offering a defined return, the charges are built-in from day one." How do fees compare with other similar products? How does the provider price the product?

Halford says: "If a private bank trades with its own investment bank, it may not be taking an explicit fee but the investment bank could be taking a chunk at its end." What are the tax implications of using a particular type of wrapper and would an alternative be more efficient?