WHAT IS THE EFFECT OF AVERAGING ON STRUCTURED PRODUCTS?

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Plain vanilla structured products such as a bond plus call option can provide an investor with a defined return at maturity and often an element of hard protection. At their simplest, these returns at maturity can be very transparent for the retail investor, especially if the underlying component can be easily monitored. However, as many retail structured products increasingly contain an element of averaging, it is important to discuss the effect that this can have on the maturity value of these products.

Averaging is achieved using what is referred to as an Asian option. The payoff is determined by the average underlying price over a pre-set period of time. This is different from the usual European and American options where the payoff of the option depends on the price of the underlying at maturity. Because of this fact, Asian options have a lower volatility and hence they are typically a cheaper alternative to their European / American counterparts.

The main use of averaging in retail products is to cheapen the option and therefore allow more to be spent on enhancing other variables in the product. Usually, averaging takes place between 3 and 12 months prior to maturity and takes monthly observations. In addition to the cost benefits, averaging can also limit losses in a falling market. However, it can also limit gains in rising markets.

Some perfect examples can be seen in the recent volatile markets. For example, using a recently matured 6 year growth product with the FTSE™ 100 Index (FTSE) as the underlying, an investor could have expected a moderate growth return after the recent rally in the FTSE. However, if the product had averaging over the previous 12 months, then this gain would be considerably lower. This is because one year ago the FTSE level was around 4,400 (as at 12/05/2010 the FTSE 100 was 5383) and this lower level would be taken into account using the average levels over the last 12 months of the FTSE.

Conversely, during the falling markets of 2008, a growth product with 12 months averaging beginning in early 2008 would have taken the first level of the FTSE at over 6,000. This high level would be taken into account leading to a higher performance at maturity then a product maturing without averaging at the end of 2008 when the level of the FTSE was around 4,000. These factors are both interesting and can also have considerable effects on maturity values.

Averaging or Asian options can be used in other ways in structured products. Averaging can be used at the beginning of a product to determine the strike of the underlying. It can also be used on observation dates, typically on kick outs. Here the average level of the underlying can be used prior to a observation date to determine whether the “trigger level” has been reached.

Whether the effect of averaging is beneficial or detrimental will of course not be known until maturity of a particular plan but it is just one of the risk mitigation tools that can be used by product manufacturers to help them to produce a range of plans that appeal to different clients and risk appetites.

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