INTRODUCTION

NEW ENVIRONMENT WILL BENEFIT EXOTIC ASSETS

The structured product arena has undergone a revolution, doing away with the traditional fixed income portfolio and replacing it with capital protection products that explore slightly more exotic offerings, says Elizabeth Cripps

So you think you know what a structured product is all about? Traditionally, it may have been based on a fixed income portfolio, with interest income used in a swap to provide some specific return, either fixed income based or equity based.

Think again. The structured product market has assumed a whole new level of sophistication in recent months. Wealthy investors can take advantage of capital protection techniques in the context of overall asset allocation – so called structured portfolios. They can explore new, exotic options in terms of underlying assets, and even combine them in hybrid products. And they can cream off the top of the market, retaining the reassurance of a familiar structure, by investing in a range of certificates through a mutual fund.

CHANGING STRUCTURES

Andrew Popper, chief investment officer at SG Hambros in London, is a vigorous proponent of the new portfolio approach to structured products, for which he reports growing demand.

"Obviously, at a simple level, a structured product allows you to take a position in a certain market, with capital protection or at any rate in a risk controlled environment," he says. "Recently, however, structured products have been used not only on a standalone basis but also in the context of asset allocation."

The idea, he explains, is that a portfolio is run "in a manner very similar to a traditional portfolio" but with derivative instruments used to provide some form of capital guarantee or protection on top of that.

Popper: vigorous proponent of the new approach

Dickie: innovation from wealth management side

The most significant step, adds Mr Popper, "is that you are able to establish capital protection for the portfolio but continue to manage it on a dynamic basis in the same way as you would without the capital protection. A few years ago, this was not possible. If you had decided on a certain type of portfolio and wanted capital protection, that portfolio would have been rather inflexible."

Structures are also developing in another way, reports Christiaan Sterckx, head of product development at KBC Asset Management, widely acknowledged as one of Europe's leading innovators. Brussels-based KBC has more than €25bn in its portfolio of structured products and launches some 25 new products a month, according to Mr Sterckx.

He has seen a shift from structures based on exotic options to "more plain vanilla" products – high exposure to a particular basket combined with capital protection on a variety of underlyings – at the same time as growing interest in structured products without capital protection or only partial protection.

These, he explains, can boost clients' participation in a particular market by giving up some or all of the capital protection. The use of partial capital protection, in particular, has developed over the last six months, something Mr Sterckx attributes to the market environment.

"On the one hand," he says, "it is cheap on a historical perspective to buy upside, on the other hand, interest rates in the eurozone are relatively low. So we can either offer, say, 100 per cent protection and 40 per cent participation, or 90 per cent plus 100 per cent of the upside. We can increase exposure a huge amount by giving up a small percentage of capital protection. That is something new – imagine what you can do with that concept."

KBC also offers a range of constant proportion portfolio insurance-based (CPPI) solutions, which are, at first glance, almost paradoxical; structured products without derivatives. These, according to Mr Sterckx, offer "a floor level kind of protection". They are based on balanced portfolios, with the specific floor level adjusted according to the client's risk profile, and they aim to keep above the floor by specific management techniques which use only conventional instruments. Offered as a discretionary wealth management service for private clients, these have collected some €6bn.

EXOTIC UNDERLYING ASSETS

At the same time, those structured products which still focus on one underlying asset class are seeing a shift to more exotic classes. Mr Popper says: "In terms of underlying assets, right now the most interesting is commodity markets." Most recent interest from investors has, he says, been in this area, with "significant strides" also being made in real estate structured products.

According to Colin Dickie, director of Barclays Investor Solutions, the market for structured products is polarised, with the retail side remaining fairly conservative, and the wealth management side increasingly innovative. "There is quite a surge in interest in more exotic underlying assets," he says, "and strong support for commodity-based products in particular, given what has happened with the oil and energy sectors."

Barclays has recently launched its GSCI Agricultural Index Tracker, exploiting what Mr Dickie sees as an opportunity within the commodities market.

Across the channel, however, things seem to be moving more slowly. For KBC, which sells in particular to Belgium, Poland, Hungary, the Czech Republic and Slovakia, commodities are less the asset class of the moment than perhaps that of the future.

"There is some interest and we believe commodities can add value because of decorrelation," says Mr Sterckx, "but the demand from clients themselves has

Mutual funds help develop the new face of structured products

Structured products have traditionally been the province of the investment banks, presenting formidable rivals to fund management products. Increasingly, fund houses have been developing their own offerings to compete. But now some houses have gone a step further, co-operating with their rivals to produce funds, which give clients exposure to a range of structured offerings.

According to Andrew Popper, chief investment officer of SG Hambros, Société Générale's asset management arm (SGAM) has been developing structured products, especially structured portfolios. However, he adds that despite this internal trend, externally SG Hambros still sees most structured products coming from the investment banks.

In Germany, funds house DWS has launched itself wholeheartedly into working with the opposition. It has developed a series of funds investing in so-called certificates, taking advantage of growing demand for guaranteed, low-risk products in the wake of the stock market depression.

"Not so long ago, there was a battle between the certificate industry and the funds industry," says Claus Gruber, a spokesman for DWS. "Now we see a sort of congruence between the two. Some certificate players are issuing funds which they wrap into a certificate, and the fund industry is now buying into certificates."

This merging process is, he says, very much in the interests of the end investor. "You have to look at where the alpha is. This is a huge area." There are, he estimates, more than 60,000 certificates in Germany, and about €80bn invested in this kind of product.

DWS launched the DWS Europe Discount fund in August. With assets now at about €120m, it invests in discount certificates – very much a defensive strategy, with returns at approximately cash market plus 200 basis points. Mr Gruber explains: "A discount certificate is essentially a share and a covered call. With this construction, you can buy the share at the lower price and get the amount from the written call. It is a good strategy if you expect the equity market to go sideways or fall. You lock in this covered call amount."

The DWS Bonus Certificate fund, launched in January in combination with Independent Derivatives Consulting, has since raised some €180m. It is, according to Mr Gruber, the first fund in Germany to invest only in bonus certificates. As well as the dividends on a stock, these offer investors a bonus between certain stock prices. The idea, according to DWS, is to offer a security buffer in falling markets, attractive returns in flat markets, and unlimited exposure to bullish markets.

The latest launch is the ZJ Zertifikate Select DWS Fund, which invests 80 per cent in the defensive discount certificates, and 20 per cent in more aggressive products.

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COLIN DICKIE, BARCLAYS INVESTOR SOLUTIONS

not been massive. However, it might be an interesting new thing for months to come."

The most popular underlying instrument right now is equities, says Mr Sterckx. "It came from 100 per cent equity to 80 per cent fixed income in the first quarter 2003, then in 2004-05 it was mainly equal. The last quarter has seen a shift to 80 per cent to 90 per cent equity."

For those investors unable to choose between underlying asset classes, there is yet another approach. SG Hambros offers a structured product, which claims to give investors the advantage of hindsight. It has, Mr Popper explains, three portfolios: one is predominantly invested in equities, with a smaller allocation to fixed income and commodities; a second takes its heaviest bet on fixed income, while the third is predominantly commodities.

"It is capital guaranteed, with three to five years maturity," he adds, "and at maturity you get the performance of the best of the three. You can choose the asset allocation with the benefit of hindsight."

MIX AND MATCH

The other key trend in the structured products market is, of course, towards hybrids. It is a term which can be used in various ways but, says Mr Sterckx, understood as combining different underlying assets in one product, hybrids are growing increasingly popular.

Mr Dickie agrees: "We are certainly seeing some hybrids. I think people just seek diversification." Hybrid structures, he says, might combine a mature market with something more exotic, or just combine two complementary asset classes.

Barclays' new Diversified China Bond is a case in point. It invests in the Chinese equity market through the Xinhau 25 and combines this with base metals. "The idea is that they complement each other," says Mr Dickie. "It is linked to the story of a growing economy, and the demand for commodities that will drive that – it is a push and pull effect."

Structured products, then, remain an unknown quantity – but in a positive sense, the market always has something new to offer. Fund houses and investment banks are falling over each other to come up with new and innovative ways of exploiting the ever-developing instruments. The challenge for wealthy investors is to keep up with them.