Structured Products…
An Introduction

What is a Structured Product?

A structured product is generally a pre-packaged investment strategy using a bond & derivatives which provide exposure to a variety of asset types, such as a single security, a basket of securities, options, indices, or commodities. They are predominantly fixed term investments (tranche based) with a limited opportunity to invest, (the open offer period), which can be anything from 4 to 8 weeks. They can be offered in a variety of currencies and provide a variety of returns in terms of capital, income and growth. As a result there is no single, uniform definition of a structured product. Structured products can be created to meet specific investor needs, ones which it may not be possible to be met by the more standard or traditional investments. They are no longer seen as a niche market, and with Advisers seeking whole of market solutions, they are an attractive and versatile solution within wealth management strategies.

Diversification

Structured products can offer investors access to asset classes that are difficult and expensive to invest in. It's quite expensive buying a portfolio of houses, but an investment linked to the Halifax House Price Index can deliver the same benefits with a greater level of diversification and a fraction of the associated costs. Investing in one or two shares, with their price being impacted by speculative trading, poor company results etc., is far riskier than the FTSE100 where there is a more diverse company and sector exposure. Commodities have also proved popular in the structured product market in the last couple of years, as well as overseas equity markets.

Why should Investors be interested in Structured Products?

With interest rates at an all-time low, many investors are no longer able to secure returns in the bank or building society that they would like. Some have sought higher returns from the stock market, but with uncertainty dogging the global stock many have been disappointed, receiving with low returns or even losing money. So, what makes structured investments attractive? Structured products can be designed to deliver attractive returns in both rising and falling markets. Details of how the performance of the investment will be determined, repayment dates and capital risk are all set out prior to investment. This investor knows what he is buying and so his expectation of returns is managed effectively. The returns are clearly defined, and they do what they say on the tin. With no ongoing fees, the investments beat most traditional investments in terms of the charges. The initial charge, which includes the commission paid to the adviser, is an implicit part of the structure's design and so the total of the client's capital is invested.

How are Structured Products built?

Most structured products are made up of a combination of cash and derivatives. The cash element and sometimes the whole structure can be composed of Medium Term Notes (MTNs). In essence these are loans to the companies that issue them. They are designed to have a set "life" and most product providers would buy MTNs from recognised financial companies such as investment banks.

The derivative element provides exposure to the underlying stock market Index. Most commonly used are Put Options and Call Options

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Call Option	Put Option
A Call Option gives its holder the right, but not the obligation, to buy something at a previously agreed price at some point in the future. So, if someone holds a call option on the FTSE 100 Index that can be exercised in 5 years' time, they will be able to "buy" the Index at today's price. In other words, if the Index has risen, they will be entitled to that gain, but if it has fallen, the option is worthless.	A Put Option gives its holder the right, but not the obligation, to sell something at a previously agreed price at some point in the future. So, if someone holds a put option on the FTSE 100 Index that can be exercised in 5 years' time, they will have the right to "sell" the Index at today's price. In other words, if the Index has fallen, they have protected the value of their investment because they can sell it at today's price.

How do Structured Products Work?

There are all sorts of ways of putting together products to generate different returns, but the basic principles are quite straightforward. Products broadly fall into two categories:

- Those that offer capital protection and some stock market exposure
- Those that pay a higher return generated at the cost of some risk to the investor's capital

Basic structure

Enough of your capital is invested in cash so that at maturity it will be worth 100% per cent (or more) depending on the product – this is how the capital is protected. The remainder of the invested cash goes towards charges and to buy call options. The amount of money spent on call options dictates the terms of the product. The returns offered are net of any charges, and with no ongoing fees, the investor is not exposed to deductions during the life of the product which with many investments can reduce or even cancel out any growth which may be generated.

Let's take a simple example of a product with a term of 5 years. The cost of the protection is dictated by the current bond interest levels. If we assume a rate of 3% p.a. then 85% of the capital will be needed to buy an MTN which will grow to 100% at the end of the term. This leaves 15% of the original investment to pay the initial charge and to buy call options which will provide the returns. These building blocks allow a variety of pay-offs (i.e. what the client will get for his investment) to be structured. Let's look at those most commonly available.

Popular features

One feature which can be very attractive in uncertain markets is capital protection and as noted above, MTNs can provide that and the use of derivatives, may also provide returns higher than cash. If the investor is willing to accept a degree of risk to his capital then less money is used for the MTN and so more is available to buy the options and so seek out opportunities for growth. Or if the investor, whilst accepting that it is a fixed term, likes the idea of early maturity, then this feature can be provided as well.

With these basic pay-off styles both capital growth and income products can be designed. We have found that the most requested structure is the latter and so let's look at that in more detail.

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Autocallable Notes

These are designed to mature (or call) before the end of the fixed term, should certain pre-defined criteria be met. For example, where an investment is linked to the performance of a stock market, the criteria (often called the trigger) for the early maturity may be that at a predetermined date (say 6 months or 1 year after the product starts), the index is at or above its initial level. If the early maturity is triggered, the investor receives both his capital and any predefined returns, and then has the opportunity to reinvest once more. This structure also provides for the return (or coupon) to be accrued until the maturity is triggered –known as a snowballing coupon. For example, if the product has a fixed term of 5 years, with annual trigger points and pays a coupon of 10%, if the trigger event happened at the end of year 3, the investor would get his capital plus 3 coupons –i.e. 30%. To provide the early maturity feature and an attractive coupon a level of capital risk is incurred. The risk is limited to a predefined level (safety net) with the performance of the linked investment needing to fall say by 50% before the capital return is impacted. By fixing the returns at the start of the investment, there is always the chance that the actual market returns are in excess of the fixed coupon. But the reverse is equally true, if the investor is happy with the terms of the autocall, then this type of product my well suit him better than any direct investment.

This is not the end of the story

Structured products are just that – structured for a specific reason and to meet a specific demand. The variety of underlying performance links, MTN and derivative combination provide a flexibility that more traditional investment can never provide. The investments can be delivered to market in a very short timeframe (e.g. as little as 1 or 2 days) then this speed allows the investment to make the most of market opportunities as they arise. In an adviser's whole of market solutions the structured investment is a very useful tool – and with its defined returns and protection, it sits well within any client's portfolio.

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