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KEEPING AN EYE ON THE RISK-REWARD RELATIONSHIP

As the structured products market gets more crowded, careful selection is crucial, warns James Grayson of Thesis

The growth of structured products has been phenomenal. It appears that with the advent of the Retail Distribution Review, banks and other intermediaries are jostling to set up or expand their existing structured product platforms to service existing and prospective clients.

I anticipate the retail investment market will become saturated with products, from the local bank to the investment intermediary market, creating oversupply.

I view structured products as a form of convertible bond, where the bond element is designed to provide the capital security while the derivative element is to provide either the capital or income return. Given this approach, I break down the risks posed to both elements from the terms of the note to the counterparty risk.

Prior to last autumn's events, counterparty risk was viewed as more theoretical than probable and, I suspect, was overlooked by many investors. The crucial issue on selecting any structured product is whether the risk-reward relationship is attractive enough to warrant investment.

Ironically, last October was a highly attractive time to strike structured products that were short on volatility such as 'auto-call' and synthetic zero notes (notes that provide a fixed return).

The VIX index, which measures implied volatility, reached record highs following the collapse of Lehman Brothers. The bond element in most cases is backed by the underlying issuing bank, which at that time were experiencing exceptionally wide credit spreads as the credit markets were predicting Armageddon.

The investor had the dual benefit of attractive bond and derivative pricing, which provided exceptionally high gross redemption yields in the high teens to low twenties.

Today's market conditions could not be more different,

with market volatility nearer to the long-term average and credit spreads significantly narrowed. Structured products that were short volatility now only offer yields of between 7%-8% in the secondary market. In terms of more attractive pricing, structured notes that are long volatility (which generally provide a geared return on the underlying market index) are appearing more attractive and offer investors a tactical asset allocation opportunity given the recent market rises.

At Thesis we have an historical preference for the autocall and synthetic zero notes that are often used as fixed interest proxies and for tax-efficient investments for clients who are higher rate payers.

We also have successfully structured notes for tactical allocation purposes to express a particular view on both currencies and markets. One example would be the purchase of a capital protected note on the S&P 500 (to benefit on a 1:1 upside, but protected on the downside) and the currency hedge in sterling (concern on dollar depreciation), which we held into the beginning of the credit crisis.

In terms of maturity, I prefer notes that are shorter dated than those with longer timelines of five years or more, as the time value becomes a larger factor and the differential between the market price and the mark-to-market value is greater.

It is critical for structured products providers to offer a tradeable and liquid secondary market, and that the platforms are visible (internet access) and clear pricing. Historically, Thesis has used the investment banks such as Barclays Capital, Morgan Stanley and Bank of America Merrill Lynch via their Elders platform.

The interesting differential of the latter is that the bond element is not backed by Merrill Lynch, but by the senior debt (medium-term notes) of building societies (five names in one note).

The pricing of many of these notes are relatively attractive because the credit spreads on the senior building society debt is still reasonably elevated. If you are happy with the counterparty risk there are some interesting returns to be had, such as the Merrill Lynch Japan Protected 3 Shares.

The note is capital protected at 100 pence with the



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derivative element out-of-the-money with a price at around 78.5p, which makes it an attractive synthetic zero for a two-year period.

James Grayson is an investment manager at Thesis Asset Management

