

# Structured Products

## FAQ's

As with any investment decision, reaching a final verdict requires careful consideration of the facts and figures. While we're all familiar with 'frequently asked questions' – in investments and beyond – it's worth remembering that frequency doesn't always equal importance. In this document, we'll focus not just on the answers typically provided, but on the more meaningful questions we should be asking. After all, it's often the quality of the questions that leads to the most informed outcomes.

### What actually is a Structured Product?

To put it simply, it is the investment product that results from a combination of bonds and options put together to achieve the desired return for investors. Demonstrating how these blocks are put together to deliver different structures and returns brings clarity to the response. The client should understand how the investment is designed with the assistance of explanatory diagrams at the investor's disposal. Most products will have a clear set of outcomes depending on the performance of the underlying indices or stocks the product is linked to.

### What is my client buying?

A common misconception is that a structured investment is the same as a mutual fund, or they believe that they have invested directly into the underlying index, commodity etc. Here the client needs to understand that the investment takes the form of a debt to the issuer who agrees to pay back to them the capital and returns being offered subject to a set of pre-defined conditions. There is no need to hide this fact - a cash investment does the same thing.

### What happens to my client's money?

Knowing the name of the institution that is responsible for delivering the returns and the capital is crucial. The client needs to be fully aware of the risk that they may lose a portion, if not the entire investment with the possibility of a bank defaulting. Whilst the majority of banks remain robust, there is still a risk that comes with it, particularly in times of turbulence. Information from the rating agencies, lending rates, and capital ratios can help clients and advisors evaluate the risks.

### More about the Counterparty Banks

It goes without saying that counterparties (the banks investors are 'lending' their money to) are very important when creating structured products. Most of the major banking groups will have an investment arm that can provide the necessary components to build such products. As with any market, there are a number of key factors to consider when selecting and reviewing counterparties. Here are some of them explained below:

#### Financial Strength

Rating Agencies analyse an institution's financial strength with a view to providing an opinion on the probability that they can repay debts. As a general rule we would require the rating to show that the bank is low risk with its ability to meet its obligations seen as good. An "A" rating by any of the three main agencies confirms that this criterion is met. A further pointer is the progress towards the institutions "Tier 1" or capital adequacy target - the level of capital that must be put aside to cover its debts. For more information on this please refer to the document on Tier 1 Capital Ratios.

## Fair Value

The CDS (credit default swap) rate is the premium that an investor would pay to insure against a default on a bank's debt. In terms of a structured investment, it is useful as an indication of how 'risky' the market feels a particular institution is and also as a guide for the rate payable by the bank in return for borrowing the investors' money. This rate a bank pays to 'borrow' money is often referred to as their 'funding level'. The higher the funding level of the counterparty bank, the more cash will be available to provide the returns to the client. If a bank's funding level is close to its CDS rate, this can be an indication that investors are receiving fair value for the credit risk they're taking. But this still needs to be viewed as part of the assessment as a whole. More information on CDS can be found in a separate document at the same location as this.

## Market View

A company's reputation, its relative industry standing, and analysts' views are also part of this assessment. Negative publicity can make the counterparty unattractive, by undermining investors' confidence and impacting the share price. Whilst these views are sometimes subjective rather than substantive, they are considered in the assessment process.

## Summary

Together these factors provide a rounded picture of the counterparty, and it is this which will underlie our decision to work with them.