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Trading positions

Money Management brought together a group of experts operating in the UK structured products market to discuss the merits of using such instruments within a wealth management context.

By Ashley Wassall

There has been much talk in recent months regarding the role that discretionary managers will play in the advisory world once the RDR proposals have been implemented in 2013. Already there is a sense that a growing number of IFAs are looking to outsource the investment management side of their business, a trend that is expected to pick up momentum as advisers preparing for a commission free future increasingly focus their services on straightforward financial planning.

Investment managers are often not client facing and have only one goal: to meet the investment objectives set for them by the client through exposure to sanctioned asset classes. Unencumbered by the prejudices of past mistakes, such managers seem to increasingly be looking to structured products to provide a suitable mixture of growth and protection. Moreover, an active secondary market that is largely unavailable in the retail world gives added flexibility to lock in pricing when opportunities arise.

But how appropriate are these products and what issues arise when utilising them within clients' portfolios? Money Management convened a roundtable in August to discuss this issue, inviting several experts representing both the provider and manager sides of the debate. Themes discussed included the risk/reward balance offered by structured products, the liquidity provided within discretionary management, and the growing utilisation of UCITS III fund wrappers to provide piece of mind to investor

The panel:

- Ashley Wassall, Money Management
- Chris Woods, Matrix Investment Management
- Tobias Raymond, Access Equity Management
- Matthew Robinson, Morgan Stanley
- Alexander Robinson, Barclay's Capital
- Gary Dale, Investec
- Lester Petch, TAM Asset Management
- Emma Louise Davidson, Citigroup
- Alistair Soames, Charles Stanley

AW: To start off I'll ask the discretionary managers at the table, why would you use structured products? What objectives are you trying to achieve?

CW: We don't mind giving up some upside in order to secure the downside protection. We manage them on a global thematic basis and look to gain exposure to the themes we like. We like structured products a lot and we have up to 50% of our portfolio in them at any one time. The only problem is counter party risk, if we have a double dip and there are banking problems and so on. Certainly versus the other direct investments in our portfolio, from a risk/return basis structured products have performed very well.

TR: We deal with a handful of institutional type family offices based here in Europe and in the Gulf. Recently we've seen these families bringing a lot of the investment decisions inhouse, but where they will still allocate money is in markets or strategies where they couldn't do it themselves. For example, North American equity long-short: you won't see many of those funds in their books going forward. Distressed credit: probably. Commodities or more specialist alternatives: definitely. It may be that structured products offer an opportunity for them to gain exposure to these type of trades in a more cost efficient way.

AW: That's interesting, because on the retail side there seems to be a certain way that people think about things and they tend to focus on markets like the FTSE that they are familiar with. Is that very different in the discretionary management space, are managers using structured products to get into more exotic asset classes?

MR: I would say no actually, 80% of the products we sell are still linked to FTSE, with Euro Stoxx being the second candidate and access to exotic or emerging markets being only maybe 5% of what we sell. It's very much about managers looking to take care of their UK portfolios and using structured products within that.

AR: I think it's actually gone more to the FTSE because of the recent crisis. Probably four years or five years ago there was much more variation.

GD: Interestingly, we recently did quite a lot of research when we established our new discretionary business. Our view was that it had to be esoteric, different, alternative, and linked to strange and wacky underlyings. What we've been told by the majority of managers is that that's not the case and mainstream underlying downside protection was where it was. You can link the upside to alternative indices but the downside protection had to be effectively the liquid part of the structure. So I would suggest that it's more FTSE based currently and swapping upside for alternatives.

LP: But this is only because 2008 absolutely scared the hell out of people. Unfortunately, and I think you providers will know full well, as soon as they get bullish they'll be back in for anything you can find that's esoteric, so that's just a market functionality of where they are in their mindset. They're bearish: they want FTSE, they want to stay at home. They get bullish: they'll start fiddling around in all sorts of goodies that you chaps can provide for us.

MR: It's also the pricing environment for exposure to emerging markets, which is expensive in terms of volatility at the moment. Discretionary people would like to access it in terms of principal protection but the upside offered currently is very low, so you do have to take some downside risk if you are going to get exposure to those markets.

AR: I think that we could also probably try to push more products that are not just using a traditional call option. Maybe we could use historical volatility to price versus just using implied volatility. I think that's an education we've got to give providers to show people that maybe products that switch when volatility goes high into a cash position can benefit them and make the product look good as well.

MR: They are very popular in the Irish life insurance market and they can be translated into the discretionary world.

LP: It's actually quite a core asset allocation in Ireland. We've got a lot of Irish people we deal with and I was actually quite shocked. I have to say I don't think they understand them; when you ask them why they have got them it's only about downside protection. They don't really get the upside level and whether it's right or wrong and they don't know if they are getting a good deal or a bad deal, they just know they're getting protection and that's the key issue.

AR: Well I suppose in Ireland rates are so low for them that they kind of feel that as long as they've got their capital protected they're not losing a great deal. It was rather like when people were doing commodities five years ago, when you could get 200% upside and 100% protection.

MR: Those were the days!

AR: It was great, it was such a cheap option to fill up on and people had a great experience. Now that's not available any more because everyone has worked that out and the back end of the commodity curves have gone up. We've got to find a new, cheaper option to keep people protected.

ED: As with every single security, market forces impact pricing. The fall in rates has meant the traditional hard protection with participation is not possible. On the other hand autocall products are clearly impacted by volatility.

MR: A nice, simple way of doing it is to sell 1/5th of a put option on the downside so that for every 5% loss in the market you are exposed to 1% erosion of capital. The advantage of that is that it's as simple as it gets, the maximum you could lose if the market goes to zero is 20% of your capital, and with volatility relatively high you're still rewarded and can get some interesting upside potential there.

AW: For the managers at the table, what are you looking for in terms of a balance between risk and reward from a structured product?

AS: If you look at the market going sideways over perhaps the next couple of years with volatility, then there are a few structures out there that will give you a return in those situations. Although they will tend to underperform in a bullish market, you have got to look at it over a couple of years and also in terms of people's attitude to risk. They are very quick to shy away from risk in turbulent times and yet six months later when everything looks a lot better and the market has had a big rise they'll say that product hasn't done very well. You've got to look at it in perspective

AW: That goes back to the idea of products doing 'what they say on the tin' – they are what they are.

AS: Yes, and I think that the providers here will have plenty of examples of products that have done that and matured and paid out. As long as that continues then I think the market will carry on growing as it is at the moment.

GD: This is a very momentum driven industry. As momentum drives in a bull market everybody buys them and people tend to forget about, or look less closely at, risk, until something goes wrong. Coming back to what structured products do: they mitigate downside risk, that's all. These animals should never have been used or sold to outperform alpha, because by definition they'd be very bad at it. If they are used and adopted to provide natural hedging, or something a little bit more specific in the portfolio, they work fundamentally well because they always do what they say they will do. They do that because they are bought upfront and they've got pre-definition – they deliver x, y or z. It is all about matching them to an objective.

TR: Well that just comes down to the manager knowing their client.

GD: Absolutely. You all run portfolios with different mandates – plus or minus whatever it is – that's where these things fit. It doesn't really matter what index it's linked to, or what the downside is linked to. If the end game, or the end result, matches off to an objective, you will use it.

AW: It's interesting that you draw the comparison with active fund management, because we've talked about how they are linked to the FTSE and so on and I'd have thought that they are effectively a passive investment of a sort.

GD: I disagree. If a discretionary manager is using an equity benchmark, that portfolio is designed to outperform that benchmark and that's it. If you outperform by 1, 10 or 15% you've met the object by definition. That's what it's about. So if a structure can mitigate some of that down, or remove one or two of those variables, then it doesn't really matter what it's linked to.

MR: We see a lot of investors looking to use our structured funds or notes as safe cash alternatives, so they're not chasing double digit returns; 6-7% is fine.

AW: So for the providers at the table, how do you internalise that and go about creating a product to meet those ends?

ED: We are talking continually to individual managers across the market to try and pick up emerging views on the investment outlook, as well as talking about ongoing client needs. We use this to try and design products that fit in to where the market is.

MR: Two very important issues to do with creating structured products from the provider's perspective are the counterparty risk that the end client is taking on and cost, which has led us to issue UCITS III compliant funds. This addresses counterparty exposure through collaterisation on a G7 or G20 basis, and the costs are minimal with a maximum that you would pay being 50 basis points per annum. For a structured fund that compares favourably whether you are looking at the hedge funds universe or other structured funds.

AW: And I suppose UCITS III is also useful because you also have to have a certain amount of liquidity, right?

MR: Behind the scenes there is a swap hedge in a UCITS III fund, so there is unlimited liquidity to the extent that the FTSE futures are liquid. We're talking billions as opposed to tens of millions.

AR: I agree with Matt. That is definitely another arrow for us to shoot. I think that the traditional mechanism for structured products, the note, also offers good value and there are funding spreads that can be picked up. I've been doing this for 12 years and for a long period of time there wasn't a funding spread over LIBOR but now that's there and I think that offers opportunities for discretionary managers to think that, as long as they don't get over exposed to one provider, there is some good value there to be picked up.

GD: I think when you look at the difference between retail and institutional mandates, institutional managers understand volatility and understand counterparty risk, and expect to be paid a premium for that risk. In the retail world everything has to be bundled together in a nice pretty package with a glossy brochure, and collaterisation helps for momentum driven sales. Discretionary fund management is about utilising optimal strategies to benefit clients upside, given a whole host of factors such as volatility, downside protection and so on.

MR: Indeed. We've seen discretionary managers become very reactive in the way they trade our spreads, as well as volatility. For instance, we'll launch an autocallable note in the morning at 10am and have uptake by 1pm for, say, £5m. Discretionary managers are taking an active view on volatility and spreads and they want to be able to lock into market terms there and then.

AS: That's a very good point. Being in a stockbroking firm I've always been interested in structured investments from the institutional side not the retail side, but we find that stockbrokers are very set in their ways about buying investment trusts, individual equities and sometimes unit trusts. I've always been pushing the boat out on structured shares and I think the idea that there is liquidity in the secondary market, and the fact that you can perhaps buy secondary market issues, gives you the opportunity to take advantage of market situations and volatility to make some kind of pre-defined return based on a set of circumstances that perhaps you can't do by buying individual equities. Many are slowly coming to terms with the fact that there is perhaps a place for them in the portfolio, which I think is a good thing.

TR: Have they previously actively opposed structured products, saying they just don't want them?

AS: Yes because basically a) they don't understand them, b) they think they are expensive because they get mixed up with the retail side of things, and c) they don't think they're liquid, so if you want to get out of them how do you do that? Providers would do themselves no harm by pushing the fact that there is liquidity in the institutional side of things.

AR: I think a lot of people almost prefer to buy these products in the secondary market as opposed to sometimes the primary market.

AS: Well I personally prefer to do that as you know exactly what you're getting. From my perspective I might look at an autocallable that has, say, three or six months to go. Perhaps there is an opportunity to make an upside of just six pence in the pound, but the actual market could fall by as much as 20%. So you can say, "I can have a bit of that, the market can actually fall by 20%, and I'm still delivering a positive return for my client." And if doesn't kick out in that year it's not a problem it just rolls over into the next year.

AW: And for the providers, is it essential that you have this kind of secondary market potential to capture discretionary managers?

ED: The reality is that without a secondary market there would be no market in this area. For a real example, note the total change in fortunes of the closed end London listed hedge funds.

MR: Yeah I'd say we see 75% of our volumes in the secondary market. You live and die by the secondary market in the discretionary world.

AW: And for the managers do you trade in and out of them? Do you buy into one and then sell out a couple of months later at a good price, treating them like a normal share effectively?

AS: Yes, but you'd tend to do that less because there is a cost implication of setting these things up. When you go in there is obviously a spread in the market and sometimes it's not that easy to get back into them, especially if the liquidity is a bit difficult. So you can trade them but you don't tend to unless there is a specific opportunity. Obviously things change and it is nice to know you could get out of them if you wanted to.

MR: We launched a product a couple of weeks back that was looking to autocall at the end of six months at 107. Two weeks later it was trading at 106 on the bid, so we had a lot of people offload. That's where you have to sponsor the market and be there behind the bid, it has to be a real bid.

AW: So how does pricing work on the secondary market – is it purely a market driven price?

MR: It's purely an economic price for mid-market and then a symmetric spread around that economic price. Supply and demand, unlike the investment trust world, does not affect the secondary market.

LP: I think it is also worth noting as fund managers that liquidity is not always there. In 2008 I can assure you it definitely wasn't there. No matter how much people say it was, it wasn't.

AR: I think there were still buybacks, but it was the prices that were the issue. The surprising thing that came in was the credit application spread that got put onto things, which I think surprised us all.

LP: No, of course. It wasn't a criticism; it was more that we all have to be aware that while liquidity improves enormously in the good times, in the bad times, with respect, it quite often completely disappears. When you're a DFM that manages money rather than possibly trades money, quite often you're not in the price. You're not watching it every day; you're not watching it even every week because you've got it for a reason. So when you need to do something you've got to completely start again.

MR: If you're buying a collateral backed security then the spread backing that instrument should be less volatile in a downward market.

LP: How do you think your UCITS III products would cope with a massive exodus in the event of something catastrophic happening, assuming that 2008 was almost catastrophic.

MR: The specific answer for that in the context of our products would be that there would always be liquidity to the extent that there is liquidity on the FTSE.

LP: That's good to hear.

AW: From a provider perspective, given that these products are likely to be traded a bit more than a retail product, which is usually a buy and hold, does that change the way you structure the product?

AR: I think retail could get a secondary market but the systems just aren't there at the distributor end to allow that to occur. I don't think there is anything different that we do. There's no magic element that we put in, no secret ingredient.

GD: There is no central hub where you can access all of the notes and all of the inventory in the market. You rely on your own research around different sites to access pay off and price. I think that will evolve over time.

MR: Interestingly the guys over at Matrix are setting up a third party market making service for structured products and that's a role I really applaud. You'll have neutral entities making markets on structured products and that can only help liquidity.

LP: I talk to a lot of financial advisers on the street and their overriding fear is still liquidity. Now I'm a middle man here and I know that within confines you provide liquidity, but trying to get them to understand that is difficult. There is a chasm there, a difference in understanding that has to be breached somewhere.

AS: That is sort of highlighting the difference between the institutional side of things and the retail. Maybe when RDR comes into play the retail side of things will be less of a factor and actually they'll all be kind of institutional, because ultimately if you're paying IFAs or whoever commission that is going to affect the terms of the product.

LP: I think that is where the regulator comes in, though, because prior to 2008 there was a plethora of products being sold to the retail end of the market. People at the lower end, and possibly not the knowledgeable end, were starting to buy the products because they were genuinely being offered to them and there are some good case studies about that now.

AR: Do you think RDR might prevent a little bit of this?

LP: Well that's what I'm saying – that is where the regulators have come in. They think RDR will make that impact, and possibly it will. I think the jury is still out to be fair.

AR: More banks are now trying to directly list products onto exchanges and almost take away some of that commission element, so perhaps that might help and investors then aren't being pushed products which are unsuitable to them because of the commission element.

LP: Well I think the commission element is going to die anyway, whether it's a structured product or any other type of product. I don't really think you'll go into a brave new world where they're not going to worry about whether it's on a commission – they'll have to not worry whether it's giving extra commission.

AR: I've always felt that a lot of these problems have happened because commission became quite a large element of why these products we're being pushed, if you look back to endowment mortgages and so on.

LP: Yeah but you can do that with unit trusts and life products and everything else. I agree with you partially, but not entirely because every product has the same issue.

AS: There probably became a point where people's appetite for going into unit trusts was not great and therefore this satisfied a certain demand. Advisers thought we can still push this type of investment; it makes more sense from a client perspective and we can get paid for it as well. Obviously there were some problems like the precipice bonds and SCARPS and subsequently you have to have lots of risk warnings. The products you guys are launching are not SCARPS and they don't have a geared downside and yet people still remember that kind of mis-selling. It's a very different animal and compliance as a whole don't understand these products so they don't make our lives easy. Perhaps there can be more from your side to help our compliance departments understands these things?

LP: The other thing for us is unfortunately they seem to have 20:20 hindsight as well. We've done all of our due diligence to make sure that this is all OK and then something comes out of left field in two years' time and they'll say, "But you should have spotted that."

AS: We're not running the world. We're not responsible for Lehmans going bust, or Goldmans going bust, or whoever. We can only do what we know and we're simple individuals. We're not trying to be clever, we're just buying into something that has a specific remit and if they don't understand that then that's their ignorance not ours.

GD: There appear to be a few entities that require education. One is the manager; one is the compliance departments, who are driven by the regulator with their 20:20 hindsight; and the other is the PI insurers, who are driven by actuarial pricing I'm afraid.

AW: Are these educational issues significantly less of an obstacle than in the retail market?

CW: I think structured products got a very bad name because of the front loading 10% fees in the old days via IFAs. How do you think the market is still affected by the hangover from selling those products?

MR: I'd say that the discretionary base has been tainted by some of the practical experiences in the retail world and where you blur the two it's unfortunate. At the end of the day all of these products are priced at 100 and there is no commission.

AS: I think we should change the name of them from structured products to structured shares, for example, on the institutional side.

AW: That's an interesting point. I've heard a lot of people call them many different things and a lot of the time they're not called structured products any more. Is that something providers think about, making sure they are termed in a way that doesn't bring echoes of those past issues that people have had?

GD: Yes, because it's marketing isn't it? That's what it's all about – you've got to attract people to your website, your products, whatever. But that's all it is: marketing spin. At the end of the day it's still a note, a fund, or an asset underpinning an upside. We labelled our discretionary proposition 'structured opportunities': it's still a note, it's still a structured product, it's just there is not a not a plan wrapped around it.

AS: I think that's where the product thing came about because it was wrapped up together, but it often isn't that any more.

AW: Coming back to secondary pricing, how does volatility affect pricing in the secondary market, or how does it affect how you look at pricing?

MR: It is hard to answer that in general but for the products we've been issuing over the last two to three weeks a one point move would typically move, depending on the product, the asset price by 1%. It is very correlated to volatility on the launch date.

AR: As the products move more into the money they become less sensitive to volatility. Volatility tends to have an impact when you're at or around the strike – if it's deeply in the money it starts to become less relevant and you start moving towards that Delta.

AW: I suppose that's because you're talking about having to have huge market swings then.

AW: One other point I wanted to talk about is averaging – front-end averaging and things like that. Is that something that people are looking for at the moment? Is there demand for phased entry into the market rather than taking a strike at a particular date?

AR: Those are popular products but I think you give up something to get them – generally participation. So it depends on how active I suppose managers want to be in their portfolios and I suppose it's a question for them to say, "Would I give up the extra 50% upside with a look back on the strike?"

GD: The question is, "Do I believe the asset class or the index is good value? Am I confident that if I go in now it's not going to drop?" We don't see that many managers taking a view on that basis. Front end averaging was popular when volatility was really high, but it was expensive and involved giving up quite a large chunk of upside to buy a safety feature that actually, with respect, they are paid to manage anyway. We believe that to build these notes and issue them they tend to fall in favour of the bank more than the client. Back end averaging is a moot point, because it can go one of two ways: it can protect the client or it can go against them.

AR: As long as there is too much averaging. What does the FSA say? Six months?

GD: It's a good question. The industry says on a five year plan no more than 12, most providers use six – on a three year no more than three. It'll be interesting to see if the FSA do come out with a dictat on averaging, but it tends to be three and six months.

AW: One of the things that I have noticed is that there seems to be a movement into this market by providers. Do you think that is going to continue to happen?

CW: It'll increasingly happen because the problem with conventional investment is that when the wheels fall off everything becomes correlated. Using structures allows you to get access to themes that are uncorrelated and use them to your advantage. What we try to achieve is basically low volatility non-correlated returns so, as someone else said, we'll probably underperform in a bull market, but obviously in a down market you still want to be banging out consistent returns.

GD: The distribution demographic will dictate where providers go. As RDR starts to bite – which won't be 2012, sadly it'll be 2014 when they all pull their heads out of the sand – investment management will become the domain of discretionary managers far more than it is now. IFAs will become effectively advisers on tax and legal and pensions and so on.

AS: I think that's starting to happen now. We're getting a lot of enquiries from IFAs, who want us to be investment managers. But there seems to be a big issue with what they want to charge and there seems to be so many mouths to feed that at the moment the client seems to be lost, which needs to change.

AR: One important issue from the buyer's angle is that you've got to deal with banks that have a track record. Sometimes you see banks arriving and saying they're going to have a presence and then disappearing. That is something you guys have to think about: is there going to be someone there in three or four years to keep making prices? Just as Lester says that you see people buying more esoteric products, when there is a bull market you find investment banks wanting to move into these areas and staff up and then they reduce back later.

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