INTRODUCTION

IS IT TIME FOR A FRESH START?

They may have recieved a bad press recently but some believe that structured products have been unfairly lumped in with other failing investment vehicles and that they can still offer solutions to complex problems, writes Nat Mankelow

Not a standalone investment product, but a flexible solution for the knowledgeable investor to use when seeking the diversification uplift which can be derived from accessing esoteric asset classes such as FX, volatility and hedge funds. This is was what senior industry professionals believed the structured product universe should view as its remit going into 2009, delegates discovered at an event organised by the *Financial Times* last month.

Product manufacturers and private bank salesforces were mostly in agreement that a fresh start is required after a torrid last few months which had become almost unbearable following the collapse of major structured product underwriter and counterparty Lehman Brothers. Complex payoffs and wrappers, just because manufacturers have the technology and ability to construct them, should be put to one side as the marketplace goes back to its roots, delegates heard.

However, as James Bevan, chief investment officer at CCLA Investment Management, acknowledges, structured solutions retain the capacity to meet the needs of an embattled investor base during this unsettled period. "We are looking at back to basics in terms of product design. However, the industry shouldn't shrink from the reality of having increased complexity, rising governance and compliance to deal with," he says. "The significant demands of the customer necessarily lend themselves to wanting structured solutions to these complexities".

According to Mr Bevan, though there is limited scope for the industry to be more inventive than it has been to-date, "there remains an ever expanding set of imaginative people with deep skill prepared to deliver structured solutions".

Timothy Hailes, speaking as chairman of the Joint Associations Committee (JAC) on retail structured

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JAMES BEVAN, CCLA

products, likewise suggests that the "perfect storm" of recent months shouldn't detract from the plusses that lie behind the utilisation of structured solutions. "They can provide risk diversification, flatten volatility, and enhance investment portfolios. It is the endless combination of such characteristics which makes structured products so versatile," he adds.

Mr Hailes claims that structured products have in many respects been the victim of mistaken identity and that it is down to the industry to get the correct message across. He explains: "Structured investment products are not the same as off-balance sheet mortgage-backed securities or structured investment vehicles (SIVs), but have been lumped into the same structured credit basket. The issues that have affected retail structured products have not arisen from the structuring or engineering but rather from the fact they are subject to the same influences as any other products."

INNOVATION ON HOLD

But there remains much work to do within the industry to get to this point of clarity, for both the retail market and institutional space. For now, when the providers look at themselves some find a market "polarised" and "in shock", selling sometimes to "ill informed investors" and in some cases offering structured products where the total expense ratios "are absurd".

From a private banking perspective, the default and eventual downfall of Lehmans has radically changed the activity of structured products to the extent that the concept of 'innovation', for the time-being, should be left in the laboratory.

Lynn Skelly, global head of products, ING Private Banking, says a number of private banking clients, though not totally shy of going with the structureds option, are keeping a close watch on the underlying credit risks of the counterparty issuer nonetheless.

"Having got lolled into a false sense of comfort, clients are still looking for some derivatives exposure but examining far more the wrapper and the cash piece, and the credit risk you may have on that cash piece. For the most part the big derivatives houses have responded quite well and offering better-rated issuers and lots of options, but we still have further to go," says Mr Skelly.

Peter Ham, head of transaction products at UBS Wealth Management, calls for next-stage products to arrive minus the bells and whistles which have accompanied the more advanced structured solutions in previous years. "I get nervous when innovation is mentioned and I'm not a fan," says the private banker. "It was popular in the 1990s and 2000s but innovation is not what clients are looking for now. They are seeking straight-forward payoffs instead," he adds.

Mr Ham, occupying the space between investment bank think-tanks and the family offices and high net worth individuals, believes that what currently works for wealth managers are ideas "tuned into our clients".

The delivery mechanism used by private banks to shift structured products has also come under scrutiny as clients seek clarification that their investments are not being exposed to failing counterparties. "I run an open architecture platform on the private banking side and the good news about the current crisis is that it has validated this method of selling. Clients are trying to anticipate the next Lehmans of this world and grappling with how to engage with issuer risk," explains Mr Ham.

UBS Wealth Management's products provide clients with three-way pricing. "It's fair to say clients simply don't give any credit to rating agencies anymore and don't rely on them for guidance," he adds.

Mr Skelly agrees that open architecture is moving into the limelight. "How have attitudes to structured products changed in recent weeks? Clients have been looking for open architecture from private banks and lots of these banks have moved to that business model," comments Mr Skelly at ING Private Banking.

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TIMOTHY HAILES, JOINT ASSOCIATIONS COMMITTEE

He concurs with Mr Ham that selling new and "cleverer" solutions to a bedazzled customer base has been suspended. "Innovation is proving not to be such a great sales pitch and clients in hindsight wish these products had not been as innovative as they had been," he says. "If I see algorithms and Greek symbols I'm turned off already. The marketing material should be fewer than four pages and not misleading."

The private banking industry now has an ideal opportunity to steal some of the glory from the investment banking world in the provision of expert advice and after-sales service related to structured solutions, reckons Mr Skelly. "It's about establishing this relationship on an advisory basis and not on a product basis," he claims. "For us the differentiating factor is having the expertise and not just the necessary architecture, in some ways to protect the client from the investment banks. We see this as an opportunity to offer this level of advice and look at portfolio management and not just product pushing."

While the message that structured solutions will in 2009 comprise more plain vanilla characteristics, Blue Sky Asset Management CEO Chris Taylor goes further with his forecast that this year will be for non-bank providers and boutique market-makers to seize the moment.

"The question of independence is coming across strongly in the marketplace today. People want to see value and independence in their products and not to see someone has dreamt up cheap derivatives and then invented a sales or marketing message as dressed up research-driven structuring," he says.

According to Mr Taylor, traditional private banks, especially those part of wider universal banking franchises, should expect stiff competition from indies in the next 12 months. "Clients perceive that at the end of the red carpet, they are being offered a product but not a solution. Independent wealth managers will give private banks a serious run for their money. We are talking more about service and solutions, research-backed portfolio advice and this will be a challenge to them.

"The market is polarised and clients and advisers can spot the difference between two ends of the spectrum – easy products versus intelligent issuers," he adds.

DIFFERENT CLIENTS, DIFFERENT NEEDS

Lea Blinoff, managing director at HSBC private bank's wealth management and investment division, argues that whether or not independent houses will thrive during an expected market shakeout depends largely on the client type."Wealth management continues to be a fractured industry and even the top three players only have about 7-8 per cent market share each, so it may be possible for specialist boutiques to steal some of this business. However it's all about best price from a family office's viewpoint, where the bigger players will be better positioned. Outside of the family office, there is always the case for using a specialist structureds house."

But Ms Blinoff cautions against portfolios having a fixed allocation to structured solutions. Instead they should look consciously at these products as a means of gaining exposure to other asset classes, such as hedge funds or volatility.

Allocation should be governed by suitability and appropriateness and as a means to implement diversification. She adds: "We continue to use and have throughout the market dislocation, structured products as a key means of implementing clients' strategic asset allocation or tactical asset allocation. We don't use a structured product as an asset class in itself."

Against the grain, Alexandre Zimmerman, group head of advisory and investment solutions, SG Hambros, sees room for less simple structured products in 2009. "Clients in September 2008 looked for anything other than complex solutions but the situation has changed slightly and there are investment opportunities in the market," he says.

One area where Mr Zimmerman views this potential is in the better use of derivatives when constructing structured products. He adds: "We are promoting some attractive payoffs to clients as they realise cash is only a temporary investment solution and the private banking world will use more instruments, such as derivatives, to meet client needs."

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LEA BLINOFF, HSBC

Anton Simonet, head of wealth management, Dresdner Bank, questions whether the industry can rid itself of the products mentality altogether, as the business model is set up in such way that pushing off-the-shelf solutions is in many respects the ultimate payoff. "Our industry is not going to be paid for educating the investor base, at the moment it's paid for selling products but we need to be paid on giving expert advice and offering expert solutions," says Mr Simonet.

September last year saw many high net worth individuals in Hong Kong lose money in Lehman Brothers' Mini-Bonds structured notes, which, according to JAC chairman Timothy Hailes, caused the market to refocus on the very real risk of an issuer defaulting.

Since then, a next wave of solutions claiming to virtually eradicate issuer risk have sprung up, one example being DWS' 'Go' platform, which features a mechanism "that sharply reduces issuer risk".

Yet Sebastian Dovey, managing director and head of consulting at Scorpio Partnership, an adviser to the wealth management industry, suggests that the role of structured product distributors and their attitudes towards issuers, the role of issuers themselves and supporting private clients, needs to be addressed in wake of the sweeping changes of 2008.

"Of the top 20 private banks in the world, 85 per cent have gone through a seismic structural change at shareholder level, or gone out of business entirely. We should note that one third of revenues in most of the major markets of these banks were being generated through structured products during 2007-2008," he says.