Why I don't (yet) recommend structured products

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I was recently invited to attend a seminar run by a provider of structured products. Because I try to have an open mind about investment and because I believe there is always the opportunity to learn, I attended. Here is an "open letter" to the company concerned – I have sent it to them, but think it would be unfair to disclose the company's name; while not all structured products or their manufacturers are the same, it seems to me that the principles outlined below are the same for all, and therefore singling out one company would be inappropriate.

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Dear ____

Thank you for inviting Catherine and me to your recent seminar. It is important to stay abreast of developments in investment and I found your presentation very interesting and informative. Having reflected on your presentation, I will still not be recommending your products (or indeed any other structured products) for the time being. I think it only fair to explain why.

You began the presentation by asking a number of questions, which you yourself said were loaded. Among these, you asked if anyone in the room thought that the FTSE100 index would be below 2,750 in five years and were positioning clients accordingly. Unsurprisingly, no-one in the room thought this (for myself, I have no opinion in the matter) but that's not the same thing as saying it couldn't happen.

You then showed that you could create products which had limited downside unless – a crucial word, 'unless' – the FTSE fell by more than a set 'barrier' level, typically 50%. Below this point, the value of investment fell in line with the index. I would submit that this is like giving someone an umbrella in the sunshine, allowing them to keep it when it's drizzling, and then taking it away in a downpour. It fails to protect a risk-averse client at the very moment of greatest need, when the market is sharply down.

The point was made that dividends are forfeited. You agreed with this, but countered that if the market falls that far, companies would be unprofitable and not paying much in the way of dividends. This is, frankly, rubbish – the market fell 44% between October 2007 and March 2009, without any noticeable reduction in dividends that I am aware of; the yield on the FTSE simply went up. Dividends represent a massive share of any UK equity investor's return. I worked out recently that someone investing £100 in the FTSE All-Share in January 1986, even if the market collapsed to zero price on 7th May 2010, would still have £572 in dividends received.

You claim that you can remove an investor's equity market risk and replace it with credit risk. I accept that it is possible to do this for an investor – but at what cost? I would contend that, while the investor would appear to have shed the equity risk, such risk is still inherent in the product and someone must be carrying it. And if it's not the investor, then – because the counterparty is not a charity – the investor is paying for it, both in actual fees and in loss of performance, whether through lost dividends, or a cap on

performance. (Another of your scene-setting questions was, Do you think the market will go through 9,000 in the next five years – again, I have no opinion, but that's not the same as saying it can't happen.)

Structured products are a zero-sum game – there is a winner and a loser in every deal. You point out that investors don't care if the counterparty loses. True; but neither does the counterparty care at the level of any individual deal. That's because (like casinos and bookmakers) they always win in the long run, when all their deals are taken into account. They must do, or they would go out of business. The corollary of this is that investors must lose in the long run, even though they may feel happier in the short term – a bit like going to the bookies or the casino, I suppose.

You made the point that it is the mutual fund industry that has told us all we know about investing and that they have a vested interest in so doing. There is a very large grain of truth in what you say, but unfortunately for that theory, they are merely repeating – admittedly for their own ends – what academics from Harry Markowitz, to Bill Sharpe, to Gene Fama have discovered: diversification, and long-term buy-and-hold strategies are the key to success.

Would you accept that there is also a certain irony in that it is now the structured product industry which is educating us about their story? You are clearly very bright people, which is part of the problem. No-one at these seminars, least of all myself, is clever enough to challenge your well-made points 'on the hoof'. I would welcome a forum where you make your presentation to some sceptics who have the research background and intellectual brain-power to challenge points that need challenging. If you ever decide to arrange something like that, please let me know. After all, peer review is supposed to be what science is all about.

I remain open-minded, I really do. It would be brilliant to be able to offer a product with no downside, all the upside, and daily liquidity, but I suggest that, like the perpetual motion machine and the philosopher's stone, it's not possible yet, if ever. For the meantime, structured products remain, for me, the financial equivalent of homeopathy: they make investors (patients) feel better and make the advisor's (doctor's) job easier, but the science says that they are not actually doing anything.

Yours sincerely

David Crozier CFP[cm]

Navigator Financial Planning
3b Milltown Hill, Warrenpoint, Newry, Co Down BT34 3QY
T: 028 3085 1199 E: david@navigatorFP.com

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