

Thesis

Product Update

October 2011

Welcome to Thesis Product Update, a publication about the latest developments and news on Thesis products.

Gilt yields fell to historic lows in the past month, and clients' holdings are showing substantial gains as we have maintained our long-dated gilt weightings over the last two years when they have been shunned by many investors.

With economic growth lacklustre, it is possible that the UK will not be able to maintain its current financial standing, so we have taken the opportunity to trim gilt holdings by between a third and a half, depending on the risk model. Finding an asset in which to reinvest the proceeds as a low-risk component of a portfolio is not a simple task however.

Investment Analyst **Matt Hoggarth** reintroduces structured products, and describes why we think a defensive structured product is a good solution.

What is a structured product?

A standard bond, such as a gilt, pays interest at a fixed (or sometimes variable) rate, and then returns a pre-determined amount of capital to the investor at maturity. Structured products are essentially bonds whose payoff is determined by a more complex set of rules. The return may be linked to the value of an equity index, a commodity, specific stocks, or any other underlying asset. By incorporating financial options into the structure, capital can be protected against falls in the underlying asset in return for some sacrifice of income, or conversely returns can be increased by taking on additional (albeit sometimes remote) risk of losses.

For investors this gives the opportunity to tailor an investment with almost any return profile, and to gain exposure to assets that may normally be difficult to include in all but the largest portfolios. Products can also be designed to give their returns either as income or as capital gains in order to suit clients' tax situations, and can be made eligible for inclusion in ISAs and SIPPs.

We are in regular contact with the major banks and boutiques who design and issue structured products, and frequently review new product ideas. The size of our client base means that where we have specific requirements we also have the option of having a bespoke product created for our clients.

What are the risks?

As with any investment, it is imperative to understand the risks a structured product embodies, and how these can be combined with other assets to form an efficient portfolio. This is an area where our investment process, with the appraisal of risk at its core, can really add value.

In the past some structured products in the retail market have received a bad press. Terms such as "precipice bonds" have been used to describe high risk structured products which were sometimes sold inappropriately to risk-averse investors looking for a high yield, and which subsequently lost money following falls in the equity markets to which their returns were linked. We would always seek to ensure that any structured product we use is appropriate both for the client's risk appetite and the role the product will play in their portfolio.

The key risks for structured products are:

■ Interest rate risk

As with any bond, if interest rates rise then the value of a structured product that pays a fixed income may fall prior to maturity. Interest rate risk is higher for bonds with a longer lifespan.

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Please feel free to contact your local **Investment Manager** to discuss any aspects of this update.

For any other feedback regarding this month's Product Update email: james.goward@thesis-plc.com

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■ Credit risk

Because a structured product is a debt obligation of the issuing bank then there is a risk that it will not be able to repay the capital when it falls due. To create a defensive structure it is important to select a high quality issuer. It is also prudent not to hold too large a proportion of a portfolio in bonds from one issuer. If a bank is wound up then holders of its structured products rank alongside depositors in receiving money back from the liquidation. (The structured products are senior unsecured debt.)

■ Price of underlying asset

Movements in the underlying asset will have an effect on the value of the structured product. The exact relationship and level of risk will be determined by the design of the product and any options that have been included. A product containing options that can be triggered at any time during its life is riskier than one with options that can only be triggered at maturity.

■ Volatility of underlying asset

If the market is expecting the value of the underlying asset to be more volatile, then the price of a structure that includes protective options will move higher, and one that includes options that increase risk will move lower.

■ Liquidity

Where a client may need to realise their investment in a structured product before it matures, it is important to be able to do so without a penalty. Banks generally make a market in their structured products, and even during the 2008 banking crisis were still willing to redeem their structured products on request, as they represent a comparatively small proportion of their overall debt.

Our defensive structures

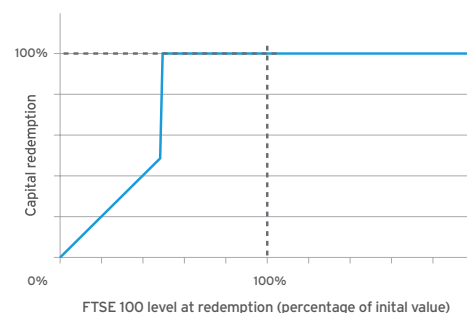
Having taken profits on clients' gilt holdings, which form part of the most defensive allocations in our models, we needed to find a safe home for the proceeds. A very high quality investment grade corporate bond fund could have been an option, but with interest rates so low this type of fund might not have matched the level of income yield that clients have been accustomed to from the gilts. To maintain a good level of income while preserving capital, we turned to structured products.

We were looking to create a product with a good level of guaranteed income yield, but reduced interest rate risk (lower duration) relative to our long-dated gilts. The lifetime of the product has been set at six years to ensure that it is eligible for ISAs (securities with less than a five year lifespan cannot be purchased in an ISA.)

Selecting the issuer was the most important consideration. We chose HSBC, as it should be the least likely to default of any bank active in structured products issuance (it has an AA credit rating, and the lowest credit default swap spread.) We could have obtained higher yields by using other banks as issuer, but feel more confident in the strength of HSBC's balance sheet, and the international spread of its revenues. Even so, we are following our standard limit of only holding up to 5% of a client's portfolio in the debt of a single issuer.

To boost the yield that would be obtainable on medium term senior unsecured HSBC bonds we can introduce some equity risk. Because equity market volatility is currently high a good return can be obtained by linking the capital repayment to the performance of the FTSE 100 index. The maturity value is only at risk if on the redemption day the index has fallen by more than 50% from its initial value (this is equivalent to selling a put option on the FTSE 100.)

As this level is only observed at redemption the index can fall lower during the life of the product, as long as it then recovers before the redemption date. A 50% fall in the market



would take us to levels not seen since the early 1990s, and would require very significant reductions in corporate earnings, which could only be caused by extremely severe economic turmoil. The largest fall over any six year period since the start of the FTSE 100 index in 1984 was 30% from mid-July 1998 to mid-July 2004, and its predecessor the FT30 which dates back to 1935 would only have broken the 50% barrier over six years if the product had matured during the worst months of the oil crisis and recession of 1973-4. Since the FTSE 100 has already fallen significantly from its recent peak in February the probability of a further 50% fall in the next six years should be very small. Nevertheless, we are observing market conditions carefully with a view to striking (preceding with) the product when the market has fallen and volatility is high, so we can obtain the lowest possible barrier and receive a good return for the equity risk we are taking.

Depending on the market conditions when we strike the product, we aim to receive a yield between 4.5 and 6%. We are also creating a zero coupon version, which will have its returns treated as a capital gain. Its return will be slightly higher, because it is not received until the end of the product's life. These are not returns that will turn heads, but they reflect the defensive low-risk nature of the investment we have set out to create. Considerably higher yields are available on other structured products, but this diversity illustrates the flexibility of structured products as an asset class, and the need for careful analysis of their risks.

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