

INVESTMENT STRUCTURED PRODUCTS vs UNIT TRUSTS

FOR STRUCTURED PRODUCTS: JOHN GRACEY, DIRECTOR OF STRUCTURED PRODUCTS, MERCHANT CAPITAL

Structured products are complicated and incorporate derivatives. To understand their inner workings may require knowledge of options, but from the point of view of risk you can choose how much you are prepared to accept. Risk can range from full capital protection (offering certain, normally modest, returns) to higher-risk kick-out plans based on a few stocks or commodities that offer you substantial (but more risky) returns. The risk equation must also include the strength of the issuer. It is imperative to check this.

Structured products incorporate risk, but so does all investment. The important point is to understand the level of risk and be comfortable with it. Risk itself does not rule out structured products.

The risks of structured products are precisely defined. There is counterparty risk (who is the issuer and what is its financial status?). There is capital risk; typically this is based on a 50% protection barrier which, if not broken, means your capital will be returned in full on the plan's maturity. The risk to your plan income or growth is also defined, normally in

terms of the underlying index itself: is it above its start level or at some other pre-defined level? If yes, income or growth payments are secure. Some of the risks to take into account if investing in a unit trust (which do not apply to a structured product) are:

- Will the fund manager beat his benchmark or will you end up holding one of the many dog funds?
- Will the fund manager invest in accordance with expected investment parameters?
- Will a star investment manager be poached by another firm? Do you sell and realise a gain that might be taxable?
- Are there conflicts of interest between the fund manager and the companies in which he invests?

An investor in a unit trust typically looks for exposure to the major investment markets. Let's take the FTSE 100 as an example. Compare a recent structured product, which offered the growth in the FTSE 100 over five years plus 35%. Your capital was protected as long as the FTSE did not break the protection barrier (in this instance go below 2,500 points in the next five years). Even this risk to capital dropped away if the FTSE 100 was more than 10% higher than its start level on any anniversary of the plan.

First let's compare a FTSE 100 tracker fund. The FTSE tracker will give you the increase or decrease in the FTSE 100 over the term of your investment; you will not get

dividends re-invested. If the market falls you will lose your capital. The structured product offers you both a better return and better capital protection.

Now compare it with an actively managed unit trust. What is the unit trust's benchmark? Is it the FTSE 100? How many actively managed unit trusts have actually beaten the index by a margin of 35% over a five-year period; will the manager's stock-picking skills continue for the next five years? What if the market itself goes down 10% or 20% over the next few years?

The investment decision is simple; the outcome of the investment in the structured product is clear and much of the worry of investing is eliminated.

In the case of structured products, the costs are now disclosed fully and in almost all cases paid upfront. The provider charges a fee (to administer the plan throughout its term) and the adviser is paid a fee for their advice (the amount is fully disclosed). The product's performance is set out in the brochure and will not be impacted further by costs. The only exception is where clients may choose to surrender their plan early. Then an administration fee will be charged.

Compare this with the death by a thousand cuts of an actively managed unit trust: there is likely to be an initial charge; an annual management fee; an administration or custody fee; and potentially a performance fee if the fund does well.



FOR UNIT TRUSTS: JULIE PATTERSON, DIRECTOR, AUTHORISED FUNDS AND TAX, THE IMA

The argument for authorised funds is a simple one. Authorised funds present a safer investment for the ordinary retail investor than structured products because they are regulated and subject to specific investor protection safeguards.

With an authorised fund (a unit trust or an open-ended investment vehicle), the underlying assets are held by a trustee or depository in safe-keeping: they are not held on the balance sheet of the fund manager. Although the value of an investor's assets may go up or down, they are held safely by an independent and regulated third party. In contrast, an investor in a structured product gives money to the provider, so the underlying assets backing the structured product are not subject to detailed regulation or independent oversight.

Authorised funds are governed by strict rules and are independently overseen. The trustee or

depository of the fund regularly checks that the fund is being managed properly. If the trustee or depository is not satisfied that a fund's holding meets requirements, it can require the fund manager to sell an asset. The ordinary retail investor also benefits from diversification: of both market and counterparty exposure.

Strict rules governing authorised funds generally dictate a maximum exposure of 20% to any one issuer or counterparty. With structured products there is no such restriction and many will have 100% exposure to a particular counterparty.

According to IMA research on the effect of Lehman's collapse on UK authorised funds, only a small number of funds were affected and very marginally. This provides strong evidence of the importance of diversification and the need for effective independent oversight and good information for investors. Where fund managers had used Lehman's as a counterparty for derivative transactions, they were able to call into play the standard legal documentation they had in place, allowing them to close out those transactions.

Authorised funds must disclose risk, charges

and performance. Because an authorised fund's price is typically valued daily according to strict rules, the investor knows the net value of assets at all times and has the ability to redeem at any time at the published price, with no hidden costs. What can be charged to an authorised fund is also subject to detailed rules. No such rules apply to structured products.

Unregulated products have their place in the investment universe. However, the IMA contends that any investment products sold to retail investors should be subject to similar disclosure requirements. Where products are listed, they are subject to certain reporting requirements, but they are not designed with the ordinary retail investor in mind.

The need for retail investor-focused disclosure is self-evident from the fall-out from the credit crunch. If structured product providers are already putting sound governance structures and disclosure practices into place, they should have nothing to fear from rules that seek to achieve just that. I invite them to join the side of retail investors in this debate and to cease lobbying for structured products to be exempt from such rules.