

ARE STRUCTURED PRODUCTS REALLY A HOLD TO MATURITY INVESTMENT?

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As users of these financial instruments you will be aware that structured products are definitive with regards to the payoff at maturity. 'What you see is what you get' is a term you hear used reguarly.

In essence, it is simple to produce a payoff table detailing certain scenarios and to show what return the investor will receive in each of these. Retail-structured plans are predominantly five years or over in duration, but what happens to the price of the plan throughout its term? I will try to explain in this article the main drivers for price movements of structured products and also whether secondary market sales should be considered.

Let's take a vanilla five-year 100% capital guaranteed bond plus long call structure on the FTSE 100 as an example. At maturity, the payoff will be linked to the percentage rise in the underlying muliplied by any participation achieved. But throughout the plan's term, its price will have moved around considerably. The main drivers for this price movement will be: the spot price of underlying relative to the strike; interest rates; volatility; time value and current credit / funding levels of the counterparty.

All of the factors above will contribute to both the price of the underlying options and of the bond component of the structure. In addition, there are sensitivities upon these which need to be considered. Probably the most pertinent amongst these is delta. The delta of an option represents the sensitivity of the option price to movement in the price of the underlying. The delta of an option is not constant throughout its life. It will change with the time to maturity, underlying's price and implied volatility as well as other market factors. For example, for an in-the-money call option, as the underlying's price increases the option's intrinsic value increases in line with the underlying price, whilst the time value decreases by smaller and smaller amounts, hence the delta increases, tending to 1 when the option is deeply in the money.

A delta of 1 means that for every 1% change in the price of the underlying, the options value follows suit (providing all other factors remain constant). Typically, the delta is less then 1 throughout the plan's duration, which means that the price of the plan will not mirror the increase in the underlying. For example, a delta of 0.5% means that for every 1% gain in the underlying the option price increases by 0.5 (if all other factors remain constant).

Calculation agents for the most part provide a liquid secondary market for structured products. They also publish bid-and-offer prices on many information feeds or their own websites. Some even provide online trading tools. A key point to consider is that the maturity values of plans may not have been the highest return that the plan achieved.

Merchant Capital are looking to make sure that all prices of plans are monitored and possible opportunities of taking profits from plans that are offering high bids in the secondary market are suggested to investors. By doing this we believe that a greater level of service is provided to investors as well as the potential for greater profits. In conclusion, trading out of plans prior to maturity can sometimes be lucrative and it is important to understand the factors which contribute to the dynamic pricing nature of a structured product during their terms.

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