MARKET-LINKED INVESTMENTS

Demystifying structured products

In these turbulent markets, investors and financial advisers are demanding more information on their investments. With the spotlight turned on structured market-linked investment products that are sold to retail investors, Lauren Ash, Global Head of Structured Products Marketing at Citi, addresses some key questions about how these investments work

Is credit risk inherent in structured products?

Yes, credit risk is inherent in the majority of investments, including structured products (both capital and non-capital protected).

Whenever an investor makes an up-front investment in exchange for a return at a future point in time, an element of credit risk is involved. With that said, there are a number of techniques that structured product providers can use in order to limit or enhance credit risk.

In the private wealth management market, the majority of structured products have been delivered in the form of market-linked securities (including notes, certificates and preference shares) or deposits. Product material should always clearly state where the investment is being held and the nature of the credit risk associated with it.

For market-linked securities, normally the credit risk is that of the issuer of the security and/or the guarantor of that issuer. For a bank deposit, the credit risk is generally with that of the institution taking the deposit or the guarantor of that institution.

It's important to note that the credit risk may not necessarily be that of the financial institution that distributes the investment.

There are a number of ways credit risk can be limited/credit quality can be enhanced, including:

- Providing investors with security over a pool of liquid, good quality assets such as G10 government-issued debt that are ring-fenced from other creditors.

- Segregating the pool of assets supporting the investment in a separate custodial account to which only the investors in the product have access / recourse.

- Delivering the investment in a format that requires compliance with regulations limiting credit risk, for example a Ucits III fund.

- Arranging for the investment return to be guaranteed or insured by a highly rated third party (e.g. G10 government).

> "ISSUERS WITH LOWER CREDIT QUALITY TYPICALLY PAY A HIGHER MARKET-LINKED RETURN ON STRUCTURED PRODUCTS THAN HIGHER QUALITY ISSUERS"

How is an investor compensated for taking credit risk?

An investor is compensated for taking credit risk through the terms of the structured product.

Structured products generally pay a market-linked return instead of ordinary interest. The terms of the market-linked return will vary by product and issuer.

One of the factors relevant to determining the level of the market-linked return on a structured product is the interest rate that the issuer would normally pay for borrowing funds in the market-place.

Issuers with a lower credit quality are typically required to pay more in the market-place for borrowing to compensate investors for the higher credit risk. This feeds through into structured products. Issuers with lower credit quality typically pay a higher market-linked return on structured products than higher quality issuers.

Where credit enhancements (as described above) are built into a structured product, the market-linked return is typically reduced.

Aside from credit risk, what are the other main risks of investing in structured products?

The risks depend very much on the specific product and how it has been structured. The product

material should contain a complete description of the main risks of any specific investment. Aside from credit risk, two key risks that are most commonly present in structured investment products are market risk and liquidity risk.

Market risk: The return on a structured product is linked to one or more underlying markets, such as equities or commodities. The value and return of the investment during the life and at maturity will be impacted by the performance of that underlying market.

An investor may also be exposed to FX risk if the investment is denominated in a different currency to that of the underlying market.

Liquidity risk: Most structured products have an investment term of up to ten years. Investors wishing to liquidate their holding prior to maturity will need to find a buyer for their investment in the secondary market.

Often the issuer of the structured product will agree to make a secondary market for the product throughout the investment term. The secondary market trading price for a structured product will be subject to a bid-offer spread and will depend on many factors including the level of the underlying market, volatility, prevailing interest rates and the time remaining to maturity.

The secondary market price may well be lower than the initial investment of capital, even for a capital protected product. If the issuer is not making a secondary market (and it is typically not obliged to), it may be difficult or impossible to find another buyer.

It is important to note that most issuers of structured products, including Citi, are continuing to make a secondary market for their structured products in spite of the market turbulence.

If the bank from which an investor purchased a structured product is downgraded, is the investor compensated for the additional risk?

No, it is unlikely that an investor will be compensated if the credit risk on a structured product increases. However, the downgrade of the financial institution that has sold the product does not necessarily impact the credit risk of the product itself.

"THE DOWNGRADE OF THE FINANCIAL INSTITUTION THAT HAS SOLD THE PRODUCT DOES NOT NECESSARILY IMPACT THE CREDIT RISK OF THE PRODUCT ITSELF"

As explained above, the credit risk of a structured product may not necessarily be that of the bank from which the investor purchased the product. The investor generally takes the credit risk of the issuer and/or the guarantor of the product.

If an investor makes any fixed term investment and the actual or perceived credit risk of that investment subsequently increases, then the investor will not be compensated for the additional risk. In fact it is likely that, all other factors being equal, the market value of the investment will decline reflecting the increased credit risk.

This is true of any investment which involves making an investment decision at a particular point in time. For example, a property purchaser would not expect to be compensated if the value of the property subsequently declines.

Where the credit risk is limited / credit quality is enhanced (as described above), a downgrade of the issuer / guarantor is unlikely to impact the credit risk of the investment.

Over the investment term, how do the fees in structured products compare with those of a typical mutual fund or an index-tracking fund?

Generally, the fees for structured products compare favourably with more traditional investments.

Structured products are a very efficient mechanism for allowing investors tremendous flexibility in choosing a product with a risk / return profile that cannot be otherwise achieved with more traditional investments. Most structured products have all the fees already incorporated into the pay-off described in the product, so what the investor see is what the investor gets. The product material should clearly disclose the fees payable to distributors, intermediaries and financial advisers. Clearly, fees vary by product, by market and by distributor, but typically they are of the order of 0.50 per cent to 1.50 per cent per annum.

If an investor needs their cash back sooner than expected or becomes uncomfortable with the risk profile of the investment, is it possible to sell the structured product before maturity? What sort of penalty/haircut should an investor expect to take?

Yes, most structured product providers provide a secondary market throughout the life of the product, making it possible for investors to sell back the product prior to maturity.

The product material should explain the expected secondary market liquidity and any bid-offer spread charged. For most products, a bid-offer spread of around 1 per

cent is typical. Some products will have early redemption penalties which should be clearly stated in the product materials.

Do structured products only work in rising equity markets? Are structured products less attractive in the current environment?

No, structured products are incredibly flexible and can be designed to work in any market environment.

Products can be created to deliver returns in stable or downwards markets, as well as rising markets. Structured products can be linked to any underlying market, including equities, commodities, interest rates and FX.

Historically, different markets have created new trends in investor demand for certain types of structured products. For instance, following the emerging market crisis, bursting of the tech bubble and declining rate environment starting in 1999-2000, demand for capital protected notes (both growth and income) grew significantly.

This was a direct result of investors seeking bond alternatives or conservative ways to position the equity portion of their portfolio.

The credit crisis has resulted in an environment of volatile equity markets and low yields.

Going forward, this is likely to again increase demand for structured investment products, primarily from investors seeking to achieve the following goals:

"PRODUCTS CAN BE CREATED TO DELIVER RETURNS IN STABLE OR DOWNWARDS MARKETS, AS WELL AS RISING MARKETS"

- Gaining exposure to the market while protecting their capital.

- Enhancing returns on low yielding cash balances.

- Repairing equity allocations within their portfolios caused by the market sell-off with products that provide partial protection and accelerated participation in any recovery.

- Diversifying risk by investing in products that provide tailored exposure to a range of asset-classes (FX, rates, equities, commodities), often with features that provide for optimal asset allocation.

Structured products are described by some as complicated and lacking in transparency. Should investors who do not understand complex derivatives steer clear of structured products as they are too risky?

No, structured products investors do not need to understand derivatives. All investments involve various levels of risk. Structured products can provide investors with a very clear and unambiguous risk/return profile as described in the product materials.

Investors should ensure they understand the materials and seek appropriate advice in relation to any investment decision. Some products are more complicated than others but generally, the key risks, benefits and fees should be clearly stated in the product materials.

At this time, the difference in credit quality between issuers of structured products is more marked than previously and quality investment advice is more valuable than ever before. In securing the best result for an investor, financial advisers should not simply focus on the best price/cheapest product.

Financial advisers should pay close attention to credit quality, clarity of product materials and to the after-sales service offered by product providers, particularly in relation to secondary market making. Investors' interests are best served where product providers and financial advisers work closely together on investor education and understanding.

CORPORATE STATEMENT

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