INTRODUCTION

ENTERING THE EFFICIENT FRONTIER

As structured products become more scientific in their implementation, institutions are more willing to embrace the strategy. Elisa Trovato dispels some of the myths surrounding structured products and outlines the most attractive areas

How do structured products fit into asset allocation strategies? And when should portfolio managers decide that they are more appropriate for their clients than a traditional mutual fund?

Investment banks have recently tried to provide a convincing answer to these increasingly pressing questions by developing formal models, which examine the effects of structured products on measures such as 'value at risk' (VAR) or, more commonly, the 'portfolio efficient frontier'. Thanks to these new developments, relationship managers can now rely on a more scientific method when they take their decisions on the employment of structured products in a client portfolio.

"Through our modelling tools, we are now in the position to tell clients what the effect of structured products is going to be on their efficient frontier, whether they can reduce volatility for a given return or increase return for the same volatility," says Jean-Eric Pacini, head of structured products sales, at BNP Paribas in London.

"CLIENTS MIGHT BELIEVE IN YOUR STORY BUT THEY WANT IT TO BE SUPPORTED BY A GOOD RATIONALE AND RESEARCH"
PIERRE BES, BARCLAYS CAPITAL

"We can now demonstrate that specific structured products can improve significantly the efficient frontier of the investors."

The current trend towards a greater choice and diversification of the underlying investments can also provide a good justification for including these flexible investment vehicles in a client's asset allocation.

Andrew Popper, group head of portfolio management at SG Hambros UK, part of the private banking division of the Société Générale, speaking at the Structured Products World conference in London, said: "One of the dilemmas that we all face is whether we should introduce structured products in our private clients' discretionary portfolios". There is little justification for a portfolio manager to include a plain vanilla structured product in a discretionary portfolio which is linked to the FTSE, believes Mr Popper, because presumably even an indexed fund, for example, can do the job. But there is a strong argument in favour of structured products linked to more exotic asset classes, such as commodities or oil, which are not normally directly included in a private client discretionary portfolio.

"If a portfolio manager decides to take exposure to these more exotic asset classes but in a risk controlled environment, it is probably justified to introduce one of the structured products in a discretionary portfolio," he explains.

Indeed, the main benefit of structured products is that they control risk and can match any client investment profile. Their structure can be designed accordingly to meet the most aggressive or the most conservative investor's request.

Structured products can be created very quickly to meet the demand of a small number of investors, unlike mutual funds, which need to reach a minimum size to be efficiently managed.

Moreover, the ability of structured products to match perfectly any specific market scenarios offers investors, in particular the private investors, more informed and demanding, an investment rational in its own right.

"The underlying itself and the rationale of the investment has become more and more important to private investors," states Pierre Bes, managing director and head of private banking coverage in Europe at Barclays Capital.

"Clients are not looking to buy pay-off as they could have been in previous years, but they are much more interested in buying a story, to agree on a scenario. They might believe in your story but they want it to be supported by a good rationale and research."

Structured products can also be designed in a way so that performance is somewhat insensitive to the market scenario. 'Profiler'-type pay-offs have been very popular, explains Mr Pacini. "In essence, you build three portfolios with different asset allocations and the structure price is going to offer the investor the performance of the best performing portfolio". Most often structured products are formula-based, he says. "The investors buy a specific pay-off formula, all clear from day one."

INNOVATIVE UNDERLYING INVESTMENTS

In the last 18 months, innovation has mainly focused on the underlying investments rather than the structure.

In terms of geographic exposure, there is an increased interest for emerging markets, which, moved from the European convergence markets to the BRIC (Brazil, Russia, India, China) countries or other currently booming markets such as Saudi Arabia and Emirates, says Mr Pacini.

Commodities have also become very popular over the last year, because of their strong performance and the diversification benefits they offer. "Structured products are a very good way to start investing into commodities," says Mr Pacini. "They offer capital protection to hedge away the high volatility of these markets and can be tailor made to specific market views. They also offer that liquidity that is insufficient in many commodities markets."

"From global commodities, private clients are switching to more precise underlying commodity assets, such as precious metals, energy or soft commodities. This is because they are much more selective and knowledgeable, they are informed on how the market is performing, what the performance depends on," adds Mr Bes.

Volatility, correlation and dispersion are also popular underlying investments. "These market tools are heavily used by hedge funds, but we increasingly see more and more investors who want to buy the same kind of ideas, but not necessarily through hedge funds." The secret is to provide clients with a transparent structure, so that they do not need to go to hedge funds, which are often seen as "black-box", says Mr Bes.

Indeed, if there is something that all distributors and providers seem to agree on is that these investment vehicles need to be simple and easy to understand.

Anna Viviani, head of marketing of retail financial products at Italy's Banca Intesa identifies in simplicity and transparency the key of the bank's success in structured products. The financial heavyweight, which is in the midst of a merger with the other major Italian institution Sanpaolo IMI, has sold an annual average of €5bn of structured products to its clients over the last three years.

"Sixty per cent of the total bulk of structured products that we have distributed are inflation-linked," says Ms Viviani. "The product we sell is very simple. The client understands that the product will cover them from the erosion of the purchasing power, due to the increase of inflation and they will receive their capital back at maturity"

But the main driver for employing structured products remains the theme of capital protection. "From the majority of client surveys that we conduct periodically, it emerged that around 40 per cent of our clients want to have guaranteed capital at maturity," says Ms Viviani. "Moreover, we wrap structured products in a bond, meeting the favour of retail investors, who represent the large majority of Banca Intesa clients. They have traditionally invested in government or bank bonds, as they typically have a low risk profile."

Viviani: 40% of clients want guaranteed capital

Despite declaration of intents on maximum transparency, the market seems to be inundated by structured products, that, apparently simple, hide their true nature in some complicated formulas. The theme of "treating customers fairly" assumes perhaps a stronger meaning here.

"It is important for us to treat the customers fairly in general," says Mr Popper at SG Hambros. "But, in particular, in the case of structured products, where there is more room for confusion and for technicalities to take advantage of the customer's understanding."

"Most of the structured products will include some horrible formulas, and it is probably necessary to prominently display them for legal considerations and to explain exactly in a technical way what the product aims to do," continues Mr Popper. "However, trying to sell the client a product just based on a formula is certainly inappropriate."

Dr Christoph Hott, chief investment officer for private banking at leading German institution Sal. Oppenheim, warns: "Due to commission structures and sales pressure, in many cases structured products are sold in a way that look quite easy to understand, but in reality they are very complicated. Sooner or later that might lead to strong disappointment in customers."

The solution is to avoid any complex instruments, says Mt Hott: "This is why we focus only on two types of instruments, protect bonus certificate and protect discount, which behave as investors would expect them to behave."

The question is if products difficult to understand might be more efficient. Mr Hott is adamant once again: "The more complex the product is, the less efficient it is for the client. They become less transparent, and as there is less competition, they become more expensive."

PULL OR PUSH?

Providers and distributors often engage in a fascinating interactive dialogue. At each step, both provider and distributor progressively fine down the assumptions and the structure of the new products. "I think the most innovative products I have traded so far were products which were the result of very deep discussion with distributors," says Mr Bes. But he also admits that in the past, when structured products were not popular, it was much more the manufacturer driving the growth of the market.

"The trend is now reversing, and we see that the demand is really coming from the clients, who are much more aware of what we can do, they are better informed," he adds.

Distributors are increasingly adopting an open platform approach in structured products. At Sal. Oppenheim, for example, beauty contests traditionally include UBS, Société Générale, Commerzbank and Deustche Bank, in addition to the internal structured products capacity at Sal. Oppenheim itself, which, according to Mr Hott, is regarded as just like any other player in the market.

"In the past, structured products were developed in investment banks and then sold maybe as single opportunities to institutions and private investors. Now people have a more systematic investment approach in structured products. They don't just buy products constructed by investment bank, normally they go to different banks and go for the best price, this is the future," he says.

Ms Viviani brings in the Italian perspective and boasts that, despite Caboto, the structured products manufacturer of the Intesa Group, the Italian bank approach to structured products is totally open. "We rely on all main global manufacturers, including Lehman, Goldman Sachs, JP Morgan, Credit Suisse, Barclays and Merrill Lynch, each in its own area of expertise, because we reckon that the best ideas, the scouting of the best structures and best market indices are generated in a system of open architecture".

Ms Viviani estimates that 60 per cent of new ideas on structured products are proposed to them by external banks, with 40 per cent of new ideas are generated within her dedicated unit. "Once we have decided which product to launch, we put it to tender to cover the risk." External banks cover the risk for almost the totality of structured products that Banca Intesa distributes, she explains.

MISCONCEPTIONS

One of the many misconceptions surrounding structured products is that they lock investors in to maturity. "On the contrary, there is an active and lively secondary market in structured products," says Mr Popper.

Indeed, the provision of a liquid secondary market, along with daily real time valuation reporting, flexibility and the possibility to trade on the internet, is a key component of that after sale support that structured products providers are so keen to offer their clients.

Mr Bes explains that sometimes the underlying are traded just in some specific exchanges: "Thanks to Barclays Capital's global platform and global trading books, we have started to do structures with European large banks, offering liquidity during Asian market hours or US market hours," he says.

The current trend of listing structured products on stock exchanges goes to meet the need for market transparency. Banca Intesa, for example, has listed all its structured products on MOT, the Italian electronic government bond and securities market. "Listing our structured products on MOT guarantees a very transparent and liquid secondary market," says Ms Viviani.

The merger of two investment worlds

The traditional fund management business and the traditional structured product business run by the banks, which have been separate in the past, are now beginning to merge, says Garry Topp, director of equity derivatives at Japanese investment bank Nomura. Thanks to Ucits III, which allows for a wider use of derivatives, funds are now incorporating some of the instruments that previously would only have been seen in banking products.

"Funds can now include capital protection instruments, typical of notes and certificates, such as CPPI [constant proportion portfolio insurance], but we are also seeing the use of put options in or order to reduce volatility on the downside." Mr Topp says the other area in which derivatives are appearing increasingly more in fund management is in the use of total return swaps, which are derivatives providing access to a stock, an index or an asset class, without having to buy it.

Earlier this year, Nomura launched a new open-ended global emerging markets fund, which the company claims to be the first of its kind to combine a globally emerging market underlying with capital protection. Investing in six specialist emerging markets fund managers, any day the fund protects the investor by guaranteeing 80 per cent of the highest net asset value achieved during the fund's life.

"Fund managers have now an opportunity to provide new types of fund that may offer less risk for investors, while also giving them good potential for growth," says Mr Topp.