

Structured Products

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A Chequered History

Retail structured products have become a feature of the financial services landscape since 1996. As interest rates have fallen below their historic levels, **investors requiring income have been attracted by the exceptionally high income rates** on offer. Investors who took out the earlier offerings of such products were generally delighted with the returns that they achieved, either in income or capital growth.

However, since 2002 structured products have not had a good history. These products have suffered from poor selling practices and investors purchasing through newspaper advertisements **with no real understanding of what they were buying.**

The problems first appeared during the severe bear market of 2000 – 2003. This showed for the first time that **there can be a fairly severe downside to some of these products**, which came to be known as ‘precipice bonds’, in terms of capital loss. Many investors during this period lost all, or virtually all, of the capital which they invested into, what turned out to be, the riskier structured products on offer.

More recently we have seen **the collapse of Lehman Brothers**, counterparty to many structured products and **the demise of Keydata** in June 2009 following problems over its selling of ISAs.

Lehman Brothers, a 158-year-old Wall Street institution was among the leading underwriters of mortgage-backed securities and was left with large holdings after the subprime crisis curtailed investor appetite for the fixed income products. On 15 September 2008 Lehman filed for bankruptcy.

Now a Success Story

The market has learned from these setbacks. Product design has improved, **the majority of products now offer good capital protection**, and advisers have had to make sure that they really understood what they were recommending to their clients.

In particular, whereas in their early days, 80% of retail structured products were sold through newspaper advertisements, direct offers through the post, or over the counter at a high street bank branch; **independent financial advisers now account for around two-thirds of the market.**

As a result **the structured products business is booming.** This is no doubt due to the large falls across nearly all asset classes in 2008, combined with the extremely low returns from deposit accounts. According to Barclays Wealth, **more than £8 billion was invested in structured products during 2008**, with 2009 likely to achieve an even higher investment total.

‘With markets volatile and interest rates low, mutual funds cannot match the protection and known outcome that structured product providers are keen to promote.’

Professional Adviser 24 September 2009

There are now over 100 providers issuing products although there is **a much smaller number of product providers who would pass muster** as far as independent financial advisers are concerned. Many of the players are simply re-packaging the product provided by a larger provider.

Although structured products have issue periods of around six to eight weeks, **many providers now offer a fairly constant stream of issues.**

What are Structured Products?

Structured products are **also referred to as ‘protected investments’**. They have been defined as ‘investment products that deliver a known return for given investment circumstances.’

A more detailed definition of retail structured products would be ‘investment vehicles, which facilitate a defined exposure to various indices or measurable asset classes, run for a fixed term and offer protection to the capital outlay.’

‘The first thing to say about structured products is that we should probably call them something else!’

Barclays Wealth Protected Investments

In other words **the return is based on the performance of one or more stockmarket indices**, or a portfolio of shares, but usually with some form of capital protection. Some structured products providing a high level of income provide no capital protection and these are referred to by the FSA as **‘structured capital at risk products’ (SCARPS)**. Providers of SCARPS now have to inform clients periodically on the progress of their investment and the risk the capital may be at.

One of the reasons that independent financial advisers were slow to use these products for their clients is that **structured products are tranche products which are only open to subscription for six to eight weeks** and there is not always a new product available once one tranche has closed.

The IFA would therefore be involved in a great deal of research into a product that would only be available for a short time and **the costs involved in doing this could easily become prohibitive**. However, this is not really the case anymore.

While some providers will launch a structured product relatively infrequently, many now ensure that **once one tranche has closed another of a similar structure and objectives will become available**.

It is important to remember that structured products are not an asset class in themselves; **they are merely a way of gaining exposure to asset classes**. If the risk profile of an investor shows that he or she should hold 40% in equities, then a structured product linked to an equity index could form part of that 40%.

One of the advantages of structured products is that **they 'do what they say on the tin'** and this is after all charges have been taken out. Although we could certainly do with more clarity over charges, and no doubt this will come, **the investor knows what he or she will receive net of all charges if certain conditions are met**.

Capital Protection

Most investments, as opposed to leaving your money on deposit, do not include any form of capital protection. Retail structured products, however, **do usually provide a measure of capital protection** and this is what makes them so attractive to investors.

Potential investors should **note the difference between 'protection' and a 'guarantee'**. Although some structured products do carry a real guarantee, this is unusual as it can only be provided by a third party and the cost of providing a guarantee is normally prohibitive.

There are two types of protection generally offered:

- **Hard protection** is where the minimum return is fixed regardless of the underlying investment performance.
- **Soft protection** is where the minimum return will only be achieved if the underlying investment maintains a certain level. If not, the protection can be lost in part or completely.

Capital protection is **usually provided by placing a proportion of the original investment in a bond**, called a zero coupon bond, which will pay out the protected amount at maturity (usually after three to six years).

Example: Assuming that the bond provider of a six year structured product is able to obtain an interest rate of 3% pa, the product would need to set aside approximately 86.2% of the original investment so that this would grow to 100% after six years. Assuming 5% for expenses this leaves 8.7% to provide the index performance.

The level of protection offered is directly linked to the level of participation offered in the particular asset. In other words, **the greater the capital protection, the less participation in the performance of the index** or asset and vice versa.

'You have to find a happy medium between a quality issuer, who you have a high degree of confidence will be there when the note matures, versus something that is going to give you an acceptable return'

Phil Cutts, head of advisory RBC Wealth Management

The Underlying Investment

The underlying investment for the majority of UK retail structured products has been the FTSE 100 index. However, **the market is increasingly offering products linked to a wider range of asset classes**. Structured products can now be found which link to a range of stock markets or other financial indices or indeed almost any measurable asset type (eg commodities, house prices, inflation).

Where the asset is valued in a foreign currency the return is almost always hedged for retail structured products, that is, the currency difference between say the US dollar and the UK pound is not taken into account and **does not become an extra risk for the investor** to think about.

Products will not necessarily be linked to just one index or asset. **Sometimes, the return can be dependent on the performance of more than one index** and this will obviously change the risk profile of the product.

If the product is linked to say, the FTSE 100, the Nikkei 225 and the Nasdaq 100, investors need to be clear whether returns are based on all three indices, or the worst performer or the best performer.

Who Offers Structured Products?

The product providers are usually **the big investment banks and high street banks**.

With a subscription period of between six and eight weeks **it is impossible to research the market without good online research systems**, as any lists of products could be out of date almost as soon as they are published.

We use the following research systems and websites:

- **Defaqto Engage** - has been researching the UK retail financial services industry since 1994. During this time they have established a track record and brand reputation for providing in-depth information across the whole financial market. They are a major name within the industry.
- **Future Value Consultants (FVC)** - is a company specialising in structured products and derivatives strategies. Founded in 1998, it provides consultancy, analytics, reporting and research to many financial institutions in the UK, US and worldwide.
- **Citywire** - is an independent financial publishing and data group, with a team of over 80 staff, producing news, investment ideas and recommendations every weekday. Citywire was founded in 1999 by its Chairman Lawrence Lever, formerly Financial Editor of the Mail on Sunday and Assistant City Editor of the Times.

The Parties Involved

A structured product **will normally involve three separate parties** who come together to build and distribute the product:

- **The Product Provider** - who will have conceived the product and will be responsible for distributing and marketing it.
- **The Administrator** - usually outsourced, who will run the scheme.
- **The Counterparty** – this is the supplier of the underlying derivatives which are used to power the product.

The same organisation can undertake one or more of these.

Counterparty Risk

It will be clear that the strength of the protected part of the product is **only as good as the strength of the bank or other institution, that is, the 'counterparty'** which is looking after the major part of the investment which is deposited with them.

Counterparty: the institution, usually an investment bank, which provides the underlying investment package for a structured product.

In the early days of retail structured products it was not normally declared who the counterparty was, just that they had a certain minimum credit rating.

Today, **IFAs will not usually recommend a product unless they know the name of the counterparty.**

The main credit rating agencies are **Standard & Poor's, Moody's and Fitch**. Ratings of AAA (the company's capacity to pay interest and repay principal is extremely strong) to BBB (the company is regarded as having an adequate capacity to pay interest and repay capital) are generally considered as 'investment grade' and would be acceptable for structured products.

It is usual for IFAs to only recommend companies with a rating of A and above.

At the time of writing Barclays (rated AA- by Standard & Poor's) has a robust market position and strong standing in the UK as a structured product provider through Barclays Wealth. Conversely, Investec is rated as less secure (BBB from Fitch Ratings and Baa3 from Moody's) and so its structured products may offer more attractive returns.

However, Investec (Winner, *Professional Adviser Awards 2009, Best Structured Products Provider*) has sought to deal with this issue as many of its plans are available in two versions, one of which uses Lloyds Bank as the counterparty rather than Investec for added security. A current example is their 5 year Capital Guaranteed FTSE 100 Plus Income Plan where the normal Investec version provides income of 7% pa and the Lloyds version provides income of 5.75% pa. In this way investors can make a choice depending on their need for a high income and their attitude to the risk of capital loss.

Term of the Investment

Retail structured products are **set to run for a fixed term, typically three to six years**. It is not possible to redeem the investment early unless there is a specific trigger point (referred to as a 'kick-out' or 'knock-out') to do so, stated at the outset.

Kick-out/Knock-out: a feature that brings forward the maturity date of a plan, usually with a predetermined return. In retail products kick outs are usually triggered by index/asset levels on a plan anniversary.

If an investor does require access to their investment in an emergency **there will be penalties imposed, which can be heavy**, as it will usually involve cashing-in a financial instrument early.

At maturity, **the investment comes to an end, whether or not market conditions are favourable.**

Most structured products introduce 'market averaging' over the final 6 or 12 months of the term, so if the value of the index being tracked does take a tumble towards the end of the term, **the averaging will dampen the effects**. Of course it has the opposite effect if markets are rising as the upside return is diluted.

Averaging: the process of averaging of an index/asset level. This is normally to determine the final level, but sometimes to set the initial level. Final averaging may be at any frequency (typically monthly or daily) over a fixed time frame, for example the final year or six months of the investment period. Initial averaging tends to be over much shorter periods.

Participation

Returns at maturity can be geared, that is, **the percentage return could be more or less than the equivalent asset performance**. In broad terms, the higher the participation in the performance of the asset, the less the capital protection.

Gearing: a measure of the movement in product value as a percentage of the movement in underlying index/asset level. 300% gearing is a 3:1 movement. Gearing may be at different levels for rises and falls.

Sometimes, in order to maintain a high participation rate and maintain good capital protection, **the return at maturity can be capped**.

Cap: an upper level on overall product returns. It is here that difficulties arise in comparing products. Is one-for-one participation in the asset better or worse than 150% participation that is capped at say 50% over the five years?

There is, of course, no right answer to this question, **it depends on the investor's confidence in the markets** and this aspect will need to be examined independently for each investor.

Taxation

Growth structured products **are subject to Capital Gains Tax (CGT)**. In view of the generous annual exemption and the fact that the maturity date is usually known, this means that **there is an opportunity for some beneficial tax planning**. Investors need to bear in mind, however, that a plan with an early maturity kick-out **can mature early and throw out any carefully thought out tax planning**.

Capital gains tax (CGT) is currently paid by individual investors at a flat rate of 18%, but the annual CGT exempt amount may cover all, or a large portion, of the gain.

In the main, **income producing structured products are subject to the personal income tax regime**. If this is a problem for an investor then **use could be made of one of the offshore income producing structured products** where the income is treated as dividends, meaning there is no further liability to income tax as a basic rate tax payer.

Using ISAs or Pensions etc

Most retail structured products can be held in an ISA, or self invested pension plan (SIPP) or offshore bond. **Many independent financial adviser firms now use wrap platforms** and a good number of these will allow access to structured products.

'Nucleus [Wrap] has attracted £18 million in structured assets and currently offers 50 different plans.'

David Ferguson, Chief Executive of Nucleus

Whether it is tax efficient or not to hold a structured product in an ISA is largely dependent on the investor's own circumstances.

As most of the retail structured products are subject to CGT, **they may be more appropriate for direct investment** as the likely return and maturity date are known, so that CGT exemptions can be planned and utilised.

It might be preferable for an investor to **keep the tax free status of his ISAs for investments where the return and investment period is unknown**.

General Guidelines

If investors take note of some of the basic principles of using any form of investment, then **structured products may well be a useful addition to their overall investment portfolios**.

For example:

- Remember that **equity investments** (ie stocks and shares or stockmarket linked) **need to be made for the longer term**. Investing in a structured product with less than a five year term that is linked to an equity index, and only has soft capital protection, is therefore taking a high risk.
- **Diversify your assets among different types of investments** such as equities, bonds (ie fixed interest) and easy access (ie deposit based or similar). This will avoid having all of your eggs in one basket. Investing **more than 15% of your capital in a single structured product is again increasing your risk**.
- Make sure that you understand the risks involved. **If you do not understand the circumstances in which you might lose money on your investment then you should not invest**, and you should look for something to invest in that you do understand. An important part of our role as independent financial advisers is to make sure that you understand the investments that are being recommended to you.

- Consider whether **other investment types may be more appropriate** and offer a lower risk to your capital. For example, the prospect of a high level of income may be attractive but if you do not require that level of income why expose your capital to more risk than is necessary?

Questions to Ask

It is easy for **investors to get carried away with the promise of an income of 7% pa guaranteed for five years**, as is currently available from some retail structured products.

It is important that **the investor understands what is being promised and in what circumstances they will not get their capital back**. It is also important for the investor to understand what the counterparty risk is.

Once the product is understood the investor can rest assured that (subject to the counterparty risk) the product will do exactly what it says it will do.

Investors should use an IFA to research the market for them and should be clear that they understand the answers to the following questions:

- **Which asset (or assets)** is the product giving exposure to, and does this fit in with your asset allocation strategy?
- What is the **term of the product**?
- What are the potential **penalties for early surrender**?
- Is the protection and/or participation dependent on **the performance of more than one asset**?
- What is the level of **capital protection**?
- Is it **hard or soft protection** that is offered?
- What is the **level of participation** in the performance of the underlying asset?
- Is the return at maturity **capped**?
- What is the **tax treatment** of the product?
- Is the product available through a **desired product or platform**?
- Has the product got an **early redemption kick-out**?
- Does any **averaging** of asset performance at the start or end of the term fit in with your view of the market?
- Are you happy with the **counterparty**?

Risk Factors

- Plan returns are based on the performance of an index or particular asset class. The past performance of an index or particular asset class is not a guide to its performance in the future and there is no certainty that the future performance of an index or particular asset class will be positive.
- Plan returns do not include any returns from dividend income or participation in corporate actions, as would be the case if you invested directly in the shares underlying the index etc. Accordingly, the return on the plan may, in some cases be less than the return from a direct investment in these shares etc.
- It may be possible to sell your plan prior to maturity. However, the proceeds you receive will depend on many factors, including, but not limited to, the index level, interest rates and the credit rating of the issuer. Consequently, investors selling prior to maturity are likely to receive less than their initial investment.
- The plan is not the same as a bank or building society account where capital is guaranteed and usually readily available without penalty. There is a risk that the product provider may not be able to meet their obligation to pay the advertised returns or to repay investment capital both during and at the end of the investment term.

Please note that this information does not constitute personal advice and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether a particular structured product, or indeed any structured product, would be suitable for you, then you should discuss the matter with a suitably qualified independent financial adviser such as ourselves.

Any information given in this Guide relating to income tax legislation is based on our understanding of legislation and practice in force at the date of this Guide. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

For personal advice

If you would like to discuss whether a structured product or other investment would be suitable for you please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**
or **01483 204600** (if local)
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**



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