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Why should investors be mystified?

By Pauline Skypala

The Christmas period in the UK heralded the beginning of the end of the split capital investment trust saga, with the announcement of a compensation deal struck between the Financial Services Authority, the UK regulator, and the companies involved.

Under the settlement, 18 of the 22 firms that were under investigation by the FSA will pay £194m to compensate up to 40,000 private investors in zero dividend preference shares.

This may strike anyone outside the UK investment trust industry as parochial and of little concern. But I would not be so dismissive. Splits were an example of a complex product where the risks, stemming mainly from leverage and cross-holdings, were not clearly understood by some of the people who designed them, let alone the advisers who sold them or investors who bought them.

There are plenty of complex products on the market now of which the same may be true, with structured products at the top of the list. These are a growth area for many providers around the world, so it is important that the risks are properly assessed and communicated to potential investors.

They are used by private banks for high net worth clients, distributed to the retail market by banks, financial advisers and other intermediaries and are being taken up also by institutional investors.

It must be hoped that the designers of structured products do know what they are letting investors in for, and are concerned to make sure the products are suitable for the intended market. But there is a suspicion that the products represent just another way of offloading risk on to investors, while charging them for the privilege.

It is a certainty that many of the salespeople advising on them are not in a position to assess the products themselves and must rely on what they are told by the provider. As for the average investor, there is the perennial problem that they will hear what they want to hear, and complain if their expectations are not met.

That puts the onus squarely on providers - not salespeople - to design something capable of meeting the expectations that the sales process creates.

Regulators have expressed concern about the difficulties of assessing structured products' fair value. Marcello Minenna, enforcement officer with Consob, the Italian securities market regulator, says it is crucial that investors are provided with a new way of analysing and effectively quantifying the risk/return features of structured products.

Writing in the specialist magazine Structured Products, he says: "The cost of engineering these products, borne by the end-investors, does not necessarily pay for a professional financial risk management assessment carried out for their benefit." Instead, pricing represents the shifting of the intermediaries' risk on to investors, who are unable to recognise this issue because of the lack of disclosure of the fair value of products.

In the UK, the FSA has issued fines and forced some firms to pay compensation to investors who were mis-sold structured capital at risk products (Scarps, also known as precipice bonds).

But regulators are often a step behind the industry, constantly playing catch-up with the latest clever wheeze.

Take the move by the structured product industry to employ the technique known as "constant proportion portfolio insurance" to provide capital protection, instead of using the better-known bond-and-call-option combination. Is there enough information about what expectations these are raising, the risks involved and the likely outcomes?

CPPI is essentially a portfolio rebalancing exercise, with money moved between the chosen underlying investment and bonds or cash typically to provide a minimum return of 100 per cent of original capital at maturity. It is probably more transparent than a derivative-based approach, but still mysterious to high street investors.

This approach has only been used in the UK in the last two years, so there is no information on actual outcomes. In Italy some products failed to provide the returns investors expected because the mechanism moved the money invested entirely into bonds or cash during the bear market, and was unable to move it back to participate in the post-Iraq war market bounce.

Providers and other commentators argue that structured products meet investors' current demands for investments that offer the potential to beat cash, but protect against downside risk.

But the costs of the protection may not be fully understood: the opportunity cost of interest foregone, the loss of dividend income where the underlying investment is a stock market index and the actual charges on the product.

The costs may be worth paying but with stock market growth forecast to be between 5 and 10 per cent in most developed markets over the next few years, the products could struggle to beat cash returns.

Perhaps what investors really need is a good old-fashioned managed fund, but one that pays proper attention to asset allocation and uses modern risk management techniques to lower volatility.

There are no easy answers, but history suggests that complex products carry the seeds of their eventual blow-up, especially in the retail savings market.

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