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Structured Product Autocall Review

A review of the evolution of the UK Retail Structured Product, Autocall sector, including performance review of the first 1,000 FTSE 100 linked, capital at risk autocalls to reach maturity.

Introduction

Structured products first appeared in the UK retail investment space in the early 1990's as fixed term, equity-linked growth products. Various income products followed, some of more than questionable design and in 2003 the first autocall, or kick-out contract was issued. Whilst the sector continued to be dominated by growth products for a number of years, the popularity of autocalls grew to the point that they are now the most common product offering. Whilst the sector has witnessed many variations on the theme, FTSE 100 linked, capital at risk autocalls have become the mainstay of the UK IFA distributed market.

February 2021 saw the maturity of the 1,000th FTSE 100 linked capital at risk autocall in the UK retail market and so we take this opportunity to review the evolution of the sector and its performance.

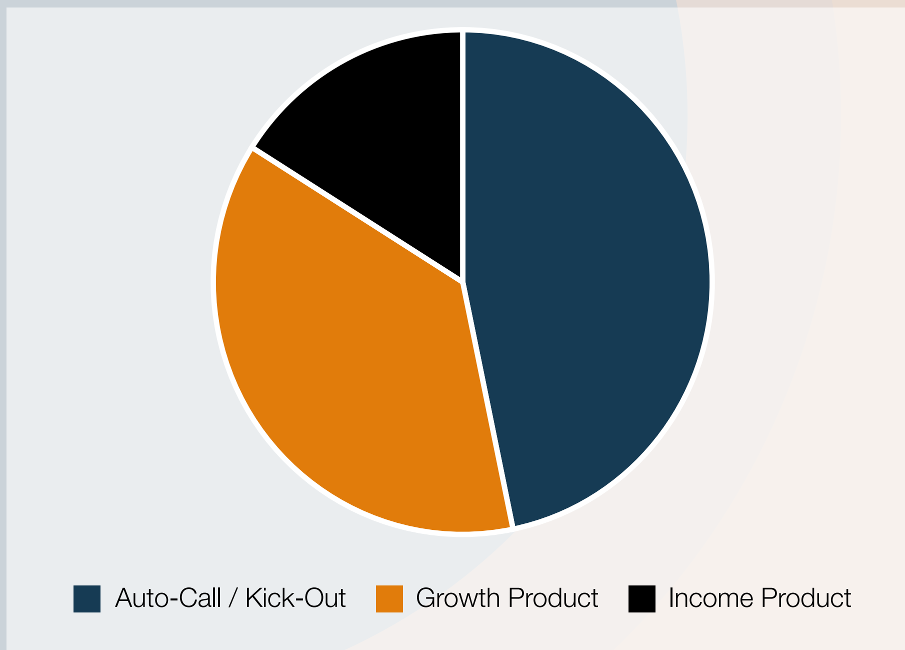
Autocall, which is the abbreviation of 'automatically callable' aka kick-outs, deliver investors a defined equity-like return through limiting investment exposure to an underlying equity index, such as the FTSE 100 Index, whilst further building in a buffer of protection against falling markets, thereby increasing the probability of the defined return being achieved. An autocallable product would be called prior to final maturity date if the reference asset is at, or above its initial level (or any other predetermined level) on a specified observation date.

The investor would receive their investment capital plus a pre-determined premium (often referred to as a coupon) and the autocallable product is redeemed early. Autocallable products may be linked to individual or, baskets of shares, stock market indices, commodities or other asset classes.

The first autocallable structured product, Premier Asset Management's FTSE 100 Growth Plan (Editions No. 8) was issued in May 2003. It offered an 8% simple return for each year it was in force and would mature on the first anniversary that the FTSE 100 index was above the level recorded at commencement. If it had not matured by the sixth anniversary and the FTSE had fallen by more than half during the term the investment would track the index. As it was, successful maturity was triggered on the first anniversary.

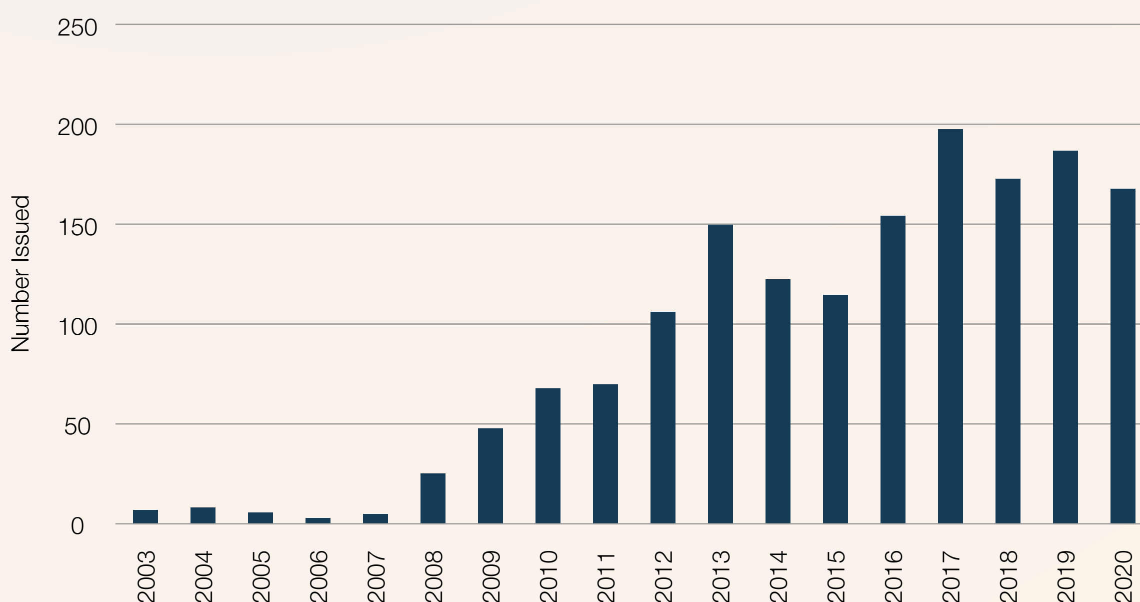
By the end of the first decade of the 21st century, fourteen providers had issued 100 broadly similar contracts, almost half of which were issued in 2009. Over the second decade of the 21st century 2,463 autocallable structured products were issued to the UK retail market, making them the dominant structured investment shape accounting for 55.40% of products issued.

The dominance of autocalls in the UK retail sector 2003 - 2019



These autocalls ranged from deposit-based FTSE 100 only linked structures, to those linked to two, or three mainstream indices, baskets of commodities and baskets of shares. Of all of these autocalls, the dominant shape was capital at risk structures, linked solely to the FTSE 100 index with 1,609 being issued between 2003 and the end of 2020.

FTSE 100 linked, capital at risk autocalls issued per year



Autocall shape variations

Capital at risk FTSE linked autocalls can be subdivided into four main shapes:

At-the-money autocalls
Designed to mature on the first potential maturity date that that the FTSE 100 Index is at, or above the strike level, this typically being the index level recorded at commencement of the term.

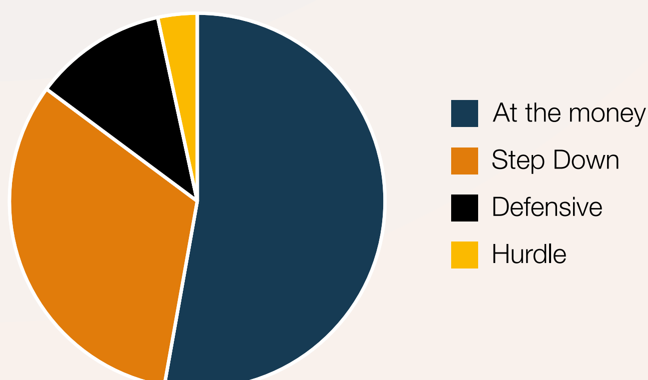
Hurdle autocalls
As with at-the-money contracts but rather than the maturity trigger being the same as the strike level, it is at a higher level, requiring the index to grow in order to trigger a positive maturity.

Defensive autocalls
The opposite to hurdle contracts in that the maturity trigger is set at a level below the strike level.

Step-down autocall
The maturity trigger for the first potential maturity date is set at a level which could be the same, or higher than the strike level but if maturity does not occur, the maturity trigger reduces on subsequent anniversaries, albeit not necessarily on the next.

Of these four shapes, the most common has been the at the money autocalls, accounting for 62.5% of all FTSE 100 linked autocall maturities, followed by the step-down (22.5%), defensive (13.2%) and hurdle contracts (1.8%).

Prevalence of different shapes of FTSE 100 linked, capital-at-risk autocalls 2003-2020



Capital protection barriers

There have been two types of contingent capital protection barrier utilised in the sector: European and American.

European Barriers are observed only at the very end of the maximum investment term and then, obviously only if the investment did not mature sooner. A 60% European barrier for example, protects capital from falls in the underlying of up to 40%. If the autocall does not mature positively and the underlying ends the term, say 39% lower, all of the original capital would be returned but if it was 41% lower, only 59% of capital would be returned.

American Barriers are observed throughout the term and if they are breached, then there is effectively no barrier at the end of the term. For example: 60% American barrier, the underlying falls 40.1% in the early years, a positive maturity is not subsequently triggered and the underlying finishes the term below the strike level by any percentage. In this instance the loss will be in line with the fall over the term, no matter how small. Whilst all products issued early in the sector's evolution utilised American barriers, these have now been completely replaced to the extent that all products now utilise the European variety.

Maximum durations

The maximum duration of an autocall only has a bearing if the investment does not call / mature before the final date. Clearly, the longer the maximum duration and the more frequent the callable maturity dates, the greater the potential for the investment to mature with a gain. A longer duration also defers the ultimate loss determination date, which may prove beneficial in adverse market conditions.

Six years was the most common maximum term throughout most of the sector's evolution, but this is no longer the case. The first ten-year plans were launched in 2015 and since then, the sector witnessed a move to longer maximum durations to the extent that since 2019 more than 70% of new issues utilised a maximum investment term of longer than the traditional six years.

The evolution of maximum durations and move to European barriers is shown below.

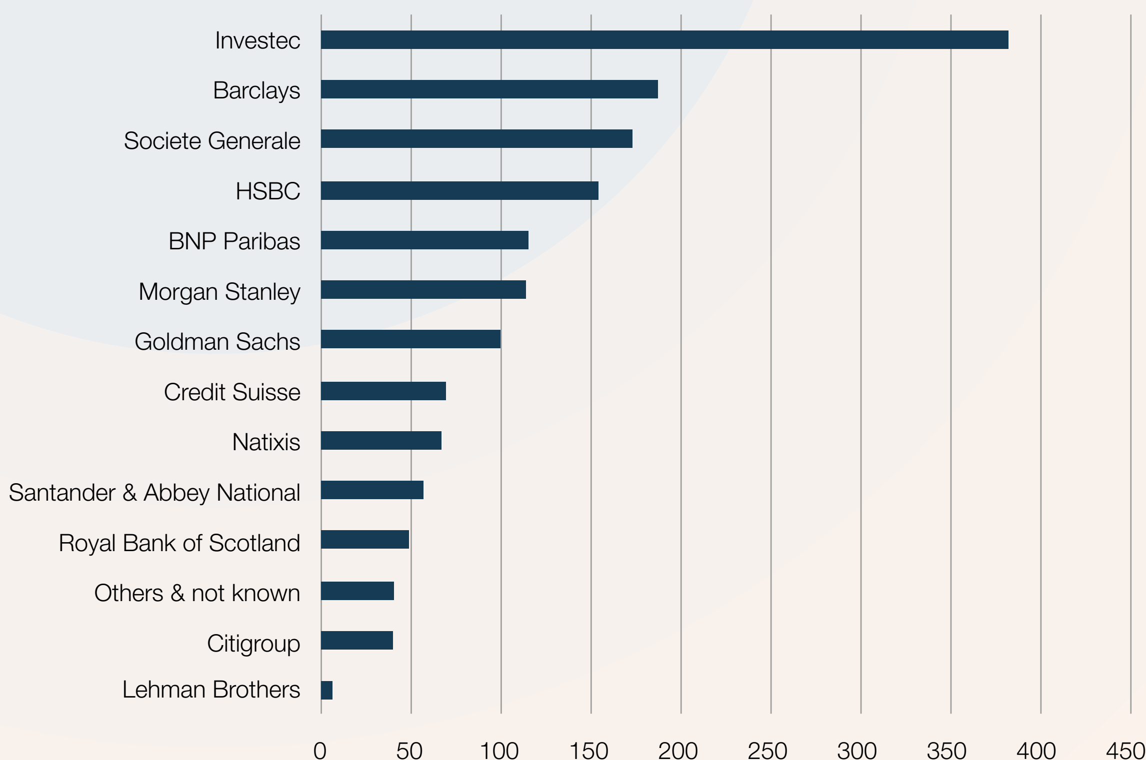
Evolution of maximum duration of FTSE 100 linked autocalls

Maximum Autocall Duration
12
10
8
6
4
2
0
2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020
American Barrier
European Barrier

Prior to the market correction in 2020, these extended terms proved inconsequential. However, the market correction and uncertainty arising from the Covid-19 pandemic is the sort of 'Black Swan' event that the introduction of the longer terms sought to overcome, by providing more opportunities for the investment to mature with a positive outcome. With coupons on autocalls snowballing each year, a prolonged recovery, albeit within the maximum term, could prove very beneficial for these investments. Conversely, a long-term depressed market would see long duration autocalls simply prolong the return of capital only, or a loss.

Counterparties

The 1,620 FTSE autocalls issued to date utilised eighteen counterparty banks, eleven of which were participating in the sector in 2020. The chart below highlights that the most prevalent counterparty was Investec Bank, issuing approximately one in four of all contracts, more than the next two banks combined: Société Générale and Barclays. This will however no longer be the case following Investec's announcement in February 2021 that it was withdrawing from the market.

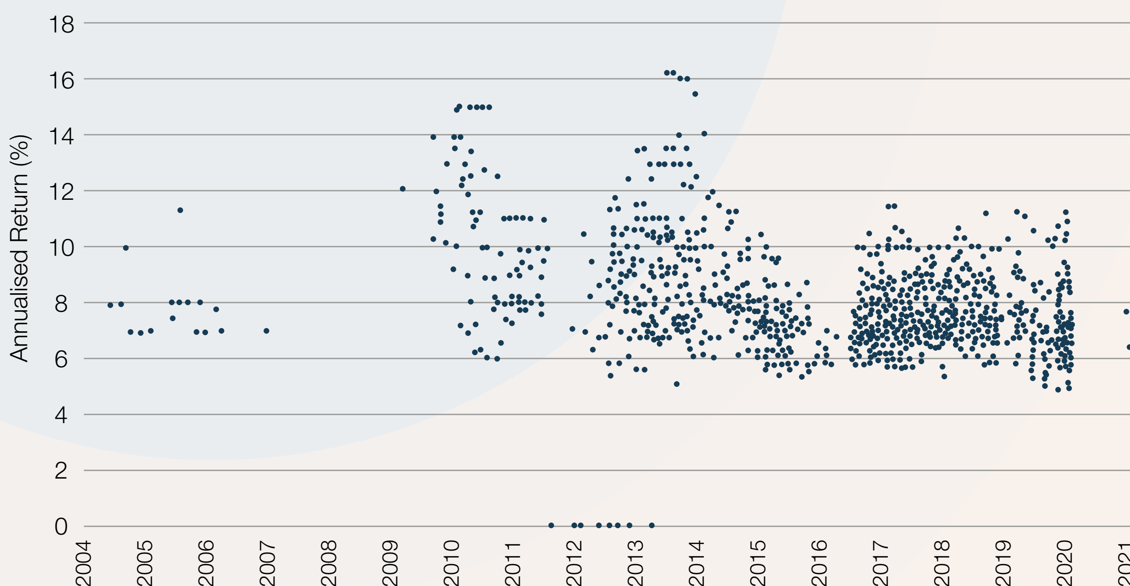


Four FTSE 100 linked autocalls issued between April and August 2008 utilised Lehman Brothers as counterparty and as such, failed in October 2008 when the bank collapsed. Whilst these investments did not therefore, ever mature, the wind up of the Lehman's' estate saw investors recover between 79.53% and 97.48% of original capital, depending upon the product, albeit this was paid in instalments over the following 11 years.

FTSE 100 Autocall maturity analysis

The sector witnessed the 1,000th FTSE linked capital at risk autocall to mature on 12th February 2021 when the Investec FTSE 100 Defensive Kick-Out Plan 47 matured on its 3rd anniversary returning original capital plus a gain of 20.55%, over the three year term the FTSE 100 index fell by 8.89%. The 1,000 FTSE maturities are shown below with their total, annualised return at maturity date.

UK retail FTSE 100 linked, capital at risk, autocallable structured product maturities



Overview of the FTSE autocall maturity data

Number of maturities	1000
Number marturing at a loss	Nil*
Number returning capital only	8
Mean annualised return	8.04%
Lowest annualised return	0%
Lowest annualised return (where a gain achieved)	4.87%
Highest annualised return	16.2%
Shortest term	0.51 years
Longest term	6 years
Average term	1.99 years

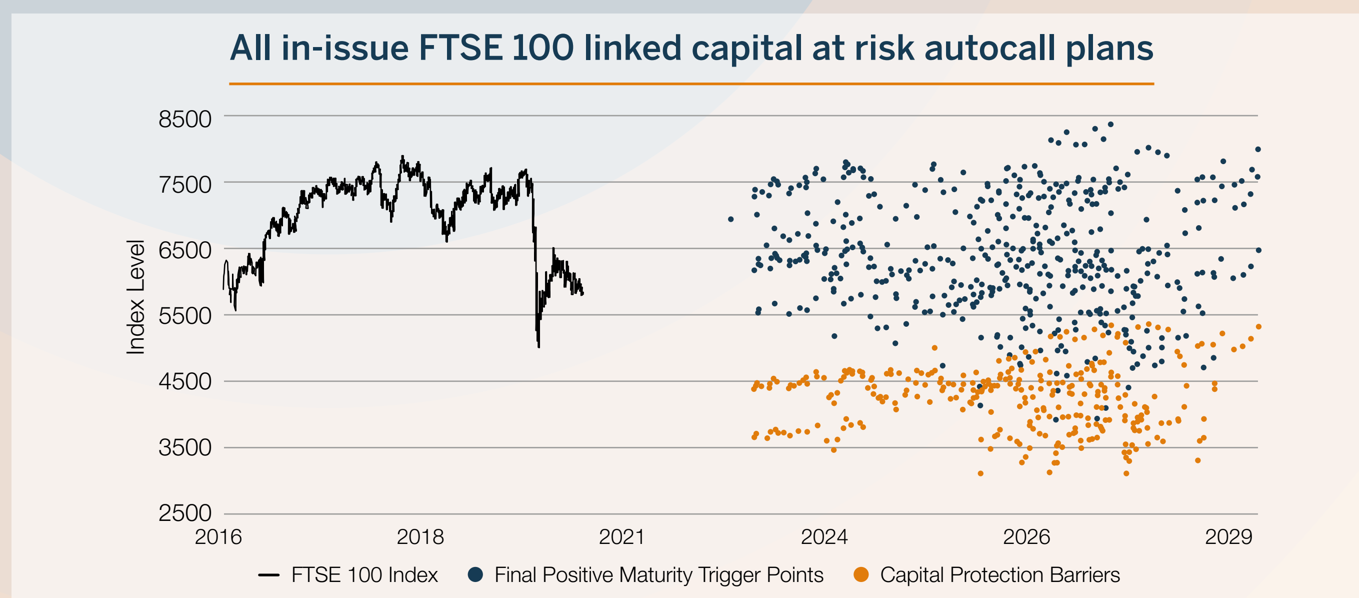
Eight of the 1,000 maturities returned no gain. These commenced prior to the financial crisis and the FTSE 100 Index did not recover prior to their final maturity dates but the capital protection barriers remained in-tact. These eight products had maximum durations of five, or six years and had this been seven, or eight years, as is more common today all but one would have matured positively, on or before the seventh anniversary.

*As discussed on Page 6, four FTSE 100 linked autocalls failed in 2008 and as such, never reached maturity as these utilised Lehman Brothers as counterparty.

The future and the impact of Covid-19

The two fundamental changes to the autocall sector that have been witnessed were, the evolution of maximum durations and the phasing out of American capital protection barriers. Whilst these changes will have had little bearing on the investments themselves, they have served to provide a degree of potential 'Black Swan' protection which may now prove very beneficial if the Covid market correction takes some years to recover.

The chart below shows the FTSE 100 autocalls issued pre-2021 which are yet to mature, showing their final positive maturity trigger point and capital protection barriers relative to the FTSE 100. Those with a final maturity date prior to May 2025 had a maximum term of less than 7 years. Those maturing in the later years had longer terms, which will prove valuable in the event of a prolonged recovery. The snowballing effect of the coupons means that the longer the market takes to recover, provided it does recover sufficiently to trigger a maturity on, or before the final maturity date, the greater the extent of potential out-performance against the FTSE 100. The chart shows us that very few autocalls will give rise to a loss unless the FTSE 100 falls significantly below the March 2020 low.



A further impact of Covid-19 has been on dividends. Structurers rely upon expected dividends from the underlying shares in the FTSE 100 Index, which in 2019 were 4.07%– falling to a predicted 3.24% for 2021 (Bloomberg). The fall in dividend expectations arising as a result of the pandemic meant that structurers not only have less to play with but are also erring much more on the side of caution.

To overcome this issue, the sector has seen the introduction of a new index, designed specifically for structured products - the FTSE Custom 3.5% Synthetic Fixed Dividend Index (FTSE CSDI), an Index we expect to become a staple within the sector over the coming years.

The FTSE CSDI aims to closely replicate the performance of the same 100 companies as the FTSE 100 Index, but after including the dividends – the equivalent to the FTSE 100 'total return' index, from which, a constant annual dividend of 3.5% is deducted. The FTSE CSDI index may therefore be expected to perform in a similar way to the FTSE 100 Index although, it would be expected to slightly underperform the latter where the total dividend yield transpires to be less than 3.5%. The correlation of FTSE CSDI to the FTSE 100 over a 10-year simulated back-test is 98.25% (Mariana Capital).

By removing the uncertainty of managing future dividends, the issuing banks may face lower costs and risks. The risk, or even the expectation that dividends will be lower than 3.5% is, in turn, accepted by the structured product investor but the acceptance of this, together with the cost saving arising from the issuer not having to make assumptions on the dividends, ultimately leads to greater potential returns for the investor.

About StructuredProductReview.com

StructuredProductReview.com is a dedicated research service conceived, created, developed and maintained to help Professional Advisers engage with the structured products sector and to aid in the identification of providers and products that may be suitable for their clients.

In addition to provider/product information, tools, services specifically designed to assist in researching and advising on structured products. The service is an extension of the earlier service provided by Lowes, that sought to warn advisers and retail investors away from various negative elements of the structured product sector early in its development. In 2009 in the wake of significant mis-information and mis-understanding about what had become a much improved sector, the original Lowes database was transferred to StructuedProductReview.com which set out to improve transparency, help educate, inform and dispel the many myths. The structured product sector has improved significantly since, to the extent that it now has an exceptional track record.

StructuredProductReview.com aims to provide the deepest and most comprehensive one-stop source of information and education available for the IFA market. It amalgamates the best that the structured product industry and its providers themselves make available.

The service is maintained by Lowes Financial Management (Lowes). For more than two decades Lowes has played a significant role in helping to shape the UK retail structured product sector by championing good product development and governance with a focus on investor outcomes.

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