FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

In Defence of Structured Products – Why they aren't as scary as Friday 13th

13th October 2017

The fear of Friday the 13th, which is known as Paraskevidekatriaphobia, is rumoured to cost the US economy close to $1bn per year![1] Despite the scaremongering, there is yet to be a specific phobia assigned to a structured product, though it is likely that misconceptions and falsities have hurt our market too. This week's returning FNL is going to focus on a direct comparison of actively managed funds to structures. What emerges is that those under the impression that structured products are illiquid, expensive ways for investors to make less money, are in fact mistaken (or so say the SP sales house…).

So how do the costs compare to funds? Well, a passive tracker or ETF charges anywhere between 10bps and 1% p.a. depending on the underlying, whereas an active manager typically charges between 0.75% and 2% p.a., which is as long as they outperform, is a justifiable premium to pay, given the added work involved. So, what about a structured product? Well, an investor would typically pay circa 25bps p.a., which is on the low side of the funds industry for sure. Moreover, that is the extent of their fees. The investor will not be charged anything else. These fees are referred to as the expected issuer margin (or P&L) which includes not only their profit assumptions, but also the bank's hedging costs (we'll come on to these) and all the issuer's operational costs. These include inter alia personnel costs, exchange listing fees, settlement, and legal costs.

Structured Products… Surely not the scariest thing to happen today…

Though we don't see it, the bank is operating something not dissimilar to a fund in setup every time you buy a structured product – all fully customized to you the buyer, for as little as £1m. However, there is one fundamental difference. The bank is responsible for offsetting the risks of this trade – any mistakes made are worn by them, and most definitely not passed onto investors like in funds. They do this by actively managing their book to mirror exactly the payoff you have purchased. A structured note position results in several different exposures which can be complicated to hedge, including (but not limited to) volatility, correlation, interest rates, dividends and currencies. These exotic traders are in effect top tier fund managers, consistently managing risk vs reward throughout the life of the trade. And remember, because you have agreed to a defined returns package, they are obliged to honour your terms, so unless there is a default event, you will receive exactly what was promised by that bank, regardless of the trader's performance internally. This is not unlike an airline selling tickets for a flight the following summer. They only have a rough idea of fuel costs, the number of people on the plane, taxes and the next wage agreement

Recent Launch:

Product	Snowballing Return
Soc Gen 6yr FTSE 100 / Eurostoxx 50 Autocall EIS	5.75%

Rates (bps)		
	Current	Week Chge
GBP 1yr	67.10	3.4
GBP 3yr	94.50	4.9
GBP 5yr	111.00	3.9

Equity Indices (%)		
FTSE 100	7,534.65	0.16%
S&P 500	2,550.93	0.06%
Nikkei 225	21,155.18	2.24%
Eurostoxx 50	3,606.61	0.09%

Currencies (%)		
GBPUSD	1.3258	1.47%

5yr Credit Spreads (bps)		
Citigroup	47.817	2.181
Credit Suisse	67.618	-0.503
Deutsche	91.829	0.754
GS	62.619	2.43
HSBC	24.135	-0.658
JPM	45.916	2.093
MS	57.35	1.435

Commodities (%)		
Gold	1293.95	1.35%
Oil (CLA)	51.39	4.26%

3m Implied (vol pts)		
FTSE 100	9.38%	0.05%
S&P 500	8.96%	-0.17%
Nikkei 225	13.40%	-0.08%
Eurostoxx 50	12.30%	0.05%

5yr Implied (vol pts)		
FTSE 100	16.32%	0.20%
S&P 500	18.41%	0.20%
Nikkei 225	18.44%	0.10%
Eurostoxx 50	17.92%	0.00%

Source Bloomberg / Partner Banks
Data as at 13th October 11.00am

Upcoming events	
13th Oct	US CPI % m/m
17th Oct	EU CPI % m/m
20th Oct	Janet Yellen Speaks
22nd Oct	Japanese General Election
26th Oct	ECB Rates Decision

Contact:

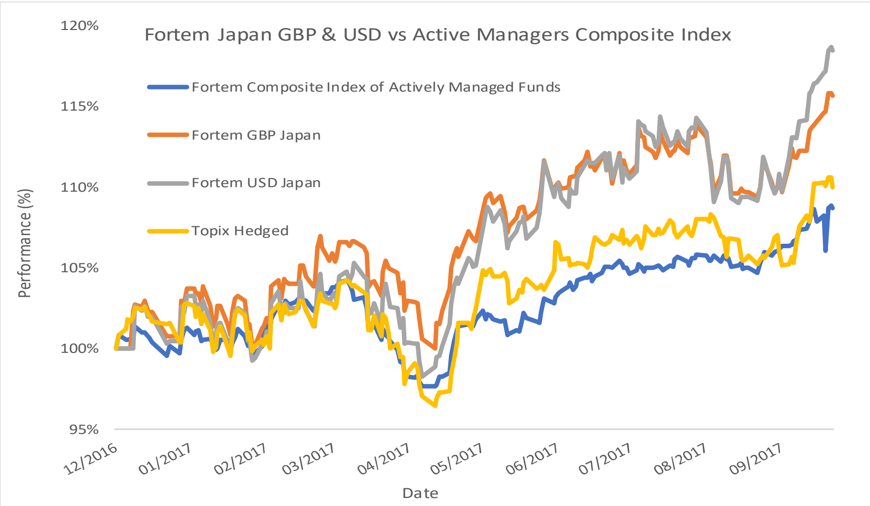
General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2905 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2904 E research@fortemcapital.com

"The value of a promise is the cost to you, of keeping your word." – *Brian Tracy*

…for their staff. However, they charge a fixed price for a ticket nonetheless, and that will include an assumption of these future costs. Once the airline has sold a ticket, they must allow that individual access to the plane, unless of course the airline in question is Ryan Air...

To continue the analogy, you've bought a ticket for the plane, how comfortable is the flight? Well firstly, because the underlying investments are incredibly liquid (the global derivative market dwarfs that of the equity market many times over), you can de-board the plane any time you wish. In short, the commonly held myth of liquidity is just that; a myth. Moreover, as investors in many "absolute return vehicles" will attest to, though these vehicles claim to target returns of 3m Libor + 3-5% p.a., many have failed to perform as such, passing those failings onto you the investor, resulting in a rather unpleasant journey. Indeed, in one study from earlier in the year, over 25% of absolute return vehicles had failed to garner positive returns over the prevailing 12 months – and a quarter of those funds had fallen by more than 10%.[2] In the case of a defined return product (certainly not something we would claim is absolute return), the investor's payoff is easy to calculate based on the pre-defined terms of your note. Moreover, in anything but a sustained aggressively bear market, these products consistently perform well. Taking this week's launch as an example, on a backtested basis from January 1990 to the end of September 2017, this defensive autocall product would have returned your capital 100% of the time, and resulted in a positive ROI of 5.75% p.a. (simple) more than 95% of the time.[3] That sounds like a decent alternative to an absolute return vehicle if you ask us. Please do get in touch or see footnotes 3&4 for more details on this specific product.

What about something that could be compared to more traditional long only active managers? Well, we're going to look at Japan (one of our favourite topics). When Fortem launched these investments, we put together some analysis around how regularly active managers underperformed the underlying Topix Perfect Hedge Index and how inefficient their currency hedges were; please see footnote 5 for more details. To avoid single manager bias, we then constructed a weighted average Composite Index of Actively Managed Japanese Equity Funds (please see below table and graph*) and compared its performance since launch to these investments. For a more thorough update on the performance of these products, please see footnote 6.



Fortem Composite Index of Actively Managed Japanese Equity Funds			
	Initial	Current	Change
Schroder Tokyo	£77.47	£81.87	5.68%
Baillie Gifford Japan	£1317	£1511	14.73%
JPM Japan Focus	¥19551	¥20646	5.60%
BlackRock Japan	£112.35	£123.92	10.30%
Polar Capital Japan	£19.22	£22.45	16.81%
J O Hambro Japan	£1.661	£1.792	7.89%
GLG Japan Core Alpha	£181.82	£189.17	4.04%
Weighted Average	100%	108.72%	8.72%

	Participation	Offer
6yr Citi Daily Hedged USD 100/140 CS with 60% EKIP	425%	~118
6yr Citi Daily Hedged GBP 100/140 CS with 60% EKIP	325%	~117

** Source Bloomberg, as of close on 8th Dec 2016 to 29th Sep 2017, 09.00am*

As you can no doubt see from the graph above, the Topix Perfect Hedge Index has outperformed the Composite Index of active funds, despite their promised alpha and the structured product investments have consistently out-performed both the Composite Index of Actively Managed Japanese Equity Funds and the GBP Hedged Topix (and therefore any passive trackers) to date. So, there you have it. Not only are these products capable of consistently outerperforming their active management alternatives, but they do so at a reasonable cost. We leave it to you to decide whether the funds industry can say the same!

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2905 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2904 E research@fortemcapital.com

Footnotes

1. http://news.nationalgeographic.com/2015/11/151113-friday-13-superstition-phobia-triskaidekaphobia-culture/
2. https://www.forbes.com/sites/cherryreynard/2017/08/28/absolute-return-no-return-absolutely/#43602e3c4c7b
   https://www.theinvestmentassociation.org/assets/files/sectors/20171009-TARmonitoringdata.pdf
3. http://www.fortemcapital.com/factsheets/defensive_auto_backtest1.pdf
4. http://www.fortemcapital.com/factsheets/GB00BF6XD422.pdf
5. http://fortemcapital.com/fnl/2016_10_28.pdf
6. http://www.fortemcapital.com/factsheets/japanq32017.pdf

Disclaimer

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2905 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2904 E research@fortemcapital.com