A Guide to Autocalls
A 20-Year Evolution

StructuredProductReview.com

AUTOCALLS: DELIVERING GOOD OUTCOMES FOR RETAIL INVESTORS

Content

Important information

This guide is intended for UK investors only and does not constitute personal advice or a recommendation to invest.

All investments carry risk of loss which in extreme circumstances could be substantial.

Past performance may not be repeated is and therefore not a guarantee of future performance.

Any reference to taxation could differ in respect of your own circumstances. Taxation rates, reliefs and exemptions are subject to change.

If you have any potential misunderstanding about taxation implications, the risk associated with a proposed course of action, or doubts as to its suitability for you, you should contact your financial adviser.

StructuredProductReview.com is a trading style of Lowes Financial Management Limited. Lowes Financial Management Limited is authorised and regulated by the Financial Conduct Authority. (FCA register number 114650).

E&OE

Preface

Investing is important for various reasons. Besides helping individuals achieve their life goals, save for retirement, or build an emergency fund, investing is essential for wealth preservation. While “safe”, cash-based investments are a vital part of portfolios, their purchasing power is typically eroded by inflation over time.

The fundamental purpose of investing is to combat the impact of inflation. However, all investments come with risk, and investors must be prepared for the worst-case scenario, no matter how unlikely it may seem. Higher returns, whether potential or actual, usually come with higher risk. This risk could result in no return at the end of the expected holding period or a loss of the original investment capital.

Autocalls are one of the many investment opportunities available to investors. They offer predefined returns at predetermined dates, under specific circumstances while protecting the original capital from all but the most extreme situations. The investment proposition is therefore relatively simple, with the investor effectively swapping variable returns from other possible investments for fixed potential returns, perhaps more suited to achieving their investment goals, all whilst repositioning risk. Yet, despite having an excellent track record, autocalls have often been overlooked by retail investors and their advisers.

This guide aims to explain the history and features of autocalls to help demystify them.

It’s essential to remember that investment involves risk, and it could result in a loss of capital.

Introduction

The retail investment landscape

The retail investment landscape has experienced significant developments in structured products since their introduction in the early 1990s. Initially, these investment vehicles were introduced to provide funding for banks or insurance companies and offer stock market exposure for investors while safeguarding their capital. However, the sector faced challenges and scrutiny due to the introduction of high-risk products with deceptive marketing practices, leading to the Precipice Bond Scandal.

Among the various structured products, autocalls (aka kick-outs) emerged as an innovative solution in 2003, offering equity-like, albeit capped returns with a buffer against market downturns.

Autocalls have become the most popular sector offering in the UK. The following sections delve into the evolution, performance, and dominant trends of autocalls in the UK retail sector over their 20-year history.

%

The first autocall

The first autocallable structured product in the UK retail market was **Premier Asset Management's FTSE 100 Growth Plan,** issued in July 2003.

This product had a maximum term of six years and offered a simple return of 8% per year. If the FTSE 100 reached or exceeded its initial level on any anniversary, the plan matured, returning the investors' capital and an 8% gain for each year.

The successful maturity of this plan one year later demonstrated the potential benefits of autocalls, especially considering the significant decline in the FTSE 100 during the early 2000s.

Extract from the brochure of the first autocall

Premier FTSE 100 Growth Plan
- Potential 8% p.a. growth on your capital for six years
- Your capital is not protected

Investment

Year 1 is FTSE the same as or greater than start value? — YES — Initial investment + **8%**

NO — GO TO YEAR 2

Year 2 is FTSE the same as or greater than start value? — YES — Initial investment + **16%**

NO — GO TO YEAR 3

Year 3 is FTSE the same as or greater than start value? — YES — Initial investment + **24%**

NO — GO TO YEAR 4

Year 4 is FTSE the same as or greater than start value? — YES — Initial investment + **32%**

NO — GO TO YEAR 5

Year 5 is FTSE the same as or greater than start value? — YES — Initial investment + **40%**

NO — GO TO YEAR 6

Year 6 is FTSE the same as or greater than start value? — YES — Initial investment + **48%**

NO — Did FTSE 100 Index remain above 50% of the start value throughout the life of the plan? — YES — Full return of capital

NO

If FTSE 100 index did, at some point during the life of the plan, dip to 50% or below the start value, then you will lose 1% of the capital for which 1% final value is below the start value.

Capital at risk

The first autocall and most issued since are capital at risk investments. This manifests in two main ways:

1. Market risk:

If the underlying, be in a stockmarket index, a basket of shares or some other measure, performs poorly so a positive maturity is not triggered, investors may face an equivalent loss if the underlying is below the capital protection barrier at the final maturity date.

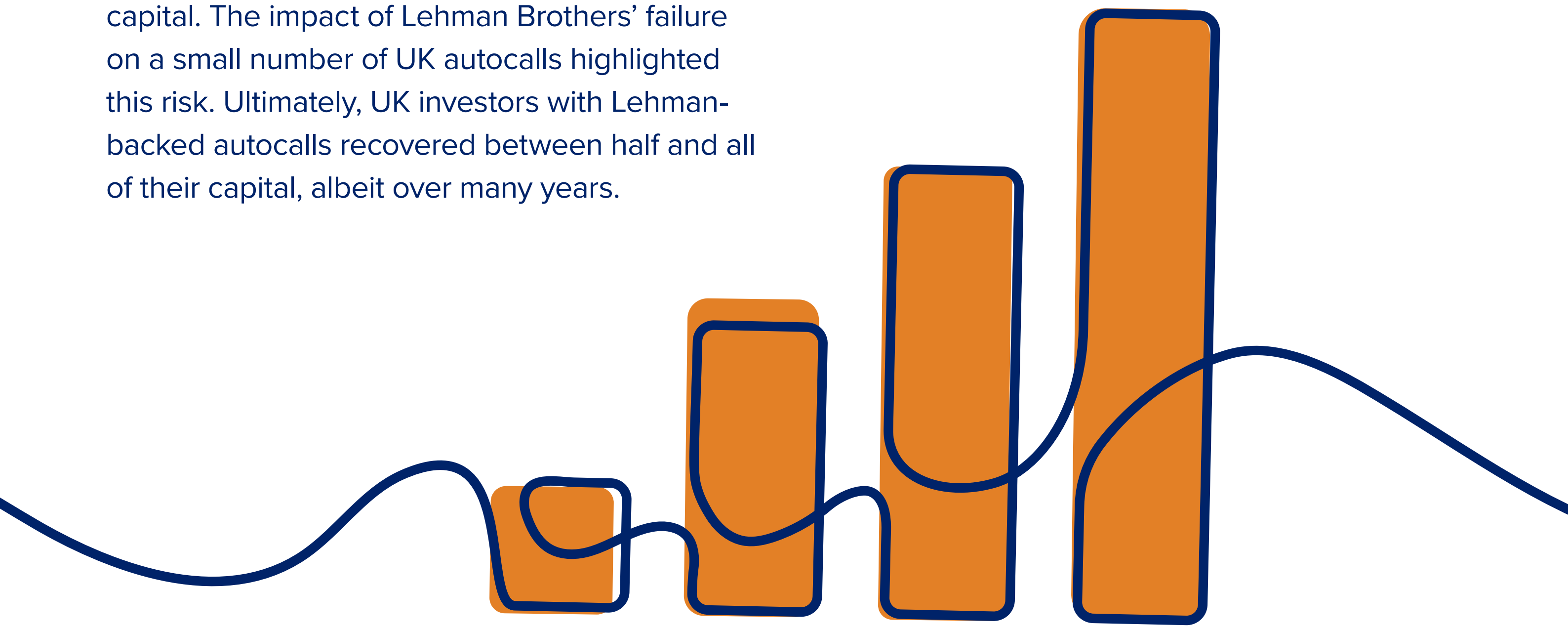
2. Counterparty risk:

Most autocalls involve investors loaning money to a significant bank or major financial institution (the 'counterparty', see further details to the right). If the bank becomes insolvent, it may not be able to meet its obligations in full, resulting in investors potentially losing a substantial part of their capital. The impact of Lehman Brothers' failure on a small number of UK autocalls highlighted this risk. Ultimately, UK investors with Lehman-backed autocalls recovered between half and all of their capital, albeit over many years.

Counterparties

UK retail autocalls have been issued by more than 20 major financial institutions. In 2023, nine significant financial institutions act as counterparties. These typically are Globally Systemically Important Banks (G-SIBs) with strong ratings from the major credit rating agencies. Despite their perceived strength and importance the risk of a potential bankruptcy of a counterparty needs to be acknowledged.

Diversification of counterparties can reduce the overall risk. A further risk mitigation methodology is for the autocall issuer to collateralise the credit risk with UK Government Gilts but this reduces the coupons on offer and beyond funds of autocalls, this is rare.

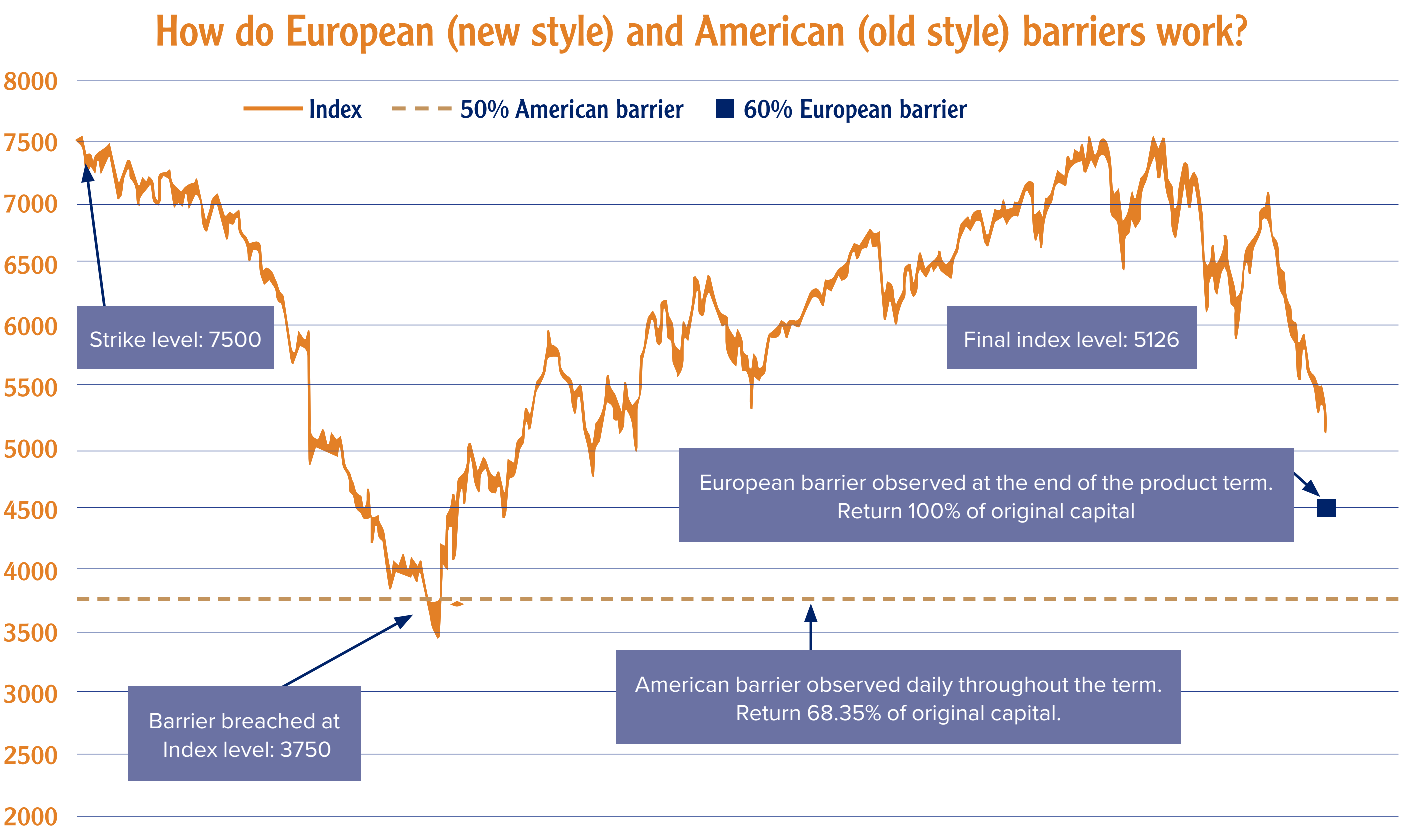


Capital protection barriers

In poor market conditions an autocall may run for its maximum possible term, at which point, the counterparty is contracted to return all of the original capital at maturity unless the underlying (e.g. FTSE 100 Index) falls below the capital protection barrier.

Early autocalls had 'American' capital protection barriers at 50% to 60% of the start level but these could be breached by a market fall on any day of the investment term.

Modern autocalls typically have 'European' barriers at 60% to 70% of the start level but these can only be breached at the very end of the maximum term.



Deposit-based/capital-protected variants & sector dominance

Deposit-based/capital-protected variants

The first capital 'protected' autocall was issued in 2005, with a similar design to capital at risk autocalls but with no risk of loss at maturity arising from poor market conditions. These still however, carried the risk of loss from counterparty failure.

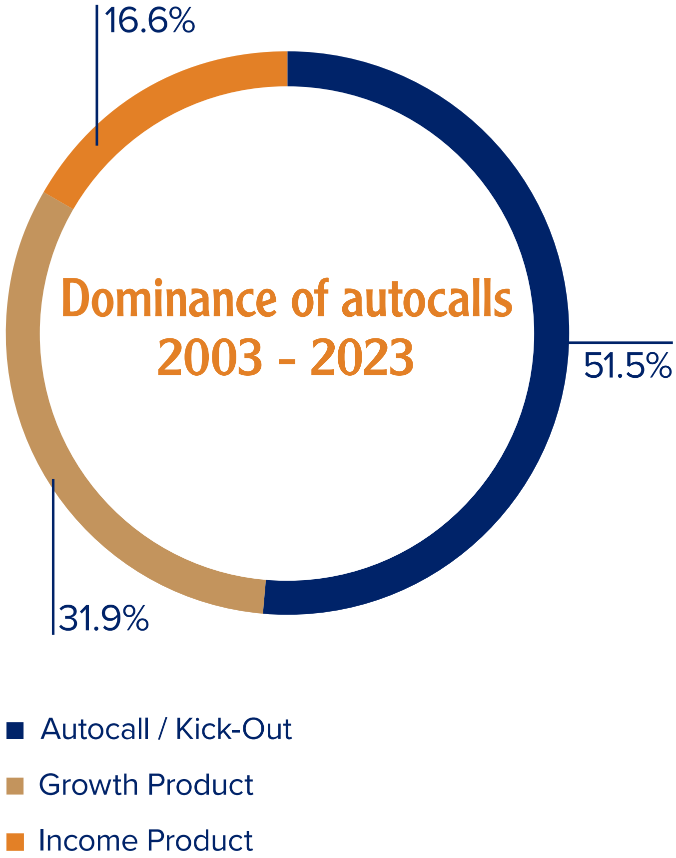
Deposit-based autocalls were introduced in 2009. These provide greater protection from counterparty risk and benefit from Financial Services Compensation Scheme (FSCS) coverage, subject to eligibility.

The coupons offered on these autocalls are commensurately lower than those offered by autocalls that derive additional potential returns from putting capital at risk. Furthermore, the returns on these plans are taxed as interest, rather than capital gains unless held in a tax shelter (e.g. ISA or Pension).

Since 2005, only 15 capital 'protected' autocalls have been in the UK retail space, whereas 236 deposit-based autocalls were issued. Higher interest rates will mean new issues are more common.

Sector dominance

In contrast to the small number of deposit-based offerings, over 3600 capital at risk autocalls have been issued since the first one back in 2003. These now represent more than half of all retail structured products issued in the UK.



Autocall product issuance since 2003

15 capital 'protected'

236 deposit-based

3665 capital at risk

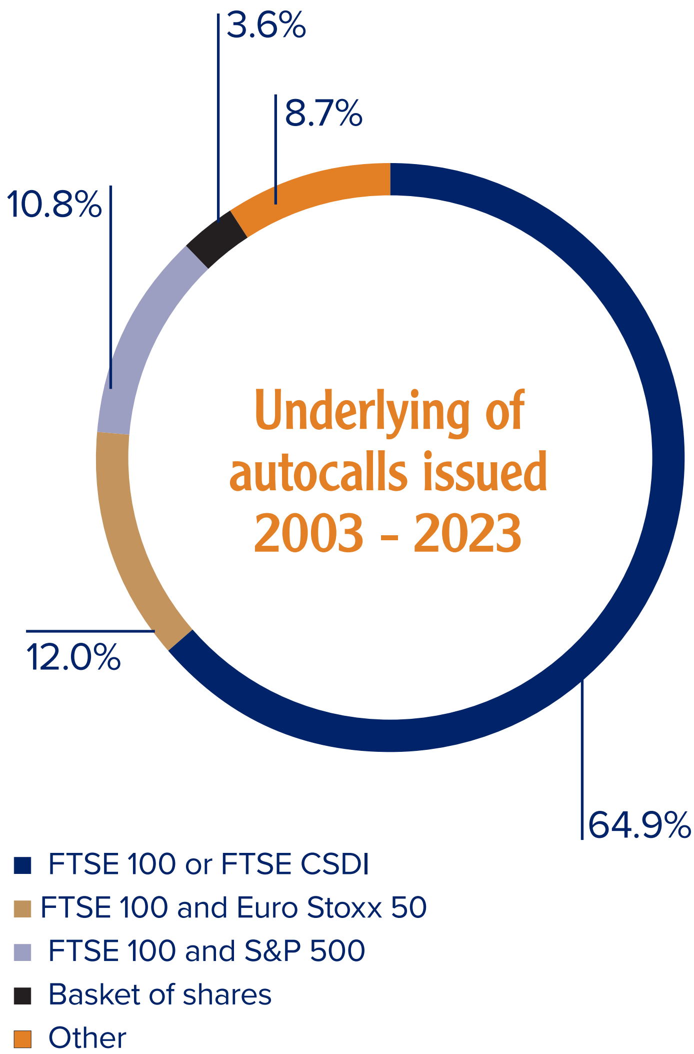
What's underlying?

The term "underlying" refers to the asset or measure that an autocall is linked to, and its performance determines whether the autocall matures and the outcome for investors. The majority of autocalls have been linked solely to the FTSE 100 Index or more recently to its closely related cousin, the FTSE CSDI (see Appendix A). These indices track the performance of the top 100 companies listed on the London Stock Exchange.

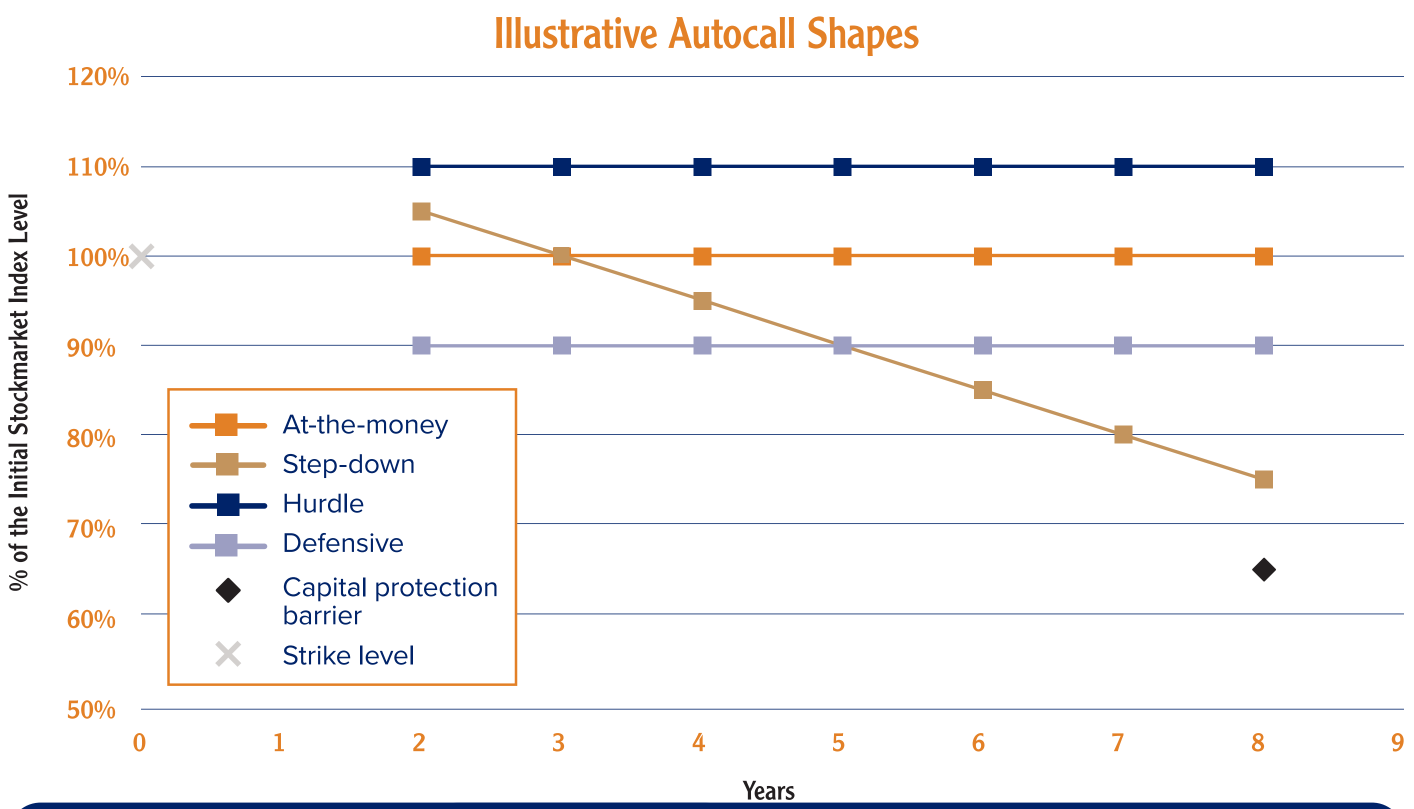
Another common approach is to use two stock market indices, typically the FTSE 100 along with either the S&P 500 or Euro Stoxx 50 indices. In these cases, the worst performing index determines the autocall's outcome. For a positive outcome, both indices must be above the required maturity trigger levels, and the worst performing index determines if there is a breach of the capital protection barrier and the extent of any potential loss.

Some autocalls have been linked to baskets of individual shares. While these plans offer high potential returns, they lack the diversification benefits of indices. Typically, the worst performing share in the basket determines the outcome. Consequently, share-linked autocalls are considered high risk and have represented both the best and worst performing structured products.

In addition to stock market indices and individual shares, other underlying measures used in autocalls include baskets of commodities and proprietary indices created by banks specifically for structured products.



Defensive, neutral, or optimistic shape...



At-the-money contracts

The early maturity trigger points for the first autocall were the same level of the FTSE 100 index recorded at the beginning of the term, observed on each anniversary date. This is referred to as 'at-the-money' where minimal or no growth in the underlying is required for a positive outcome.

Hurdle contracts

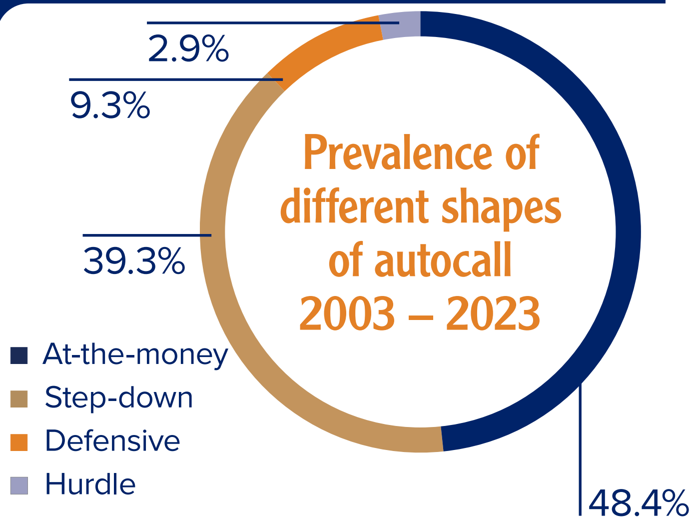
Hurdle contracts are similar to at-the-money contracts, but the maturity trigger level is above the initial index level. For example, the index may need to rise by 5% to trigger a positive maturity.

Defensive contracts

Defensive contracts, on the other hand, have the maturity trigger set below the initial index level, at say 95%. This allows the index to be up to 5% lower and still achieve a positive maturity.

Step-down contracts

Step-down contracts involve the maturity trigger level decreasing over time. Often, the first trigger level for a step-down contract is set above the initial index level and gradually reduces thereafter. This reduction may not follow a linear pattern but ultimately reaches a level significantly lower than the initial index level at the final observation date.



The lower the maturity trigger levels used the greater the potential for a positive outcome but this therefore translates to lower potential returns.

First call, last call & frequency

First call

The first autocall had the potential to mature on the first anniversary and annually thereafter. It is now popular to defer first potential maturity until the second anniversary when two times the annual coupon would be paid. Some contracts defer the first possible maturity until the third, or even the fourth anniversary.

Deferring until the second or subsequent anniversary can result in a greater total return when compared to the underlying, less frequent reinvestment activity and lower intermediation fees. Conversely, deferring the first maturity reduces the potential for a positive outcome by reducing the number of maturity opportunities.

Call frequency

Most autocalls have the potential to mature on anniversaries of the plan commencement date, be it the first anniversary, second, or later. However, some can mature semi-annually, quarterly or even daily.

The frequency of potential maturity trigger dates directly impacts the potential for a positive outcome, but it is important to note that this is usually reflected in the coupon offered.

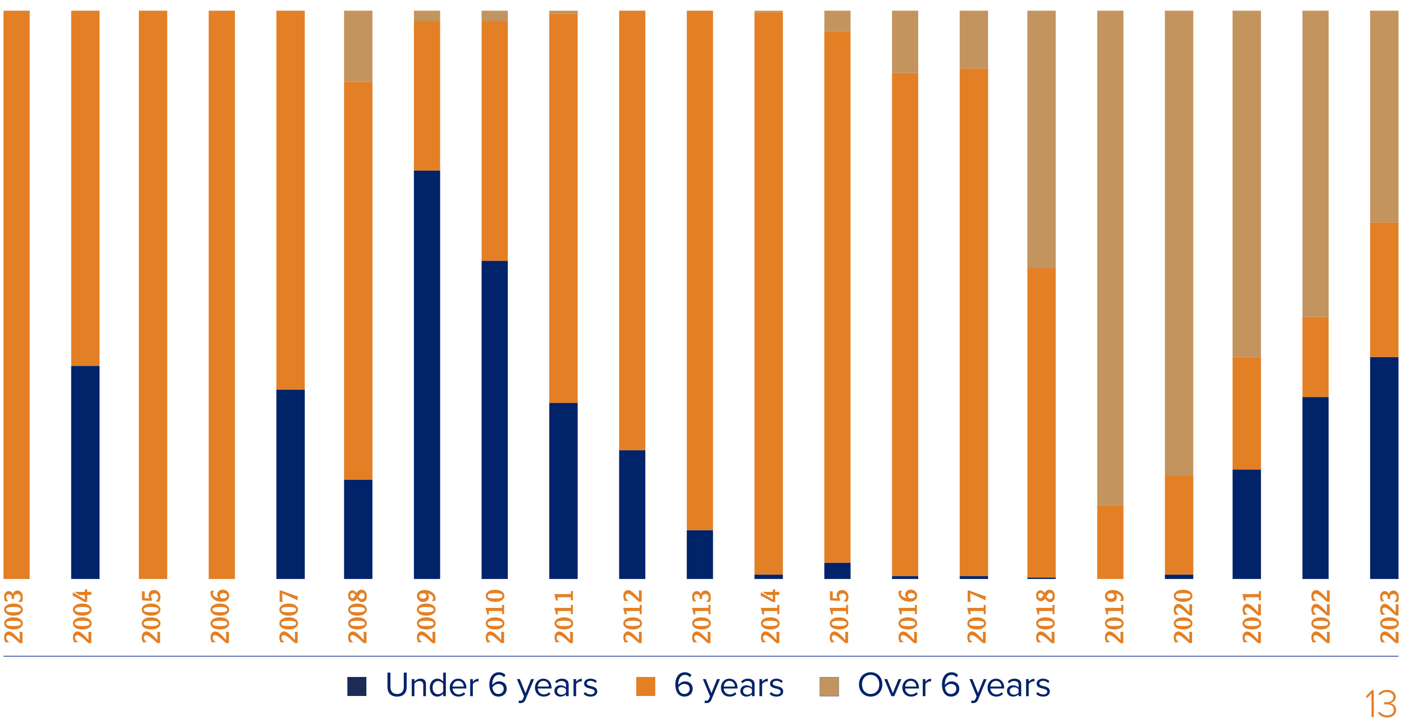
Last call - maximum term

The maximum duration of autocalls plays a crucial role in providing more maturity opportunities and allowing additional time for the underlying asset to recover in case of a market crash. A longer-term also means that the determination of loss or observation of barrier breach is deferred.

The first autocalls had maximum terms of six years. Five-year terms were subsequently introduced and have recently become common once again.

However, many new issues now offer more appropriate maximum durations of six years or more, with some extending up to eight or even ten years. These longer-term structures aim to provide investors with greater potential for positive outcomes and can accommodate depressed market conditions over an extended period.

Maximum lengths of capital at risk autocalls



Backtesting

Autocalls are designed to adhere to the terms stated in the contract, allowing for the possibility of modelling their performance based on historical data. By simulating the contract under various scenarios, we can evaluate how it would have performed if it had commenced on any day the underlying asset has existed.

Backtesting analysis reveals that many defensive and step-down autocalls using the FTSE 100/ FTSE CSDI indices as the underlying would have been successful had they commenced on any day in the history of the Index.

Others might have a very low number of historical scenarios where the outcome would have been the return of capital without additional gains.

When analysing autocalls that follow common strategies and have a typical capital protection barrier, observed only at the end of the maximum term, there are very few instances in the history of the FTSE 100 Index where a loss at maturity would have occurred.

Backtesting becomes more complex when two or more underlyings are used in the contract, but regardless, it is crucial to understand that historical backtesting or actual performance does not guarantee future results. The coupons offered on autocalls serve as compensation for the risk that the future performance of the underlying assets may differ from their past performance.

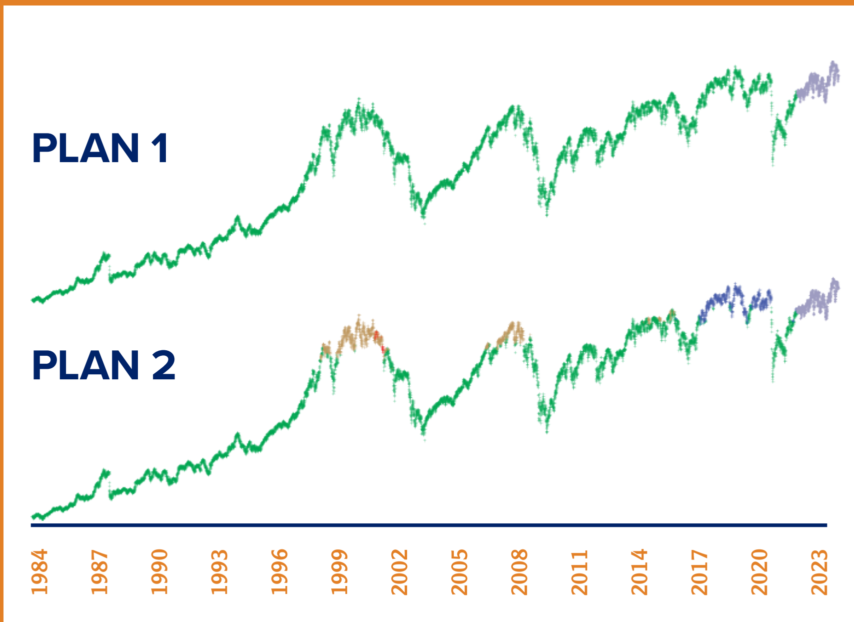
Historical backtesting of FTSE 100 linked, autocalls

8-year maximum term, first maturity trigger on 2nd anniversary and annually thereafter 65% end of term barriers.	**PLAN 1:**	Defensive - maturity trigger at 90% throughout
	PLAN 2:	Hurdle - maturity trigger at 110% throughout

Total possible start dates	10,222
Of which, yet to reach 2nd anniversary	504
Total possible maturity dates	9718

Maturity outcomes (percentage of total possible maturity dates)

	PLAN 1: Defensive	PLAN 2: Hurdle
Matured realising a gain	100%	80.66%
Matured returning capital only	0%	10.50%
Matured with a loss	0%	0.28%
Yet to mature	0%	8.56%



Maturity performance

Most historically issued autocalls have utilised the FTSE 100 index only as the underlying. Of these, over 1600 have matured with eight returning capital only and the rest returning gains.

Higher risk plans utilising more than one underlying have typically offered higher coupons but the greater potential for loss, or just a return of capital with no gain, has manifested in many instances.

Deposit based autocalls have no potential for loss but an increased potential to return capital only at maturity which has occurred in 15% of all historical maturities, albeit less than 4% where the underlying was the FTSE 100 only.

Deposit maturities (as at 1 June 23)	Underlying	
	FTSE 100 only	Shares
Total maturities	137	32
With gain	132	11
Only capital	5	21
With loss	0	0
Average annualised return & duration	4.75% p.a./ 2.8 years	2.44% p.a./ 4.7 years
Top quartile	6.66% p.a./ 2 years	8.41% p.a./ 2 years
Bottom quartile	2.90% p.a./ 3.9 years	0.00% p.a./ 6 years

Capital at risk maturities (as at 1 June 23)	Underlying			
	FTSE 100* only	Dual index	Shares	Other
Total maturities	1641	806	97	119
With gain	1633	780	70	95
Only capital	8	12	14	17
With loss	0	14	13	7
Average annualised return & duration	7.70% p.a./ 2.2 years	8.29% p.a./ 2.5 years	8.42% p.a./ 3.2 years	6.50% p.a./ 3.4 years
Top quartile	10.28% p.a./ 1.7 years	11.47% p.a./ 1.7 years	19.10% p.a./ 1.2 years	12.50% p.a./ 2.4 years
Bottom quartile	5.68% p.a./ 2.7 years	5.00% p.a./ 3.5 years	-8.48% p.a./ 5.9 years	-1.18% p.a./ 5.2 years

*Including FTSE CSDI only. See Appendix A.

Tax

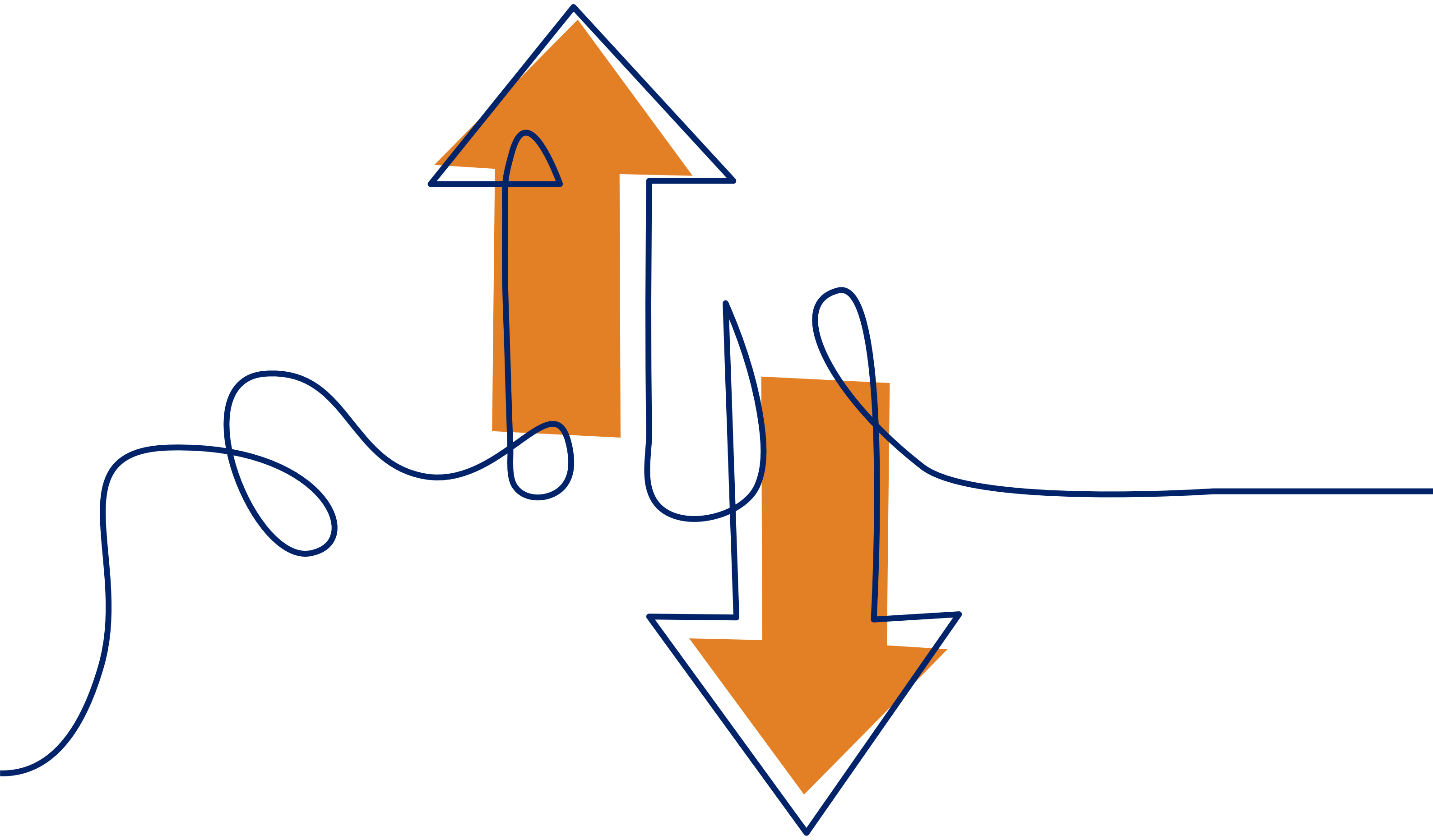
Autocalls are a versatile investment option accessible to a wide range of investors, including children, retirees, corporates, trusts, and charities.

For individuals, autocalls can be held within tax-efficient accounts such as Individual Savings Accounts (ISAs), including Junior ISAs, or Self-Invested Pension Schemes (SIPPs). Alternatively, they can be held directly without any tax shelter.

When held outside of a tax shelter, autocalls that involve the risk of capital loss are generally subject to capital gains tax if gains are realised. On the other hand, returns from deposit-based autocalls are typically subject to savings income tax.

For corporates and partnerships, taxation is based on investment income or corporation tax rules, depending on the specific circumstances.

It's important to note, tax regulations and rates can vary and are based on individual circumstances and local jurisdiction. Therefore, it is recommended to consult with a tax adviser or financial professional to understand the specific tax implications of autocall investments in your situation.



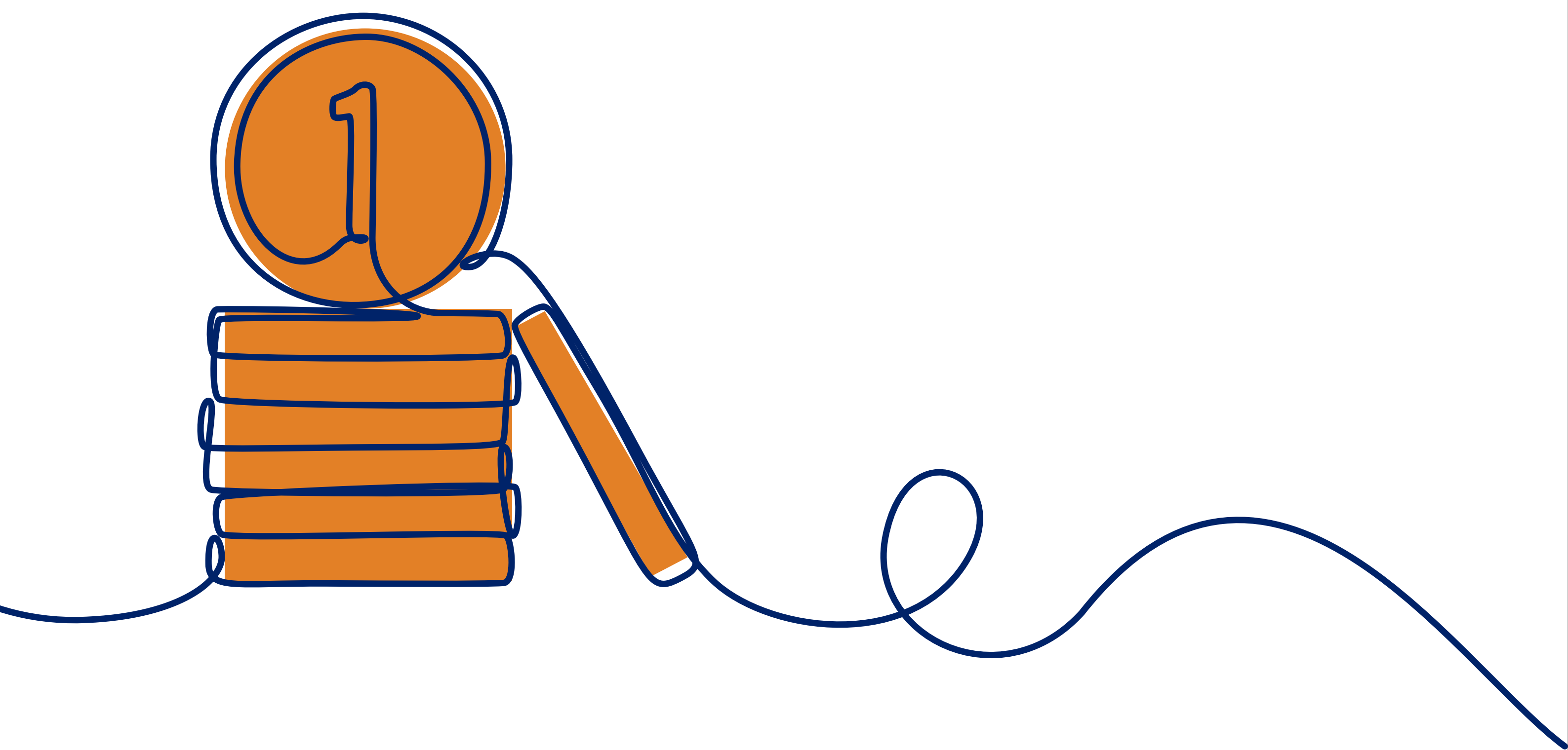
Plan managers, administrators and custodians

For investments of £500k or more, a customised autocall can be created. However, this investment amount is beyond the reach of most individual investors for a single investment. To make autocalls accessible to retail investors, Plan Managers step in to purchase the securities from the counterparty bank and package them into investment offerings with minimum investment thresholds as low as £3,000.

Once an investor proceeds with an autocall, their investment is held on their behalf by an administrator custodian, typically a specialised stockbroker. The administrator custodian is responsible for safeguarding the investor's assets.

In the rare event of a shortfall caused by the failure of the administrator custodian, eligible investors retain certain protections. They potentially have the right to seek recourse through the Financial Services Compensation Scheme (FSCS), which offers compensation of up to £85,000 per investor in the event of breach of contract.

It's worth noting that the involvement of Plan Managers, Administrators, and Custodians ensures that autocalls can be made more accessible to retail investors while providing a level of protection and professional oversight for their investments.




ADVERTISEMENT
arcus
Arcus Partners
A fresh perspective on Structured Products
At Arcus, we see and do things differently. Experience the future of investing with our range of value driven capital-at-risk and capital protected structured products. Including autocall investment products offering up to 10.30% p.a. and autocall deposits offering up to 7.25% p.a.
To view our full comprehensive range of products, including growth and defensive options, visit arcusforadvisers.com.
Join Arcus for Advisers today and see the world through our eyes.
Sales, product and general enquiries:
Telephone: 0204 582 2798
Email: salessupport@arcus.partners
Web: arcusforadvisers.com
Portal: portal.arcusforadvisers.com
Investec Transfers: investecforadvisers.com

Early surrender & charges

Early surrender

Whilst the defined outcomes offered by autocalls only apply when a maturity is triggered it is possible to exit the contract early.

The return at that point will be determined by a number of factors, such as the expected outcomes at future maturity trigger dates, the likelihood of breaching the capital protection barrier, prevailing interest rates, and the financial strength of the counterparty.

While early surrender could potentially lead to a positive outcome, it is important for retail investors to consider autocalls primarily as long-term investments. The maximum term of the contract should be taken into account when evaluating the potential benefits.

An early surrender example is provided in Appendix B.

Charges

The potential coupons offered by autocalls are quoted net of all fees, except for brokerage/ intermediation and personal advice fees.

The charges built into the terms of the autocall can range from as little as 0.5% to over 3%. Higher charges correspond to lower potential coupons on offer. Additionally, there is typically an early surrender charge, which can be up to £200. This charge is applicable only if the investor chooses to exit the contract before a triggered maturity.

Where next?

Many autocalls are designed for distribution through financial advisers and some counterparty banks even insist that investors have sought such advice. Others accept that they can be appropriate for informed investors who choose not to seek advice. In every instance the investor should understand the arrangement, commitment and risks.

StructuredProductReview.com is designed to give IFAs a better perspective of the structured product market. Launched in 2009, it helps thousands of financial services professionals with their research into structured products.

With weekly updates and new product alerts, IFAs are kept up to date with the latest product launches and the site gives users the key information on each product in a clear and concise format, also providing access to product literature and a product archive stretching back to 2000.

StructuredProductReview.com is also dedicated to improving knowledge of structured products and houses an extensive archive of educational material with a wide range of bespoke articles from leading figures in the industry.

The website is maintained by Lowes Financial Management, an Independent Financial Adviser with an over fifty-year pedigree and one of the country's first adviser firms to achieve the 'Chartered Financial Planners' accreditation.

Visit StructuredProductReview.com to sign up and recieve access to the terms, features and analysis of current products on the market. The site also provides access to product archives, performance history, educational materials as well as research support through our counterparty platform and tools allowing 'at a glance' product comparisons.

Appendix A - FTSE CSDI

Appendix A - FTSE CSDI

The FTSE Custom 100 Synthetic 3.5% Fixed Dividend Index (FTSE CSDI) was developed specifically for structured products by FTSE Russell, the same organisation that calculates and publishes the FTSE 100 Index.

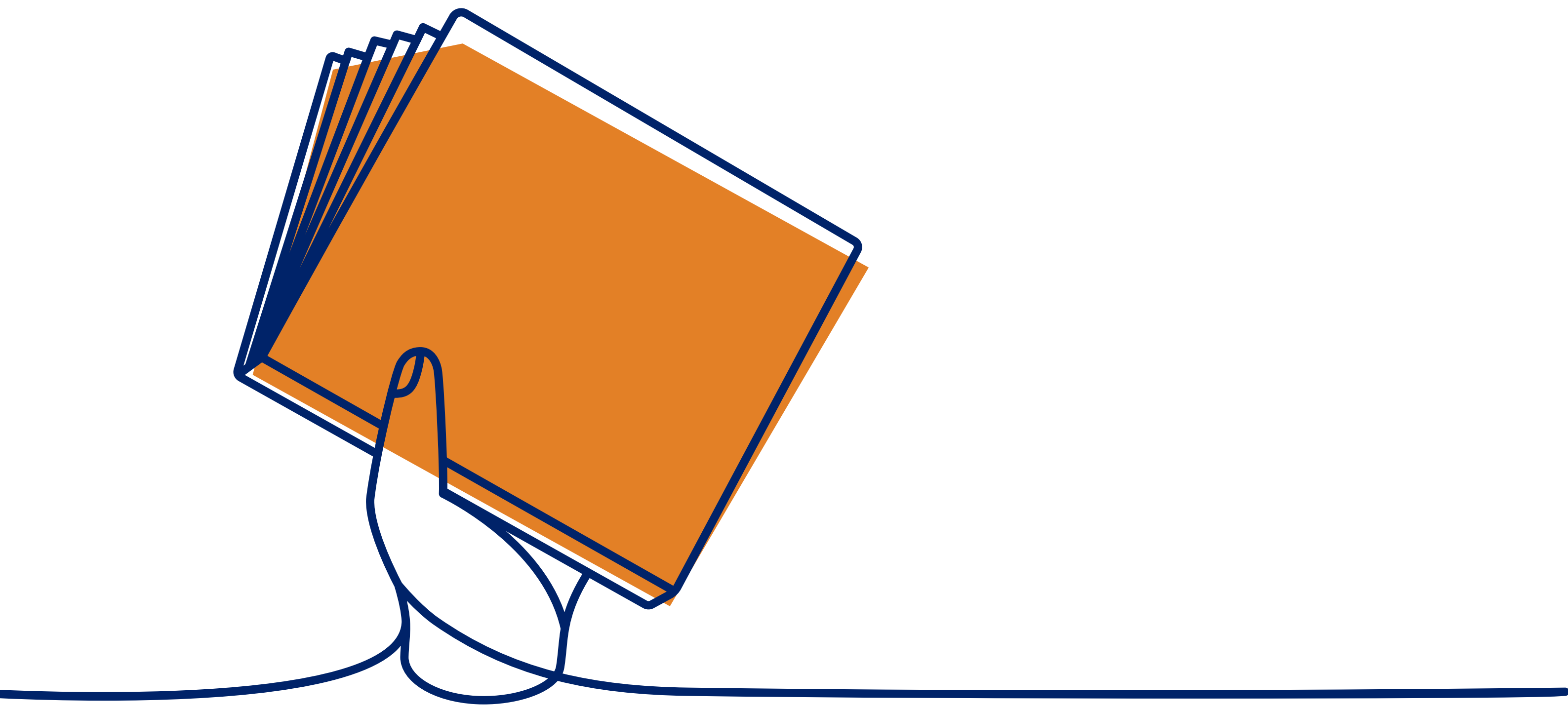
The CSDI tracks the same 100 shares in the same proportions but unlike the FTSE 100, the CSDI includes the benefit of the dividends paid by the 100 companies (which have historically averaged around 3.5% per annum) and then deducts the equivalent to a fixed 3.5% per annum, on a daily basis.

The result is that the FTSE CSDI will perform almost identically to the FTSE 100 if dividends are at 3.5% p.a., moderately underperform if they are less, and moderately outperform if they are more. At end of June 2023, the dividend yield for the FTSE 100 index is 3.77%.

The CSDI has been 99% correlated with the FTSE 100 Index, which can be followed as a proxy.

By utilising the FTSE CSDI rather than the FTSE 100 as an underlying in autocalls the coupons offered can be noticeably enhanced.

The current level of the FTSE Custom 100 Synthetic 3.5% Fixed Dividend Index can be found via www.ftserussell.com/products/indices/synthetic



Appendix B - Early surrender example

Appendix B - Early surrender example

Scenario: A ten year, maximum term, hurdle autocall that commenced in June 2017 and required the FTSE 100 Index to be 10% or more higher on the third of subsequent anniversary.

Initial index level was 7312.72 thereby requiring the FTSE 100 to be above 8043.2 on a relevant anniversary date to trigger a positive outcome.

At the time of writing (12 June 2023), the FTSE 100 stood at 7560 - a long way from the maturity trigger level, which the index has never reached.

With five annual observations remaining the potential gain at the next maturity trigger date is 69.72% and this increases by 11.62% for each subsequent year that passes.

The last observation date is in 2027 when the maximum possible gain is 116.20% if maturity was triggered at that point but if the index is still below 8043.2 only original capital would be returned unless the capital protection barrier - FTSE 100 level of 5118.9 is breached in which case a 1:1 loss would arise.

The surrender value on 12 June 2023 would give the investor a 42.6% gain less any charges associated with the surrender.


ADVERTISEMENT
EXPERIENCE THE IDAD DIFFERENCE, TODAY
iDAD
DELIVERING AUTOCALLS
FOR 20 YEARS
www.idad.co.uk

StructuredProductReview.com
Fernwood House
Clayton Road,
Jesmond,
Newcastle upon Tyne,
NE2 1TL

Contact us
t: 0191 287 8716
e: enquiry@StructuredProductReview.com
w: StructuredProductReview.com