



How does it work again?

According to Blue Sky Asset Management (BSAM) sales of retail structured products hit a record £9.7bn in 2008 as investors sought to combat low interest rates and stock market volatility, and this figure is expected to be exceeded in 2009.

Even though the use of structured products appears to be growing, they continue to evoke what I can only describe as polar opposite points of view among the IFA community, with some advisers and commentators loving them and some hating them.

In this article I discuss, in simple terms, how structured products work and provide some guidance as to some of the issues that I believe should be considered when looking at using them.

How does a structured product work?

For many structured products, the first step is to secure the capital protection at maturity. This is generally done by placing money on deposit or by purchasing bonds where the interest paid over the investment period accumulates sufficient funds, together with the initial investment into these assets, to return the total initial capital to the investor at maturity.

Looking at a simple example then, it might be that if 80% of the total initial capital is placed on deposit or in bonds with a counterparty, at prevailing interest rates this is sufficient to generate 100% of the total initial capital over, say a five-year period if the interest rates are locked in. Once the return of the initial total capital has been assured then in this example approximately 5% of the initial investment may be used to cover costs for the five-year period. This could be broken down to pay 3% to the distributor as commission, and the remaining 2% to cover the administration, marketing costs and a profit for the provider. This means of course that after 80% is set aside and 5% is allocated to costs, 15% of the initial investment can be used to gain exposure to the stock markets. In order to achieve this the product provider will purchase call options in the derivatives market. The most popular index bought for UK based structured products is the FTSE 100.

It is important to note at this stage that the attractiveness of a structured offering is enhanced the higher the return available from the deposit or bonds and/or the cheaper the call options are, because this means that a higher number of call contracts can be bought, therefore increasing the level of participation in the index or indices being tracked.

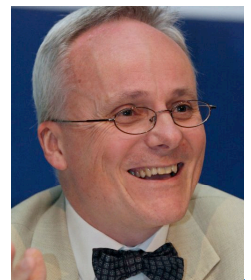
So how can the participation level be increased?

One option is to put a limit or ceiling on the amount of upside that can be gained should the index rise substantially over the set investment period. This is because it is cheaper to buy call options that limit the total return achieved to a predetermined amount, for example, 60%. The result is that if the market goes up there is higher exposure, of say 120% or 140% of the FTSE 100 return, but the total profit that can be made is limited.

Another way to increase the number of options that can be purchased and thus increase the participation rate is to buy options where there is "averaging" at the end of the investment period to determine the final return. Averaging reduces the price of options because it is accepted that averaging will most likely reduce the overall payout because if the index or indices move higher during the averaging period then the investor won't receive the full gain. Generally, the longer the averaging period the cheaper the options, so the higher the participation rate.

Finally, linking the return on the offering to a basket of indices rather than just the FTSE 100 will also result in cheaper options and higher participation because including exposure to a wider range of stock markets means that the overall pattern of expected returns will be less volatile. Gains in some markets can be offset by losses in others.

Of course apart from these strategies it is worth noting that the various stages in the stock



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market and interest rate cycles influence the amount required to secure the capital repayment and the price of the options. The lower the level of prevailing interest rates when the structured product is “set-up” the bigger the proportion of the overall investment required to be kept as cash or invested in bonds to secure the 100% return at the end of the period. Consequently this lowers the amount of money that can be used to purchase the call options. In addition the price of call options will also vary according to the prospects of the stock market. When markets are volatile and the anticipated returns are greater, call options will be more

expensive and vice versa when the market outlook is less exciting.

Who are structured products suitable for?

Some cautious investors are prepared to accept that provided their capital is secure, the interest they receive can vary, and they may receive no income at all. This is the philosophy that underpins the concept behind many structured products where capital is protected and the provider is, in effect, using the opportunity cost of the potential interest that the money could have earned to speculate for potentially higher returns from equity based exposure.

Whether or not capital protection is, in fact, required depends ultimately on what an individual investor actually needs and the risks they are prepared to accept. If a client is, for example, approaching retirement or will only look at equities or other assets with the peace of mind of capital protection then a structured product might be suitable. Provided the investor is fully informed of the nature of the investment they are making, especially the downsides of the offering and alternative investment possibilities available are fully discussed (if you are investing in the expectation that the market will be higher in five or six years’ time do you really need downside protection?) then a structured product may be appropriate.

Some of the drawbacks of structured products

When considering the merits of a structured product there are, in my opinion, a number of potential drawbacks that should be considered.

- The first is that any averaging not only reduces the risk of missing out on returns should the market fall just as an offering is due to mature and also increases the participation rate, but on the downside in a rising market it can result in lower returns.
- Then there is the tax treatment of the product (ie the total return may be treated in some cases as income rather than a capital gain) and the tax point is set by the maturity date of the investment some years hence and you are unable to alter this.
- Then one should consider the fact that with, for example, the FTSE100 index structured products do not provide the dividend income as part of the return and remember that a return of the initial capital after an investment period of, say, five years means that although the investor may have received the same monetary value back as they originally invested this may have been eroded in terms of purchasing power by inflation.
- Also remember that generally the capital protection only applies if the investment is held for the full term and there generally isn’t a secondary market for many structured products.
- Finally the credit rating of the institution with whom the monies are placed (known as the “counterparty”) is vitally important because if this institution were to default the capital would be at risk. This risk has been highlighted by the collapse of Lehman Brothers last year. Indeed with reference to this risk it is worth noting that whilst certain products might be offered by major retail banks some are in fact guaranteed/ underwritten by offshore subsidiaries or backed by other institutions which may have lower credit ratings or less favourable compensation arrangements. Indeed in terms of compensation arrangements with reference to the Financial Services Compensation Scheme, because the issuing of securities is not considered to be “designated investment business”, the FSCS does not offer compensation for a failed counterparty.

Axioms

I would however like to conclude by saying that when I started my investment career over 25 years ago I was taught a couple of axioms that have served me well and I think are particularly relevant when considering structured products. First the higher a potential return is the higher the risk and secondly if you don’t understand how something works or are not provided with full details, such as who the counterparty is, then avoid it.

With current low interest rates and market volatility we are seeing many “new” types of structured product being brought to the market and some, in my opinion, have been put together by “rocket scientists” on their days off!

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