Planning Research Note

STRUCTURED PRODUCTS

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Structured products use **derivatives** to offer a range of different opportunities for growth, income, or guarantees which may not be available by direct investment alone.

The products can be complex, and the terms of offer should be carefully examined to ensure that it offers the desired outcome in **all** market scenarios.

We look here at some of the different types of structured product available, and the pitfalls to be aware of.

SUMMARY

Structured products have become more prevalent in recent years with increasing use of **sophisticated derivatives** and the demand from investors for structured investments that will **retain their value in bad years and rise in good years**.

Providers generally compete on the headline **income** or **growth** figure the product has the potential to achieve. Investors must remember the basic investment rule that a **higher potential return equals higher risk**, and examine carefully the **underlying terms** of the product, which may contain **hidden risk and complexity**.

There are two main types of product – **capital secure** and **growth/income secure**. However, there are increasing numbers of new products that fall somewhere between these two types.

These are **fixed term investments** that should only be considered if money can be tied up for the duration of the plan. There is **no secondary market** for plans, and **penalties may be applied** on early withdrawal.

Products can be either structured to pay profits as **capital gains** or (less usually) **taxable income**, which can make a large difference to the return net of tax.

TYPES OF STRUCTURED PRODUCT

CAPITAL SECURE

These types of product are also known as guaranteed or protected capital/equity bonds, although should not be confused with either corporate bonds or insurance company bonds.

Perhaps the best known structured products are those that offer a capital guarantee together with a percentage of any upside in a market or basket of individual stocks or funds – known as a 'participation' product. The price of the capital guarantee is that the equity participation is limited, especially during volatile market periods when the price of the capital guarantee is high.

A typical example would be a 100% guarantee together with 80% of the upside in the FTSE 100 index over the next 3 years. This structure is often achieved by investing most of the capital into a secure interest-bearing deposit or zero coupon bond that will return 100% of the capital over the set period. The balance is used to purchase sophisticated derivative contracts that deliver the participation in any index rise. For example, an investment of £1million may be allocated £900,000 into a zero coupon bond returning £1million after 3 years. The other £100,000 may be used to purchase derivatives that will give exposure to 80% of any increase in the FTSE 100 over 3 years.

An alternative to the traditional participation structure is what is known as a 'cliquet' design. With these types of products, the index growth is calculated periodically throughout the term, with upper and/or lower limits applied. The total growth achieved is the sum of these periods of growth. These types of product can allow a higher potential maximum return, and give the potential to outperform the market, even if it has fallen over the period.

GROWTH OR INCOME SECURE

These types of product are also known variously as guaranteed or protected income bonds, or high income bonds, and again should not be confused with either corporate bonds or insurance company bonds. These products typically offer attractive headline rates of income, with some degree of capital protection, however, will usually not protect against heavy market falls.

To achieve a higher level of income than deposit accounts, there must be some element of risk to capital linked to poor market performance. Investors who require this higher level of income must recognise that there is a risk to their capital, and that this will be proportionately higher for higher levels of income.

Some of these types of structured products are highly risky – so called "precipice bonds." Here, the capital return at maturity can be less than the original investment if the index falls over the period of investment. Upside returns are often higher than the index return. Commonly, capital is lost on more than a one for one basis (i.e. is geared) and can leave the investor with virtually no capital return. Precipice bonds were very popular in the mid to late 1990s; many investors did not understand the level of risk that they were taking, and so received unpleasant shocks.

POTENTIAL PITFALLS

There are so many permutations of these types of products that we cannot cover all the potential pitfalls here. The terms of each individual product must be examined carefully prior to investment to establish the potential worst and best case scenarios, and likely returns given set variables.

Structured equity products are more often suitable for those investors who have a lower appetite for risk and wish to 'hedge their bets', whilst accepting that potential returns are lower for a lower level of risk taken. In many cases, if an investor has sufficient appetite for risk to invest in the equity markets over the longer term, direct investment will give potentially better returns than guaranteed equity plans, and will be more flexible.

Structured income products are more often suitable to those who require a higher level of income, and fully understand the downside risk to their capital. They are not suitable for those who cannot afford to lose capital.

Some of the main pitfalls are as follows:

- Investors should consider whether they could achieve a similar or better result themselves more cheaply, especially if investing large amounts. It would be possible to invest a lump sum in a zero coupon bond, possibly a Gilt Strip and acquire index options or Contracts For Difference to give any upside exposure. Specialist advice would be essential in this case.
- Most structured products do not offer dividend payments, as these are used to help meet the cost of the guarantees. Dividends may, however, provide a significant proportion of total equity returns. For example, if the total average equity return achieved is 7%, with half of this coming from dividend income, the actual capital appreciation captured by the structured product (assuming that 80% of the index is captured) may be only 2.8% (80% x 50% x 7%). Participation terms are therefore extremely important.
- The investor must be aware of who is providing the guarantee, whether this is underwritten, and the creditworthiness of this institution.
- The dates at which the index value is "struck" can be a number of months after investment and the date of the index used for maturity growth calculations can be an average of a number of months prior to maturity. As a result the true growth of a 6 year investment may only be 5 years if the delays are 6 months in each case. The headline rate may then not even be achievable on the most optimistic scenario, when averaged over the true length of the investment.
- Some funds lock-in growth on a regular basis up to a set limit (e.g. up to 6% growth per month), so in actual fact only a limited amount of the index growth may be captured, whilst positive returns may be subject to the full falls in any one month. Overall protection is not always as simple as a definite "guarantee" resulting in the return of the original capital invested.
- A "precipice" drop in protection may exist with large swings in market value.
- The underlying index chosen is important, for example, the Nasdaq is very much more volatile than the FTSE 100. In some cases, a basket of indices (or individual stocks) is chosen. The correlation between these should be carefully examined, as lower correlation could reduce potential risk/return and vice versa.

TAXATION

It is important to consider the structure of the product, as this will affect how the proceeds are taxed.

Many products are structured as shares in, often, a Dublin listed company. Returns on these shares are usually classed as capital gains, but dividend payments are also possible. Capital gains may be subject to Capital Gains Tax (CGT) and therefore benefit from any unused CGT exemptions.

The structure can also be that of a bank account, in which case all of the return is classified as interest income and is potentially subject to income tax on maturity.

Products can also be structured as offshore single premium insurance bonds, and taxed accordingly, as income.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

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