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Structured Product Update

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This article considers the current decline in the prices of structured products and highlights how some products may tolerate substantial falls in equity markets whilst still paying out their maximum predefined returns. This article does not constitute financial advice or a recommendation to you. Any products referred to within it may not be suitable for you or your circumstances and you should take independent advice before deciding to invest.

<u>What are structured products?</u>

Structured products are investments that provide predefined returns dependent on the performance of an underlying asset, often a market index, over a set period. They are typically issued by banks and normally comprise a zero-coupon bond and an options package, which will provide gains should certain circumstances come to pass.

Structured products are designed to facilitate highly customised risk-return objectives. There are a number of different types, including 'synthetic zeros' and 'autocalls'. The main difference between these two is that synthetic zeros must be held for their full term while autocalls have the possibility of redeeming early (usually depending on the level of an underlying index on a set annual date).

<u>What purpose do they serve and why do we use them?</u>

They are designed to provide a predefined capital gain at maturity, or to provide income payments over the life of the investment with initial capital repaid at maturity. Returns do not require growth in equity markets, some products can tolerate substantial falls in equity markets and still pay out their maximum predefined returns. They are generally less volatile than their underlying indices.

<u>Apart from capital risk, are there any other risks to be aware of before investing?</u>

The main risk to consider, aside from risk to capital, is the risk of the issuer defaulting (also known as 'counterparty risk'). If the issuer does not fulfil their obligations to pay back the capital promised under the product's terms for any reason, for example if it becomes bankrupt, it's important to know where you rank in a list of creditors. A structured note (a type of structured product) is classed as a senior unsecured debt.

<u>How do they work?</u>

Please note this case study is for illustrative purposes only.

In this example, we'll use a Defensive Autocall with the following features:

- An autocall coupon of 8%
- Barrier drops of 7.5%
- Capital protection set at a barrier of 50%
- Maximum term of five years
- The example client is called Mr. Cooper and his cost to invest is £1,000
- Level taken at exact date 12 months after purchase

We'll use a hypothetical starting point of 1000 for the Index.

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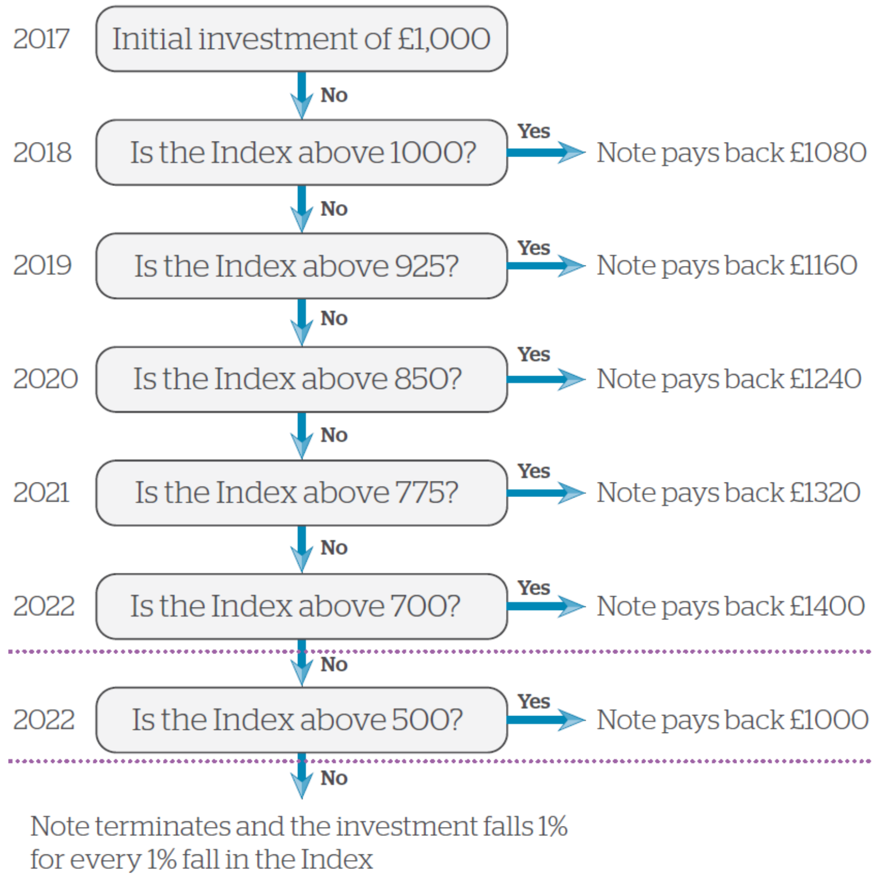

What the above illustration shows:

- If, at the end of year one, the Index is greater than or equal to its starting point, the autocall will terminate and Mr. Cooper will receive his initial investment (£1000) plus the 'autocall coupon' of 8% (£80).
- If the Index has fallen, he will continue to hold the autocall for another year. If, at the end of the second year, the Index is greater than or equal to 925 (1000 minus the 'barrier drop' of 7.5%), he will receive his initial investment plus the autocall coupon of 8% interest for the two years (£160).

If the autocall has not expired before the maturity date (the 'maximum term', five years, after its issue date), then one of two things will happen:

1. If the Index closes at more than the 'capital protection barrier' of 50% of its starting level of 1000 (500), the autocall returns Mr. Cooper's original investment of £1,000.
2. If the Index closes below 50% of its starting level, Mr. Cooper's loss tracks the fall in the index, meaning he will lose 1% of his investment for every 1% the index has fallen by.

Please be aware that, under this arrangement, Mr. Cooper theoretically has the potential to lose all of his investment if the Index were to fall to zero (or if the counterparty failed to fulfil their obligations).

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Why have the prices of structured products fallen?

The large market falls witnessed over the last three weeks have seen the sensitivity of a structured product's price increase from around 50% to 80% (this is known as the Delta) to the underlying market indices that they reference. The pricing of the structured products has not just been impacted from the sharp falls in equity markets, but also from a sharp rise in price 'volatility' and widening credit spreads (the two main other ingredients which help primarily determine a price of a structured product). However, we believe that these falls do not reflect the likely economic outcome and upside potential.

Brooks Macdonald typically invests around 10% to 16% allocation into 'defensive' structured products for Low, Low to Medium and Medium risk portfolios.

For a structured product to be allocated within a Brooks Macdonald portfolio, the note must provide 'soft capital protection' of at least 35% (capital is at risk on the date of maturity if the underlying reference index has fallen by more than 35% from the index level set on the issue date).

How much further can equity markets fall before a structured product doesn't produce a positive return?

We buy structured products throughout the year and thus each product has different initial reference index levels. As detailed above, Brooks Macdonald only buys structured products which offer 'soft capital protection' of at least 35% of these initial reference levels. This results in the structured products within a Brooks Macdonald portfolio having a diverse set of maturity dates and reference index levels.

We have recently conducted an in-depth analysis of the most widely held structed products in Brooks Macdonald portfolios and these products can tolerate substantial falls in equity markets and still pay out their maximum predefined returns. Despite the falls seen in the prices of structured products, the actual term structures are still offering significant capital protection and that capital is only at risk (apart from counterparty risk) on the final day of maturity.

Structured products are complex return investments which may not be suitable for all investors. Investors' capital is at risk and is not guaranteed. Should the counterparty fail, you may not have access to the Financial Services Compensation Scheme (FSCS). Investors should speak to their advisers for further information and to ensure they understand the risk and return factors applicable in their case.

The value of your investments and the income from them may go down as well as up and neither is guaranteed. Investors could get back less than they invested. Past performance is not a reliable indicator of future results.