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Foundation for growth

Structured products are back on the investment menu

JAMES DUNN

IN the wake of the global financial crisis anything with the word structured attached to it was market poison, implying a nebulous investment that contained dodgy derivatives, too much leverage and maybe a link to a toxic mortgage loan somewhere in the American rust belt.

But structured investment products are back and they have had a makeover. The products have gone back to basics, with simple asset exposures, shorter terms and walkaway features to allow investors to exit.

The basis of a structured product is that it packages a loan, an exposure to an asset class and some kind of capital protection. The attraction of structured products, in theory, is that they are a simplified way of making a confident punt on a particular market, with the potential for plenty of upside while giving protection from the downside.

Pre-GFC, the underlying asset in structured products was often exotic — hedge funds, emerging markets equities, commodities indices or climate change and “green energy” funds — and the term was seven years plus.

The capital guarantee at maturity was a backstop, but the leverage was where the excitement was to be found.

Everyone is wiser after the GFC. Instead of a proprietary stock index or

portfolio developed by an investment bank, the equities exposure is likelier to be an exchange-traded fund that replicates a well-known sharemarket index or a basket of well-known Australian shares. And the method of protecting the capital is a lot simpler.

The tweak on structured products is the focus on yield enhancement.

Many of the structured products sold in the Australian market pre-GFC used the constant proportion portfolio insurance technique in which, if the value of the underlying assets fell, a portion of the assets was sold and replaced with an investment in cash or a cash-like financial instrument.

While CPPI is infallible in providing capital protection, if the value of the protected assets falls far enough, 100 per cent of the investment is moved into the cash exposure and is stuck there for the remainder of the investment term, meaning the investor no longer has exposure to the assets in which they wished to invest.

Many such products sold pre-GFC ended up with investors who had borrowed at 10 per cent-plus for terms up to seven years effectively locked into a cash fund, with no way out.

“There has been a move towards simplicity and greater transparency, from both an adviser and investor per-



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spective,” says Suleiman Ravell, managing director of funds researcher and discount broker FundsFocus. “There’s been quite understandably a backlash

against ‘cash lock’ and the products are now simpler and shorter dated.” If the industry is honest about it, he says, pre-GFC advisers “didn’t really understand

properly” how these products worked.

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Dealers do the structuring now

The structured products market has changed its focus, tailoring offerings to better meet investor need

JAMES DUNN



THE structured products market has changed greatly from the halcyon days of 2007, when issuers created and sold \$4 billion of product to investors keen to gear into ever-rising markets — often with 100 per cent of the money borrowed — to get the biggest bang for their dollar.

These days, the focus is more on income and the product is likelier to have been built by the issuer according to a financial planning dealer group's requirements.

"Over the last 18 months, the dealer groups have really tried to move away from the situation where they get sold the product, and rather start developing products based on their client base's needs," Deutsche Private Wealth Management head of global investment solutions Joerg Koeppenkastrup says.

Previously Koeppenkastrup worked as a structured products consultant, helping dealer groups and big financial planning firms design products and tender their requirements to investment banks.

"The traditional approach was that the investment banks put a product together and went out to sell it to the dealer groups or to investors in general. Now the dealer groups are working out exactly what are the products that they really need for their clients. They're looking at a number of different structures that would fit their wealth building or their income strategy."

Koeppenkastrup says this "reverse-inquiry" approach has been "a really good development" in the structured products market.

"Instead of having to take or leave the product — to try to work out whether it is good or right for their clients, which can be difficult to do — the dealer groups now know it will suit their clients because they have designed it and given the job to the investment banks that can deliver that product in the most efficient and cost-effective form."

Much of this reverse-inquiry business does not reach the wider public,

but it is having a positive effect on the public market for structured products, Lonsac head of ratings, income and alternative products Michael Elsworth says.

"Investment banks are still putting products together and going out and selling them, but I think they've definitely been influenced by the reverse-inquiry transactions because the dealer groups are best placed to work out what features their client base would like to see.

"We think this has driven a very positive development in the whole space, where there has been a move away from the mega-transactions to the smaller, more targeted transactions.

"We think that's a positive thing: you're more likely to attract investors who know and understand the way in which the product is designed to work. The current crop of products is, generally speaking, much more simple and clear in what they're trying to do."

The result, Elsworth says, is smaller, more targeted issues.

"As a general comment, volumes are still well down on what they were pre-GFC, but we are reviewing more products than ever," he says.

Managing director of funds researcher and discount broker Funds-Focus Sulieman Ravell says product issuers are showing a definite move to address income needs.

He says this reflects the fact the self-managed super fund sector holds just more than \$400 billion, or 31 per cent, of a \$1.3 trillion market. (Only industry funds hold a bigger chunk of the superannuation pool.)

"Quite a lot of the structured products have shifted towards an income

bias, which we put down to the issuers realising that the big money is in SMSFs and the big money is in the older market," he says.

"The whole market is focusing more than ever on SMSFs because that's where the money's coming from at the moment.

"The issuers are looking to enhanced-yield products, and there is a huge and receptive market out there for them."

Koeppenkastrup agrees: "I think another major development in the market is a product that has been around for years. I call it reverse-convertible, but you often see it referred to as a worst-of-kick-in, or WOKI. That's been developed as a basket of stocks, where you are exposed to the performance of the worst-performing of the basket, but an enhanced yield is created by selling a downside exposure to the shares through a put option.

"You still have an equity investment, but the yield becomes enhanced through the selling of the put option to an investment bank.

"Through the product the client sells downside risk, but the premium provides for monthly income."

In return, says Koeppenkastrup, if any one of the shares in the basket falls below a certain pre-defined point, the investor runs the risk of losing the capital protection and being delivered the worst-performing share.

Provided that share prices do not fall to the kick-in level, the investor will be paid back 100 per cent of their invested capital.

But if the price of one or more of the shares in the underlying basket — usually five Australian blue-chip

Look around for the best benefits

STRUCTURED products fees vary widely between products, but the rule of thumb is that the packaging of the components costs more than a normal investment product.

For a start, advisers typically get paid about 2 per cent of the client's investment and there may or may not be a trailing fee (typically an annual ongoing fee paid for the life of the investment). It depends on the product. As a rule of thumb, capital-protected products cost clients about

4 per cent a year, so clients need to be looking at whether they are accessing something that's not available elsewhere or that gives them some perceived benefit.

The loans in structured products have a margin of 3 per cent to 3.5 per cent a year in them for the provider (but this is not really a cost to the client as they're never going to get a loan at inter-bank lending rates).

Loan rates, however, do vary between providers and since only the first 8.8 per cent a year is deductible, it can be an important consideration.

JAMES DUNN

Capital protection products

Investment name	Min. initial investment	Type of capital protection	Investment term	Income	Level of protection/guarantee	Level of participation in underlying investment fund	Able to borrow to invest
AXA NORTH (INVESTMENT GUARANTEE)	\$20,000	Dynamic hedging	6 or 8 years	Distributions reinvested	100% rising guarantee	100%	No
AXA NORTH (GROWTH GUARANTEE)	\$20,000	Dynamic hedging	10 or 20 years	Distributions reinvested	100% rising guarantee	100%	No
AXA NORTH (RETIREMENT GUARANTEE)	\$20,000	Dynamic hedging	Lifetime	5% pa guaranteed for life	100% rising guarantee	100%	No
MACQUARIE - FLEXI 100 (CLASS AI-AL)	\$25,000	Bond + call	5.5 years	4% pa	100%	100% (hurdle of 22%, ASX 200, US & BRIC options capped at 100% growth)	Compulsory (available to SMSFs)
MACQUARIE - FLEXI 100 (CLASS AM-AN)	\$25,000	Bond + call	3.5 years	6.5% pa in years 1&2 + 3.25% in year 3	100%	150% - Aus Equity with a 65% capped growth return 100% - Asian Alpha (hurdle of 16.25%)	Compulsory (available to SMSFs)
MACQUARIE - FLEXI 100 (CLASS AO-AQ)	\$25,000	Bond + call	3 years	Distributed each year as income (capped at approx 17%)	100%	100%	Compulsory (available to SMSFs)
MAN INVESTMENTS AUSTRALIA - OM-IP GLOBAL	\$5000	Bond + call	9 years	No	100% and rising as fund value increases	160% (100% participation in AHL and 60% to GLG Global)	100% available through NAB
UBS GOALS SERIES 12-14	\$10,000	Put options	15 mths	12.4%, 14.4%, or 17% pa irrespective of performance	100% provided lowest share does not fall > 30%	N/A	No

shares — touches the kick-in level during investment period, the capital protection is lost, and if the price of one or more of the shares is at or below the kick-in level, the investor will receive a defined quantity of that worst-performed shares.

"In return for bearing this risk, the investor receives an enhanced income," Koeppenkastrup says.

"The first of these WOKI products were paying 15 per cent-plus, but that has come down slightly, although it is still a double-digit yield.

"Another thing that investors have liked about these products is that they have had short terms, usually 15-18 months, which is definitely another investor preference post-GFC."

Tony Rumble, managing director of structured product issuer Alpha Structured Products, which has issued 10 series of WOKI-style products, says: "As volatility is falling in the market it's becoming cheaper to wrap physical put option protection around physical shares.

"We can now create one-year put

options, for a very attractive interest rate."

Ravell says these enhanced-yield products have been very successful in the SMSF space, which is "where the money's coming from" at the moment.

"They're very yield-oriented, equity underlyings: things like the UBS GOALS and Alpha RESULTS, they work almost the same, they're saying to you, 'You get a dollar back for a dollar invested, provided we don't hit a barrier, and in the meantime you get enhanced yield.'

"To give you an idea of the stability of them, Alpha has had 39 products across 10 series, and has not had a single stock hit a 'barrier event' yet.

"In exchange for that, they give you a fixed income, irrespective of the stocks' performance, because they're writing put options off the back of it and the yield they pay to clients is the cost they're charging for the put options.

"Going back to June 2010, that was as high as 22 per cent a year, which was quite sexy for the risk on the money."



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Time to take stock on structured investments

Continued from Page 1

would have said: "If you want to walk away, you'll have to pay a break cost."

The ability to pay interest in advance is still popular, Lucas says, because it gives a tax deduction in the current financial year, but the walkaway option makes it even more attractive.

"The other main thing that makes it attractive is that all the products have cut their timeframes. Rather than five or seven-year products, they're all around the three-year mark," he says.

As well, the underlying asset exposures in structured products are "much more vanilla" than they were pre-GFC, says Tony Rumble, managing director of structured product issuer Alpha Structured Products.

"There is a big trend towards ETFs over indices with which people are familiar," Rumble says.

"Usually ETFs are marketed as, OK, if you don't believe an active manager is going to add value, and you don't want to pay a couple of per cent a year, you can get guaranteed index performance for, say, 28 basis points.

"But what's happening now is, the investor is saying, 'I'm prepared to take the view that our sharemarket is stabilising, I'm prepared to leverage into it, but I'm still not convinced there's not every now and again a hidden surprise - a black swan event - even in an individual stock.' So I'd rather stay exposed to the index."

A good example, he says, is Leighton Holdings' recent troubles with profit downgrades relating to the Airport Link project in Queensland, the Victorian desalination plant and its Al Habtoor joint venture in Dubai.

"Who knew, unless you were following Leighton closely, that it was going to keep giving profit downgrades?" Rumble says.

"Post-GFC, the adviser doesn't feel competent to make a value judgment about individual stocks because of that black-swan event concern. He doesn't want to put his credibility on the line."

The result, Rumble says, is that for the peace of mind of the investor and the adviser, the adviser is much likelier to recommend market exposure in the form of ETFs.

"Investors want a transparent structured product. They want to have leverage available and hopefully it's going to give them the ability to make money in the sharemarket," Rumble says.

"They actually didn't feel that they needed to understand the products that well, because we'd had such a bull run with the markets, these one-in-20-years downside scenarios hadn't happened.

"Whether you were an investor or an adviser, it didn't matter so much whether you understood the product because the feeling was that you were never going to have to fall back on capital protection."

With CPPI well out of favour, the capital protection is likelier to come in one of the following two forms.

It can be a bond and call option, where the issuer takes a large portion of the client's upfront investment and deposits it in a zero-coupon bond, where the interest is capitalised and added to the capital value of the bond.

By buying a zero-coupon bond for, say, \$70, the issuer knows it will be worth \$100 one day because of the daily accruing interest, which is being capitalised within the bond.

The remaining \$30, say, is used to buy a call option, which gives exposure to the underlying asset to which the protected product is linked.

Alternatively, it could come from selling a put option over the investment portfolio (which grants the right, but not the obligation, to sell it to an investment bank, earning premium income.

The CPPI disaster has made liquidity a prime concern of investors, says George Lucas, managing director of structured products issuer InStreet.

"Virtually all the products now have 'walkaway' features: you pay your interest one year in advance, and then if you choose not to pay your interest in year two you walk away without penalty," Lucas says.

If you walk away, he says, you've lost the interest payment, plus any loan establishment fee you agreed with your adviser. You get your principal back, but your principal goes back to repay the loan.

But they're not going to come to you and say "your principal is only \$80,000 and your loan is \$100,000, therefore you have to stump up \$20,000". If your principal is only \$80,000, it doesn't matter, the only thing you'll lose is your interest payments.

In 2007 and 2008, the products

product to have emerged in the last couple of years. This product is like a self-funded instalment warrant: it's basically saying, 'You're leveraging up, you're putting in roughly \$50,000 to get \$100,000 exposure, but we're capping your return at 10 per cent. But in capping that return, we'll give you an enhanced yield.'

Ravell says March generally sees the end of one set of structured products offers, with a new batch coming out heading into the end of the tax year in June.

"This new batch comes out with the key selling point the loan that's attached: investors can pre-pay the interest and get a tax deduction. The peak flow for this sector comes in June because people leave their tax affairs to the last minute.

"It's the nature of the beast; structured products becomes a tax-driven market in the June quarter, it's the same the world over.

"If you look at marketing material, the products are marketed in much the same way that they're marketed in August, but in August an investor is a lot less likely to be concerned about the tax implications."

Research firm Path Independent's managing director Geoff Watkins says there is "probably a little more need for tax cover" this year, but he expects the design of products to reflect the fact "everybody still likes equities".

"I think equity underlyings will be the main game in town this tax season, as we're seeing in things like CBA's Compass Series, the InStreet MAST product and Macquarie's Flexi product, and I think those will be the models for what we see," Watkins says.

He says the issuers have created much more certainty in the minds of investors with regard to improving the liquidity of products, so we can expect to see more investors willing to borrow in a structured product.

"To get the deduction, they need to have borrowing; and to get the borrowing they need to have capital protection," Watkins says.

"And to have capital protection, investors have realised that there is no point to it if their money is locked up when they want to get it out."

Wesfarmers and Macquarie, investors will take the chance that none of these will fall by more than 40 per cent over the 18-month term.

"Their million-to-one risk is that one of those stocks goes out of business and they end up with zero: they'll take that chance, too."

The latest tweak is capping returns, he says.

"For example, we really like the InStreet Income Instalment product: we think it is the most exciting structured

"The yields they can offer have come down, though, because market volatility has come down. It's more like about 12 per cent a year income on their low-risk product and 15 per cent a year on the leveraged income product."

Ravell says investors in these products are taking the risk that one of the stocks in the basket will fall by more than 40 per cent.

"If you're talking about a basket of the likes of QBE, Brambles, Rio Tinto,

Source: Funds Focus

Ability to borrow to invest	Closing date	Fund choice	Lonsec rating	Notes
No	Ongoing	49 funds	Recommended	Change for protection is explicit and can initially look more expensive than other products. Added benefit of ability to turn off when not needed. Ability to switch funds.
No	Ongoing	49	Recommended	Change for protection is explicit and can initially look more expensive than other products. Added benefit of ability to turn off when not needed. Early encashment benefits from an "accrual" of protection level.
No	Ongoing	49	Recommended	The guarantee of 5% pa of the highest annual anniversary fund value makes this an attractive alternative to lifetime annuities.
Compulsory (available to SMSFs)	30/06/2011	S&P ASX 200, Asian Equity Indices, S&P 500 (US) or BRIC Indices	Recommended	Fixed income is an attractive feature. Note that the final growth deducts this (the hurdle). Trade-off is the cap on returns. Annual walk away feature means investors are not tied in.
Compulsory (available to SMSFs)	30/06/2011	20 largest ASX shares or Macquarie Asian Alpha Fund	Recommended	Investors receive 150% of gains (Aus. Equity Focus) or 100% of gains (Asian Alpha Fund), over the 16.25% hurdle, ie the distributions are deducted from the final growth payout. Annual walk away feature means investors are not tied in.
Compulsory (available to SMSFs)	30/06/2011	S&P ASX 200, S&P 500 (US) or Commodities Portfolio	Recommended	Annual walk away feature means that investors can walk away if the investment falls in value and reset at the lower level.
100% available through NAB	21/04/2011	100% exposure to AHL Diversified program & 60% to GLG Global (hedge fund)	Highly recommended	The lower cost of protection has seen a reduction in the term to nine years from 10 years on recent issues. Primary returns anticipated to come from AHL. One of the few investments that aims to provide returns in both rising and falling markets.
No	16/05/2011	Choice of three baskets of five blue chip shares	Approved	Strategy considered suitable for sideways markets as capital growth is given up in lieu of receiving a fixed monthly return. Conditional protection provided - provided no share falls by >30% at maturity, 100% capital return.



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