MARKET ANALYSIS

# A structured solution for every risk return profile

Arnaud Sarfati, Société Générale Corporate & Investment Banking, financial engineer, head of equity linked structured products, looks at how structured products have solidified their position after the rapid growth of the past few years

Developed in the 1990s and promoted with impressive marketing campaigns, structured products (SPs) have experienced spectacular development over the past few years, which continues today. The structured products market has matured into a sophisticated market. These products now occupy a recognised place in academic theories of wealth management and asset allocation.

The total size of the retail structured products market in Europe in terms of annual sales is estimated at €136.9 bn in 2005, representing a year-on-year increase of 11.1% over 2004. Switzerland, Italy, Spain, Germany and France are the strongest markets. Germany and Spain are leaders in product diversity while the UK is home to a number of market regulations.

Although SPs currently account for only a small proportion of total assets under management in Europe, they are one of the fastest-growing asset classes. Sales are expected to continue their upward surge, with 2006 figures expected to nudge €152bn.

## MAJOR TRENDS

Over the past year, equity market performance has had the most significant influence on trends in the European retail SPs market. Structuring houses have also played a role in modeling the structured products market: product developers aim to provide products that can exploit opportunities identified in implied parameters (such as volatility, correlation, interest rates, dividend levels, and so on).


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Unlike previous years, when volatility levels were much more significant (highs in 2003 and lows in 2004-2005), there has been no clear trend in volatility over the past year. In this climate, structuring houses have had to adapt their supply to customers' profile.

The risk aversion of retail investors is directly influenced by trends in the parameters they can easily identify. For them, the most significant parameter is the trend in the underlying.

A study of trends in the European equity market reveals two types of investor approach, which simply bears out the fact that SPs have become and will remain an inevitable component of all investment strategies.

## SHORT-TERM MEMORY INVESTORS

Short-term memory investors focus on the most recent trends in equity market since 2003. As the market has risen steadily in the past three years, their risk aversion has declined. They are all the more prepared to take greater risks to obtain higher returns through SPs as interest rates levels are still disappointing. This has led to three trends, studied here from the less risky investment solutions to those designed for riskier profiles:

### RENEWED INTEREST IN PRODUCTS INDEXED TO GROWTH IN THE UNDERLYING

Given the bullish momentum in most asset classes, growth products have accounted for more than 90% of issues since 2004. As regards the choice of underlying, equity or index-linked products are the most popular. In 2005, they accounted for 85% of the total SPs market in Germany, 90% in Spain and 98% in the UK.

Among the parameters that influence the choice of a structured product, retail networks try to combine the market expectations of their investors with implied market parameters such as volatility of the underlying.

## DEVELOPMENT OF EARLY REDEMPTION PRODUCTS

Some investors expect the equity market to rise in the next few years. They are keen to invest in a market that has enjoyed strong growth in the last three years but are still seeking more security. They are looking for capital guaranteed structures and are mainly confident in short-term investments.

In 2003, volatility levels were so high that they could be used as additional resources to design short maturity products. The situation may differ today. It is hard for structuring houses to offer short maturity products in current market conditions, that is, low interest rates combined with low volatility.

Early redemption products could well be the best compromise as they combine capital protection with the opportunity offered by shorter maturity products.

## EMERGENCE OF PARTIALLY GUARANTEED PRODUCTS

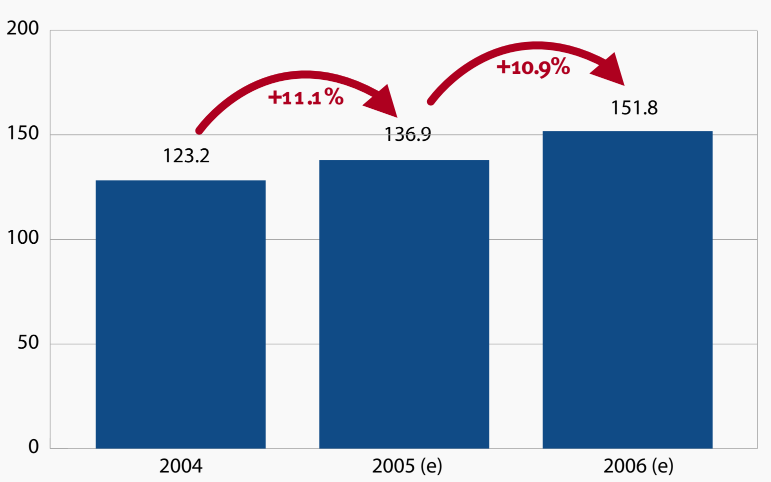
Although capital guaranteed products dominate the European markets, a growing number of investors are prepared to take greater risks, for the following reasons:

- The sharp rise in the equity market over the last three years is encouraging and reduces their natural risk aversion. This has led to the emergence of retail structured products that are not 100% capital protected, a real "revolution" in some traditionally conservative retail networks (such as France, Belgium, Italy and Spain).
- Low interest rates have been disappointing for investors with a preference for more conventional products. This drives them to seek higher returns, which they have found in SPs. Hence the development of products delivering high fixed coupons but with no capital protection in compensation.

## LONG-TERM MEMORY INVESTORS

Long-term memory investors

**Figure one: Sales of the retail SPs market in Europe (€bn)**




Source: Risk Executive Report

look at the longer term trends in underlyings such as the DJ EuroStoxx 50.

Despite the bullish markets since 2003, they find it hard to forget the bubble burst and ensuing market decline from 2000 to 2003. These investors are afraid of potential future falls and they invest mainly in simple, full-capital protection structures. However, new types of SPs have recently emerged. They are designed for customers seeking to outperform current low interest rates and diversify their portfolios. These are three outstanding trends depicted here after on a growing scale of risk-aversion:

## DEVELOPMENT OF THE CLICK-INCOME CONCEPT

Since the stock markets collapse in 2001, risk-averse retail investors have not been keen to move back into the equity market. Since then, they have invested massively in fixed-income instruments. However, due to the fall in interest rates, returns on bonds, insurance life policy or defined benefit plans are now very low and hardly more than the rate of inflation. Many retail investors are seeking new investment products that offer higher incomes but still with a reasonably low level of risk.

Structuring houses have to find a compromise between capital pro-

**"STRUCTURED PRODUCTS NOW OCCUPY A RECOGNISED PLACE IN ACADEMIC THEORIES OF WEALTH MANAGEMENT"**

tection and potential return. This led to the construction of equity-linked products that can be converted into a high-yield, fixed-income investment.

## DEVELOPMENT OF MULTI-ASSET CLASS PRODUCTS

In 2006, investors were still shaken by the low levels of returns across most asset classes in the past years, and were seeking solutions providing higher returns. In response, structuring houses have enhanced their existing multi-asset class products.

More and more SPs are not only linked to conventional assets such as equities, indices, interest rates or foreign exchange, but also to other asset classes such as commodities, property, inflation, mutual funds or alternative strategies. Multi-asset class structured products offer an appropriate solution for risk-averse customers: one investment transac-

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tion provides them with diversification and complementary profiles.

### EMERGENCE OF ABSOLUTE RETURN STRATEGIES

The recent success of absolute return strategies is due to the increasing difficulty in anticipating equity market trends. After a continuous rise in the equity markets over the last three years, risk averse investors are seeking "absolute return" investments which can deliver returns even in bear markets.

Investors who are less confident in the equity markets are then enticed into diversifying their portfolio with alternative investment products. However, the alternative investment markets are highly regulated in most European countries and therefore relatively inaccessible for retail investors. Equity-linked SPs are an easier way to provide investors with strategy-linked products.

Future demand for these absolute returns strategies is expected to grow in 2006-2007.

### NEW SOURCES OF DIVERSIFICATION

In addition to the classic equity linked structured products, new sources of diversification have come to light this year. The ability of emerging markets, commodities, real estate or even new energies to outperform more traditional underlyings is one of the main drivers of growth in demand.

### DEVELOPMENT OF NEW UNDERLYINGS

Over the past few months, keen demand for exotic underlyings has been identified. Erratic movements in asset classes such as emerging markets or energy have generated investment opportunities. New underlyings have become a key driver in the SPs market. They used to be the preserve of private banking networks but are now becoming more and more popular on the retail scene.

The difficulty is that there is no exchange for some exotic products. In other words, the challenge is to convert investment ideas into viable financial underlyings. These underlyings must be representative, affordable (i.e. investable whatever the amount) and liquid – features that have to be secured over time.