Demystifying Structured Products

Investec Structured Products

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Investec
Corporate & Investment Banking

Contents

01	Learning objectives	3
02	What are structured products?	5
03	Myths debunked	9
04	Summary	21

01 - Learning objectives

The aim of this session is to debunk some of the common myths surrounding structured products. We will also explain how structured products are put together, the risks involved and the benefits for both advisers and retail clients.

- Define what a structured product is and understand what is meant by investing by contract.
- Challenge the common myths surrounding structured products
- Understand the benefits of using structured products and their potential uses in portfolios

02 What is a structured product?

- Investment that is designed to offer a pre-defined return for a pre-defined risk
- Linked to the movements of an underlying asset e.g.: stock market index

There are two main types of structured product:

- Structured Deposit – capital protected
- Structured Investment – capital at risk

Structured Deposits

Structured Deposits are … fixed term deposit accounts.

01

Capital protected – no market risk

Legal obligation to return the original deposit at the end of term

02

Return: pre-defined, based on the performance of a reference asset

E.g.: Equity index – FTSE 100

03

FSCS depositor protection up to £85,000 per eligible claimant

04

Taxed like bank accounts

Subject to income tax, interest paid gross

Market: ‘cash’ investors/holdings

Structured Investments

01

Fixed Term

02

Capital at risk

03

Usually some form of capital protection

04

Contract based investment

Legally binding on issuer

05

Return subject to CGT (growth products) and income tax (income products)

Market: ‘equity’ investors

03

Myths associated with structured products: debunked

1 Structured products don’t work in portfolio planning

- Direct alternative to other asset classes
- Work best in conjunction with other investments
  - UKSPA Portfolio Optimiser
- Defined returns and capital protection:
  - Balance long equity positions
  - Low risk portfolios provide cash plus returns
  - Returns in flat, falling and rising markets
- Diversification tool:
  - Active funds take on risk to outperform the market
  - Passive investments follow the market
  - Structured products offer pre-defined returns and a level of capital protection

Available now

UK Structured Products Association Portfolio Optimiser

- Enables Advisers to allocate structured products within a model portfolio framework using an online tool
- Generates independent analysis and full audit trail
- Functionality to include any funds within a clients’ portfolio, or choose from pre-built model portfolios
- Historical & forward-looking analysis: volatility, drawdown and sharpe ratio statistics, and expected return analysis
- Developed by FVC

2 Structured products are too complex for retail investors

- Market choice: simple to the complex

- Transparency:
  - Clear defined returns
  - Pay-outs formula based
  - Defined market risk

- Investing by contract:
  - Legally binding on issuer
  - Client has no investment process risk – contract terms

3 Structured products contain derivatives, which are ‘risky’

- Common misconception that clients that invest in structured products are purchasing derivatives.
  - Structured Deposits: Client’s money is deposited with a bank in the same way as a bank account. The bank is legally obliged to repay any equity-linked return due to the client, and repay the deposit when the structured deposit matures.
  - Structured Investments: Client’s money is used to purchase an equity-linked corporate bond issued by the bank. The bank is legally obliged to repay any return due to the client, as well as the maturity return specified by the terms of the structured investment.

- Client has no exposure to derivatives
  - At the discretion of the Counterparty (i.e. the bank that has manufactured the structured product) as to how it generates any returns due to clients that have invested in its structured product.

- Derivatives are used to hedge returns offered:
  - Provide cash flows at certain date
  - Internal risk management tool

4 Structured products are expensive

- In built charges/fees
- Any returns net of all charges/fees
  - Simplicity
- MIFID II compliant
  - KID available
  - Cost competitive
  - No on-going fees to report

Average OCF of active funds	Average Investment Plan charge *(Investec)*
0.75% - 1.25% p.a.	0.35% p.a.

5 Structured products providers pocket share dividends

- Dividends key component of fund based returns
- Structured Products performance linked to movement in index e.g.: FTSE 100
- Price return index – tracks growth of underlying equities, no dividends
- Reasons clear and transparent why no dividends:
  - Designed to give specific returns
  - Offer capital protection
- Exchanging uncapped returns and dividends for capital protection and defined returns

6 Regulators imposes strict limits on investment in structured products

- FSA guidance 2009
- Consider the suitability more closely if:
  - >10% single counterparty
  - >25% structured investments
- Not fixed limits:
  - Capacity for loss & ATR = suitability
- Scenarios shown where %s over guidelines
- Reasonable approach for any type of investment

Our expectations

3.14 Advisers should always seek to diversify a customer's investment portfolio. The nature of these products means it is essential that advisers should consider both product and portfolio concentration risk and limit the risk to customers of total loss of capital through counterparty failure:

- product concentration – the suitability of the level of investment recommended for a single product relative to the customer's other savings and investments; and
- portfolio concentration – the suitability of the total proportion of a customer's savings and investments portfolio invested in a single product type (i.e. structured investment products).

3.15 This requires an adviser to consider, and take account of, a customer's capacity for loss as well as their attitude to risk.[8]

Good practice: level of investment in structured products

One adviser set himself initial guidelines of 10% (single product) and 25% (multiple products) for the maximum exposure his customers should normally have to this product type, taking into account the customer's wider circumstances.

Source: Financial Services Authority: Quality of advice on structured investment products, 2009

7 Structured products can underperform unprotected equity (fund) exposure

- Can under and outperform
  - Example:

FTSE 100 Enhanced Kick-Out Plan 65:	Start Date: 3 Jan 2017	Matured: 3 Jan 2018	Return paid: **10%**	FTSE 100 Total Return over same period:* **11.16%**
FTSE 100 Enhanced Kick-Our Plan 66:	Start Date: 27 Feb 2017	Matured: 27 Feb 2018	Return paid: **10%**	FTSE 100 Total Return over same period:* **4.31%**

- Trade unprotected equity exposure for:
  - Defined return
  - Capital protection
  - Potential returns if market is falling
- Compliment direct equity exposure
- Diversification of returns

Source: Investec data and Bloomberg

*Includes dividends but before fees

8 Credit risk is unclear

- All structured products expose the client to the Credit Risk of the deposit taker (structured deposits) or issuer (structured investments)

- Counterparty fully disclosed

- There are multiple ways to evaluate Credit Risk, including:
  - Credit Ratings (agencies such as Moody's and Fitch Ratings)
  - CDS Spreads
  - Financial reporting

- Independent comparison websites
  - FVC
  - SRP

9 Structured products are inflexible, clients are locked in

Designed for Full Term

Underlying Unit Price

Calculated Daily

Potential early withdrawal charge (deposits only) – charge varies between issuers

Online Valuations

10 Access to structured products and tax wrappers are limited

ISA/ISA Transfer

SIPP/SSAS

WRAPs/Platforms

Charities

Corporates

Trusts

Offshore Bond

(deposits only)

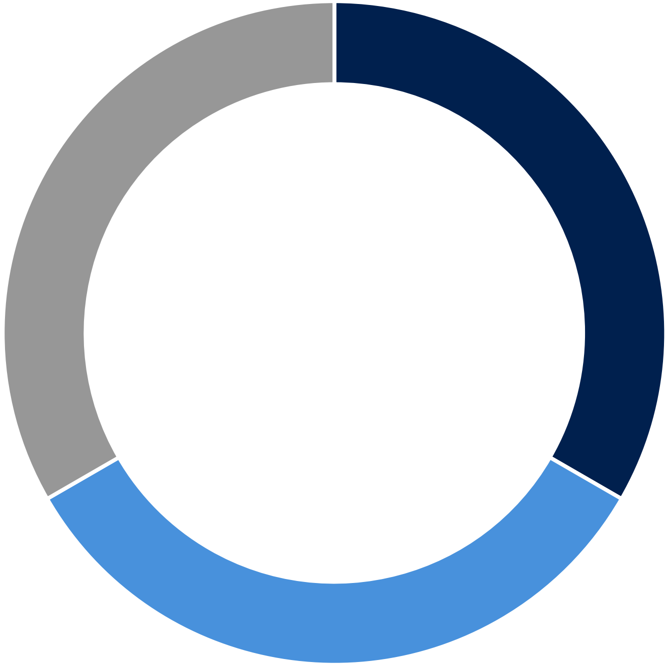
Investec for Advisers

04 Summary

04 Summary - Structured Products

Client portfolios

- Complement traditional asset mixes
- Diversification tool
- Defined returns
- Returns in rising, flat & falling markets
- Capital protection
- Reduce volatility
- Manage portfolio risk



Improved regulation

- Low cost, value for money
- Transparent, easy to understand Plans
- Predictable client outcomes
- Defined risk parameters

Track record

Annual study - UK retail structured product maturities in 2019

- 94.31% produced +ve return
- 4.49% returned capital only
- 1.2% produced a loss – 4 share based Plans

Average annualised returns:

- 6.74% p.a. capital at risk plans (Investec average: 7.49% p.a.)
- 3.01% deposit plans (Investec average: 3.86% p.a.)

Source: SRP and Investec. *Past performance is not a guide to future performance*.

Investec Structured Products

1,175

matured products

£780,400,000

wealth generated for our clients

7.41% p.a.

average returns

- 5.34% p.a. for Deposits
- 9.04% p.a. for Investments

0

instances of capital loss

Figures correct as at 24/06/2020. Past performance is not a guide to future performance.

Market leader (retail)

~55%-60% market share (2019)

Sensible range offering different risk/return profiles every 6 weeks

Deposit Plans: growth and income

Investment Plans: growth and income

Investec Bank plc.

A1	Moody's
BBB+	Fitch Ratings

WINNER TEN TIMES Moneyfacts Awards 2010-2019 Best Structured Products Provider

SRP EUROPE AWARDS 2020

Cash alternative – FTSE 100 Kick-Out Deposit Plan 94

End of Year 3

Is the Kick-Out Level of the FTSE 100 higher than **100%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus **10.5%**

No ↓

End of Year 4

Is the Kick-Out Level of the FTSE 100 higher than **100%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus **14%**

No ↓

End of Year 5

Is the Kick-Out Level of the FTSE 100 higher than **100%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus **17.5%**

No ↓

End of Year 6

Is the Kick-Out Level of the FTSE 100 higher than **100%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus **21%**

No → If the FTSE 100 is equal to or lower than 100% of the Initial Index Level at the end of the Plan term, you will receive back your initial investment with no return.

Probability of pay-out – FTSE 100 Kick-Out Plan

Tables show number of occasions Plans would have matured at each potential maturity dates.

Scenario	Frequency	Frequency (%)
Early Maturity Year 3	5731	75.17%
Early Maturity Year 4	417	5.47%
Early Maturity Year 5	319	4.18%
Final Maturity: +ve return	231	3.03%
Final Maturity: return of capital only	926	12.15%
Total number of tests	7624	

Source of Index Data: Bloomberg. Past performance is not a guide to future performance.

First backtesting date: 3 January 1984. Final backtesting date: 1st March 2014

Equity alternative – FTSE 100 Step Down Kick-Out Plan 37

<u>End of Year 2</u>
Is the Kick-Out Level of the FTSE 100 higher than **100%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus 12.5%

<u>End of Year 3</u>
Is the Kick-Out Level of the FTSE 100 higher than **95%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus 18.75%

<u>End of Year 4</u>
Is the Kick-Out Level of the FTSE 100 higher than **90%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus 25%

<u>End of Year 5</u>
Is the Kick-Out Level of the FTSE 100 higher than **85%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus 31.25%

<u>End of Year 6</u>
Is the Kick-Out Level of the FTSE 100 higher than **80%** if the Initial Index Level?

Yes → Plan matures early (Kick-Out). Return of your initial investment plus 37.5%

No → If the FTSE 100 is <u>lower than 60%</u> of the initial index level at the end of term your initial investment will be returned minus 1% for every 1% market fall

Probability of pay-out – FTSE 100 Step Down Kick-Out Plan

Tables show number of occasions Plans would have matured at each potential maturity dates.

Scenario	Frequency	Frequency(%)
Early Maturity Year 2	5,935	77.85%
Early Maturity Year 3	456	5.98%
Early Maturity Year 4	459	6.02%
Early Maturity Year 5	319	4.18%
Final Maturity: +ve return	381	5.00%
Final maturity: capital loss	0	0.00%
Final Maturity: return of capital only	74	0.97%
Total number of tests	7,624	

Source of Index Data: Bloomberg. Past performance is not a guide to future performance.

First backtesting date: 3 January 1984. Final backtesting date: 1st March 2014

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