There is no single, uniform definition of a structured product. The way they can be linked to many facets of the market, such as a single security, a basket of securities, indices, commodities, credit and foreign currencies, means they defy a simple, all-embracing explanation.

But that’s not so important – at least, not to investors. Because what they have in common is far more important – the ability to tailor an investment structure to meet specific investment objectives. These objectives take into account market or indices exposure; the final required payoff; and capital protection, while taking risk tolerance of the investor into account. Features can be added: yield; exposure to less accessible markets; or internal leverage via options, swaps or dynamic management.

Structured products were developed in the late 1980s and early 1990s as a way for individuals and institutions to structure investments to get their preferred mix of risk, return, yield, liquidity, income and capital gain in one product. They were a tailored investment to meet specific needs. By the early 1990s, they were popular products being distributed by European bank retail departments and global private banks.

The home of the structured product has traditionally been and continues to be Europe, where it is especially strong in Switzerland, Italy, Germany and Belgium, where it is the preferred investment vehicle of the ubiquitous Belgium dentist. However, in less than a decade, the US, Scandinavian countries and Britain have fallen for its charms, showing double-digit annual growth in the boom years leading up to the worst of the Global Financial Crisis.

Their popularity in Europe at the mass retail level is fuelled by the low interest rates environment. There, they are offered from national post offices and even supermarkets as an alternative to deposit products, which provide lower yields.

Today, their appeal is global. Structured products are now offered by a range of financial service companies, ranging from the retail banks, investment banks, brokers and boutique fund managers.

In Australia, investors initially favoured capital protected products that gave access to investment themes: market, funds and indices that were difficult to get exposure to, such as China; commodity trades or emerging market infrastructure.
The cost was not prohibitive with $10,000 minimums making it highly accessible to the high net worth individual.

The capital protection gave the investor the opportunity to borrow up to 100 per cent of the investment amount. The interest on these loans may be tax deductible, making structured products combined with loans a tax effective investment by deferring or minimising tax.

Not surprisingly, debt, and how it can be used to minimise tax, has now lost some of its allure. Preserving capital is front and centre of most investors’ minds. So now the market is favoring structured products without the loan component, investing in the product for the capital protection, yield or internal leverage.

THE TYPES OF STRUCTURED PRODUCTS

The GFC has reminded investors that risk means there is something to lose. For the investor, that loss is the loss of capital. For some investors, loss of their savings or capital is an unacceptable risk. Traditional risk management via diversification minimises risk, but there is still a risk that capital will be lost.

In the 10 years before the GFC, this risk was low, as market volatility was low and diversification minimised this risk significantly. However, in the post-GFC environment, volatility remains high and the risk of loss of capital has increased, even after diversification.

This environment has lead to an increase use of capital protected products in standard portfolio allocations, protecting the capital for the investor.

The other two styles of structured products that have seen success recently in Australia are reverse convertibles and products with no capital protection providing internal leverage.

Reverse convertibles have capitalised on the recent high volatility in the market converting this volatility into a yield for the investor. Capital is not protected. However, the risk of capital loss is minimised through the structure. In this structure the market must fall through a threshold level before capital is at risk.

The other types of structured products that have been popular recently are those with no capital protection. But they risk the full amount invested being lost. They provide internal leverage and the cost of these products are a fraction of the notional exposure. Investors used these products as a tool to construct their own capital protection strategies; an alternative to margin loans; or a tool to rebalance portfolios where by allocating 1 per cent of your portfolio can give you 10 per cent extra exposure (this is possible due to the internal leverage).

REGULATORY ENVIRONMENT

One common theme is that the structured product that delivers transparent risk/reward is being increasingly favored in times of market uncertainty. This is after the lesson learnt during the GFC where the complicated structured products behaved in unexpected ways and could not be explained to clients by their adviser.

In a bull market, that hardly mattered. Investors were just enjoying the drive, paying little concern to who was in the driver’s seat. Now they are far more questioning, and, in this environment, structured products, like many investments, have fallen foul of investors. As a consequence there has been a flight to cash, “sucking out” available funds for investment.

There was a perception that the products failed to produce the absolute returns expected; the truth is that in Australia they performed as expected; that performance, however, might not be the way the investor expected. There was also a perception that the capital protection did not work. This was due to a large amount of capital protected products that were sold during 2006 and 2007 in combination with investment loans; for these products the capital protection would not take effect until 2012 to 2014 and the value of the products fell as the markets fell in late 2007 and 2008.

There has also been a perception that structured products contain high commissions and fees that are not transparent because of the many parts, options swaps and fx hedging that can go into constructing a product.

A reaction to these issues has been a national debate on financial products and a parliamentary joint committee on corporations and financial services – chaired by Bernie Ripoll MP – to investigate initially the issues around product and service providers by Storm Financial, Opes Prime, but also eventually concentrated on the industry as a whole. It was tabled last November in Federal Parliament.

The report looked into, among other things, the role of financial advisers, the general regulatory environment for financial services, commissions, consumer education, and the need for legislative or regulatory changes.

The key ingredients in the report are appropriate – enforcement and education – based around educating the product provider and the investor.

But in all this debate it should not be forgotten that many structured products did perform as expected and some products did actually deliver above investor expectations during 2008 – those with managed futures, some market neutral funds and gold bullion components, for example.

Nonetheless, the sale of structured products fell by about a third in comparison with similar periods in 2009 as investors took a dim view on new investment products.

Also changes by the RBA to the capital protected borrowing rate caused investors to recalibrate their tax considerations for the product. Structured products had always been considered as a tax-efficient means of access to fully taxable investments because of use of lending to buy the products in Australia.

However, in the cautious aftermath of the GFC, renewed interest is being shown, particularly because of the ability to convert high market volatility into yield or the capital protected aspect of the product.

HOW STRUCTURED PRODUCTS WORK

The “capital protected” structured product offers protection of principal if the product is held to maturity.

For example, if an investor invests $100, the issuer invests in a risk-free bond that has sufficient interest to grow to $100 in, say, five years. That bond might have cost $80 today, so with the leftover funds ($20) the issuer purchases options or swaps that can satisfy the investors’ strategy. This option or swap may give exposure to an investment theme such as Emerging Market Infrastructure or to a market such as China.

Reverse Convertibles convert market volatility and correlation between assets into yield. The reverse convertible is issued
over a basket of stocks. As long as the worst performing stock does not fall below a barrier, say 35 per cent, the investor will receive their capital back plus a fixed yield. This yield is substantially higher than the current rate they could receive on deposit with a bank or building society. The risk is if, however, the stock does fall below this barrier then the investor will receive the yield – plus the performance of this stock till maturity. The stock could continue to fall or it could rally. The investor thus needs to have a view on the performance of each stock in the basket.

There is always a cost. For the reverse convertible it is the loss of capital if one of the stocks falls significantly over the term of the product. For capital protected it is the cost of protection. Some products use caps on the capital return to minimise costs. These limit the returns when the product does well, such as in strong bull market, thus limiting profit potential. It is the price that needs to be paid by an investor to reduce the cost so that they can benefit from capital protection.

Other risks to consider are the liquidity risk. A lot of structured products are illiquid and there is no secondary market. If the investor sells before maturity, there could be a penalty or break cost. Capital protection may not apply until maturity so unless you hold the product to maturity you may not receive the capital protection benefit.

There is also the credit risk – structured products are unsecured debt from the issuer of the product. Investors need to be aware that they are putting their principal at risk to the credit quality of the structured product provider.

THE FUTURE

A survey in Britain conducted by Morgan Stanley in the middle of last year gave a pointer to how financial advisers are now thinking about structured products. According to the survey, structured products have leapt to the lead, over bonds and mutual funds, as products most recommended by advisers – with capital protected structured products the most popular.

When quizzed about risk on a scale of one to 10, (with one being cash and 10 is emerging markets equities), structured products find themselves in the middle.

Despite the fact that structured products in Europe are offered in post offices (and even supermarkets) they are generally considered more secure than the 100 per cent protection provided by term products.

One of the criticisms of structured products mentioned earlier is their fee structure: many issuers work their fees into their pricing so there is no explicit fee or other expense revealed to the investor, making it hard to compare prices with similar products.

Capital protection is also involving into an open-ended style – this means it can apply at any stage and not just at maturity. This capital protection in this open-ended style will be at a lower level than the 100 per cent protection provided by term products.

One of the criticisms of structured products mentioned earlier is their fee structure: many issuers work their fees into their pricing so there is no explicit fee or other expense revealed to the investor, making it hard to compare prices with similar products.

Transparency of fees can be a problem with some structured products. Advisers should be able to assess the expected final outcome of each product and try to ascertain the fee level.

Around the end of the financial year, structured products are often offered with loans as tax effective investments. Its efficiency in such cases depends entirely on the applicable tax treatment – something that should be closely discussed with an experienced tax adviser and constantly changing. It is rare to see a structured product that has an ATO ruling.

To analyse structured products, both advisers and investors should not only assess the underlying investment based on their expectations but also the overlying structure as well, including the additional cost created by the particular strategy. Investment decision alone should not be made on tax effective arguments and the after tax running costs.

Some of these tax effective products defer the tax bill to maturity of the product which needs to be carefully analysed. As a rule of thumb, the breakeven IRR for a tax effective structured product will be the interest rate.

Structured products will remain an essential part of any investors’ portfolio as governments shift more and more responsibility on to investors to fund for retirement and the tolerance for investors to any capital loss remain low. Diversification only gets you part of the way there for these investors.

History has taught us that retail investors have a long memory and even after the rallies of 2009 investors’ tolerance to losing any capital will remain low for a long period.

Capital protection, because of this, has come out of the GFC market shake-up looking stronger than ever as a value proposition. And investors have been reminded that markets can correct quite strongly and quickly. And investors certainly do not want their retirement plans linked to the performance of the Australian equity market.