

# A WIDER RANGE OF INSTRUMENTS

The structured products industry responds to pressure to create new, performance based solutions

Due to its vigorous growth, the structured products industry is now facing new challenges. The old times, when basic principal protected products indexed on the S&P500 were successful and matching most distributors' or investors' requirements, are now over.

**'Now more than ever, the concept of an open platform in a structured products department has proved to be a key factor of success'**
**Yann Thomas, SGAM AI**

This could only be a good sign for the industry and its sustainability. The degree of knowledge of most players on the buy side – especially in the wealth management universe – has significantly increased and most structured product selectors or investors are pushing providers to generate new and performance-based solutions.

Until recently, the number of eligible underlying instruments for structured products was very limited. Innovation lay mostly in issuing very sophisticated payoffs on those very common underlyings. Today, most of the innovation and the added value from product providers consists of giving access to alpha-generating asset classes or underlyings.

Market appetite for usual index-linked products or traditional interest rate derivative-linked products has significantly decreased among the wealth management community. The two main reasons behind this fall are:

- Private banks have no competitive advantage to launch those products as the market has already been saturated by them.
- The lack of medium-term visibility from most investors pushes them either towards "non-traditional" asset classes or towards skilled managers or to active strategies.

## UNDERLYING

Innovative asset management groups have been launching products linked to either equity value funds or to dividend-based indexes. These are easier to develop and distribute to the correct audience when a funds house is also linked to a private banking subsidiary of the same group. The average size of collected funds through this route at SGAM in the last 12 months has been between four and six times bigger than the average collected size of product linked to a traditional equity index.

This year, the most popular and successful products among the wealth management community were guaranteed products linked to funds or indices invested in commodities, hedge funds, emerging bond or equities and real estate.

Now more than ever, the concept of an open platform in a structured products department – based on both a quantitative and a qualitative due diligence team – has

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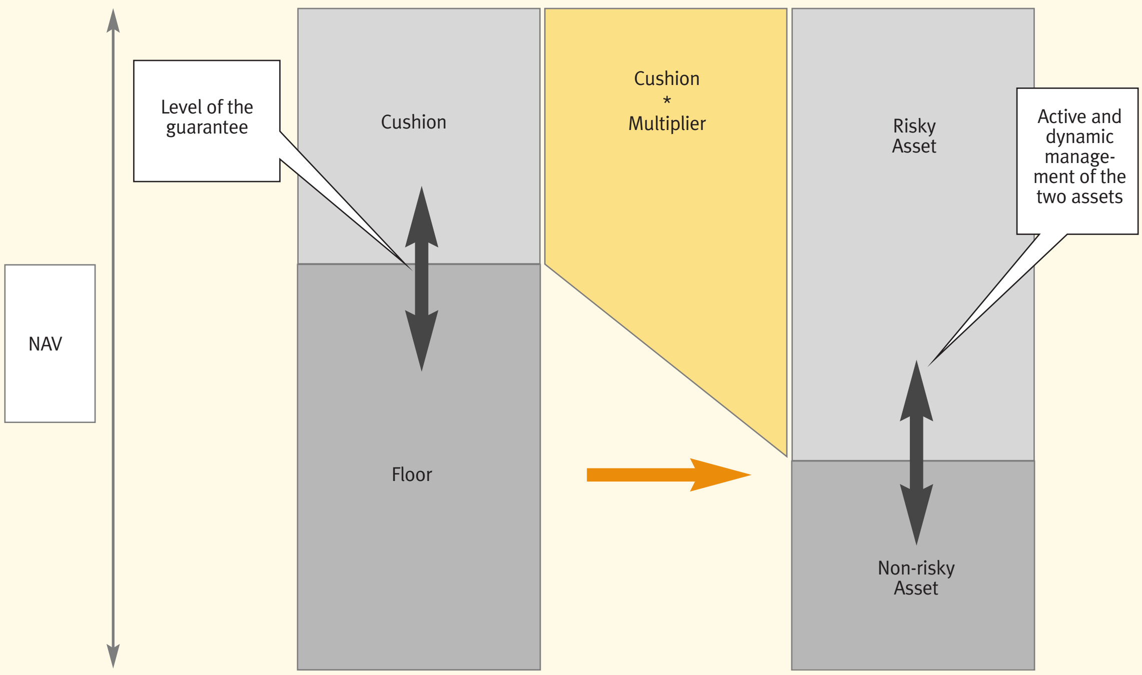
**Dynamic portfolio insurance methodology**




**Definitions**

- NAV: Net Asset Value of the fund
- Floor: The minimum present value of the guaranteed NAV that is sufficient to provide the guaranteed capital at maturity
- Cushion: NAV – Floor
- Multiplier: Leverage applied to the cushion which determines the exposure to the risky asset
- Risky Asset Exposure (%): (Multiplier x Cushion) / NAV

*Source: SGAM AI*

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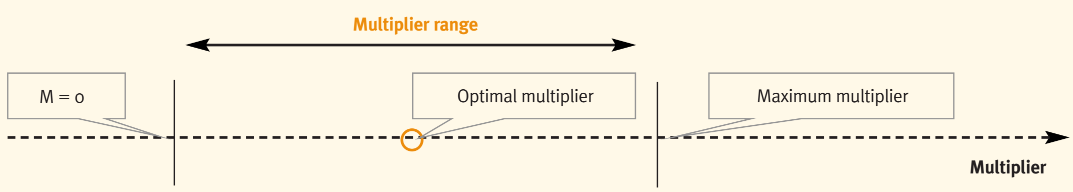
**Multiplier adjustments**




*Source: SGAM AI*

proved to be a key factor of success. Such a team can monitor thousands of funds on an ongoing basis, ranging from hedge funds, to emerging credit funds, to growth or value equity funds and commodities. Its goal should be to identify the best performing managers from either boutiques or large asset managers or to select the index if no sustainable alpha-generating fund is identified on that specific market.

Basic and standard characteristics have to be identified while designing structured products. Those main features are the maturity, the level of capital protection, the level of minimum return, structure of fees, wrappers, coupon features, profit lock-in features and the type of protection (at maturity or at any time) and leverage.

Already at this stage, the choice of the product features should satisfy not only marketing prerogatives but also – and most importantly – performance expectations. For example, shortening the maturity and increasing the level of capital protection or the minimum guaranteed return – which are key points for the marketing success of a product – are ultimately likely to play against the performance of the product. Therefore, when designing a product, the provider and distributor have to find a balance between the marketing impact and the performance of the product.

Each underlying has its own risk parameters and as a consequence is likely to lead to different appropriate structuring.

As far as mature and highly liquid underlyings are concerned, structured products built as a combination of zero coupon plus a standard option can provide satisfying results. This is mainly due to the high liquidity of the underlying and to the efficiency of the correlated derivative markets enabling providers to hedge their risks and to quote efficient options.

## GUARANTEE

However, for most adding value and less liquid underlyings, there is no such organised or OTC (over-the-counter) derivatives market. Product providers are faced with limited solutions in hedging this risk and in offsetting it by issuing products which have opposite risks. As a consequence, the cost efficiency of the guarantee may become a real problem.

Therefore providers and distributors looking to issue competitive product with an optimised cost of guarantee have to be ingenious and tailor each product to the nature of the underlying.

Hence SGAM AI's approach is to analyse the most efficient technique for lowering the cost of the guarantee borne by the investor for each product. It either leads to option-based products or to dynamic portfolio insurance (DPI) based products.

Another solution is to include specific devices to control the volatility of the underlying or to improve its liquidity. Recent issues, such as Nirvana – a six-year capital guaranteed product indexed to a managed basket of Indian and Chinese equity funds and distributed by private banks in Europe, Middle East, and Asia – have been designed to optimise the cost of the guarantee.

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In order to optimise the participation level, the basket of emerging equity funds can be diluted with cash as long as its short term volatility is above a predetermined level (historically almost never reached). This specific device has enabled a boost of the participation levels by more than 25 per cent, thus improving the expected return of the product.

Similarly, the DPI methodology aims at improving the cost of the guarantee. As opposed to constant portfolio protection insurance (CPPI), where the allocation between risky assets and non risky assets is determined by a fixed multiplier, the DPI methodology multiplier is variable, managed to be inversely correlated to the realised volatility.

## ACTIVE

Active – also called dynamic – management has turned out to be a key competitive advantage for structured products aimed at HNWI in terms of performance expectation and marketing impact for the distributor.

Depending on the mandate given to the provider, the active management can either lie in optimising the product underlying funds selection, in the active asset allocation (for multi-asset products) or in the management of the interest rate sensitivity through the lifetime of the product.

For dedicated products, this active feature also becomes a significant marketing tool for the wealth manager. The wealth manager or the private bank can participate and also become a partner in the development and management of the structured product.

The flexibility offered by these solutions has enabled providers to deal with many family offices or directly with some ultra high net worth investors who hitherto had been totally reluctant to invest in traditional and passive structured products. For instance, the last product SGAM AI issued for such an investor was a seven-year note indexed on a portfolio of Japanese equity mutual funds, Indian equity mutual funds, Chinese equity mutual funds, and hedge funds.

What made these sophisticated investors choose the product was that at any time the investment adviser can intervene in the allocation between the four asset classes and replace the selected funds.

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