



FEATURE ARTICLE

Date: 12th February 2010.

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Structured Products

According to industry data from StructuredRetailProducts.com annual UK retail structured product sales grew by 47% in 2009 to a record £13.3 billion, compared with £9 billion in 2008. Indeed detailed analysis of the StructuredRetailProducts.com data by Blue Sky Asset Management highlights that the structured product industry has experienced average gross annual sales growth of 20.3% over the last 10 years. Yet even though the use of structured products is undoubtedly 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 will examine a particular imaginary income orientated structured product and provide some guidance as to some of the issues that I believe IFAs should consider when recommending such a structured product.

For the sake of this article the product we are considering pays an income to the investor of 6.75% of the original investment once a year over the five year term of the investment. The investor will receive the original capital invested back at maturity in five years time unless a 50% downside barrier is breached during the product term. Once the barrier has been breached then an investor is fully exposed at the end of the term to any decline in the underlying index (FTSE 100) on a 1% for 1% basis. If however the index subsequently rises to at or above its initial level at maturity no loss will be incurred.

In my opinion the first thing that an IFA should do with reference to this offering is to look “under the bonnet” at how this product has been put together. Well the answer is that in order to achieve the product specifications a deposit or zero coupon bond is purchased from a counterparty which, when interest is added to the initial investment over the term of the offering, will repay the original capital of



the investor at maturity. Let's say that in this case that costs 86% of the original investment. In addition we also have commission payable to the IFA of 3% and various fees totaling 2%.

Now because there is a downside barrier at which capital is lost this is the result of selling a put option – which generates income but potentially depletes capital as described in the product specification. Let's say that in this case the income generated by selling this put option and accepting the risk of the index falling and capital being lost is 22%.

The overall result is that this product now has enough income generated from the sale of the put option plus initial capital remaining (allowing for discounting) to pay the yield of 6.75% per annum and meet all of the other product specifications as described.

Now in addition to understanding how the product works an IFA should, in my opinion, consider and explain to a client a number of factors in relation to this offering. These include, for example, the fact that if the index rises over the investment term there is no participation by the investor in that rise. 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 also remember that a return of the initial capital after an investment period of 5 years means that although the investor may receive the same monetary value back as they originally invested this may have been eroded in terms of purchasing power by inflation.

It should also be noted and explained that although an annual income of 6.75% may appear to be attractive in the present economic climate this may also be eroded by the effects of inflation over the investment term and may not therefore be as attractive at the end of the investment period as it appears now depending on prevailing economic conditions over the investment term. I would also consider and explain to an investor that the FTSE 100 index is a market-capitalisation weighted index and risk therefore is not, in fact, as diversified as the name implies.

In addition I would ask what the tax treatment of the investment is and whether this is tax efficient for the investor and of course the credit rating of the institution with whom the monies are placed on deposit or in a bond (known as the "counterparty") is vitally important because if this institution were to default the capital would be at risk. This risk was highlighted by the collapse of Lehman Brothers in 2008. 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.



It should also be noted that in this example the potential loss of capital in terms of the downside “barrier” of 50% from the initial index level is triggered at any time during the investment term rather than simply at the end. By doing this it makes the put option more attractive to any purchaser (remember the structured product has sold the put option) and this therefore increases the price of the option and therefore the income that can be generated by the offering.

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.

Now I must stress that what I have described here is a relatively simple structure and I am fully aware that there are many different income and growth structures out there including so called “kick-out” income plans and various growth plans. These plans will all have different terms and specifications and may, unlike the product I have described, include additional potential areas of risk such as, for example, using averaging over various time periods or using multiple indices or a basket of individual stocks to determine the ultimate returns.

Ultimately however my view is that when an IFA is considering whether a structured product is appropriate for a particular client there are a couple of axioms which have served me well over the years and which I think are particularly relevant in that process.

First, when considering any investment, the higher a potential return, be it income or capital growth, the higher the risk and secondly if you don't understand how something works or are not provided with full details, then avoid it.

So who are structured products suitable for?

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. The cost and risks of any capital protection must however be fully understood not only in terms of any potential capital loss but also in terms of any opportunity cost.

My view is that ultimately provided an investor is fully informed of the nature of the investment they are making, especially the risks of the offering and in addition alternative investment possibilities available are fully discussed then a structured product might be appropriate.

I personally would not start from a position of saying I would never recommend any structured product but as I have already said I would never recommend something which I did not understand.



A good starting point for me when reviewing and comparing structured products available at any point in time is the service provided by Future Value Consultants at www.futurevc.co.uk. This is free to financial advisers once you have registered and I would urge anybody thinking of recommending a particular structured product to take a look.

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