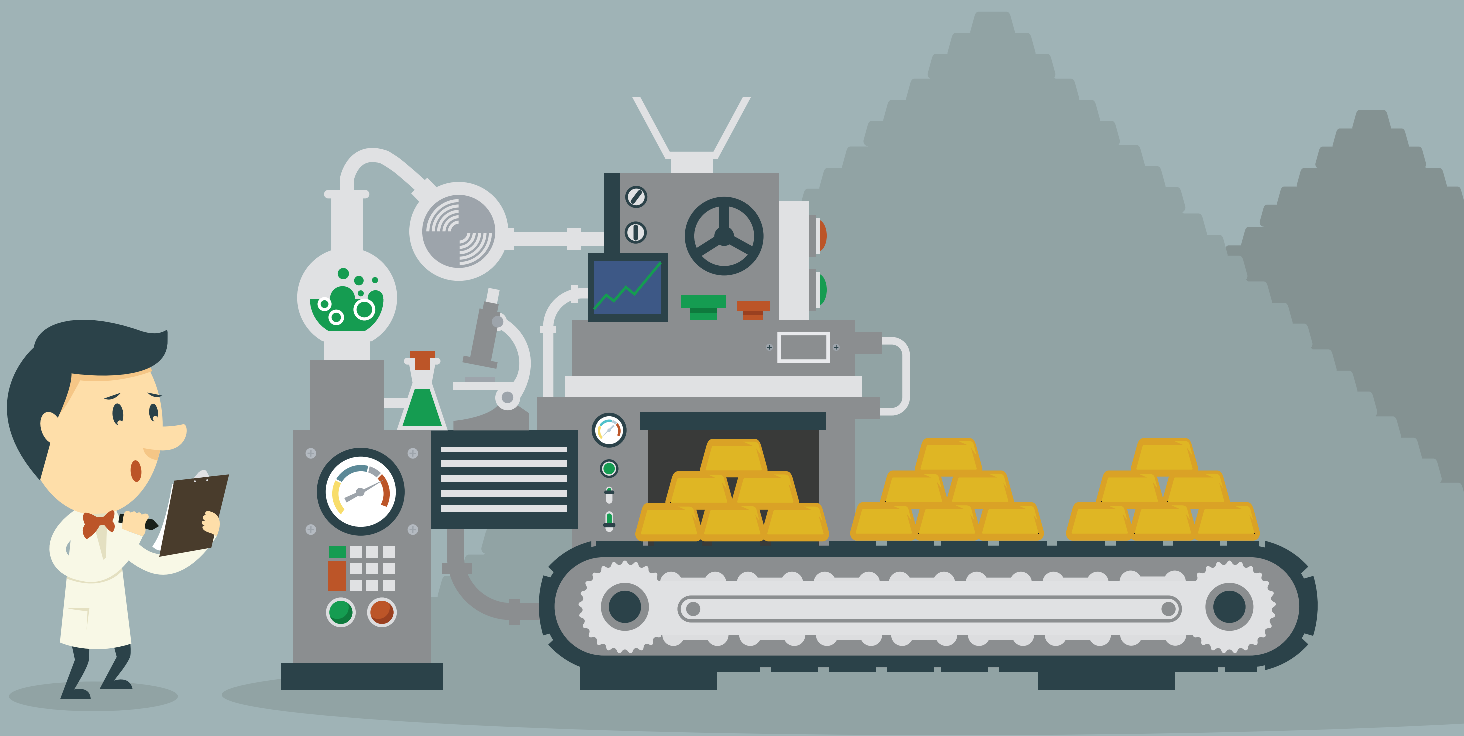
The *What Investment* guide to

Structured products

Controlling risks, choosing rewards



What Investment

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Experts

On 22 August 2013, *What Investment* brought together three leading experts from the structured products industry. This guide is based on their discussion.

James Harrington

James Harrington is currently head of structured solutions at Legal & General Investments. Having entered the industry in an advisory role in 1993, James has subsequently held various product design and business development roles within Legal & General. He is a former chairman and continuing executive member of the UK Structured Products Association (UKSPA).

James says:

'Structured products tell you exactly what you will get back in certain circumstances and how much it is going to cost you'

Ben Thompson

Ben Thompson is director of business development for listed products and Lyxor ETFs UK at Société Générale. He joined the bank in January 2011 to build on the marketing and partnership programme for independent financial advisers (IFAs) and retail investors in the UK. Today, he is also responsible for Lyxor ETFs in the UK retail and IFA channels. Prior to Société Générale, Ben was the head of marketing for UK structured products at RBS.

Ben says:

'When returns on cash and bonds are low and equity markets are going sideways, structured products can provide an alternative'

Ian Lowes

Ian Lowes is managing director of Lowes Financial Management and founder of CompareStructuredProducts.com, which provides consumers with the tools to search, compare, select and invest in a wide range of structured products. A multi-award winning IFA, Lowes has been analysing structured products for its clients for over 16 years and the company's expertise is widely respected by industry professionals, the financial press and private investors.

Ian says:

'Structured products are complicated, but not for the investor. You don't have to understand the science behind a microwave to be able to use it'

Controlling risks, choosing rewards

> 'To dismiss the entire structured product industry out of hand would be a big mistake'

If you've heard the phrase 'structured products' before, the chances are that it's been in a negative context.

The structured product industry has been fighting to rid itself of a reputation that it gained over the financial crisis, the result of a few high-profile product failures. But there have also been unit trusts and investment trusts that have imploded and left investors with next to nothing. Even some humble cash ISAs had to be bailed out by the UK government after the Icelandic banks behind them collapsed.

In fact, the risks of structured products are much better defined than those of unit trusts or investment trusts. If the financial institution that is backing a product (called the 'counterparty') goes bust, you may lose some or all of your money. But barring this highly unlikely scenario, a structured product will tell you exactly what you stand to gain or lose, and what's more, the date on which you will gain or lose it. It is designed to deliver nothing more, and nothing less than that.

For a whole swathe of British savers and investors who are deeply unhappy with the measly interest rates offered by conventional savings accounts, and yet don't want to take full stock market risk, structured products could have an important place. To dismiss the entire industry out of hand is easy for a lazy commentator, but would be a big mistake for someone who wants to get a better return on their money along with a measure of protection against losses.

Horses for courses

It's not just the combination of better returns and some protection that is appealing. It's also the investor's ability to take control by selecting the products that offer the balance of risk and reward that they feel comfortable with. For example, the risk-averse investor can opt for a product that exposes her to no more danger of losing her money than an ordinary bank account, but with the chance to earn a better rate of interest. The more confident can accept a small risk of loss in exchange for a higher potential return, while the adventurous can put together a portfolio of products with a more daring risk-reward profile.

This guide is split into two parts. Firstly, it explains the benefits and risks of structured products, how to access them, and their tax implications. Second, with the help of three industry experts, we take a deeper look at the issues surrounding these investments, and explore the role they could play in a wider portfolio.

I hope this guide will be useful to you and encourage you to take a fresh look at a large and diverse family of savings and investment products. ◆

Nick Britton
Editor, What Investment

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Debate

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What are structured products?

Structured products give you defined returns, in defined circumstances, on a defined date. The returns depend on the performance of some underlying asset or index, for example the FTSE 100 index.

There are two types of structured products, structured deposits and structured investments.

Structured deposits

What are they?

A structured deposit is like a cash account, in that it protects the money you originally deposited (your capital). However, the interest rates you could earn are normally dependent on the level of a share index, such as the FTSE 100, on a particular date. A typical structured deposit will pay you a set interest rate if the FTSE 100 reaches or exceeds a particular level. If the FTSE 100 does not reach that level, you earn no interest, but your capital is protected.

Benefits

- You will get your money back unless the company backing the product (the 'counterparty') goes bust
- Even if the counterparty goes bust, you may be eligible to claim up to £85,000 from the Financial Services Compensation Scheme (FSCS)
- You may earn more interest than if you put your money in a bank account
- You know exactly when you will be getting money back with any potential gain, which can help with tax planning

Risks

- You may earn no interest if the FTSE 100, or the relevant index, does not reach the specified level
- When your money is returned to you at the end of the term, its real value is likely to be less because of inflation
- If you need your money before the end of the term, you may not be able to cash in the product, or (more likely) may have to cash it in at a loss

Examples (no longer available)

Investec Deposit Growth Plan 22 – Option 1
This product returns your capital after five years, together with an interest payment equivalent to any rise in the FTSE 100 over the period. If the FTSE 100 does not rise, you get your money back. (Note that you do not benefit from any dividends paid by FTSE 100 companies.)

Legal & General 6 Year Growth Deposit Bond 18
Provided that the FTSE 100 rises over the six-year term, you will get an interest payment equal to 1.15 times that rise, capped at 40 per cent. If the FTSE 100 does not rise, you get your money back after the six years.

Societe Generale Money Builder Deposit Plan 1
This six-year product may accrue interest of 8 per cent on each anniversary of the start date, depending on the performance of a basket of five shares (BP, BT, Rio Tinto, Tesco and Vodafone). On each anniversary, the five share prices are checked, and if any one has fallen more than 5 per cent below its initial level, no interest payment is made that year. If all share prices are above this threshold, you get your 8 per cent. Your capital is returned at the end of the six years whatever has happened to the shares.

Structured investments

What are they?

Structured investments are often known as 'capital at risk' products, because you may lose some of the money you invested. As with structured deposits, the returns will depend on the performance of some underlying asset or index. However, they differ from investing directly in the stock market because, in many cases, your potential losses and/or gains may be capped.

Benefits

- Your potential losses are likely to be less than if you invested directly in the stock market
- You may be able to get a better return than you could with a cash deposit, or a structured deposit
- You know exactly when you will be getting money back with any potential gain, which can help with tax planning

Risks

- Because they are classed as investments, structured investments are not protected by the Financial Services Compensation Scheme (FSCS), so you could lose some or all of your money if the counterparty goes bust
- You could lose some of your money if the underlying assets or index perform badly
- If you need your money before the end of the term, you may not be able to cash in the product, or (more likely) may have to cash it in at a loss

Examples (no longer available)

Meteor FTSE Defensive Growth January 2013

This product pays you a 33 per cent gain at the end of a six-year term, provided that the FTSE 100 closes at, or above, 50 per cent of its initial level. If the FTSE 100 is at 6,284.5 at the start, for example, it needs to close at or above 3,142.25 for you to receive your money back plus the 33 per cent gain. If it closes below 3,142.25, you lose money in line with the fall in the index. So if it closes at 2,513.8, a 60 per cent loss, you will get £4,000 back from a £10,000 investment.

Investec FTSE 100 Defined Returns Plan 1

This product matures with a 45 per cent gain after three years if the FTSE 100, subject to averaging, is above its initial level. If that doesn't happen, it offers a 75 per cent gain after five years if, subject to averaging, the FTSE 100 is above its initial level. If the index is less than its initial level you should get your money back unless it has closed at less than half that level on any day during the investment term *and* ends lower than the initial level. 'Averaging' means that an average is taken of the closing level of the FTSE 100 on a set number of days approaching the maturity date.

Capital protected products

Somewhere between structured deposits and structured investments lie a small number of 'capital protected' products. These aim to return your money in full, but they are not protected by the Financial Services Compensation Scheme because they are viewed as loans to a financial institutions, not cash deposits.

Kick-out plans

Kick-out plans, also known as autocall plans, are a popular type of structured product. Both structured deposits and structured investments (see pages 6-7) can use a kick-out mechanism

Examples of kick-out products (no longer available)

Name of plan	Max term	Kicks out…	You lose capital if…
Investec FTSE 100 Kick-out Deposit Plan 39 (D)	6 years	From second anniversary onwards if FTSE 100 closes at or above its initial level, subject to five-day averaging*, paying 4.25% for each year held	n/a
StartPoint Investments: FTSE Autocall Plan August 2013 (I)	6 years 2 weeks	From second anniversary onwards if FTSE 100 is at or above initial level, paying 7.2% for each year held	The plan has not kicked out early and the FTSE 100 finishes below 50% of its initial level on the closing date of the plan
Walker Crips Defensive Dual Index Plan Issue 18 (Kick-out) (I)	6 years	From second anniversary onwards if both FTSE 100 and S&P 500 indices close at or above their initial levels, paying 8.5% for each year held. If the plan does not kick out early, you could still get the full 51% gain provided that neither index has fallen more than 25%	The plan has not kicked out early and either of the two indices finishes below 50% of its initial level on the plan's closing date

(D) = Structured deposit; (I) = Structured investment.
** An average is taken of the index closing level on the five days up to and including the anniversary date.*

How does it work?

The product has a maximum term, usually five or six years, but can 'kick out' early (return your money with any gains) if certain conditions are met – for example, if the FTSE 100 is above its initial level. These conditions are usually checked on each anniversary of the plan's start date. Often, the plan has a minimum term of two years, so the conditions are checked from the second anniversary onwards but not on the first anniversary.

What happens if the plan does not kick out early?

If the kick-out conditions are not met and the product reaches the end of its term, your money will usually be returned with no gain. You may suffer a loss if the reference index falls below a particular level (often 50 per cent of its initial level). Some products also pay you a gain at the end in certain circumstances.

A simple kick-out plan

The diagram to the right shows how a typical kick-out plan works.

The five-year product can kick out from the second anniversary onwards if the FTSE 100 is at or above its initial level, paying 7 per cent for each year held. If the plan does not kick out by the fifth anniversary, you get your money back with no gain. If the index has fallen by more than 50 per cent, you lose some of your capital.

Start date
FTSE 100=6,500

First anniversary
Nothing happens

Second anniversary
Is FTSE 100 at or above 6,500?

YES – Your capital returned with a 14% gain (7% x 2)

NO

Third anniversary
Is FTSE 100 at or above 6,500?

YES – Your capital returned with a 21% gain (7% x 3)

NO

Fourth anniversary
Is FTSE 100 at or above 6,500?

YES – Your capital returned with a 28% gain (7% x 4)

NO

Fifth anniversary
Is FTSE 100 at or above 6,500?

YES – Your capital returned with a 35% gain (7% x 5)

NO

Is FTSE 100 below 3,250?

YES – You lose capital in the same proportion as the fall in the FTSE

NO – All your capital is **returned with no gain**

A more complex kick-out plan

This product is more complicated, because the 'reference level' (the level against which the FTSE 100 is checked on each anniversary) reduces each year. There are also two indices involved.

It's a maximum six-year product that can kick out from year two onwards, returning your capital with a 9.25 per cent gain per annum, provided the FTSE 100 and S&P 500 close above reducing reference levels. On the second anniversary, the reference level is 100 per cent of the initial level, on the third, it's 95 per cent, on the fourth it's 90 per cent, and so on. If either index has fallen more than 50 per cent by the end, you lose some of your capital.

Start date
FTSE 100=6,500
S&P 500=1,600

First anniversary
Nothing happens

Second anniversary
Is FTSE 100 at or above 6,500 **and** the S&P 500 at or above 1,600?
YES → Your capital returned with a 18.5% gain (9.25% x 2)
NO

Third anniversary
Is FTSE 100 at or above 6,175 **and** the S&P 500 at or above 1,520?
YES → Your capital returned with a 27.75% gain (9.25% x 3)
NO

Fourth anniversary
Is FTSE 100 at or above 5,850 **and** the S&P 500 at or above 1,440?
YES → Your capital returned with a 37% gain (9.25% x 4)
NO

Fifth anniversary
Is FTSE 100 at or above 5,525 **and** the S&P 500 at or above 1,360?
YES → Your capital returned with a 46.25% gain (9.25% x 5)
NO

Sixth anniversary
Is FTSE 100 at or above 5,200 **and** the S&P 500 at or above 1,280?
YES → Your capital returned with a 55.5% gain (9.25% x 6)
NO

Is FTSE 100 below 3,250 **or** is S&P 500 below 800?
YES → You lose capital in the same proportion as the fall in the worst-performing index
NO → All your capital is **returned with no gain**

Structured products and tax

Most structured products can be included within an ISA or a SIPP. If you're not already using your ISA allowance, it makes a lot of sense to put structured products within an ISA, as it ensures you will not have to pay any tax on any income or gains.

Structured deposits count as cash from an ISA point of view, so need to be put into a cash ISA. The maximum you can put in a cash ISA in the 2013/14 tax year, which ends on 5 April 2014, is £5,760.

Structured investments are eligible for your stocks and shares ISA. You can put up to £11,520 into a stocks and shares ISA, less anything you have saved into a cash ISA in the same tax year.

What if you're already using your ISA allowance?

If you're already planning to use your ISA allowance for other investments, you need to think quite carefully about how to make the best use of the tax break.

Most structured products do not pay an income, but return a capital gain at the end of the term. All taxpayers are allowed to bank capital gains of £10,900 without paying any tax on them, so unless you expect to exceed this limit it makes sense to use your ISA for investments like shares, bonds and funds that may pay an income, not structured products.

If your structured product does pay an income, or if you expect to make capital gains of more than £10,900, you should place in the ISA the products you expect to pay the most income, or deliver the biggest capital gains. Remember that your income tax rate is likely to be higher than your capital gains tax rate, so it's more important to shield income than gains.

Tax timing

One of the advantages of structured products is that you know when they are likely to pay you income, or generate a capital gain. This can help you with tax planning. Ideally, you want to spread potential capital gains across several years so that you fall beneath the £10,900 threshold every year. This can be achieved by holding structured products that mature in different years, or kick out under different conditions.

Capital gains are taxed lower than income

	Income tax	Capital gains tax
Tax-free allowance	£9,440	£10,900
Basic rate (to £32,010)	20%	18%
Higher rate (£32,011-£150,000)	40%	28%
Additional rate (>£150,000)	45%	28%

What the table shows: Simplified tax rates and allowances for tax year 2013/14. When working out how much tax to pay, deduct your tax-free allowances first, then see how much of your basic rate band is already being used against your taxable income. Any remaining basic rate band can be allocated against your capital gains up to the threshold of £32,010. Different allowances and rates apply for those born before 5 April 1948, estates and trusts.
Source: HMRC

Buying structured products

If you're not sure whether structured products are right for you, you should go to a financial adviser. But if you know what you're doing, most products that are available to private investors can be purchased without the need for an adviser through a website called CompareStructuredProducts.com.

It's unusual to be able to buy structured products direct from the provider, although a few groups, such as L&G, allow you to do so.

Using CompareStructuredProducts.com

This website makes it easy to compare one structured product with another, listing essential terms and conditions, and you can search in a number of ways to pin down the product you want. You can then buy the product or products for an upfront fee of 1.65 per cent (a cheaper rate is available for purchases over £150,000). Always make sure you read the product literature first.

There is only one drawback if you're an ISA investor: you can't mix two or more structured products within the same cash or stocks and shares ISA, though you can hold one ISA of each type.

A few, more complex structured products are designated by their provider as 'adviser-only', and can only be bought if you have taken financial advice.

Using an adviser

Advisers are not allowed to take commission anymore when they sell financial products, so they'll charge you a direct fee for their advice and the admin work they do to implement the purchase. This may be up to 3 per cent of the money you invest in a structured product (more than this is probably a bit steep, however good the biscuits in their office). In addition to this, if the structured product is being held on an online platform, this may have its own regular charges which your adviser will pass on.

It is possible for advisers to help you buy a structured product without advising you. This is called an 'execution-only' purchase, and the fee for this service should be lower than if you were taking advice.

Trading on exchange

A third option for more sophisticated investors is to purchase a listed structured product directly through their stockbroker account. Unlike the conventional structured products described so far, listed structured products are tradeable on the London Stock Exchange. They're similar to shares, in that their price moves throughout the trading day, and your broker will charge you a commission for dealing in them. The advantage is that you can buy products after their launch period, or sell them before maturity. But be careful, because the price you pay for the units will affect the profit or loss you end up making.

Product fees

Fees within structured products are wrapped up in the advertised return, so the return you see is the return you will get after the charges. Typically, this will be up to 3 per cent of what you invest, which covers the cost of distribution, administration and of course some profit for the provider. These built-in fees will be disclosed in the structured product's literature.

Jargonbuster

Barrier
a certain index level beneath which a structured investment will not protect your capital.

Bonds
financial securities that pay a fixed income (called a coupon) for a fixed period of time, then return your capital at maturity.

Capital
your original investment, not counting any gains, losses or income.

Capital at risk products
another name for structured investment products.

Capital protected products
structured products that aim to return your money in full, but may not do so if the counterparty defaults or goes bust. Unlike structured deposits, they are not protected by the FSCS.

Credit rating
an assessment of how likely a company or bank is to default on its loans, provided by a ratings agency such as Moody's or Standard and Poor's. AAA is the highest rating and BBB is the lowest 'investment-grade' rating; bonds rated below BBB are referred to by traders as 'junk'.

Counterparty
the financial institution backing a structured product. If a counterparty goes bust or defaults, you stand to lose some or all of your money.

Default
the failure of a financial institution to pay money it owes on time.

Equities
also called stocks and shares, equities are financial securities that give you a tiny stake in a public company, such as Vodafone or Tesco.

FSCS
Financial Services Compensation Scheme, a scheme that protects UK savers and investors from losses if financial institutions go bust, up to certain limits.

Index
a collection of individual stocks, like the FTSE 100 (the largest 100 public companies in the UK).

ISA
individual savings account, a UK government scheme that allows you to shield up to £11,520 a year from tax.

Kick-out (or auto-call) product
a structured product that gives you back your money, along with any return, if and when certain conditions are met. The conditions usually relate to the level of an index like the FTSE 100.

Leveraged
describes a product that seeks to return a higher gain than an underlying index, but in proportion to the index. For example, the product might aim to return 1.3 per cent of any growth in the FTSE 100.

Listed structured product
a structured product that is traded on the London Stock Exchange.

Maturity
the closure of an investment, when your capital is returned net of any gains or losses.

SIPP
self-invested personal pension, a kind of pension where you decide what to invest in and get tax relief from the Treasury.

Strike date
the date used to fix the initial level of the FTSE 100, or other index, which determines a structured product's returns.

Structured deposit
a kind of structured product that protects your original investment and is eligible for compensation under the FSCS (see above).

Structured investment
a kind of structured product where your original investment is at risk.

Structured product
a financial product with a return that is linked to an index such a the FTSE 100, which may offer some form of capital protection if the index does badly and/or limit how much you can gain if it does well.

Term
the length of time a structured product holds on to your money before returning it to you. Kick-out products return your money before the end of the term if certain conditions are met.

Underlying
the assets or index on whose performance the returns of a structured product are based. For most structured products, the underlying is a basket of shares, or a broad share index.

What it says on the tin

James Harrington, Ben Thompson and **Ian Lowes** discuss why the reputation of structured products is improving

Few financial products have attracted such broad condemnation in recent years as structured products.

A large part of the furore dates back to the collapse in 2008 of US investment bank Lehman Brothers. About 5,600 UK investors who had bought Lehman-backed structured products were left in a long queue of creditors, with little idea when or whether they would get any of their money back. Many of these have since won compensation because the products were missold to them, while some money has been returned from Lehman's administrators.

Another high-profile failure hit a firm called Keydata, which was found to have misappropriated funds and set up ISAs incorrectly. The failure had nothing to do with the Keydata structured products, which are now all maturing as originally intended. However, the fiasco was used by journalists and even regulators as another brush with which to tar an industry which was becoming something of a pariah.

Mounting a defence

Leading figures in the industry are keen to point out that barring the Lehmans failure, structured products have performed precisely as investors expected. For this reason, they find the cloud of vague and ill-informed censure that still hangs around them somewhat mystifying – but they believe it is beginning to disperse.

James Harrington, head of structured solutions at L&G notes, 'Three years ago, if you spoke to ten financial journalists, the chances are they would all have written something negative about structured products in the last three months. Now, they are not writing about structured products because there's nothing to write about. "Structured product delivers expected returns" is not a story.'

Ben Thompson, director of marketing at Société Générale, adds that post-Lehman, regulation in the industry has been much tightened to ensure investors are aware of every conceivable risk. 'Five years ago you could launch a product with a two-page factsheet. Now, there's a 32-page brochure which has to carry more health warnings than a cigarette packet.'

Unfortunately, all this only reinforces the popular prejudice that structured products are complex and risky – a view Thompson takes issue with. 'Saying all structured products are simple or complex, risky or safe, is just impossible. You could have one structured product based on a basket of Russian stocks leveraged three times, or a structured deposit that repays your capital regardless and pays you a return as long as the FTSE 100 doesn't fall more than 20 per cent. The two are incomparable.'

The point is that structured products are a class of investments encompassing a huge variety of terms and conditions. Ian Lowes, founder of CompareStructuredProducts.com, is keen to stress that there are good and bad structured products, just as there are good and bad funds or cash ISAs. Condemning them all – he suspects – is simply a convenient fall-back for those too lazy to investigate further.

'Say you're an adviser with 30 years' experience of advising on funds. When somebody brings something new to the market, you don't really want to know. You dismiss it because you can't advise on it without putting the hard work into learning about it.'

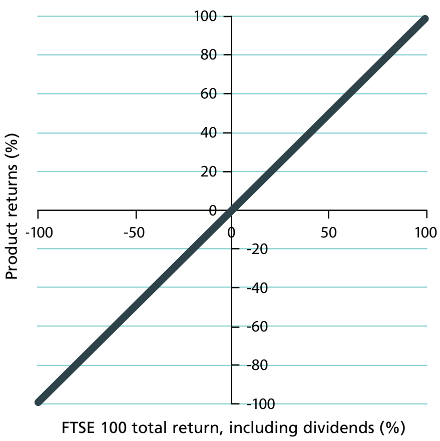
Lowes adds that advisers' scant knowledge about structured products was the motivation behind the launch of his adviser-facing service, StructuredProductReview.com, which leaves the advice industry little excuse to remain in ignorance. Although he also runs an wealth management firm, Lowes Financial Management, which covers the full gamut of investments, Lowes is a trenchant advocate of structured products and absolutely rejects the notion that they are too complicated for private investors.

'You don't have to understand the science behind a microwave to be able to use it,' he says. 'An ordinary bank account is an amazingly complicated thing behind the scenes – they don't just stick your money in a safe. You could write a thesis about it, but from the investor's point of view, it's straightforward.'

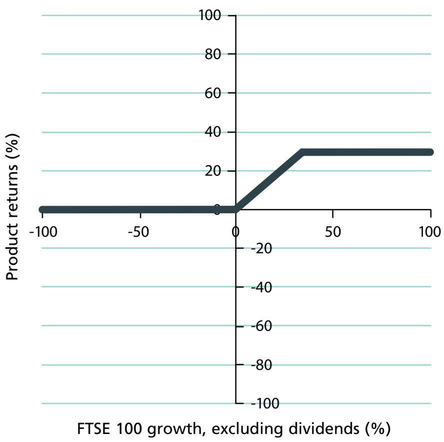
The basic principle behind the vast majority of structured products is that you

> 'Saying all structured products are simple or complex, risky or safe, is just impossible'
>
> *Ben Thompson, Société Générale*

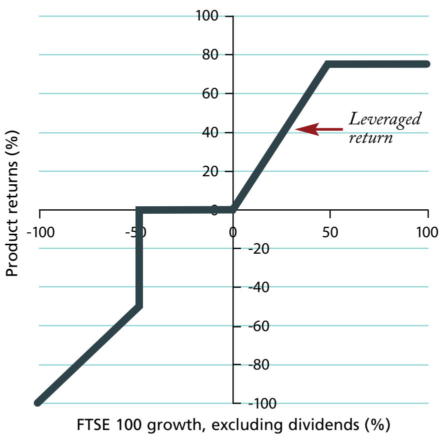
FTSE 100 tracker



Structured deposit (example)



Structured investment (example)



are giving up some of the potential return, or 'upside', of stocks and shares in return for a degree of 'downside' protection when markets fall.

Thompson elucidates, 'If you invest in a FTSE 100 equity tracker and the FTSE 100 goes up 1 million per cent, in theory you make 1 million per cent. If it goes down 99 per cent, you lose 99 per cent.

'What structured products do is enable you to give up the growth that you don't need, or that you don't think is realistic. For example, if you don't think the FTSE 100 is likely to rise more than 30 per cent in the next five years, you could buy a structured deposit that caps your potential return at 30 per cent, but protects you against a fall.'

It's a trade-off, Thompson argues. 'You have sold the gains you didn't want, because you didn't think they were going to happen. If the FTSE 100 goes up more than 30 per cent, you've lost out; but if the index falls 40 per cent, you get your money back.'

Joining the dots

Most structured products can be summed up by a simple diagram. The return of a FTSE 100 tracker fund, plotted against the FTSE 100 itself, looks like a straight line. If the FTSE 100 goes up 123 per cent, the tracker goes up 123 per cent (we'll ignore fees and tracking error for now). If it goes down 69 per cent, so does the tracker.

In the case of the structured deposit Thompson outlined, which offers a maximum upside of 30 per cent, the line looks different. If the FTSE 100 falls any amount, you get 100 per cent of your money back – that's the flat part of the line on the left. The line rises between 0 per cent and 30 per cent because your returns will track the FTSE 100 between those outcomes. And once the index surpasses 30 per cent, your return is capped, so the line flattens again.

One important point is that structured products refer to index growth *excluding dividends*, whereas a tracker fund will include the dividends in the return you get (called 'total return'). Giving up dividends is, in effect, part of what you pay for any protection the structured product offers.

Some products compensate you for the loss of dividends by 'leveraging' the index return, as in the third chart above. This illustrates a structured investment plan which returns 1.5 times the gain of the FTSE 100 between 0 and 50 per cent with a cap at this level – so the maximum gain is 75 per cent. With this product, however, if the index falls more than 50 per cent, you lose money on the same basis as the index.

The unusual feature of structured products is that you know exactly what return you're going to get in a range of defined circumstances. 'Structured products do what they say on the tin,' Lowes concludes. 'But sometimes, when this manifests itself, people go back and look at the label.' ◆

Weighing up the risks

Structured products offer clearly defined risks, but how can you go about assessing them?

The majority of structured products are exposed to two main risks. One is counterparty risk: the danger that the financial institution backing the product will default on its obligations to return your money. The other, which affects structured investments only, is market risk. While these products offer some insurance against market falls, they do not protect you against catastrophic scenarios, such as the FTSE 100 falling more than 50 per cent.

We've heard a lot about counterparty risk since the collapse of Lehman Brothers, an event that people thought would never happen. For a moment back in 2008, the whole financial system looked in danger of toppling like a house of cards. 'The consensus now is that letting Lehmans go was a mistake,' says Ian Lowes. 'It lifted the veil on how the banking system was based on confidence, and how fragile that confidence was.'

Nevertheless, Lehmans did collapse, and holders of structured products backed by the bank lost money. According to James Harrington, the problem was the way the risks were explained to some investors. 'The typical investor buying into structured products is looking for security. They didn't get it, because as an industry we failed in our obligations to explain the products well enough, and those who distributed them failed to explain them to investors or ask us enough questions about them.'

In the event, those who could prove the products had been missold to them were relatively lucky. The culpable firms themselves went bust, but their former customers could apply for redress under the Financial Services Compensation Scheme

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>
> *James Harrington, L&G*

(FSCS). Other investors, who always understood that they could lose money if Lehmans defaulted, have had to wait for a partial and uncertain payback from the bank's administrators.

Harrington stresses that the Lehman-backed products never offered investors the cast-iron guarantee some have later claimed. Their returns were always dependent on the bank remaining solvent. 'You hear people saying, "I know someone who invested in a guaranteed product and lost money." Well, it hasn't happened.'

To help clear up confusion about the risks, CompareStructuredProducts.com lays out potential outcomes in a simple summary table. 'We start off by saying "if the bank goes bust, you can expect to lose all your money",' explains Ian Lowes. 'It's just easier to say this, even though with Lehmans, people still got some money back. Then we set out a number of "what if" scenarios – if the FTSE's higher, this happens; if it's lower, that happens. But then we drum it into people to read every word of the brochure.'

Ben Thompson agrees: 'If you look at the brochure for one of our products, it tells you everything. You can see exactly what the risks are, even down to how often particular scenarios have happened in the past.'

One particularly important piece of data is the credit rating of the counterparty. This gives you an independent view of how likely it is to default. On the scale used by ratings agencies S&P and Fitch, AAA is the best rating (least likely to default), followed by AA, A, BBB, BB, B, CCC, CC, C and D. Plus or minus signs may be added to these major categories for fine tuning.

Ratings of BBB and above are considered to be 'investment-grade': in practice, says Lowes, you're unlikely to see any ratings below this on today's structured products. If you do, it should ring alarm bells.

While most structured products have a single counterparty, some spread the risk. For example, Société Générale has released a series of products where counterparty risk is divided between Aviva, Barclays, Lloyds TSB and RBS, all rated A or A- by S&P.

Credit ratings of structured product counterparties

Bank	Rating
HSBC	AA-
Royal Bank of Canada	AA-
BNP Paribas	A+
Santander UK	A
Barclays Bank	A
Morgan Stanley	A-
Investec Bank	BBB-

Source: CompareStructuredProducts.com. Ratings are from S&P except for Investec's rating which is from Fitch

Harrington points out that risk can also be spread by buying a portfolio of structured products backed by various counterparties. But it doesn't always make sense: 'If you have a product backed by an AA-rated bank, buying a BBB-rated product is not decreasing risk, it's increasing it.'

While the failure of a highly-rated counterparty is always possible in theory, Lowes and Harrington point out that it could not happen without catastrophic social and economic effects that would spread well beyond structured products. 'I sometimes tell people that if HSBC goes down, you'll have bigger worries than your structured products portfolio,' says Harrington. 'Don't forget they pay the police.'

Lowes agrees. 'If you're concerned about having a portfolio of structured products backed by HSBC, invest in National Savings and consider a portfolio of sheep and a shotgun, because if HSBC goes bust you might have to fend for yourself.'

Market meltdowns

The risk that stock markets might fall below 50 per cent seems rather more likely. This is the barrier level commonly specified in structured investments, below which you stand to lose money.

A 50 per cent fall in the FTSE 100 has happened before, although not for a while. The period between mid-2007 and early 2009 may have felt catastrophic for shareholders, but the fall was only 47.7 per cent from peak to trough. In the dotcom crash, however, the index dived 52.6 per cent from the end of 1999 to early 2003. The slump of the late 1980s, on the other hand, was a mere 35.9 per cent.

Cashing out early

One risk inherent in any product that locks you in for a fixed term is that your circumstances will change and you'll need the money early.

Structured products do offer a get-out clause. 'We never encourage early redemptions,' says Harrington. 'But if you look at the prices you can currently get to cash in early, both for deposits and investments, they're quite attractive. Many products are offering positive returns.'

That said, you will usually be offered less than £1,000 to cash in £1,000 of structured product. Harrington says this can be an advantage in inheritance tax planning, as it cuts the tax bill.

Listed structured products are, of course, fully tradeable (see page 14).

Your chance of breaking the barrier is greater if it's a so-called 'American' one. American barriers can be breached if the underlying index falls below the barrier level at any point during the investment term, whereas 'European' barriers can only be broken if the index is below the level at the end. Clearly the latter is much more unlikely, especially over a five- or six-year term.

'There has never been a five- or six-year period over which the FTSE 100 has fallen more than 50 per cent,' confirms Lowes. 'However, that doesn't mean it'll never happen. You can look at history, at probability, but nothing will tell you what's going to happen in the future.' ◆

A piece of the jigsaw

Exploring the role structured products can play in a wider portfolio

'Nobody takes a full portfolio of structured products,' says Ben Thompson. 'But when returns on cash are rubbish and bonds aren't doing too well, investors are forced to look elsewhere for an investment that protects their capital as long as nothing horrendous happens.'

Thompson adds that the unusual risk/return profile of structured products makes them a useful tool to diversify your portfolio. 'We've had periods where equity markets have traded sideways for a long time. If you're invested in straight equity funds, the charges will eat away at your capital. Kick-out plans give you a chance to earn fixed gains with the FTSE 100 staying at exactly the same level.'

For Ian Lowes, recommending structured products to clients comes naturally. He does, after all, keep over half his own personal portfolio in them. 'Give me an individual prepared to make an investment for at least five years, and I would be very surprised if I couldn't find a structured product to suit them,' he maintains.

'For instance, if you're an investor with a series of fixed-term deposits paying 2.8 per cent, I would suggest you give up the 2.8 per cent on one of them and use a structured deposit that pays you 5 per cent a year if the FTSE 100 hasn't fallen more than 10 per cent on the fourth, fifth or sixth anniversary.'

Defined returns can trump the uncertainty of active management, Lowes adds. 'Constantly trying to chop and change a fund portfolio to meet current market circumstances doesn't always help and often leads to an over-diversified portfolio. With structured products, on the other hand, I know exactly what returns I'm going to get in defined circumstances, and when.'

'Structured products let you get on with your life'

Ian Lowes, CompareStructuredProducts.com

James Harrington argues that structured products can save investors from themselves. 'Investors can be impatient – they want something to happen tomorrow, and when it does, they sell. More people sell at the bottom of the market than at the top. Structured products allow you to guard against that, because once you've bought them the date for crystallising your returns is fixed.'

Build your own investment

That said, buying structured products doesn't mean giving up control. It's just that all the control is exercised at the start, when choosing the products.

Harrington demonstrates how an investor could use a mix of products to calibrate the exact balance of risk and reward they want.

'Say you have one product that pays 6 per cent as long as the FTSE 100 stays above 80 per cent of its initial level, while another product pays 8 per cent if the index stays above 90 per cent.

'If you're torn between these two, you can put half of your money in one and half in the other. That gives you an aggregate return of 7 per cent as long as the FTSE 100 stays above 90 per cent.'

Harrington, who has spent over a decade designing structured products, visualises them as having a series of levers. If you pull on a lever that makes the product more risky, the return goes up. If you crank down the risk, you get a lower return. In this sense, they're little different from any other investment, except that the precise levels of risk and return are clearly set out in advance and built into the machine.

So, if structured products can be a core holding in your portfolio, how much should you invest in them? Official guidance suggests no more than 25 per cent, but Lowes says this is an arbitrary figure. Provided you spread your money across different products, with varying maturities, counterparties and indices, he sees only two serious risks.

Missing the party

The first is that you might fail to benefit from a big bull run in equities. 'If the FTSE 100 goes over 10,000, you won't benefit,' he allows. The second danger is a banking collapse – but that would be catastrophic for almost all investments anyway (see page 19).

Apart from these risks, Lowes only sees one serious drawback to structured products. This is that 'arguably, they are boring.' He adds, 'As opposed to allowing you to watch fund performance and decide when to buy or sell, you can get on with your life.' ◆

Structured products for all

On the face of it, structured products are ideal for investors who want to take more risk than cash but less than stocks. But they have their uses for a wide variety of investors. Says Lowes, 'Rather than asking who structured products are suitable for, it's easier to ask who they are *not* suitable for.'

The cash investor

Those who leave all their money in cash are totally dependent on interest rates for any return. Harrington says, 'The average high street rate is nowhere near the 2.5 per cent that people think it is. As a percentage of your cash holding, structured deposits give you the potential to link your returns to something other than interest rates.' With Bank of England governor Mark Carney determined to hold rates down for as long as possible, this could be particularly welcome, he adds.

The income investor

One criticism of structured products is that they are linked to the level of stock markets without dividends included, whereas equity tracker funds include dividends. However, there are structured products that pay an income in years when the FTSE 100 or other index is above a predetermined level. Thompson says that a new 'memory' feature built into some Société Générale products allows you to receive one year's missed income in the following year, under certain conditions.

The growth investor

If you don't need an income, structured products can save you tax because most of them deliver returns as capital gains rather than income. For the vast majority of people, tax on capital gains will be lower or non-existent (see page 13). You can also be certain when gains will occur, helping to avoid exceeding HMRC allowances. 'A nice structured product portfolio can be very tax-advantageous,' says Lowes.

The pension investor

'Structured products are perfect for pensions,' Harrington enthuses. He explains that longer-dated products have 'more value built in' to the advertised returns, adding that those accumulating a pension pot can use them strategically to build value over time. 'The typical pension investor, in the years before retirement, is moving everything into cash,' he continues. 'Structured products can give you something in that period.' When you are 'decumulating' (spending) your pension, shorter-dated products could come into their own, he concludes.

The adventurous investor

Thompson says that listed structured products (those quoted on the London Stock Exchange) can be set up by providers more quickly and offer a wide range of opportunities to more sophisticated investors. 'You can't trade these unless you have read and signed complex derivative risk warnings,' he notes.