London Stock Exchange Group

Structured products

**Precision tools.
A guide for private investors.**

"Structured products are listed securities available for trading on London Stock Exchange's regulated Main Market."

Structured products

100%
capital protection
offered by some structured products

These flexible instruments offer a variety of investment solutions for a range of investors to enhance performance or reduce risk. This guide is designed to introduce structured products. We look at some of the key features and consider some of the benefits and risks associated with structured products to help private investors decide whether these instruments meet their individual investment needs.

What is a structured product?

Structured products are simply financial instruments issued by banks with varying terms, payouts and risk profiles tracking the performance of an underlying asset which can be equity, index, commodity, currency or a basket.

There are no standardised structured products, the terms, payout and risk profile of each instrument is bespoke and determined at the time of issue by the issuing bank. It is therefore important for investors to understand what a particular product will do and how it will behave if certain conditions are met, before investing.

Structured products offer exposure to a diverse range of markets and underlying assets

Shares of major companies like Anglo American, Barclays, BHP Billiton, Marks & Spencer and Tesco
Indices such as FTSE, Dow Jones, S&P and Nikkei
Baskets of stocks offering access to groups of equities based on particular market sectors
Interest rates and inflation using benchmarks such as CPI, RPI and LIBOR
Commodities including precious metals like platinum, gold, silver as well as agricultural commodities and oil
Exchange rates for various currencies.

Financial instruments tracking a range of underlying assets.

Types of structured products

Structured products fall into broad categories and the terms used may vary slightly from one issuer to the next. The categorisation explored here is for guidance only. The classes of structured products investors are most likely to come across are:

— Capital protection
— Yield enhancement
— Participation

It is generally considered that capital protection products carry the least risk of the three and participation products carry the most risk with yield enhanced products sitting in between. The reality is that any instrument, regardless of product class, can be constructed with various features. Instruments should be assessed according to their specific terms and not by general product grouping.

Capital protected
Varying degrees of capital protection can be built in to an instrument. Some structured products offer 100% protection of the initial investment and others offer partial capital protection. At maturity, investors will receive the capital they have invested in the case of a 100% capital protection instrument even if the market has moved against their expectations.

Some instruments offer conditional capital protection commonly linked to the performance of the underlying asset. If specific conditions are met, for example if the price of the underlying asset falls below an agreed threshold during the investment period, the capital protection disappears and the investor may incur a loss at maturity.

A range of products to meet individual needs

Precision and flexibility

Yield enhanced
These products offer no protection for the initial investment and sometimes with a capped upside potential. The aim is to generate a return higher than that of other investment options generally considered less risky such as a bond.

Although yield enhanced instruments may appear bond-like, paying a coupon and often issued at par or at discount, their risk profile is very different to that of classical fixed income instruments. It is important to understand that these coupon paying instruments are not directly comparable to bonds.

Yield enhanced products can have features such as a barrier or multiple barriers, fixed or relative to a predetermined factor, causing certain features to take effect if specific conditions are met during the investment period.

A barrier causes a certain feature of an instrument to come into effect once a predetermined condition is met. This could be based on the price movement of the underlying asset.

Participation
These instruments commonly features leveraged upside potential or downside protection with no or only partial and conditional capital protection. Generally, no coupon is paid on these instruments and they are not issued at discount. There are many variations of this type of instrument. They are commonly known as certificates and are often equity based, but can be based on any underlying asset.

Some instruments incorporate a return at maturity which is calculated by multiplying the performance of the underlying asset by a fixed percentage, called the participation rate.

For example, if the participation rate of an instrument tracking the FTSE 100 is 60%, then 60% of the index's performance will be used to calculate payout at maturity. Participation rates can apply downside as well as upside.

Participation rate is the percentage of the performance of the underlying asset which will be used to calculate the return when a product reaches its maturity.

Investors should consider the counterparty risk before investing. In the event of the issuing bank being declared bankrupt or being unable to meet its liabilities, investors may lose part or all of their original capital investment.

Other structured products
As the structured products market evolves, more innovative products are available with ever increasing variations in terms and structure. Some instruments will fall into more than one of the broad categories we have discussed.

Investors should understand the terms, payouts and risk profile of any instrument before investing.

Advantages of diversity
Structured products offer exposure to a wide range of markets with varying features and product structures. The large diversity of terms, payout schedules and risk profiles in structured products demonstrates one of the key benefits of these products – they offer investors precision in constructing investment portfolios to suit specific investment strategies. Structured products offer a range of possibilities allowing investors to tailor their exposure to various markets and the potential to make a return in all types of market conditions, with products which respond to falling or rising markets in periods of high or low volatility.

For example, if an investor wants to include ABC plc in his portfolio, he may purchase ABC plc shares. But in uncertain market conditions, this investor's appetite for risk is low and he wants some sort of capital protection. So instead of buying ordinary shares, he can invest in a structured product instrument where the underlying asset is ABC plc shares and incorporates a capital protection mechanism.

Some investors with a larger appetite for risk and return may invest in structured products which offer geared performance rather than capital protection.

Structured products are truly flexible and can be tailored to meet individual investment needs. When choosing structured product, investors should consider what features are required and avoid ones that are unnecessary as each feature may represent additional cost and complexity.

Investors must also bear in mind that if they chose to invest in structured products instead of directly in shares, they forgo dividend payments and the entitlements which commonly accompany shares such as voting rights.

Helping investors access difficult-to-reach markets cost-effectively

Overview of the benefits of using structured products

In most cases, it is impractical or impossible to hold physical underlying assets such as oil, metals or agricultural produce and the derivatives market which do offer exposure to these assets are not easily accessible to private investors.

Structured products trade on London Stock Exchange as ordinary shares do. With these instruments investors can tap in to markets which would otherwise be difficult to reach, in a cost effective way.

Structured products are tracker instruments and holding these can be very much like holding the underlying asset directly. If the price of the underlying asset rises, the tracker instrument will gain value and if the underlying asset price falls, the tracker will lose value. These instruments offer varying levels of gearing or, for simple one-to-one trackers, no gearing at all. Accelerated trackers offer investors gearing by tracking an underlying instrument and offering a ratio increase on the level of return. For example a two-to-one accelerated tracker would increase in value at twice the rate of increases in the underlying asset. Some products offer various levels of gearing, for example, accelerated upside tracking whilst maintaining an ungeared downside.

Gearing reflects how much the price of the structured product will change in reaction to a given change in the price or a value of the underlying asset.

Some instruments have distinct structures resulting in an inverse relationship with the underlying asset called inverse trackers. If the price of the underlying asset decreases the value of the reverse tracker will increase. These products may be suited to investors with a strong bearish view of the underlying asset.

Other instruments offer investors a guaranteed return on expiry should the performance of the underlying stay within a given range and some give investors exposure to an underlying asset at a discount to their true value in return for a capped upside exposure. Such features represent some of the ways in which investors in structured products can generate a return in static market conditions.

— Simple and cost effective access to a wide range of markets
— Traded in the same way as ordinary shares
— Geared or ungeared performance
— Potential return whether the performance of the underlying asset is static, bullish or bearish
— Built-in currency risk management features in some products
— Maximum potential loss is known
— No marginal calls and no dedicated account required
— Transparent, continuous on-screen pricing throughout the day
— Market makers are committed to providing a liquid market so that investors can trade in and out of their position before maturity
— High level of regulatory oversight and disclosure
— Automatic exercise of products if held to maturity
— No stamp duty or SDRT
— Potential SIPP and ISA eligibility.

Where an underlying asset is denominated in a foreign currency, for example the S&P 500 Index on shares quoted in US dollars, some tracker instruments incorporate a ‘quanto’ feature which ensures that the tracker is constantly fully hedged for currency risk. The cost of hedging varies and is built into the price of the tracker. Other trackers can be unhedged and are therefore exposed to currency risk. Depending on individual investment strategy, some investors may want exposure to a foreign currency. Trackers will give investors the choice to include this element in their portfolio.

One of the most attractive features of structured products is that the maximum potential loss is limited to the initial invested amount. There is no margin to maintain unlike other types of derivatives such as contracts for difference (CFDs) and spread bets.

Structured products are generally eligible for inclusion in SIPPs and, depending on the structure, some may be eligible for ISAs. Investors should consult their broker or the issuer for specific information.

Investors do not have to hold a structured product until maturity, making provision for greater flexibility as investment strategy and requirement changes. Investors can trade in and out of these instruments like they would ordinary shares.

Traded on the regulated Main Market

High level of regulatory oversight

Should a structured product be held to maturity, investors are not required to give special instructions to exercise. Any monies due to investors are automatically credited to their broker.

Tax
There is no stamp duty or stamp duty reserve tax (SDRT) payable on structured products as all of the products listed on London Stock Exchange are cash settled. However, investors may incur capital gains tax and in some cases income tax.

Structured products on London Stock Exchange
Traded on the regulated Main Market, investors can be assured that there is a high level of regulatory oversight. Issuers must comply with UK Listing Authority (UKLA) requirements and produce a prospectus and supplementary documents providing full product details. Issuers are also bound by the Exchange's Admission and Disclosure Standards.

Market makers and brokers trading in structured products are subject to the Rules of London Stock Exchange ("the Rules") and all trading activity is subject to London Stock Exchange's high standards of monitoring and market supervision. The issuer is also a registered market maker in their instruments providing continuous two way prices throughout the trading day. There is no distributor acting as intermediary so the issuing bank competes directly on price. Other member firms of London Stock Exchange can also enter their own prices on the order book providing greater price depth. Investors can see the value of their holding at any time during trading hours.

Important point to consider
Because structured products are bespoke, it is important that investors understand the terms of an instrument before investing. The terms will determine how an instrument will behave if certain conditions are met and what feature of the instrument could be knocked-in or knocked-out. Investors should seek professional advice if in doubt.

How to start using structured products

When investing in structured products, investors should first consider the following questions:

- What am I trying to achieve?
- How much risk am I prepared to accept?
- What is my time frame?
- How much can I afford to lose if the market goes against my expectation?

There is a wide range of structured products trading on London Stock Exchange. Investors should consider whether these products are appropriate for them and meet their investment needs. Seek professional advice if necessary.

Investors can buy and sell these instruments as easily as ordinary shares through their stockbroker who may offer a range of services.

- Execution-only brokers will only buy or sell according to investor instructions, providing no investment or trading advice
- Advisory brokers provide advice and also execute the trading decisions investors make
- Discretionary brokers will buy and sell on your behalf and may also have the authority to make investment decision without investors' prior approval.

Some brokers may also offer Direct Market Access (DMA), a service whereby London Stock Exchange members are able to directly submit customer orders to the order book via their own systems. DMA allows sophisticated investors to take greater control of their trades by enabling them to place buy and sell orders directly on London Stock Exchange's order books and execute with other market participants.

Before buying structured products for the first time, investors may be asked to complete a risk warning assessment to ensure the type of risk associated with these products is understood.

For investors who already have an existing share dealing account there is no need to set up another to trade structured products and investors will not be called upon to maintain a margin. The cost of trading comprises the following:

- Brokerage fee payable to the stockbroker used
- Price at which the instrument can be bought/sold
- An annual management charge – this information can be obtained from the issuer.

Full terms of an instrument should also be available from brokers.

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