

Structured Products

The establishment of the London International Financial Futures Exchange (LIFFE) in 1982 created a market in financial derivatives (see Investment Bulletin 4 – Financial Derivatives) that enabled investors to access a wide range of global investment instruments without being exposed to ownership of the underlying assets.

As confidence in the use of derivatives grew, and in the quality of the financial institutions backing them, providers constructed new combinations of derivatives. The first of these, launched to the retail investor in 1991, was the relatively simple Guaranteed Equity Bond. The Guaranteed Equity Bond offered protected returns based on equity markets, assuming certain performance levels were achieved. This was the first recognised structured investment product or ‘structured product’.

In the early 2000s ‘Precipice Bonds’, another type of structured product, made the news. These offered a greater share in equity market performance, promising large returns and high levels of income in rising markets, but at the cost of some or all capital if performance targets weren’t achieved. The bear market from January 2000 to March 2003 caused havoc amongst this type of structured product.

What is a structured product?

A structured investment product aims to provide capital growth or income whilst also offering full or partial protection of the original investment. Structured products should clearly state the risks involved and the potential rewards available assuming a specific set of investment objectives are achieved. Structured products usually have a specific term or period to maturity, eg 5 years, but recently open-ended structured funds have become available.

A structured product’s pre-packaged investment strategy can be linked to derivatives based on a single share, a basket of shares, options, indices, commodities, bonds or currencies. There is no single, uniform definition of what constitutes a structured product.

How do structured products work?

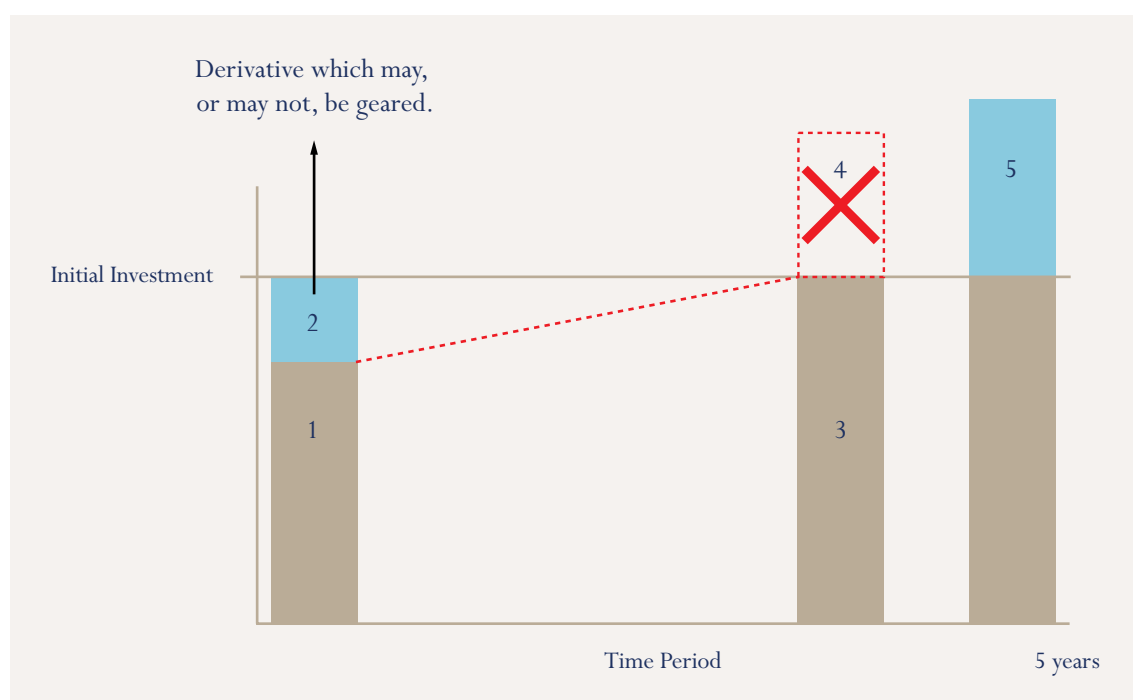
Structured products usually combine two or more different investments to achieve their stated objective, whether that may be income, growth or a combination of both.

A proportion of the investment will be invested in assets which aim to provide the 'protected' return on the product. This may be an investment based on cash deposits, government bonds or even corporate bonds, with sufficient interest or yield to grow to the specified 'protected' amount. However, some products use a derivative product to provide the protection in exceptional circumstances. Irrespective of how the product intends to provide the protection promised, the key issue, particularly in volatile market conditions, will be the financial security of the organisation providing this promise. If this organisation does not deliver on its promise, the protection will fail.

The other element of the structured product aims to provide the performance. This will be a riskier asset which has the potential to provide higher investment returns but will also have a greater potential downside. In some cases the performance potential of this element is 'capped' to preserve returns if a specific target level is achieved, but limiting returns if this element continues to perform. It is not uncommon for this part of the structured product to be 'geared' or 'leveraged'. Quite simply, the returns from this element of the investment can be multiplied by using particular types of derivatives. However, this approach can also multiply any losses and may result in this part of the investment being lost altogether.

Whether the aim of the underlying investment is to provide the protection needed to ensure the investor's capital is returned, or to provide the investment return (or upside), the actual result will also depend on the institution remaining solvent and being able to deliver on its promise, alongside the investment outcome. This is known as counter party risk.

The diagram below indicates how a simple 5 year structured product might work;



(1) The majority of the initial investment goes into a zero coupon bond (see Investment Bulletin 6 – Fixed Income), which will earn sufficient interest to return the original investment amount over the 5 year term. The remaining amount (2) purchases a call option, a type of financial instrument which gives the right to buy an asset at a specific point in the future. This element aims to provide the investment return and assumes that there will be a rise in the market over the term of the product.

On maturity, the zero coupon bond returns the original investment amount (3). However, in this example a geared call option was used which suffered adverse investment conditions and has become worthless (4). In this example, the investor only receives back the original investment amount (3).

If investment conditions had been favourable, the product would have returned the original investment amount (3) plus the growth achieved by the call option (5).

When are structured products used?

Structured products can be tailor-made to meet specific objectives and can be used as an alternative to a direct investment, as a way to diversify a portfolio, to reduce risk or to take advantage of a particular current market trend.

In recent years, financial organisations have used them as stand alone investment products with specific marketing messages to take advantage of investor demand for an element of protection when investing. However, these products are becoming increasingly sophisticated, with little explanation as to how they work other than the potential benefits and protection. This can lead to a lack of understanding for both advisors and investors.

What are some of the typical strategies used in structured products?

There are a large number of different strategies used within structured products to achieve returns using a wide range of different investments. Each strategy has its own degree of risk and potential for returns. Those noted below are the most commonly used strategies for generating returns from the risky element and fall roughly into three categories: Growth, Income and Fund Linked Products.

Growth Products

Growth products are typically positioned as alternatives to direct investments in the assets they are looking to take advantage of. They attempt to offer the investor the highest possible exposure to the chosen asset class with limited risk. Examples include;

Lookback – this strategy records the performance achieved during the investment period and will return a percentage of the highest ever value or an average of the best performance periods. This is relatively simple but does not allow the investor to benefit from all the performance. This strategy is often geared.

Captibasket – this structure allows an investor to gain exposure to the underlying asset’s performance and captures it if it reaches a predetermined level. This locks-in the growth achieved and can protect the value from future market falls, however, once the target is reached any further performance does not benefit the investor.

Income Products

Income products are often marketed as high yielding alternatives to normal fixed income investments (see Investment Bulletin 6 – Fixed Income). Usually they return the original investment at maturity whilst having provided income during the investment period. Some of the more risky structures offer even higher returns but with lower protection levels for the capital invested. Examples include;

Coupon Driver – this pays a yearly income which is linked to the performance of a basket of underlying assets. In most cases there is capital protection at maturity. This type of strategy can be very complex and difficult to understand for investors, with costly exit penalties.

Cliquet – this structure returns the sum of all positive growth over monthly, quarterly or annual periods achieved by an underlying basket of assets. This protects the investor from a last-minute crash in the value of the underlying assets. In most cases there is capital protection if held to maturity.

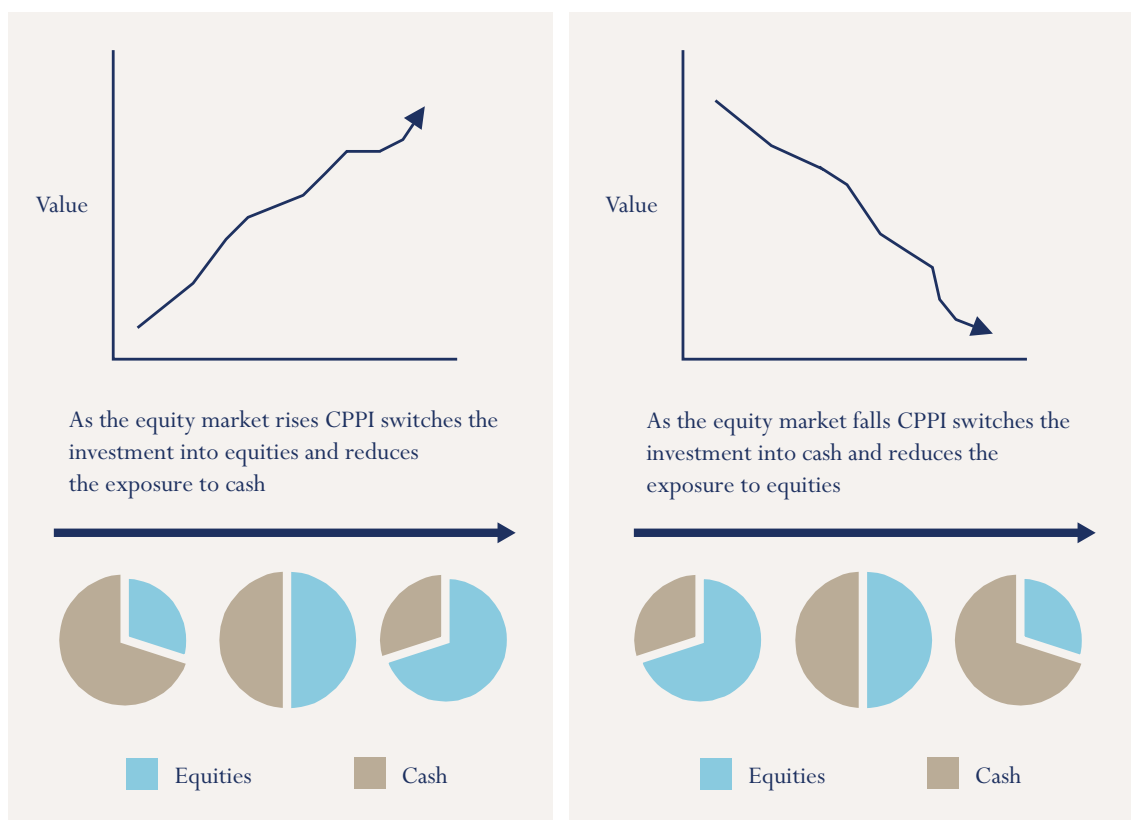
Fund Linked Products

Fund linked products are structured products where the performance is linked to a basket of actively managed collective investments, which may include Mutual funds, Hedge funds or Private Equity funds (see Investment Bulletin 3 – Private Equity).

Constant Proportion Portfolio Insurance (CPPI)

CPPI is the most common structure for this type of investment and is designed to ensure that an investment cannot fall below a minimum level. The CPPI strategy involves continuously re-balancing the portfolio of investments during the term of the product between equity-based assets and cash or fixed interest securities based on a mathematical model.

This balancing process is designed to allow investors to participate in rising equity markets while protecting capital in downward trends on a daily basis.



As the value of the equities rise, more of the portfolio is allocated to them. Conversely, as they fall in value, more of the portfolio is placed in safer assets such as cash. If the value of the equities falls too sharply, it is possible that the protected level can be breached. Therefore, the investment needs to close as it will be fully invested in cash.

What are the risks involved with structured products?

Default risk

Many structured products offer investors a level of protection against capital loss by investing in less risky assets. Default, or counter party risk, is the risk that on redemption the issuing company will not be able to pay the contractual interest or capital on their debt obligation. In that situation, investors would not receive the return of capital assumed at outset. In current markets, default risk is a consideration for many investors. The high-profile collapse of several global banking giants has highlighted the inherent risks which previously may have been ignored.

Lack of liquidity

Structured products are typically designed to be held for a specific period of time. Substantial penalties may be levied for surrender before the end of the specified term, which may mean the investor will receive less than they originally invested. Even if the underlying assets have increased in value, this growth may not be passed on to the investor.

Lack of transparency

For many investors, the ability to 'look through' their investments and understand how they are being managed is of great comfort to them. Structured products are becoming more and more complex and whilst the targeted returns may be disclosed at outset there is little information regarding charges and access to regular valuations which investors can review.

Dividend payments

Many structured products aim to provide capital protection whilst still offering the levels of return associated with equity-based investments. However, these products do not pay dividends and may track a capital return index rather than the total return version, which includes reinvested income. This can have a significant impact on returns.

The value of £100 invested at the end of 1899 in equities without income reinvested would be £13,580. However, with income reinvested, the same £100 would today be worth £1,641,485 (source: 2008 Barclays Equity Gilt Study).

Summary

With global stock markets currently experiencing a prolonged period of volatility, many investors are beginning to look at structured products as a solution to counter the unpredictable market conditions. Despite their potential attraction, structured products can be complex and expensive. Investors should carefully consider the benefits of these products and be sure that they understand the risks before deciding to invest.