

GUIDE TO STRUCTURED PRODUCTS

What is a structured product?

“Structured products” is the name given to a category of tailor-made investments generally composed of several elements or component parts, each providing a specific exposure or protection for the investor. The sum of these elements creates a tailored investment that is not easily replicated by the individual investor. A structured product can be defined as a security which is constructed by combining bond-like elements and financial options. The end result of this combination is an investment product that is generally characterized by:

- Some form of capital protection, which is provided by the bond or bond-like element. This bond, referred to as the zero-coupon bond (or simply zero-coupon) promises to pay the holder back some or all of the original investment.
- Defined return outcomes at maturity, provided by the financial option. The option is a financial instrument that pays a pre-defined amount, either a fixed amount or an amount calculated by reference to the change in an underlying asset, for example the FTSE 100 Index or a combination of stocks or indices. For this reason options are also called derivatives, as their value is derived from the underlying asset.
- Restricted liquidity (or ability to buy and sell freely), as the zero-coupon and option when combined together by an issuer into a security are normally not traded on an exchange. This means that structured products can in practice only be sold back to the issuer.

Why structured products?

Risk and return

Structured products are an expedient way to get exposure to equity and other market underlyings (for example, interest rates, commodities, exchange rates or inflation) whilst controlling risk, because the returns are clearly defined. For example, investors who wish to gain from growth in stock markets, but who are worried about their investment losing value when the market falls, can buy a structured product that gives some of the upside returns of the stock market, without the risk of losing their investment in a stock market downturn. Other investors may wish to take more risk in order to get higher returns, and may choose a structured product with partial, or conditional, capital protection.

It is important to realize that the capital protection of a structured product is dependent on two factors: holding the investment until its maturity (the end of the investment term), and the credit-worthiness of the issuer, or of the entity that guarantees the issuer.

Access

Structured products can assist in diversification of a portfolio by giving access to a wider range of markets or asset classes. Typically, certain investments, such as hedge funds, commodities or emerging markets, are not easily available to individual investors as direct investments, or not suitable for direct investment. Structured products can provide an effective way to invest, thus diversifying an investor portfolio.

Features and risks of structured products

Underlying

The underlying asset (often referred to as simply “the underlying” or “the index”) is the share or shares, share index, currency, commodity, fund or other asset which is used to calculate the return of the structured product at maturity. For example, a structured product that is described as “FTSE-linked” will have the FTSE 100 Index as the underlying . The returns at maturity will therefore depend on the level of the FTSE 100 Index at the beginning of, the end of, and potentially during, the investment term.

Complexity of the product payout

Some structured products have features such as averaging, limits on returns or complex conditions for the calculation of returns. These features can, in differing circumstances, be to the investors advantage or disadvantage - generally, features that limit return make the financial option less expensive. Investors should consider carefully all the features of a product before investing, and take professional advice if unsure about any details.

Investment term and income

Structured products have a defined investment term, and are intended to be held until maturity. This allows for capital protection and other features, but means they are not suitable for investors who may need to access their money during the investment term. Withdrawing the investment early in an emergency can cause a loss of capital, so investors need to ensure they have other funds available for use in emergencies. Further, only certain types of structured products provide a regular income, so investors who require income need to consider this when choosing a structured product.

Liquidity

Structured products generally have little or no liquidity (the ability to freely buy or sell an investment) because they can normally only be sold back to the issuer, and because the issuer generally does not keep an inventory of the product after the original offering period. This, combined with the fact that any capital protection is only effective if the product is held to maturity, makes it important for investors to ensure that they can keep their investment for the duration of its term.

Issuer

The bank or financial institution that issues the structured product is responsible for paying back the investor’s capital and return at the end of the investment term. If the issuer is unable to do so (because it is insolvent or has been put into administration), some or all of the capital may be lost, and may take a long time to get any of the capital back. Looking at the financial strength of the issuer is an essential part of deciding whether or not to invest in a structured product. It is also important to read the terms and conditions of the product together with the risk factors, as the issuer is not necessarily the bank or institution that is selling the product.

Taxation

Structured products are normally created so as to ensure the proceeds returned at maturity are categorized as capital gains rather than income. It is important to note that tax treatment is subject to change, however, and cannot be guaranteed to remain the same during the term of the product.

Common types of structured products

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Structured products can be categorized as either capital-secure or capital at risk. Capital-secure products promise to return the investor’s capital at maturity, regardless of the changes in the value of the underlying during the term of the investment. As such, they can provide investors with an opportunity to invest in a risky asset (such as shares) with less risk to their capital. In return for this security, the investor gives up some of the potential returns - the details vary from product to product.

Capital at risk structured products are those that do not unconditionally promise to return the investor’s capital at maturity. Instead, capital at risk products reduce the investor’s capital under certain circumstances, if the underlying performs differently from expectations. The most common form is for capital to be reduced in line with the fall in the price of the underlying asset only if an extreme move has occurred, such as a fall of 50% or more.

Capital Secure

Fixed return

Fixed return products provide the investors with a predetermined return (often a coupon that is fixed before the start of the product) if the underlying asset behaves in a certain way (for example, if the Index at the end of the investment term is above its level at the start of the term). Although the capital is not typically at risk, the coupon is only paid dependent on the underlying asset increasing (or simply not decreasing) in value. Fixed return products can be suitable for investors who believe that an underlying asset will increase in value, but are unsure how much.

Variable return (growth)

Variable return products, often referred to as growth products, provide a return that is dependent on the change in an underlying asset in a more linear way than a fixed return product. For example, a FTSE-linked growth product may give a return of 1% for every 1% the FTSE 100 Index increases during the investment term. Variable return products can be suitable for investors who believe that an underlying asset will increase strongly in value. Variable return products are often limited in some way, for example by stipulating a maximum return, taking average observations, or other features.

Fixed return versus variable return

The choice between a fixed return and a variable return product will depend on the investor’s personal view. In general, a fixed return product will perform better in markets that are range-bound (changing up and down over a period of time without growing or falling greatly) whereas growth products will perform better in markets where the underlying asset greatly increases in value.

Capital at risk

Structured products can be made capital at risk for several reasons, but generally the purpose is to allow a higher potential growth, income or other benefit in return for higher risk. Two common ways of doing this are income products and redemption products.

Income products

Most structured products that pay income regularly during the investment term do so by putting the investor's capital at risk. Commonly the product pays a guaranteed income during the investment term, but with the return of capital at maturity conditional on the level of the underlying asset. The size of the coupon will depend in part on how risky the underlying asset is.

Early redemption products

Another common capital at risk product is an early redemption plan, sometimes referred to as a kick-out or step-up plan. Early redemption products promise to pay the investor back their capital early (hence "kick-out") together with a coupon (which usually increases according to the time since the start of the product, hence "step-up") if the investor's view has materialized on certain predetermined dates. If the product has not redeemed before the end of the investment term, the investor's capital is usually at risk.

Difference between direct investment and via a structured product:

Investing in a structured product linked to an index is not the same as investing directly in the index itself (or the component shares). Although a structured product is intended to mimic the performance of the underlying, investors in structured products will not receive dividends or other forms of distribution from the companies in the index. However, this is reflected in the price of the financial option contained within the product, the higher the expected dividends from an index, the lower the price of the option.

This guide is produced to give an understanding of the main features and elements of structured products in general and is not directed at any specific structured product. This guide does not constitute a Financial Promotion under the Financial Promotions Order 2005, part of the Financial Services and Markets Act 2000.

Retail investors who are considering such type of investment should consult with their Financial and Professional Advisers.