# 1 Introduction

Structured products have been on the rise since the late 1990s but then lost the trust of the investors in the credit crisis of 2008. Global statistics are difficult to gather, but an estimated EUR 1000 billion of structured products investments were held in portfolios worldwide as of 2007. According to the Swiss Association of Structured Products SVSP[1], assets of over EUR 220 billion were invested in structured products held at Swiss banks in 2007, which amounted to roughly 6.5% of total assets under management in Switzerland. In Germany, the second-biggest market, about EUR 134 billion were held in portfolios. Since then, the amounts have sharply decreased. Nevertheless, individual as well as institutional investors have recognized the benefits structured products generate with their specific risk-return profile that cannot be replicated by the usual investment vehicles such as equities or bonds.

In fact, the structured product market grew so fast and became so diverse with thousands of payoff profiles in all asset classes, that many stakeholders, be they banks, financial regulators or private or institutional investors, were caught unaware and had no systems, rules, laws or processes to cope with the sheer amount of innovation that appeared in so little time. However, professionals in their respective fields reacted quickly and allocated enough resources to handle structured products: systems were programmed, rules and laws came into effect, and processes were implemented. The two stakeholders that were partially left out in the resource allocation were those furthest out in the value chain: the investment advisor and the end-user. Structured products knowledge was slow to come to private banking investment advisors, and hence to investors being advised by them.

The success of the financial industry as a whole, as well as that of individual products, is measured by the revenues they generate. Consequently, the industry's best interests are served by satisfying the needs of the investors. Whatever type of product sold most must therefore inevitably be the one preferred by investors. But does the end-user really know what he is buying, even though the terms are written on the final term-sheet? Have his preferences correctly been assessed, or have they possibly been framed in such a way that the investor only *believes* that one or the other product corresponds to his preference? The author supposes that a majority of private and institutional investors do not have a deep enough understanding about the products' functioning and the associated risks. How could they? Even the professionals do not always agree and sometimes are not aware or don't consider all the risks embedded in the products.

The volume-driven incentive structure of the industry and the relatively poor end-user knowledge has led to markets becoming overwhelmingly concentrated in a certain type of product, based on investors' uninformed preferences and decisions. In one of the largest structured product markets, Switzerland, the private banking clientele's appetite for one particular type of product from 2004 onwards outshone any other product category offering, despite the fact that more attractive and financially superior (on an after-tax basis), products could be invested in. This ravenous consumer appetite caused issuers to push the

[1] Schweizerische Verband für Strukturierte Produkte, www.svsp-verband.ch

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cost-minimizing and volume-maximizing structure known by the name of "worst-of barrier reverse convertible"! It first brought about the assignment to investors of financial stocks in the subprime crisis of 2007/08 and distorted many portfolios' risk structure in addition to producing heavy losses. As the crisis deepened and stocks plunged on a broad basis, all kind of stocks were assigned. In another large market, Germany, it was the "discount certificate" that took the lion's share of the investor's attention. A similar tendency happened on the other side of the globe, where clients in Hong Kong, Singapore and other Asian countries rushed to the "leveraged stock accumulator". In Korea, the attention was focused on the "autocallable reverse convertible". All the above-mentioned products were based on similar construction techniques and met with the same fate: a large number of their barriers were broken through, thus knocking the embedded short options in, much to the chagrin of the investors.

Structured products, which have never enjoyed a particularly good image, have become disreputable, particularly after the subprime/credit crisis. Especially since the demise of Lehman Brothers, structured products have come under heavy criticism. Aren't CDOs[2] structured products? Aren't bad mortgages repackaged by financial institutions and sold as CDOs? Isn't the source of the subprime crisis bad mortgages? Didn't the subprime crisis develop into the worst financial crisis since the 1930s and make everyone the poorer? Yes, yes, yes and again, yes. Yet it's not the investment vehicle that is to blame; rather it is the people participating in the game, and that includes everyone from the structurer to the final investor.

If anyone opens a European financial newspaper, journal or review and takes a look at the advertisements, he will notice that many of them are about structured products. Those ads are not about complex structures like CDOs, which are products used by institutional investors such as insurance companies or pension funds. Instead, most ads are promoting what seem to be simple investment strategies based on popular themes or commonly-known stocks or indices. Their content usually consists of great sounding but meaningless slogans, double-digit coupons or bonuses, nice pictures, fancy product names not found in any dictionary and colorful graphics as well as a lot of small print. In fact, structured product promotions don't differ that much from car or holiday ads. The only difference is that product names like "Reverse Convertible", "Bonus Certificate" or "Capital Guaranteed Product", commonly-found word combinations in structured products, are not as explicit as "The new Toyota Avensis" or "Sunny Holidays in Ibiza". However well conceived or badly presented, structured product advertisements are still only just that: advertisements. They simply represent a means for a product issuer to tell its potential clients that there is a new product on the market, and to encourage investment in it. Beyond that, the advertisement isn't helpful to the private investor. A sensible person doesn't buy a car or book a trip based only on the information included in the advertisement. The car is a complex machine, which needs to be examined closely, test-driven, have its options tried out ... The holiday needs to be analyzed, flights checked, hotel rooms and locations scrutinized ... The same goes for a potential investment in a structured product which – if anything – is a complex form of investment. Not only must the structure fit in the investor's portfolio, but also its maturity must match – or at least not exceed – his estimated holding period; the worst-case scenario should be considered and the potential effect such a scenario would have on the portfolio measured, etc. Falling into a habit of investing in the same structure repeatedly just because

[2] Collaterized Debt Obligations, a specific product type primarily used by institutional investors.

it seems to work well is one of the worst mistakes that investors can make. Unfortunately, besides the four universally acknowledged fundamental forces of nature (strong, weak, electromagnetic and gravitational), in the author's view, there is a fifth, obviously stronger than all the others: the force of habit. In the years from 2003 to 2007, numerous private investors found structured products attractive, cashed in high coupons or bonuses and were happy. Many repeated, multiplied and even leveraged investments as if they were a bonanza, until a bear market and the bankruptcy of Lehman Brothers came along. Suddenly everybody was finger-pointing structured products as being responsible for the whole disaster. Many structured product investments turned out to be unsuitable for some portfolios, and at least some investors found out that the worst-case scenario could not be borne. Many complained about having received bad advice. Despite the products' poor performance in the recession that followed the bull markets, the products themselves should not be seen as the cause of the investor's ire. As in a car crash, it's not the car that is responsible for the harm done, it's the driver behind the wheel. If the car had an unknown technical flaw, one can blame the constructor. If it had a known flaw, blame the seller or reseller. Finally, if the car was not fit to be driven on the road, one could even blame the authority that gave it permission to be driven in the first place. In any case, the car is not responsible. The same goes for structured products. The structurer constructing it, the seller marketing it, the client accepting it, the regulator watching it, the management cashing it, all bear a partial responsibility, but the product itself is innocent. Whatever may have been, it's useless to play the finger-pointing blame-game or dwell on the things of the past. So why not take a fresh start and reconsider structured products as just what they are: an investment vehicle or tool that can be useful when searching for investments that match one's risk-return profile.

This book casts a critical eye on the world of structured products and the factors that influence it. It helps end-investors to consider structured products from different angles and take rational, considered investment decisions. Have a look at the advertisements in the newspapers again after reading this book; they will surely appear different.