VARIETIES OF STRUCTURED PRODUCTS

The rise of new asset class underlyings

As investors realise the limits of traditional asset classes in producing portfolio growth, due to unclear equity market trends and low volatility, they are looking towards alternatives to diversify their investments. BNP Paribas examines the different aspects of the increasingly popular structured products market

The unprecedented equity returns of the 1990s led many investors to conclude that holding stocks along with bonds and cash would result in steady upward portfolio growth. One assumption underlying this was that optimal diversification could be achieved simply through exposure to stocks and bonds, as they always outperform other asset classes.

However, the upheaval seen in the equity markets over the last few years has cast doubt upon such traditional investment strategies. Not only have share prices plummeted, but volatility has also fluctuated considerably and the correlation between different equity markets has risen significantly.

Such fast-changing market conditions have prompted investors to turn to new ways of investing.

First, many investors felt the impact of the equity market decline personally and became more cautious of the stock markets, thus placing a premium on capital protection. With markets trending sideways, investors were enticed into allocating a portion of their portfolios to structured products.

This led to increased demand for principal-protected investments. Second, the high volatility/low interest rates environment prevailing in 2002 forced the typical equity and fixed income investors to diversify their investments in order to increase the portfolio risk/return ratio. Investors accepted to forego unlimited upside potential in exchange for regular income or a capped, but easily achievable, return tailored to their risk profile.

Lately, the historically low volatility and unclear equity market trends stimulated the rise of alternative investments and diversifying structured products linked to various asset classes such as commodities, mutual funds, hedge fund indices, foreign exchange, interest rates and inflation. An increasing number of hybrids, i.e. multi asset class products, have also been seen recently. Product developers are now competing on creating innovative derivatives on non-equity asset classes and alternative investments to offer the most appealing investment opportunities.

OVER COMING TRADITIONAL LIMITS

The current market situation prevents investors from generating high yields. With the current low interest rate environment, bonds may minimise risks but do not satisfy investor appetite for yield. Equity markets are expected to continue to rise until the end of 2005, although only moderately. And as correlation is currently high between equity indices, satisfactory portfolio diversification is harder to obtain out of pure equity strategies. Traditional asset classes are no longer offering satisfying portfolio growth solutions, urging investors to seek yield from new asset classes.

To many investors, mutual funds seemed like an efficient alternative to direct investment in equities or bonds, because they offer diversification solutions at a moderate cost and with a relatively low level of risk, in addition to the benefits of expert investment management.

The funds are invested in a selection of assets from a defined universe by a professional manager, who has a given reputation and track record. By benefiting from this management expertise, investors expect to achieve superior returns compared to benchmark indices. Moreover, these funds allow private investors to access some markets that might be restricted to retail investment, such as high-yield bonds, emerging market equities, Sharia stocks, commodities or real estate. They also meet the growing investor appetite for active management of their investments when offered as discretionary investments or in the form of dynamically managed structured products.

In addition to their in-built merits, mutual funds offer unlimited possibilities to product designers seeking to build tailor-made investments, because they are flexible underlyings. For instance, structured products linked to funds can embed extra value-added features like capital protection, leverage, or dynamic asset allocation.

Good examples of this are the constant proportion portfolio insurance (CPPI) structures linked to funds, which have proved to be successful alternatives to traditional asset allocation plans. The CPPI is a trading strategy designed to ensure capital preservation at maturity, while achieving a continuous rebalancing of the portfolio investments during the term of the product between risky assets (usually funds) and defensive assets

(usually bonds or cash).

Options on dynamic baskets (ODBs), another type of structure based on portfolio management techniques, typically use a dynamic allocation process that can increase the participation into the funds up to over 100 per cent. ODBs also aim to maintain a minimum degree of fund exposure to avoid any risk of locking the whole investment into cash assets.

HEDGE FUNDS

Hedge funds offer an investment that seeks to make absolute returns with reduced volatility irrespective of a rising or falling market by using non-traditional trading models.

The expanding fund of hedge funds market also stems from the development of structured products. Structured products linked to hedge funds may offer capital protection, leverage, and additional features to precisely fit investors views, risk profile and requirements (maturity, exposure, etc). Principal protected products on funds of hedge funds combine all the advantages of funds of hedge funds performances with the security of capital protection, therefore optimising the return on investment.

By using different strategies within one hedge fund, the manager offers investors the easiest way to diversify their portfolios. For instance, investing in one single hedge fund may give investors exposure to a wide range of assets, providing both geographic and economic sector diversification.

COMMODITIES AND HYBRIDS

Commodities have also become an attractive asset class for private banking and retail investors alike, providing both diversification and return. Oil, natural gas, base metals and precious metals are now assets of choice for many portfolio managers seeking to hedge macroeconomic risk, decrease portfolio volatility and enhance returns.

Three distinct features make the commodity assets an indispensable tool in portfolio management:

- Over the long-term commodities have often historically yielded returns commensurate with stocks;
- In the past, commodities have been negatively correlated with stocks and bonds;
- Commodities have historically lowered the overall volatility of a portfolio when blended with traditional assets.

Pure commodity-linked structured products sold well in 2004-2005 as energy (especially oil) and base metal markets boomed. Commodities can now also be found in hybrids, combined with other asset classes such as equities and bonds.

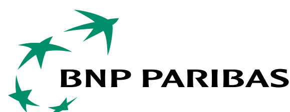
Hybrid structures are becoming popular because they provide an efficient means of gaining exposure to a variety of asset classes in one product, combining interest rates, currencies, gold prices, commodities, etc., along with equities. As such, hybrid investments stand for efficient investment solutions, because they offer the opportunity to take advantage of the different economic cycles of various asset classes and therefore receive optimum performance in any market conditions, especially via structures like 'best ofs' or 'lookbacks'. They also lower the overall portfolio volatility and allow investors to achieve diversification when the underlying assets are loosely correlated.

To obtain a hybrid payoff adapted to their specific portfolio management needs, investors can choose structures based on multi-asset class baskets. These are the best way to achieve efficient diversification and optimise the risk-return according to investors' particular objectives:

- Diversification of directional risk: hybrid structures replicate the returns from a diversified portfolio;
- Protection against inflation: several equity-based structures provide inflation-linked minimum returns;
- Arbitrage between different asset classes: investors can take advantage of return differentials between various asset classes without putting the invested capital at risk, by switching from one strategy to another, e.g. sale of bonds against purchase of equities within the framework of a structured solution.

As traditional assets such as bonds or equities may no longer offer satisfying returns, asset allocation products as well as hybrids are among the most attractive products for investors seeking yield. Many investors and distributors across European markets also tend to favour innovative dynamic management products with special features such as performance lock-in mechanisms, regular income payments and fund basket rebalancing.

Finding new sources of yield across asset classes has become one of the main drivers of client demand for structured products and, as a result, product innovation in the field of portfolio diversification solutions.



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