PROFESSIONAL ADVISER ACADEMY: MODULE 1

‘AN INTRODUCTION TO STRUCTURED PRODUCTS’

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Learning objectives of this Module …

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This Module aims to:

- Provide an introduction to structured products
- Highlight how structured products can meet investors’ interests and needs
- Explain how structured products are different from other types of investment
- Explain the roles of different participants in the structured products market
- Explain why investment banks issue structured products
- Explain the different types of structured product available to investors
- Highlight the key risks associated with investing in structured products

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About Alpha Real Capital / Tempo Structured Products …

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KEY ALPHA STATISTICS:
(as at 30.06.17)

£2.2bn+
AUM and capital commitments

80+
Professional team

10
Platforms

5
International offices

4
Core business areas

Alpha Real Capital LLP is an international co-investing fund management group.

Established in 2005, and headquartered in London, Alpha comprises an international network of offices in the UK, Europe and Asia. An 80 plus strong professional team, combining experience and expertise with research, analysis and market knowledge, operates through 10 platforms, across diversified investment markets, offering listed and unlisted property vehicles, open and closed-ended property vehicles, and UK and international funds, products and wealth management services. Alpha engages with institutional investors, family offices, wealth managers and professional advisers / IFAs, as well as UHNW, HNW and private investors.

TIME Investments is the authorised wealth management and investment services arm of Alpha. TIME specialises in ground rent and other 'long income' property funds (having acquired the real estate asset management business of Close Brothers Group in 2011), Inheritance Tax Services, including Business Property Relief (BPR), and investment services, including Enterprise Investment Schemes (EIS).

Tempo Structured Products is a new Alpha platform, with four areas of focus: i) Retail: focusing on straightforward, lower risk structured products, for distribution through TIME Investments to UK Professional Advisers (IFAs and wealth managers); ii) Institutions / Pension funds: working with institutions / pension fund consultants, to develop 'smart structured products' (fusing structured, passive and smart beta strategies together); iii) HNW / UHNW / Family Offices: working with Alpha contacts to design bespoke structured product solutions for Family Offices, UHNW and HNW Individuals; iv) Strategic Alliances: partnering with other institutions, offering our expertise and issuer relationships as a specialist structured products unit, for the benefit of their clients and customers.

Meeting investors interests and requirements …

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- **Savers and investors need ‘real returns’: over and above inflation and ‘risk free’ cash**
- **Savers and investors therefore need ‘asset-based’ returns**
- **However, most savers / investors naturally describe themselves as cautious to balanced:**
  - savers and investors want and need: *returns on their capital*
  - but they also want and need to know they will get: *return of their capital*
- **Providers and advisers need to empathise with the genuine and intrinsic interests of savers / investors**

Providers and advisers need to empathise with the genuine / intrinsic interests of savers / investors

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Savers and investors want and need returns on their capital
… but they also want and need return of their capital

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What would investors design for themselves, if they could …

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- **Let's start with the basics: if not told by the investment industry that they can't have what they would naturally want, what would investors design for themselves, if they could design their own investments?**

  Most investors (no matter how cautious or sophisticated) would:-

1. Control (and ideally remove / reduce) exposure to risk: because no-one takes risk for the sake of it

- structured products can remove, reduce or at least pre-define (levels and type of) exposure to market risk
- risk is defined 'by contract': and is not a factor of active (or passive) fund management

… however structured products are usually subject to issuer / counterparty risk

2. Pre-arrange (and maximise) investment returns: investors ideally want to have and eat their cake!

- structured products can also pre-define investment returns (on either a fixed / non-conditional or conditional basis), including providing returns that require no market growth
- returns are also defined 'by contract': and are not determined by active fund management process

… in fact the process / performance risks of structured products are borne by the issuer / counterparty (investors delegate this risk to the issuer, in a way that cannot be achieve with other investment products)

3. Ensure low (or even no) charges …

- structured products generally state and deliver any returns 'net' of charges: without direct deductions

… though there are, of course, implicit / internal charges

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What would investors design for themselves, if they could …

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- **It is probably fair to say that if investors designed their own investments, they would be unlikely to design anything that looks and feels much like a mutual fund!!**
- **However, many of the key and fundamental features of an investor-designed investment might look and feel much like a structured product:**
  - with less likelihood of capital losses being experienced as the result of market downside;
  - with more likelihood of positive returns being generated, even in challenging market environments;
  - with charges that impact less on capital and any returns generated;
  - and with providers obligated to deliver what they promise

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Introducing structured products: the basics …

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- **A definition:** there's no universally recognised definition of a structured product, but the following offers a relatively succinct explanation and some important considerations:
  - structured products are investments issued by investment banks, known as issuers / counterparties;
  - they are usually designed to run for an investment term of c.5-6 years (but it could be 1 month to 10 years);
  - they offer investors stock market (or other asset class) linked investments, with the benefit of defined and usually reduced exposure to market risk (including the potential for complete removal of downside market risk)
  - combined with defined potential returns (including fixed and non-conditional returns and / or products that can generate positive returns without requiring the stock market to rise);
  - capital invested and any potential returns are usually dependent upon the solvency of the issuer / counterparty throughout the investment term, i.e. the bank mustn't 'go bust' (which is known as 'issuer / counterparty risk')

Structured products are typically fixed term investments, that are issued by investment banks, known as issuers / counterparties, that offer investors stock market linked investments with the benefit of potentially pre-defined and usually reduced levels of risk, combined with pre-defined potential returns

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Both the potential returns and repayment of money invested are usually dependent upon the issuer / counterparty bank remaining solvent throughout the investment term, i.e. the bank mustn't 'go bust'

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Some important initial points to think about …

- **Structured products can bend or break the relationship between risk and returns that usually exists in stock market linked investments, in ways that active and passive fund management don't and can't:**
  - exposure to stock market downside risk can be removed, reduced or at least defined
  - performance can be pre-defined, and positive performance can be generated even if markets trade sideways or go down (it is important to remember that there is 'upside risk' as well as downside risk in investing, i.e. the risk that markets do not rise)
  - delivery of stated performance is a contractual obligation for the provider, which transforms the risks that are usually inherent in investing with active and / or passive mutual funds

- **While market risk can be removed, reduced or at least defined, it is usually replaced by 'credit risk', i.e. the issuer / counterparty bank must remain solvent throughout the product's investment term:**
  - it's very important that this is understood: structured products can transform many of the risks usually inherent in investing, but they are not alchemy: they don't make all risk disappear!

Structured products can bend or break the relationship between risk and returns, that usually exists in stock market linked investments, in ways that active and passive fund management don't and can't

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While market risk can be removed, reduced or at least defined, it is usually replaced by 'credit risk', i.e. the issuer / counterparty bank must remain solvent throughout the product's investment term

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Some important initial points to think about …

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- **It's important to understand that removing or reducing the stock market risk from a stock market linked investment is understandably of interest to many investors**

- **While stock markets are generally expected to rise in value, over time, returns can be unpredictable and history has shown that even a 5-year time horizon is not always sufficient to protect investor's capital:**
  - the mantra that time is the great healer is not a 'water-tight' investment strategy
  - and the conjoined mantra that diversification protects investors is also disproven in times of stress, such as recent crises, as correlation between markets and asset classes increased, with almost all going down

- **Equally important to understand is the fact that even if stock market protection might be shown not to be necessary for a particular period, because the stock market went up, that does not mean that there was no value in the protection:**
  - if a person's house does not burn down or is not burgled in a particular year, people do not look at their house and contents insurance and retrospectively deem that it was worthless

Structured products can provide investors with an increased likelihood of positive returns being generated combined a decreased likelihood of capital losses being experienced

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It is difficult to put a price on the value of giving investors peace of mind, in the way that structured products can and do

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Perhaps the most important point to understand …

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- **Perhaps the most important point to understand is that structured products equate to 'investing by contract':**
  - all of the terms of a structured product are legal and contractual obligations' upon the issuer / counterparty of the product's underlying securities;
  - if the issuer / counterparty is solvent at maturity they are legally obligated to deliver precisely what they stated to investors at the outset – with 'no wriggle room': unless they are bust!

    … and banks, governments, central banks, regulators, shareholders, employees, savers and investors tend not to like banks becoming bankrupt!

- **'Investing by contract' is fundamentally different to investing in other types of investment, such as active - or passive - mutual funds, which are basically based upon nothing more than the 'hopes and aims' of the fund manager (but hopes and aims are <u>not</u> contractual legal obligations):**
  - for many investors this USP of structured products is a major attraction: and rightly so: investing by contract can remove many of the investment risks and concerns that many investors understandably have

Perhaps the most important point about structured products is that they equate to 'investing by contract'

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Investing by contract can remove many of the risks inextricably linked with other types of investment

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The key players …

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- **Issuer / Counterparty Banks:** Major global investment banks are usually the 'counterparties' that 'issue' the securities (i.e. the investments) that structured products are based upon:
  - examples of investment banks actively engaged in the structured products market include: BNP Paribas; Bank of America; Barclays; Citigroup; Credit Suisse; Goldman Sachs; HSBC; Investec; JP Morgan; Morgan Stanley, Natixis; Nomura; RBC; Santander; Societe Generale; UBS

- **Plan Managers / Promoters:** Products are often designed, developed, arranged and promoted by providers, who are sometimes known as 'Plan Managers' (a general term, but not actually a regulatory term):
  - the provider / plan manager can be the issuing investment bank themselves or an independent firm working in conjunction with the investment banks to design and develop products

- **Professional Advisers:** While high street banks and building societies sometimes offer structured products (and used to sell a lot), most of the UK retail structured products market now operates through independent professional advisers (IFAs), who are responsible for selecting investments on merit, based upon suitability for their clients
  - 'execution only' brokers have also been quite active in promoting structured products and structured deposits to savers / investors (based on appropriateness tests, as opposed to suitability): with some x/o firms also offering advice options to investors, if advisory input is wanted

- **Investors:** Self-evidently invest their capital, in order to achieve growth or income and tax efficiency

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Counterparties are typically leading global investment banks …

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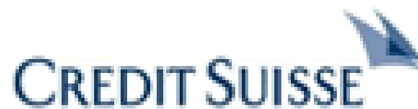

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Why do investment banks issue structured products …

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- **Why do investment banks issue structured products: what's in it for them?**
  - the answer is straightforward: investment banks use structured products as a way of raising funds, in much the same way that they might issue corporate bonds on the money markets or aim to attract deposits from retail or corporate customers (if they have retail banking / deposit taking operations);
  - more specifically, the treasury teams of the investment banks try to use structured products as a more cost effective (i.e. cheaper) means of raising funds than issuing corporate bonds

    [this point is explained in more detail in Module 2_'Understanding Structured Products']

Investment banks issue structured products as a way of raising funds, in much the same way that they issue corporate bonds or take deposits

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Types of structured products …

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- **There are TWO MAIN TYPES of structured products (with the second breaking down into two types)**:

1.Structured Deposits: are basically cash products, with the same risk and protection (i.e. FSCS protection, if the bank is licensed and the investor an eligible claimant) as deposit accounts, BUT with the rate of interest determined by the performance of an underlying stockmarket (or other asset class) link

2.Structured Products (also sometimes referred to as Structured Investments): two types:

- **Either 'Protected' Structured Products**: have the same full protection from market risk as a structured deposit, but do not usually benefit from FSCS protection in respect of counterparty failure (unless other factors, such as mis-selling, are involved)
- **Or 'Capital-at-Risk' (CaR) Structured Products:** place an investor's capital at risk from stock market downside in return for higher returns potential. As with protected structured products, CaR structured products also do not benefit from FSCS protection (other than for misselling)

- **Both structured deposits and protected structured products provide investors with stock market (or other asset class) linked investments, without market downside risk, at maturity**

- **Structured capital-at-risk products (referred to regulatorily as 'SCARPS') usually include a significant level of protection from market downside (such as a downside barrier of 40-50%)**

- **Aside from protection, taxation can be a consideration when choosing between structured products**

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Types of structured products …

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- **Explained at the simplest level, structured products can offer investors solutions designed for either:**
  - Growth;

  or
- Income;

… or a combination of both

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Product development considerations …

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- **Like any investment, structured products should be designed and developed to meet clearly identified investor interests / requirements:**
  - this is becoming embedded in investment regulation, in MiFID II (Markets in Financial Instruments Directive), but is something that the structured products sector in the UK has been working with for some time now
- **While structured products can 'bend' (or even break) the relationship that usually exists between market risk and the level of returns that investors receive, they are not alchemy:**
  - the terms of structured products can only be manufactured within the confines of what is possible based on prevailing market factors, such as: the level of interest rates; the level of the stock market; the volatility of the stock market; the credit strength of the issuer / counterparty and their appetite to attract funds, etc.
- **Prescriptive regulations govern the way that the structured products sector operates, including both issuing / counterparty banks and providers / plan managers / promoters:**
  - and the way that professional advisers select and advise on structured products

Regulations govern the way that the structured products sector operates

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Structured products must be designed to meet clearly identified investor interests / requirements

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Simple to explain: returns …

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- **The returns of a structured product are usually pre-defined and can be described in very straightforward terms:**
  - importantly, some structured products can offer fixed / non-conditional returns
  - other types of structured products can generate positive returns even if the stock markets that the products are linked to fail to rise
  - and some structured products can be specifically designed to generate positive returns for investors even if stock markets they are linked to fall

Providers must ensure that they are ‘clear, fair, and not misleading’ when describing the potential returns of a product

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Structured products operate on passive investment principles …

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- **Structured products generally operate on passive investment principles, linking to markets / assets through indices:**
  - but ‘with bells and whistles’, as opposed to investing in passive investment funds
- **Structured products can change investor’s exposure to both downside and upside stock market risk, in ways that traditional passive investment funds simply don’t and can’t, including removing or reducing downside market risk and providing the potential for fixed and non-conditional returns, including options that do not require the market / index to rise:**
  - these are important points, that may add significant value for investors, over and above simple passive investment options, particularly depending on adviser / investor views regarding the investment outlook
- **Index performance is calculated contractually, without the need for stock replication and therefore without tracking error, or direct / explicit charges etc.:**
  - however, it should be understood that most indices are based on ‘price return’, i.e. they do not take into account and include the dividend returns that may form part of the total return of the stocks: so the potential returns of a structured product, and any features and benefits that the product includes, need to be considered

Structured products generally operate on passive investment principles, linking to stock markets and or asset classes through indices: but they can change investor’s exposure to both downside and upside market risk, in ways that traditional passive investment funds simply don’t and can’t

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Simple to explain (but essential to understand): key risks …

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- **The risks of structured products can also be explained in straightforward terms. There are two fundamental / key risks in most structured products:**
  - **Issuer / counterparty risk:** also known as 'credit risk', is the risk that the investment bank responsible for issuing the securities that the product is based upon fails to remain solvent throughout the investment term

    (the bankruptcy of Lehman Brothers, in 2008, highlighted the importance of understanding counterparty risk);
  - **Market risk:** is the risk that the level of the underlying stock market (or asset) that the product is linked to will cause a loss of capital (if a product is not fully protected from downside market risk)

    (the collapse of the TMT bubble in 1999-2002, highlighted the importance of understanding market risk)

- **A number of other factors are also important for advisers / investors to consider, including:**
  - **Operational risk (Plan manager / Administration / Custody):** this includes consideration of the operational strength of the plan manager and the administration and custody arrangements, and service, throughout the life of the product

    (this risk is often overlooked by advisers and investors, but should be an important consideration)

    [these points are explained in more detail in Module 6_'Key risks / past events: the lessons to be learnt']

As with returns, providers must ensure they are 'clear, fair and not misleading' in describing any risks

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Structured products do not make all risks disappear and any risks that exist - and the consequences of the risks - must be fully disclosed and understood by professional advisers / prospective investors

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Some examples: growth products …

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INVESTOR INTEREST	PRODUCT TYPE	PRODUCT STRATEGY
Growth	**Structured Deposit**	▪ 100% protection from market risk and FSCS protection ▪ 125% participation in the underlying index growth (i.e. 1.25 x any growth / rise in the index), capped at a maximum investor return of 50% ▪ Returns are deemed interest and therefore taxed against income
Growth	**Protected Structured Product**	▪ 100% protection from market risk ▪ 125% participation in the underlying index growth (i.e. 1.25 x any growth / rise in the index): capped at a maximum investor return of 50% ▪ Credit risk is not covered by FSCS. Returns are subject to CGT
Growth	**Capital-at-Risk Structured Product**	▪ 100% protection from market risk, unless the index falls by 50% (measured during the investment term) ▪ 1000% participation in the underlying index growth (i.e. 10 x any growth / rise in the index): capped at a maximum return of 60% ▪ Just 6% growth in the index is required to generate the maximum investor return of 60%). Sometimes known as a 'super-tracker'
Growth	**Capital-at-Risk Structured Product**	▪ 100% protection from market risk, unless the underlying index falls by 50% (only measured at the maturity date) ▪ A fixed investor return of 50%, payable if the market is at or above 75% of its starting level, at maturity. Sometimes known as a 'digital' return

[See Module 14_'Product types and examples' for fuller explanations of product propositions]

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Some examples: income products …

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INVESTOR INTEREST	PRODUCT TYPE	PRODUCT STRATEGY
Income	**Structured Deposit**	▪ 100% protection from market risk and FSCS protection ▪ 4% conditional annual income, payable each year, if at the anniversary date the underlying index is at or above its starting level
Income	**Capital-at-Risk Structured Product**	▪ Fixed and non-conditional income of 4.5% ▪ Protection from market risk, unless the underlying index falls by 50% (only measured at the maturity date)
Income	**Capital-at-Risk Structured Product**	▪ Conditional income of 5% pa, payable if at the anniversary date the underlying index is at or above 60% of its starting level ▪ Protection from market risk, unless the underlying index falls by 40% (only measured at the maturity date)
Income	**Capital-at-Risk Structured Product**	▪ Conditional income of 7.5% pa, payable if at the anniversary date the underlying index is at or above 75% of its starting level ▪ A memory feature applies if a coupon is not triggered at any anniversary, due to the index being below the 75% payment trigger level, allowing for missed coupon(s) to become payable at a subsequent anniversary if the index condition is met ▪ Protection from market risk, unless the underlying index falls by 50% (only measured at the maturity date)

[See Module 14_'Product types and examples' for fuller explanation of product propositions]

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Some examples: ‘kick-out’ products …

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INVESTOR INTEREST	PRODUCT TYPE	PRODUCT STRATEGY
Growth (but may also be thought of as conditional ‘quasi’ income)	**Capital-at-Risk Structured Product**	▪ A coupon of 8% per year, and automatic maturity / repayment of capital at the first anniversary at which the underlying index is at or above its starting level ▪ Coupons accumulate for each year that the product runs, ‘rolling up’ (‘snowballing’) as the investment term progresses, until ‘kick-out’ occurs ▪ Protection from market risk, unless the market falls by 50% (only measured at the maturity date)
Growth (but may also be thought of as conditional ‘quasi’ income)	**Capital-at-Risk Structured Product**	▪ A coupon of 6% per year, and automatic maturity / repayment of capital, at the first anniversary at which the underlying index is at or above 80% of its starting level ▪ Coupons accumulate for each year that the product runs, ‘rolling up’ (‘snowballing’) as the investment term progresses, until ‘kick-out’ occurs ▪ Protection from market risk, unless the market falls by 40%: at maturity

[See Module 14_’Product types and examples’ for fuller explanation of product propositions]

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Exceptional portfolio planning / asset allocation scope …

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- **Structured products can link to virtually any underlying investment, from mainstream market indices to non-mainstream markets or asset classes, always with the potential to:**
  - remove, reduce or at least define exposure to market / asset downside risk
  - generate positive returns without requiring market / asset growth

- **The scope for the design of structured products is unparalleled**

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Summary introductory points re structured products …

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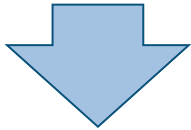
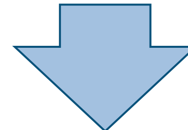
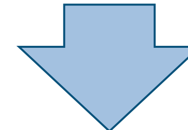
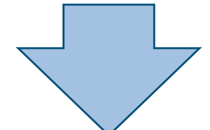
STRUCTURED PRODUCTS CAN …

DECREASE THE LIKELIHOOD OF CAPITAL LOSSES BEING EXPERIENCED BY INVESTORS	INCREASE THE LIKELIHOOD OF POSITIVE RETURNS BEING GENERATED FOR INVESTORS	FOCUS ON INCOME	FOCUS ON GROWTH	PROVIDE INNOVATIVE PORTFOLIO OPTIONS
				
structured products can remove, reduce or at least define investor exposure to market downside risk and the risk of loss of capital	structured products can provide fixed or pre-defined returns, that can mitigate the risk that markets fail to rise (or even fall)	structured products can provide income options, at a time when interest rates and bond yields are at historic lows (and may stay there)	structured products can provide growth options with risk / return profiles that are not possible through other types of investment	structured products can increase portfolio options and diversification of investment type, as well as asset class / geography

AND STRUCTURED PRODUCTS ‘DO IT ALL BY CONTRACT’

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Conclusion …

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- **As should be evident from this general introduction, structured products' offer unique benefits and advantages for investors. They can be designed to:**
  - remove, reduce or at least define investor exposure to downside stock market risk, removing or reducing the risk of potential loss of capital that is usually inextricably linked to stock market linked investments
  - provide the potential for defined returns, including the scope to generate positive returns without necessarily requiring the stock market to rise, and with some product options generating positive returns even if markets fall
- **These features are relevant and potentially value-adding for many / most investors**
- **Many / most investors want and need returns <u>on</u> their capital AND return <u>of</u> their capital**
  - this is what structured products can be designed to do
  - and, uniquely, they do it 'by contract', offering investors a fundamentally different type of investment approach

Best of breed structured products can complement and add value alongside best of breed active and passive funds - and other investment options - for investors, in diversified and balanced portfolios

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Learning outcomes of this Module …

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Following completion of Module 1, you should now:

- Have thought about general investor interests and needs and the ways that these needs can be met by structured products, as part of a balanced and genuinely diversified portfolio
- Understand what structured products are
- Understand the key differences between structured products and other types of investment, particularly the fact that structured products are contractual obligations, that can pre-define both levels and types of any risks that may exist and the potential returns
- Be able to identify the different parties involved in the structured products market, and to recognise their different roles and how they interact with each other
- Understand why investment banks issue structured products
- Have some idea of the different types of structured product that are offered to UK retail investors, and be able to recognise their key features
- Have some idea of the key risks associated with investing in structured products, with particular focus on counterparty risk, stockmarket risk and operational risk

If you would like to test your knowledge, please access the online Module test …

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Important notice

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- **It should always be understood that:**
  - structured products are not suitable for everyone
  - past performance is not a reliable indicator of or guide to future performance and should not be relied upon, particularly in isolation
  - the value of investments and the income from them can go down as well as up
  - the value of structured products may be affected by the price of their underlying investments
  - capital is at risk and investors could lose some or all of their capital

- **The ‘Important risks’ section of our website highlight the key and other risks of structured products, in addition to explaining important information for Professional Advisers who wish to access the current products area of our website and who may use our structured product plans with their clients:**
  - www.tempo-sp.com/important-risks

- **Professional Advisers should access and read the relevant plan documents relating to any structured product plan of interest, in particular: the plan brochure; plan application pack, including, the terms and conditions of the plan; and the issuer’s key information document (KID), securities prospectus and final terms sheet, before making a recommendation to their clients**.

- **Professional advisers should not invest in, or advise their clients to invest in, any investment product unless they and their clients understand them, in particular the relevant risks**

Important notice

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Contact details:

TEMPO STRUCTURED PRODUCTS

Tempo Structured Products
Alpha Real Capital | TIME Investments

338 Euston Road
London NW1 3BG

T: +44 (0)207 391 4700

W: www.tempo-sp.com
W: www.alpharealcapital.com
W: www.time-investments.com

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