

Newsflash: New Investment Opportunities

29 September 2011

Defined Returns

Given recent market volatility, we have been on the search for new ways to provide returns to clients at the lowest possible risk.

To this end, within our discretionary portfolios we will shortly be buying three “Defined Return” plans with three different investment banks, Barclays, HSBC, and Credit Suisse.

What is a “Defined Return” plan?

These are effectively contracts with an investment bank, who promise to pay a pre-set return in different circumstances. These are often called “structured products”, but this catch all title can cover many different types of plan.

An example of how the products we will use will work is shown below, using Barclays as an example.

All products are fixed term products, starting on a specific day known as the “strike date”. They may run for 6 years or may close on any of the anniversary dates prior to the maturity date.

The initial index level is the closing level of the FTSE 100 on the strike date. For Barclays, 5 October 2011 is the provisional strike date.

On each anniversary, the index level is checked against the start level as shown below:

5th October 2012

If the FTSE 100 is at or above the initial index level, the product matures early paying 100% of initial capital investment plus 12.75%. Otherwise, the product continues.

5th October 2013

If the FTSE 100 is at or above the initial index level, the product matures early paying 100% of initial capital investment plus 25.5%. Otherwise, the product continues.

5th October 2014

If the FTSE 100 is at or above the initial index level, the product matures early paying 100% of initial capital investment plus 38.25%. Otherwise, the product continues.

5th October 2015

If the FTSE 100 is at or above the initial index level, the product matures early paying 100% of initial capital investment plus 51%. Otherwise, the product continues.

5th October 2016

If the FTSE 100 is at or above the initial index level, the product matures early paying 100% of initial capital investment plus 63.75%. Otherwise, the product continues.

3rd October 2017

If the FTSE 100 is at or above the initial index level, the product matures paying 100% of initial capital investment plus 76.5%. If not, the product has two maturity scenarios:

1. If the FTSE 100 is above 50% of the initial index level then the product matures paying 100% of initial capital investment.
2. If the FTSE 100 is at or below 50% of the initial index level then the product matures paying 100% of initial capital investment less 1% for every 1% the index is below the initial index level. For example, if the initial index level was 5,000 and the final index level on the maturity date was 2,000, then the maturity capital repayment would be 40% or £400 for every £1000 invested.

What are the risks?

In some ways, these products are similar to a corporate bond. We are simply lending the bank money in return for a promised return. This means there is credit risk; we are relying on the bank's ability to make the stated payments. Note that, unlike a bond, the products pay no income. All returns are from capital.

Although there is the chance of capital loss after six years, this possibility is reduced as not only must the index be down more than 50% at the end of the term, it must also have never been above the initial level at any of the anniversary dates.

If this were to happen, we suspect that we would have seen a major financial crisis and the market risk would be secondary to the counterparty risk; the risk that the bank cannot repay their debt.

For that reason, we have only selected banks that we believe are relatively strong. The three banks selected are:

- HSBC – rated AA by Standard & Poor's
- Credit Suisse – rated AA- by Standard & Poor's
- Barclays – rated AA- by Standard & Poor's

All are senior (not subordinated) unsecured debt, so rank above many corporate bonds in the event of insolvency.

The Credit Suisse and Barclays products will potentially pay 12.75% per annum. HSBC will potentially pay 11% per annum, slightly less as they are seen as a safer bank. These rates are to be confirmed on the start dates of the products.

Note that these are simple returns, not compound returns. Using the Barclays example, you only get potentially 12.75% of your *original investment* for each year of the product's life.

We rejected the opportunity to invest with Societe Generale who would potentially pay more than 13% per annum. Soc Gen has recently been downgraded due to their high exposure to peripheral European sovereign debt.

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We suspect Soc Gen will survive. In the event of insolvency we would expect them to be bailed out by the French government. Nevertheless, we were uncomfortable with this risk.

We see the chance of default as being remote, but you should be aware of this possibility. For this reason, we are only committing around 3% of portfolios to each product.

Bespoke products

These are bespoke products created specifically for our clients.

Barclays have been offering a retail version of this product recently, which potentially pays 8.25% per annum. By getting Barclays to create a product specifically for our clients, we have managed to get potentially 12.75% per annum.

The banks have also tailored to our requirements in terms of liquidity and availability via the Nucleus wrap platform.

One of the past problems with structured products is that having bought one, investors were locked in for the full term.

The products we are purchasing are daily priced, with just a 1% bid/offer spread. We can therefore get out at any time, if the price looks attractive. In addition, if the price falls we can potentially buy more.

Another problem with many retail structured products is that they often had high charges taken out initially to pay for marketing and commission to advisers. This is not the case with the products we are using.

Asset Allocation

These products have many of the characteristics of a corporate bond, with a potential return defined in advance and returns partially dependent on the creditworthiness of the institution. However, those potential returns are affected by what happens with the FTSE. They do not really fit in any of our normal asset allocation categories.

For clarity, we have therefore created a new asset category which we are calling "Defined Returns".

We see these products as carrying similar levels of risk to fixed interest and property in the current markets. At a time where we feel we will see below average returns from these asset classes, we feel these products are a good alternative.

You will previously have received our "Guide to Portfolios" which outlines the types of investment we will make. There are specific risk warnings regarding "structured products" (of which these are one type) in the back of this document under the "alternative equity" section.

Please let us know if you would like a revised copy of this document.

This document is for information only and should not be construed as advice. Please contact your adviser before taking any action. Returns of these products are not guaranteed and past performance is no guide to future performance.

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