Explaining the basic principles...

Chris Taylor explains the basic principles and key attractions of structured products and highlights why many investors might benefit from including structured products in their portfolios.

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After a long career in the asset management industry, which has included working with both mutual funds and structured products, I think it is probably fair to say that if investors could design their own investments, they would be unlikely to design anything that looks and feels much like a mutual fund, which generally require investors to accept risks that they have long been told they cannot avoid when investing in the stock market!

However, if investors could design their own investments, many of the fundamental features of an investor-designed investment might look and feel much like a structured product. For example:

- all investors would like less likelihood of capital losses being experienced as the result of market downside;
- all investors would like more likelihood of positive returns being generated, even in challenging market environments (including when markets don't go up much or even when they go down);
- all investors would like charges that impact less on any money they invest and any returns generated;
- and what investor wouldn't like investment providers to be legally and contractually obligated to deliver what they promise!

> **"If investors could design their own investments, many of the fundamental features of an investor-designed investment might look and feel much like a structured product."**

There's no universally recognised definition of a structured product, but the following offers a simple explanation and highlights some important points:

- structured products are investments that are issued by investment banks, known as issuers/counterparties;
- they are usually designed to run for a maximum investment term of between 5-10 years (although many are designed with the potential to mature early, during the investment term);
- they offer investors stock market (or other asset class) linked investments, with the benefit of:
  1) pre-defined (and usually reduced) exposure to stock market risk (including the potential for complete removal of downside stock market risk, in certain types of products);
  2) pre-defined conditions for potential returns (including the potential for non-conditional returns and positive returns which do not require the stock market to rise);
  3) returns which are usually provided net of all charges (meaning that returns are calculated on the full amount of money invested and the repayment of money invested at maturity is usually without any charges being directly deducted);
  4) and the issuers/counterparties are legally obligated to deliver the terms of the securities/bonds that they issue, if they are solvent at maturity.

This certainly sounds like it comes very close to ticking the boxes of the features of an investor-designed investment solution, offering products which can be designed to increase the likelihood of positive returns, and decrease the likelihood of losses, by contract.

Of course, it's important for investors to understand that while structured products can pre-define both potential risk and returns, the money invested in a structured product and any potential returns are usually dependent upon the financial stability of the issuing/counterparty bank which is behind the contract, i.e. the bank mustn't 'go bust' (which is known as the 'issuer/counterparty risk').

A major bank failure is, of course, a rare event. Banks are closely scrutinised and regulated in respect of their capital adequacy and financial strength. Investors need to understand the risk, however. And, as a result of understanding counterparty risk they should seek to identify structured products which are backed by the stronger issuers/counterparty banks – such as identifying whether the bank is categorised as a Global Systemic Important Bank ('G-SIB'), in addition to also considering other important factors.

> **"Diversification is key ... investors should consider diversifying across different types of investment, including mutual funds and structured products, to achieve better diversified and more balanced portfolios."**

Elsewhere in this bulletin, the point is correctly made that portfolio diversification is key. Academia and common sense both point to this being the case. Notwithstanding the conceptual points highlighted in this article regarding the basic principles and key attractions of structured products, and the details of the past performance of structured products that this bulletin also provides details of, the fact is that no investment is perfect.

Investors should consider diversifying across different types of investment, including 'best of breed' mutual funds, both actively managed and passive, and 'best of breed' structured products, to achieve better diversified and more balanced portfolios.

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There are risks associated with an investment in any structured product. 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 highlights 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/home/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.

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