Looking past the obvious...

Chris Taylor talks about the 'contract' benefits of structured products

After a long career in the asset management industry, one thing I've learnt is the importance of looking at things the industry does and looking through the obvious, to find the more interesting aspects, that sometimes flip the obvious on its head.

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When it comes to structured products, the most obvious risk is well-known to be the 'counterparty risk', i.e. the risk that the bank behind a product can go bust and cause loss of capital. But rather than add more column inches to stating that advisers and investors should always ensure that they are cognisant of this risk, I'd like to flip the point on its head and talk about what I think is an overlooked point, which is the benefit – as opposed to the risk – of the counterparty behind a structured product!

The basic risk of a structured products is that the counterparty must stay in business – but the benefit is that they also remove or reduce some key risks that many investors naturally want to avoid… but have often been 'educated' to think that they can't.

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Most specifically, structured products can remove or reduce 'market downside risk', i.e. the risk of markets going down and investors losing capital.

But they can also remove or reduce 'market upside risk', i.e. the risk that markets don't go up and generate the returns investors need.

In addition, structured products remove the 'active fund management risk', i.e. the risk that active fund management just doesn't deliver the performance, or the risk control, that it marketed itself as being capable of providing (noting that the marketing of actively managed funds is actually based on nothing more than 'aims' and 'hopes', not legally binding contracts!).

The fact is that the counterparty banks behind structured products take on risks that exist in other types of investments, such as mutual funds, and turn them on their heads… by contractually defining both market risk and return. And the contracts mean that the process risk falls on the couterparties, not investors.

And that is the eureka point… that structured products equate to 'investing by contract'. And it's an important point.

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Investors in structured products basically delegate the investment process and performance risk to a major investment bank, the counterparty, which becomes legally obligated to deliver the terms of the contract at maturity, regardless of their process, unless they are bust.

But this major benefit of structured products is being overlooked by some advisers and investors, because they're only focusing on the obvious points, not the less obvious (although the good news is that an increasing number are slowly cottoning on).

Yes, some 'clever stuff' may be going on behind the scenes of a structured product, in order for the counterparty bank to 'hedge' their legal obligation to deliver the terms of the products they issue, at maturity.

> There are just some things active and passive funds can't do, that structured products do… and do by contract.

But investors are not investing into the the counterparty's clever stuff or process – unlike active fund management, where if a fund's process fails it's the investor who suffers. Investors in structured products are investing in contracts! And the contracts are usually issued by some of the world's strongest financial institutions, who take the process risk of investing away from the investor and own the risk themselves.

Investors in structured products therefore have a very different consideration to investors in active funds.

The key consideration is the strength of the bank behind the product and whether they will still be in business at maturity? And the fact is that the world's biggest banks like to stay in business - and governments, central banks, regulators, shareholders, deposit holders, employees, etc. also like them to!

> Of course, as with any investment, there are risks that need to be understood with structured products.

There is no such thing as a perfect investment. And, as with any investment, there are risks that need to be understood with structured products. But many investors may find it easier to consider whether a major global bank is likely to stay in business, than what may or may not happen to the stock market.

Pragmatically, a good approach to portfolio construction is to diversify across various types of investments, including funds and products. In other words: the best of active funds; the best of passive funds (pretty much everybody seems to like passive and smart beta these days!); AND the best of structured products… because there are just some things that active and passive funds can't do, that structured products do… and do by contract. It's their major benefit, to my mind.

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