How to Master Structured Products

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Why everybody Loves to Hate Structured Products

Separate the sheep from the goats

Nearly every investment and private bank issues or places structured products. At the same time, nearly every adviser is sceptical of the value that they bring, spooked by negative connotations in the press, weary of the increasing regulatory attention to them and fearful of their complexity and fees.

This is a short introduction in our new series of content which aims to explain how, when and, most importantly, why to use structured products. We argue that there is a legitimate place for these investments. The primary benefit of using them is to bridge the 'behavioural' gap. This is the term for the irrational avoidance of investing which can be explained by the irrational, emotional biases of private clients such as market weariness, fear of future regret and limited mental composure. Structured products help to smooth the return and structure the yield in the form of easily understandable coupon payments and provide full or partial capital protection. At the same time, they also help to harvest risk premiums using financial derivatives.

It is worth emphasising that structured products are generally considered to be complex financial instruments. This is not surprising since all of the above mentioned benefits of structured products are brought by utilising non-linear financial instruments. This does not mean that it is difficult to understand what they do – it means that banks which issue them have to use sophisticated risk management techniques to provide these instruments to investors.

Issuing, risk managing and distributing these products is, for obvious reasons, more difficult than, say, issuing and distributing ETFs. Therefore, it is not surprising that structured products are often linked, especially in the past, with notoriously high fees. The good news is that recent changes in the regulatory environment have made it obligatory to disclose all fees, including bank fees, distribution fees and adviser fees. So now, advisers and clients are in control of the fees and should not be afraid of obscure or hidden charges. Although the fees are justifiably higher than those of cheaper linear structured products, as long as they are lower than the un-received return due to the 'behavioural gap', the structured products have a place in investment portfolios, bringing multiple benefits to the majority of private clients.

We hope that this short informal introduction can help the reader to learn more about the use of structured products, their benefits and pitfalls, recent regulatory developments and new angles brought forward by innovations in financial services.

The best laid schemes of mice and men

Clients want to be happy, not just to make money. If on the path of an ideal financial plan, they encounter distress and regrets which changes their attitude to investing, challenges their emotional state and, ultimately, disrupts their path to the planned wealth – the plan was not the plan and we, as advisers, have failed.

This is why all modern client profiling methods split "risk" into two parts:

1. Separate the capacity to bear risk in terms of under-achieving investment goals
2. The risk of losing composure during the investment period, the risk of abandoning the investment altogether

One might say that it is wrong for an adviser to accommodate irrational fears and emotions of a client at the expense of future returns. However, it has been proven that ignoring behavioural biases of clients can cost them a large portion of their potential investment returns, the so-called 'behavioural gap'.

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It is often impossible to address both long-term and short-term requirements in an optimal fashion by investing in a portfolio of linear market instruments. One can load on the long-term risk to achieve long-standing life objectives just to find that this pushed the client's stress level to the limit and jeopardized the whole project. De-risking investments reduces the stress levels but compromises the life-term goals and ultimately fails the clients too. It has been shown in recent academic research that to build optimal behavioural portfolios advisers have to treat long-term investments and smoothing mechanisms, including portfolio insurance, separately.[1]

Structured products which combine:

- Enhanced target returns
- Defined investment horizon
- Full or partial capital protection
- Pre-defined split between income (coupon) and capital appreciation

are an obvious toolset to add to the available arsenal of an affluent adviser. They exist to address the need and bridge the 'behavioural gap' to achieve desirable long-term wellbeing.

1. Deguest R., Martellini L., Milhua V. (2013): "Hedging versus Insurance: Long-Horizon Investing with Short-Term Constraints", EDHEC-Risk Institute publication, February 2013

Challenges for Structured products

There are several well-known challenges in using structured products.

Bad Image

The structured product space has a bad name and has attracted negative publicity. This can be summed up by a quote from Larry Swedroe, Director of Research for The BAM Alliance, a community of more than 140 independent registered investment advisers in the US:

> " *Naive individuals need to be protected from exploitive financial firms seeking not to help investors, but to plunder them, treating them as Muppets* ". [1]

This opinion is shared by advisers who think of structured products as high fees, obscure pricing, complexity and mental manipulation. The high upfront fees bring large marketing budgets and aggressive sales tactics. This usually results in mis-selling and large losses from structured products, as during the market crisis. The most publicised example relates to huge retail losses in Korea in 2008 but there are other examples too.

Complexity

The products are intrinsically complex. Even when the pay-outs are explained in layman terms, they are scenario dependent, based on probabilities which makes them suitable only for sophisticated enough investors, with professional guidance.

Execution

Execution of structured products is more complex than buying and selling stocks, bonds or funds. One needs to know the market practice, have sufficient access to trading infrastructure, pricing tools and legal expertise.

These problems feed on themselves and create a vicious circle. The complexity of the products, accompanied by increased regulatory costs, complicate the sales, decrease the flow and make the sales objectively more expensive. The "lazy" tactics then evolve into bigger marketing budgets and trying to recoup the costs by putting up already high fees. The latter affects the investment profile of the products and, justifiably, bring the bad name.

On top of that one has to mention the clear investment risks - concentration on the issuer, concentration on a particular investment idea and dependence on levels/timing. This, together with the relatively high maintenance – roll of structures, watching for levels and barriers etc, really makes one think twice if the whole game is really worth it.

1. Swedroe: Avoid Structured Products Game, ETF.com, December 07, 2016

Addressing the Challenges

Breaking the vicious circle market, explained on the previous page, ultimately, needs more trade, with a lower concentration, increased diversification and developed infrastructure – in a similar way as it has been done for mutual funds and ETFs. And the only way to do it – through a portfolio approach to investing in structured products: if it works for everything else why is the structured product market is still so different!

Portfolios of Structured Products address the challenges:

1. Diversification across asset classes with global asset allocation
2. Diversification over ideas inside the asset class
3. Diversification over issuers
4. Defining the measure of capital protection – mixing products with full or partial capital protection, an adviser can tailor the portfolio to a particular client risk and personality profile.
5. Spread the maturity of products together with the above mentioned capital protection helps to manage client's requirements, not only on the risk basis but also on a cashflow basis.

This sounds simple enough, and not pioneering at all.

However, it is never simple with complex products. Here we highlight just two obvious, although unexpected, problems.

New Asset Allocation Models

We want to emphasise here that the asset allocation models for portfolios of structured products are much more complex than the ones we are used to in portfolios of linear funds because of complex, "non-bell-shaped" distribution functions for their returns.

Risk-grading Portfolios of Structured Products

There has been an open and much-discussed question of how to risk grade separate structured products, not to mention the portfolios of these products. It is clear that diversification would decrease portfolio riskiness but to explain exactly how much, one needs again to deal with correlations of these "non-bell-shaped" random returns.

Problems are clear but not insurmountable – advisers can get external help to learn how to deal with these issues. The complications are a small price to pay to bring what the client needs in a form which can reduce anxiety and increase long-term rewards.

Product Governance & Distribution under new rules

Many market participants see MiFID II as adding complexity to the product governance and distribution process. We see it as a positive development that will benefit investors, advisers and issuers in the long run.

Investor Classification and **Target Market** assessments help to ensure that the right types of products are distributed to the right type of clients according to their risk profiles. Although often viewed as unnecessary and restrictive, these are really important to protect investors from mis-selling and protect advisers and issuers from potential negative developments and claims.

Stress Tests and **Scenario Analysis** ensures that Advisers and their clients understand how different products will perform under different market conditions. This is important to manage clients expectations and prepare clients for possible negative scenarios.

From product manufacturers to product distributors to client advisers, everyone needs to make sure that the product characteristics are explained in an orderly fashion and are well understood by the end clients. The same level of characterisation also allows for the easier comparison of products and limits mis-selling and unfair sales practices.

Advisers must also continuously keep an eye on the products throughout their life cycle to make sure they are still suitable for their clients. Under different market conditions, the risk characteristics of a product may change and it may be no longer suitable for a particular client. That is why it is extremely important for advisers to continuously monitor the products in the client portfolios and to keep their clients informed about such changes taking action when it is required.

Transparency in Costs and Fees Structure

In the past, Structured Products were perceived as black-box complex derivative instruments with many hidden fees, unclear pay-outs and complicated cost structures. And rightly so.

To protect investors, MiFID II regulations were introduced which resulted in a significant improvement of the product governance and market infrastructure. Since January 2018, all investment products' and funds' associated costs, commissions and fees are now fully disclosed and investors and their advisers have full control over their investments.

Advisers can still charge for the advice on the products and product providers usually offer to facilitate the payments of the fees. The fees can vary based on product tenure and while paid upfront, if spread across the product lifecycle they are usually no more than 0.5% per year. And if the products are redeemed early, advisers usually credit the fees from the previous placement towards new products.

Structured Product became fully transparent and regulated, as they should be!

What is needed to really make it work

So, what does a Financial Adviser or Wealth Manager need to make this approach really work?

1. First, you need to have access to leading issuing counterparties to cover the full product spectrum. Having access to an institutional-like structured products market can also help you to reduce the costs.

2. Second, you need an appropriate operational setup – custody to hold the products and expertise to execute the transactions.

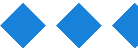
3. Third, you will need the expertise required to select high-quality structured products and conduct a rigorous due-diligence process. Structured Products are not necessarily simply Buy-and-Hold investments. An active approach to structured products portfolio management can be highly beneficial, as it can help to maximise returns and minimise risks.

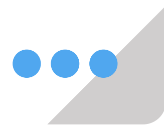
4. And last but not least, you need simple and easy to use tools to help with portfolio construction, monitoring and reporting. They will help you to keep track of what is happening, as well as generating smart-looking portfolio reports, as that is what your clients love.

You can do all the above on your own. Or, you can delegate all or part of those tasks to a specialist structured products service and focus on what you do best – making your clients happy and wealthy.

About Wealthinity

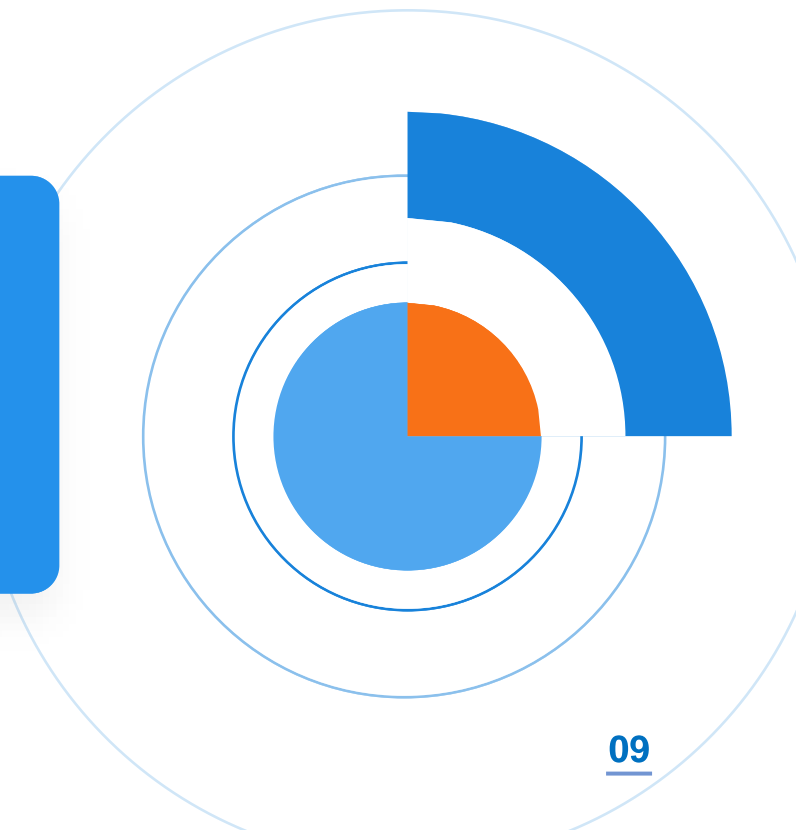
Wealthinity is an “Adviser-to-Advisers” service focusing on improving client satisfaction through research, technology and execution.
We take a fresh look at old things and try to make our world a happier and wealthier place.
We are not alone in this journey and work closely with likeminded wealth managers and financial advisers who always aim to serve their clients better.
We would love to hear from you to explore new ways on how we can improve the wealth management industry for the better.

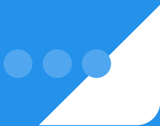




Wealthinity Ltd.
8-10 Great George Street
London SW1P 3AE, UK

T: +44 207 802 22 80
E: info@wealthinity.com
W: www.wealthinity.com





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