

Structured products - are they worth considering?

Structured products are a confusing issue, appearing under a variety of different names: National Savings & Investments (NS&I) call them guaranteed equity bonds; other companies may call them protected FTSE growth plans.

The general idea behind them is to provide an investment vehicle linked to the stock market or an index where, in theory, you cannot lose your money and you may enjoy the gains in the market over a fixed period (normally about five years). Many offer the bonus that, if the market falls, you cannot lose any money. The National Savings product is possibly the safest investment because it is protected by the Government's treasury department. Other structured products are protected by so-called very secure banks but (as was discovered when Lehman Brothers went bust), many people lost a significant amount of the value of their structured products. As investors in Key Data recently discovered, the regulator was incapable of understanding that a massive fraud had taken place over a long period of time. It finally came to light when Key Data collapsed into liquidation and the money that the regulator and everybody else thought existed in Luxembourg had actually disappeared!

As I prepare this bulletin, NDF (another large provider) may be going into liquidation because (amongst other things) they used Lehman-backed structured products.

The first point therefore to consider when investing in a structured product is that it is opaque and very difficult to understand – even if it is issued by NS&I.

Perhaps the simplest route and possibly the safest arrangement is to consider the NS&I scheme and whether it has any merit. If the idea is to invest your money in an absolutely secure investment where you cannot lose your capital, then surely it is better to invest in the Easy Access National Savings Account or Premium Bonds – even though the yield is extremely low, the capital is secure, it is accessible, and there is a modest return. Accessibility is really quite key because a structured product ties up the capital with severe penalties if the contract is broken within a specified period.

The NS&I product creates a gain based upon the increase in the FTSE index over a five-year period. However, the maximum gain is 50% of your original investment, which equates to a compound return of 8.45%.

In looking at the dividend yield on the FTSE 100 index as I compare this note, it is 3.4%. Over the last two years, it has varied between 3% and 5%, so let's take an average of 4% as a prospective future yield, albeit that of course dividends could decline in the future.

In five year's time, if the FTSE 100 index is exactly where it is today, on the NS&I product you would simply get your money back with no gain or loss. If you bought the index as a tracking fund, you would achieve a dividend yield, which if it were 4% would create a capital gain of 21.6%, i.e. compounded yield. Conversely, the market would have to fall by approximately 20% before you would lose any money; in other words, your dividend when added to the reduced value of the market would still give you back the same value as your NS&I product.

If the market moves ahead, then of course you enjoy the gain plus the dividend. So if the market is positive throughout the five-year period, then investing directly in the market will always produce a better return than investing in the NS&I product.

In conclusion therefore, if the market falls by more than 20% then you may be better off with the National Savings product. Then again, your risk profile would probably determine that you were not interested in investing in any type of investment with that sort of risk and therefore you would be even better off in the Easy Access National Savings Cash Deposit Account where at least you will have a little bit of interest return.

The above synopsis is pretty true of almost all structured products. It seems from our perspective that the main beneficiary of a structured product is the issuer and not the beneficiary. There have in the past been some very attractive structured products particularly where yields have been fixed at 8% and/or when the market has been particularly depressed (as it was in March 2003). If there is a dramatic correction in the markets and they return to the position that we saw in say March 2009 or March 2003 – and if we could see terms which created a real yield of growth and dividend cover equivalent to a reasonable estimate for returns on the FTSE 100 index – then we may recommend a structured product.

In the meantime, we continue to avoid these arrangements because:

- They represent poor value
- There may be a risk of loss of value if markets do not perform
- You could achieve a better return elsewhere
- Arrangements outside the NS&I product (the counterparty risk), i.e. the person giving the guarantee, which is not normally the issuer of the contract, may well default.

I hope these notes help.

PM

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