Choosing a Structured Product

Five Essential Factors

Structured products are a growing area of the finance sector, and some investors may never have heard of them. Therefore, we believe it is very important that advisors have a clear understanding of what structured products are, and how to evaluate them. Below are five essential factors advisors should look for when determining whether a structured product is right for their client.

1

Counterparty Risk

Every structured investment you encounter will probably rely on a single financial institution to deliver the returns offered, in just the same way as a fixed-rate deposit does. What this means is that should the bank default, the client could potentially lose some of, if not their entire investment. Always be clear on who the counterparty is and what the associated risks are. Product promoters should be transparent and be able to supply you with an up-to-date commentary, including credit ratings, CDS (Credit Default Swap) levels and general financial strength.

2

Is the pay-off suitable?

If investors are seeking 100% capital protection, it is important they understand the minimum return on such a structure is unlikely to be more than they could achieve in a deposit account or with a fixed-rate bond. Advisors should always consider the validity of the investment and express realistic expectations to their clients. Higher returns come with either less probability of achieving them, more risk to capital, or both. It is important to clarify both the level of risk and the probability of achieving the returns offered.

3

Scrutinise the risk level of the product's basket of investments

In the market, some structured products seem to be designed to prioritise the level of fees over that of the client returns. As any additional fees will reduce the amount of the client's capital available to deliver the returns, this is an important factor for advisors to consider and fee levels should normally be readily available. In the quest for higher headline rates, products may need to be linked to inherently riskier underlyings. Indices are the most widely used, with the performance of a diverse selection of stocks seeking to manage overall volatility. Stocks are also used more widely now, and it is important that the criteria used for the selection is considered.

4

Questions about the underlying(s) that should be asked:

- Is it a strong and reputable company?
- Do market analysts feel the outlook is good?
- Do the analysts have major concerns?
- What are the recent activities of the company? – positive or negative?

Advisors must be transparent about the level of risk to investors' capital. If an investor has qualms and would be reluctant to invest directly into the shares of a company, perhaps it is not right for them.

5 Liquidity and value

Any investment is worth only what it can be sold for. Recent years have shown the importance of investing in assets that are priced on a mark-to-market basis rather than a mark-to-model basis. What this means is that the bid price of an investment reflects the price it can be sold for – either because it's listed and market makers will offer a price, or because there is a firm price quoted that will be paid by the issuing bank (in the case of most structured products). Mark-to-model pricing involves the investment manager, promoter or administrator making assumptions about the value of assets and converting this into a price for investors.

This can be a useful way of valuing property assets for example, but the pricing methodology can vary considerably. Every structured product should be valued on a mark-to-market basis and should offer regular liquidity to investors.

There should be no restrictions on sales or lock-in periods. If there are, it's worth exploring different solutions.

Reputation normally counts

You may recall several investments that have failed – in some cases, quite dramatically. Traded endowment funds, geared with-profit funds, life settlement funds, certain timber schemes, mortgage funds, and property development vehicles have all, at various times, promised much and delivered little. Perhaps more surprising is how some product developers and promoters seem to move seamlessly from one seemingly promising investment – which ultimately ends in disarray – to the next.

If you consider buying a structured product from a distributor with a track record of promoting disappointing investments, it may be worth investigating alternative options. Remember, an investment that pays a lot of commission and is easy to sell won't necessarily deliver a good outcome for investors. The main priority should be finding investments that are suitable and appropriate for your client's financial objectives.