SALES GROWTH

Europe is springboard for rise of structured products

Across Europe providers have experienced increased demand for innovative new products as investors seek to shelter capital from market downturns, says Rupertus Rothenhäuser of DWS

No other area of the financial services industry has grown as rapidly over the last few years as structured products for private clients.

This is not a phenomenon that is affecting only the German market, but rather it has now used Europe as its springboard and has reached Asia.

The strong growth of structured products was prompted by the dramatic price falls suffered by stock exchanges during 2002 and 2003. Investors felt the need for security as well as alternative product and return concepts.

Financial institutions seized these opportunities and attempted to regain investor trust with structured products. The environment for developing structured products was very attractive: high volatility, high interest rates and high dividends. After low-risk discount and guaranteed certificates were launched, the markets continued to recover from 2003 to 2005. More and more innovative products were launched which, depending on investor risk preference, either facilitated participation in rising markets with a principal guarantee, or a pre-determined minimum return. Examples of these are the express certificates, high dividend basket and worst of structures.

EUROPEAN ARENA

The structured products arena was also very dynamic in Europe in 2005. Year-on-year growth rates of 20 per cent in volumes issued were no exception. In Europe as a whole in 2005, structured products valued at over €100bn were purchased. The only exception to this was the UK, where the market was stagnant.

The European sales leaders are Germany and Italy. Sales broken down by head of population show in fact that the highest per capita investment in structured products was made in Belgium.

The leading European markets for structured products (Germany, Belgium, Italy, France, Spain, the Netherlands and the UK) represent approximately 90 per cent of the total issue volume for structured products in Europe. The mature markets are increasing, just as fast as the so-called emerging markets, such as Ireland, Scandinavia, Eastern and Southern Europe.

All in all, this is no bubble characterised by strong growth in niche markets, while the major markets stagnate.

On the contrary, this is core business both for the end consumer and product manufacturers. The structured products field has now become a key business activity for investment banks.

As in previous years, customers expressed substantial interest in capital guaranteed products as well as in new asset classes, especially raw materials. At the same time, there was considerable appetite across geographical boundaries for investment products, which primarily exploit rising markets. This is why in 2005 structured products with the classic underlying equities and equity indices continued to attract high sales.

It is characteristic that investors worldwide are home biased. That means that as a general rule European investors engage in euro-denominated investments, such as DJ EuroStoxx-based products, and by contrast Asian investors typically (due to currency restrictions) focus on US dollar-denominated investments in their domestic indices.

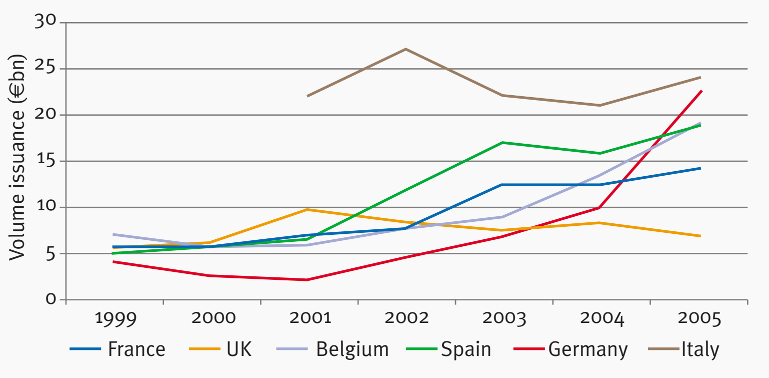
WINNING THEMES

Significantly, customer thinking took a new turn in 2005. Investors became more interested in simpler products (for example, bonus certificates and outperformance certificates), rather than in very complex exotic structures (Kilimanjaro or Adriatic option). In fact, the actual exotic component of a structured product is its underlying asset rather than its repayment or return calculation.

Precious metals, soft commodities, energy, real estate and emerging markets were the key themes in 2005. Unquestionably, private investor engagement in these exotic assets in particular did contribute to appreciation of the underlying investments, and by the nature of how markets work, increasing prices attract more capital and even more investors in their path.

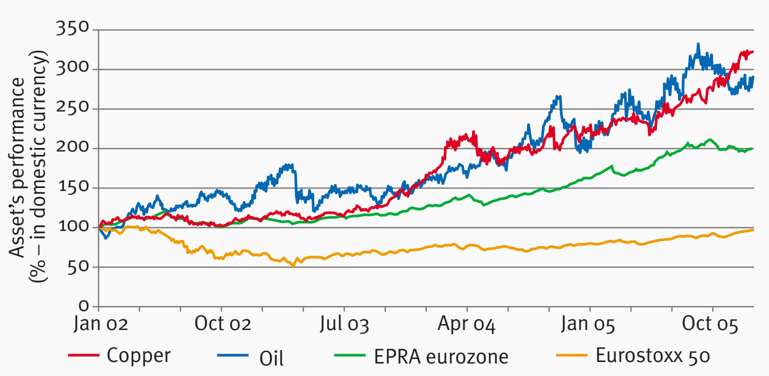
If one considers the percentage historical price development over recent years in certain modern asset classes, it becomes clear that some raw materials titles achieved much higher returns than with

Chart one: volume trends in major European countries



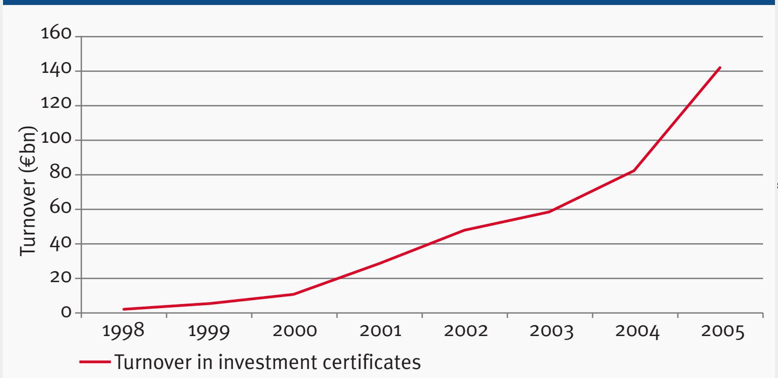
Source: BNP Paribas

Chart two: comparative historical performance



Source: Bloomberg

Chart three: turnover in investment certificates in Germany



Source: Deutsche Bank/BÖGA

equity indices which appear to be more conventional.

Provided the markets are not affected by external factors such as natural disasters or war, one can expect further sales growth for 2006 in an increasing market environment, because structured products can offer access to these interesting asset classes while offering 100 per cent or partial principal guarantees. One can expect a preference for growth-orientated products over guaranteed coupons.

OLD HANDS

Structured products are nothing new for mutual fund companies. DWS, for example, launched its first guaranteed fund in 1993. The composition possibilities were varied: bonds plus option, constant portfolio protection insurance (CPPI), bonds with special exotic options through to CPPI with a dynamic lock-in mechanism. Last year for instance one of our top investments for customers was a fund with a rainbow strategy, namely an option, whereby

"ISSUING STRUCTURED FUNDS HAS BEEN FUNDAMENTALLY SIMPLIFIED AS A RESULT OF THE NEW UCITS III GUIDELINES"
Rupertus Rothenhäuser

at the maturity date the best performing underlying stock is retrospectively overweighted in the return calculation.

The benefit of structured products in a fund wrapper is the combination of the fiduciary duty of the asset manager with modern derivative instruments. In 2005, we recognised a new trend which DWS responded to in the third quarter by launching its Certificate fund family. Unlike guaranteed funds, these funds do not have structured payment profiles, but rather they invest directly in structured products.

In Germany alone there are now over 80,000 certificates; a deluge of products which becomes more incomprehensible as hundreds of new issues enter the market every day. This inefficient market is highly interesting to an active investor like DWS. With their know-how of these instruments, alpha can be achieved for an investor.

And investors are indeed impressed. But the private investor is indisputably over-taxed in making an independent investment decision on certificates. Even when an investor possesses the necessary product knowledge, there is usually not sufficient time to personally consider all the new issues, product types and underlying titles.

On top of this, the vast majority of private investors welcome the fee transparency offered by funds. The customer knows at the outset of his investment precisely which fees and costs he will be charged.

The Certificates in Fund Wrapper product family from DWS is targeted at just such investors. The first launch was the DWS Europa Diskont fund, which invests exclusively in discount certificates from reputable issuers. In January 2006, this was followed by the DWS Bonuszertifikate fund. In 2005 in Germany, bonus certificates were the product most favoured by investors. The fund invests in bonus certificates on selected underlyings, which DWS has found to be especially promising.

Later, in April 2006 came the fund ZJ Zertifikate Select DWS, a fund which will exploit virtually the entire range of certificates as potential investments.

Issuing structured funds has been fundamentally simplified as a result of the new Ucits III guidelines. These EU guidelines permit fund companies to draw on a larger universe of investment instruments and payment mechanisms within a fund wrapper.

The supervisory authorities expect the inherent operational and investment risks of these new opportunities to be managed demonstrably by investment companies. In this case, the key 'value at risk' measurement has been introduced, among others. Fund companies in Germany are required to be able to calculate the 'value at risk' of every fund on a daily basis. This presents a real challenge for exotic options such as a bonus certificate's down-and-out puts. DWS is one of the few mutual fund companies already in a position to do this.

In conclusion, one can assume that the market for structured products will continue to grow. New trends in underlying assets and product composition can be presented speedily to the customer. To what extent structured products really provide added value will most probably become evident when the markets are no longer a one-way street upwards. That is indeed why the structuring specialists and mathematicians in investment banks and fund companies sit in front of their screens.

Quite simply, positive returns regardless of the market are just what every customer wants.

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CORPORATE STATEMENT

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DWS Investments is the mutual fund arm of Deutsche Asset Management, and with €121.2bn assets under management in Germany, it is the largest mutual fund company in the country. In Europe, with €159bn AuM, DWS is one of the leading retail mutual fund companies. It manages €241bn globally, ranking it among the top 10 mutual fund companies in the world. Its unique business model combines global investment knowledge with local presence and responsibility, one single brand and a multi-channel sales and service strategy. Leading positions in rankings of independent fund rating agencies and consistently winning awards confirm the sustainable success and the outstanding performance.