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PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

STRUCTURED CORPORATE BOND PRODUCTS

TAILOR-MADE APPROACH TO CAPITAL PROTECTION

Midway between the danger of equities and the safe cocoon of cash is the corporate bond, which is still less risky than stocks but offers better returns than government bonds. JPMorgan is offering a 'white label' guaranteed product to distributors who can customise it to match an investor's specific requirements

As Europe's high net worth investors slash their exposure to equities, they are blindly rushing straight into an asset class at the opposite end of the scale – cash. In doing so they are missing a crucial opportunity that lies in between, according to Stephen Stonberg, managing director at JPMorgan Securities in London.

Investment grade corporate credit, he argues, is perfect for wealthy investors that have been burnt by the stock market, since it is less risky than equities, but offers better potential returns than ultra-safe instruments such as government bonds and cash. However, Mr Stonberg advises against direct investment in corporate bonds. Investors would do better to access the market through a protected, credit derivative-based product, he says.

JPMorgan is among a number of investment firms in Europe rolling out a series of structured notes that allow investors to gain exposure to a wide range of asset classes while at the same time protecting them from the worst ravages of the markets. This is done typically by designing the product in such a way that it guarantees that the investor will get back some or all of the capital originally invested. JPMorgan is offering these products to fund distributors throughout Europe in "white label" form. Distributors are able to tailor the basic JPMorgan product in great detail to suit their particular client base. Mr Stonberg explains that if the distribution firm wishes, it can choose anything from the product's currency to the very holdings in the portfolio.

In corporate credit risk, JPMorgan's latest offering is ICE CAPS – Investment-grade Credit-Linked Enhanced-yield CApital Protected Securities. Mr Stonberg says that this product is ideal for the current credit market climate.

STORMY CLIMATE

Credit spreads and default rates are closely linked to the business cycle. As a result of the present weak economic conditions, credit spreads are currently close to historically wide levels. This is due to weak corporate profits, high levels of debt and a mid 1970s style collapse in business activity.

But investors should not be discouraged, says Mr Stonberg. Rather, he believes, they should be positioning themselves for an improving credit

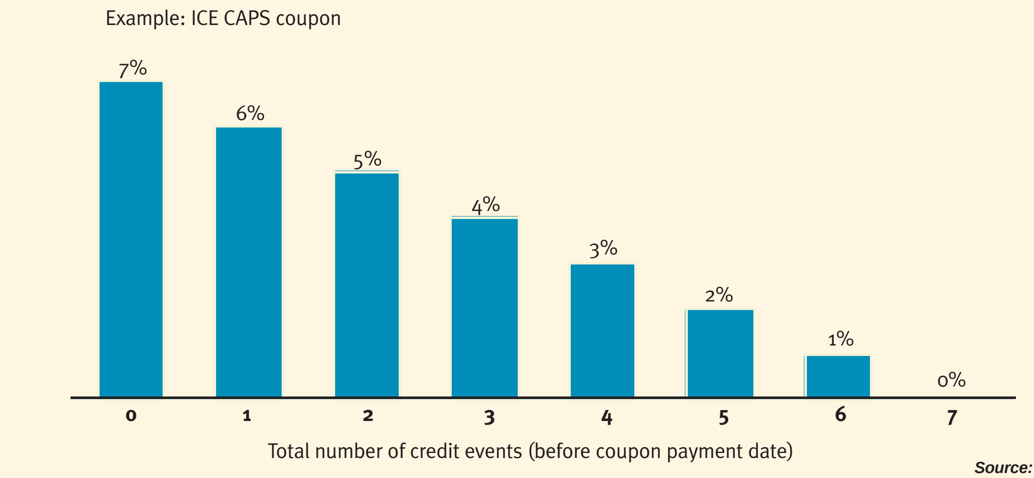
'Investors should be positioning themselves for an improving credit environment'
Stephen Stonberg, JPMorgan

Inside ICE CAPS

An example ICE CAPS portfolio is comprised of investment grade (AAA – A) bonds in 100 companies. It has a US bias, being split 71 per cent US and 29 per cent European holdings. The companies include German chemicals company Bayer Aktiengesellscaft, Spanish utilities firm, Endesa, French retailer Pinault-Printemps-Redoute and entertainment and broadcast company Walt Disney. However, each client portfolio is unique and can be structured to suit individual needs.

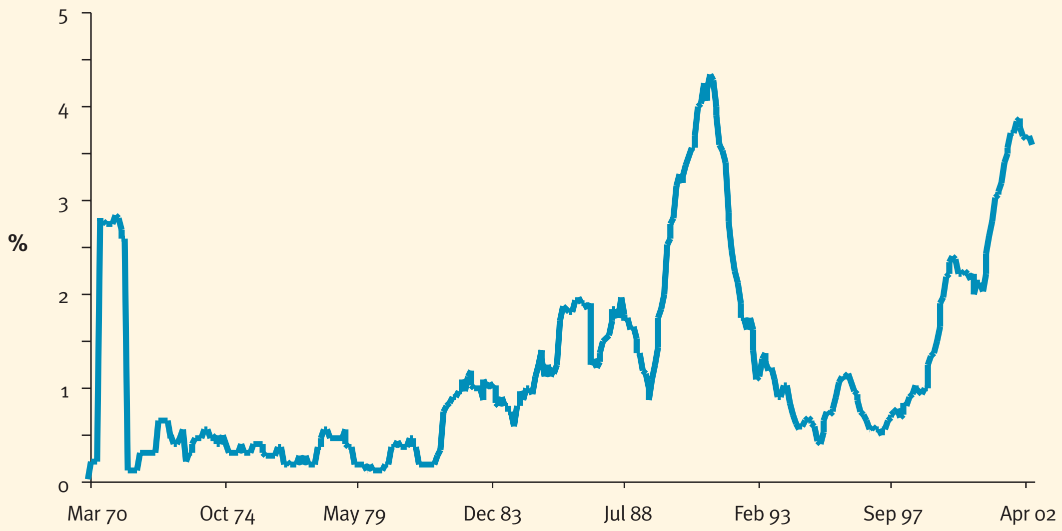
Moody's risk-adjusted average rating:	Baa1
Simple average rating:	A3
Maturity of portfolio:	5 years
Number of companies:	100

Coupon payment scenarios



Source: JPMorgan

Moody's default rates on all corporate bonds



Source: Moody's Investors Service

environment. Corporate profits as a percentage of gross domestic product are rising and companies are beginning to direct more internally generated cash flow to pay off debt. A moderate increase in business activity should generate additional profits given the historically low inventory to sales ratio.

Nonetheless, Mr Stonberg cautions that direct investment in bonds can be dangerous. First, there is the lack of compensation for the risk taken by the investor. According to JPMorgan's research, "a diversified investment grade bond portfolio yields only 1.1 per cent over the five-year Treasury note or a 3.9 per cent, which we believe is insufficient compensation."

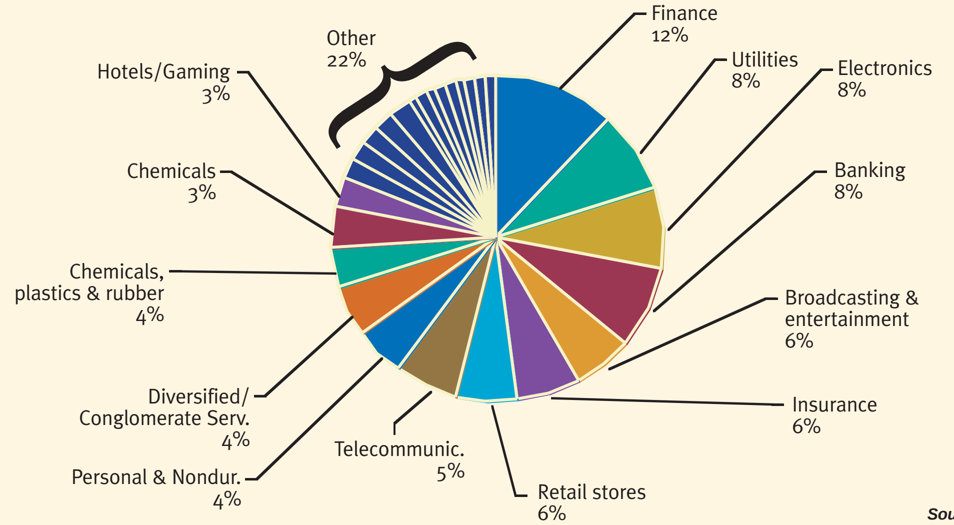
Second, trade execution is costly. Mr Stonberg says that position sizes less than €500,000 are expensive to buy and sell. For a portfolio containing 100 credits, the minimum individual investment would be around a substantial €50m – simply too much for many private client portfolios.

SHELTER

This is where products such as ICE CAPS come in. This particular example of a capital guaranteed product offers exposure to an investment grade fixed income portfolio of 100 corporate US and European bonds with 95 per cent principal protection. Buying a basket of credits in this way is much more efficient in terms of execution than purchasing individual bonds (this is made possible by the credit derivative market). As a result, the minimum investment is as low as $100,000, with exposure to 100 corporate credits – far more suitable for private investors.

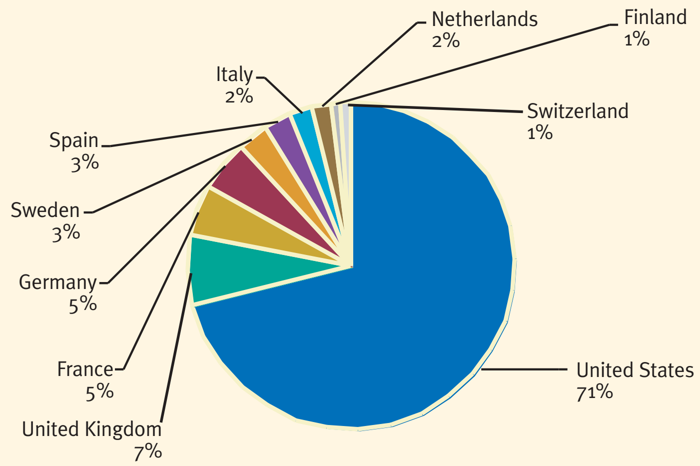
So how does the product work? ICE CAPS are structured to provide protection against the downside of 95 per cent at maturity. They are 95 per cent principle-protected by JPMorgan credit risk, which is rated AA. The maximum annual coupon payment from the portfolio is 7 per cent. This will be paid in if there are no defaults or

Example portfolio – industry distribution



Source: JPMorgan

Example portfolio – geographic distribution



Source: JPMorgan

credit events – ie, bankruptcy, failure to pay obligations – affecting the companies in the portfolio. Each credit event will reduce the principal by about 0.7 per cent.

Therefore, if there are no credit events, the product generates the type of return earned by taking sub-investment grade risk with full risk of principal. ICE CAPS allow for a 7 per cent default rate. Mr Stonberg points out that this is a conservative approach given that during the worst five-year credit cycle (1986-1991), the market saw a cumulative default rate of 5.42 per cent for investment grade bonds.

However, protected products are not risk-free. In the case of ICE CAPS, the occurrence of seven or more credit events will result in the investor receiving no interest and losing the unprotected portion of the original amount invested. Also, ICE CAPS are buy-and-hold instruments. If the ICE CAPS are redeemed prior to the maturity date, the investor might not receive the full outstanding principal amount or any accrued and unpaid interest.

JPMorgan is rolling out ICE CAPS as a white label product. The first institution to begin offering them was JPMorgan Private Bank in December 2002.

CORPORATE STATEMENT

J.P. Morgan Chase & Co. is a leading global financial services firm with assets of $759bn and operations in more than 50 countries. The firm is a leader in investment banking, asset management, private banking, private equity, custody and transaction services, and retail and middle market financial services. A component of the Dow Jones Industrial Average, JPMorgan Chase is headquartered in New York and serves more than 30 million consumer customers and the world's most prominent corporate, institutional and government clients.

JPMorgan

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