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Structured Products: The Major USP of 'Investing by Contract' ... and the derivatives red-herring!

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A major USP of structured products, that the industry, in the UK and globally, has done an ineffective job of explaining and extolling the virtues of, for advisers or investors, and to regulators, the press, consumer bodies, etc., is that first and foremost structured products equate to 'investing by contract'.

As part of a balanced portfolio, that seeks to diversify not just asset allocation but investment strategies, investing by contract through structured products is an extremely compelling investment approach for investors, with significant and unique benefits and advantages, vis-à-vis other investment types, which have, thus far, been poorly understood.

Misunderstanding that has been aided and perpetuated by the reverberating comments of the industry's detractors, many of whom have erroneously but noisily fixated on what they perceive to be major negatives of structured products, such as the use of derivatives and apparent complexity.

This Paper seeks to address these points now ... highlighting major benefit of structured products and, in the process, dispelling major criticisms and explaining why many critics have been so wrong for so long.

When investors invest in structured products they have and benefit from a 'contract', that precisely details what can be expected, in terms of potential risks and returns - dependent upon the institution behind the contact, i.e. the counterparty, remaining solvent, i.e. the credit risk.

What counterparties do behind the scenes - all the so called 'complex stuff', that critics fall over themselves to highlight as reason to avoid structured products - is done in order for counterparties to hedge themselves against their legal obligations to meet the terms of the contracts that they have issued, i.e. the 'investment process risk' of the counterparty delivering the returns contractually promised to investors.

This investment process risk is borne by the counterparties. It is their problem ... not investors. And this is in stark contrast to virtually any other form of investment - certainly in stark contrast to typical mutual funds, ETFs, etc., whether active or passive - where the process risk, of what the fund management firm and fund manager does, passes all the way down the food chain and sits squarely in the lap of investors.

The FACT is that if a counterparty behind a structured product is solvent at maturity they are legally bound to deliver exactly what they stated to investors at the outset, via the terms of the bonds / securities that they issued ... regardless of what they have done behind the scenes during the investment term: including the possibility that they've done nothing at all or that they completely mess up anything / everything that they have done!

Investors holding a structured product really can abdicate any interest in the behind the scenes process - such as the zero coupon bonds, the derivatives, the hedging process, etc. They can ignore all of it - and rely upon the terms of the contract that they hold, which details what the bonds / securities that their product is based upon will deliver - focusing all of their attention simply upon whether they believe the counterparty will be solvent at maturity.

As already highlighted, this is in stark contrast to actively managed funds, and even passive funds, where investors are directly exposed to the risks of the fund management process: if the fund management house and / or fund manager get their fund management process wrong (asset allocation, sectors, stocks, timing ... and whether the fund manager changes job, or falls under a bus, etc.) investors may underperform / lose money. They will, of course, receive a nice annual factsheet explaining why - perhaps pointing to the funds' ranking versus other similar funds still being respectable (because all such funds lost all such investors money!).

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The investment processes behind active funds are basically nothing more than 'aims and hopes' – not promises and certainly not contractual obligations to deliver the stated aims.

Let's make this major benefit USP of structured products easy to understand ... and irrefutable:-

- Imagine that an investor invests in a structured product, with a 5 year term;
- Now imagine that on the strike date, i.e. the start date, of the product the treasury team of the counterparty goes on holiday for 5 years – and no zero coupon bond is set up for the product;
- Also imagine that the equity derivatives team of the counterparty goes on the same holiday for 5 years – and no derivatives are put in place for the product;
- And, in addition and just for good measure, the entire risk management team of the counterparty also has 5 years off - and is not there to check that the treasury and equity derivatives teams are at work and 'doing their thing';
- As a result, throughout the entire term of the product, the counterparty doesn't do anything at all. No zero coupon bond is in place. No derivatives are used. In fact, there is 'no investment process' whatsoever behind the scenes of the product, throughout its entire term. Literally nothing is done by the counterparty. They hold investors' money for the full investment term, but do absolutely nothing with it.

QUESTION: *What will the structured product deliver to investors at maturity?*

ANSWER: *Everything that investors expected at the outset, if the counterparty is solvent.*

To further reinforce this point, consider this: the perfect structured product counterparty is the strongest bank in the world ... with the most stupid equity derivatives team. They offer products that are so good they could never be hedged, even if they tried, but which the bank will have to deliver on at maturity, unless they are bust!

The FACT is that the behind the scenes process of a structured product is irrelevant to investors at maturity ... because investors are investing in and hold 'a contract', which affords the counterparty no 'wriggle room' not to deliver what has been legally promised by the terms of the contract, at maturity, if they are solvent. And, remember, counterparties to structured products are usually amongst the strongest institutions in the world, and they like staying solvent – as do their governments, central banks, regulators, etc!

Investors investing in structured products are NOT investing in zero coupon bonds, derivatives, etc. They are investing in contracts. It is the issuers / counterparties of structured products that use derivatives (if they are not on holiday and don't forget!) in order to hedge THEIR EXPOSURE to THEIR LEGAL OBLIGATIONS to deliver the terms of THEIR BONDS / SECURITIES.

It can be interesting, for advisers and investors, to know what may go on under the bonnet of a structured product – in terms of the counterparties' hedging process. For example, how zero coupon bonds are priced, how call options are bought and put options are sold, etc. But, the simple fact is that this information, that might be interesting for some to know, is irrelevant at the maturity of a structured product.

During the investment term it is slightly different, as secondary market prices of structured products, where they are offered to investors, will reflect the value of the instruments that the counterparty uses and the value that they attach to them, which can be affected by interest rates, the underlying market/asset, the issuers' credit spread, etc. But secondary market liquidity and the prices available are increasingly well understood by professional advisers and investors, and are being utilised to good effect, to take early gains, etc.

'Investing by contract' is clearly one of the major and irrefutable USPs, if not the major USP, of structured products. The long-reverberating points about derivatives, and underlying complexity, etc., made by misinformed and misinforming critics, are red-herrings.

As part of a balanced and diversified portfolio, diversifying investment strategy as well as asset class, in challenging market conditions, when market direction, risk and returns are unpredictable, what can be simpler and more compelling than investing by contract – to completely remove investment process risk from retail investors and pass this up the line to major financial institutions.