

You can have your cake and eat it too

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Structured products can help you protect your principal and yet enjoy equity returns

Financial markets were roiling earlier this year. Seasoned investors were picking trend lines incorrectly and traders were getting whipsawed into oblivion. Surely, a few were venturing to pick the proverbial bottom.

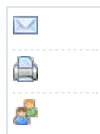
Amidst this doom and gloom emerged a few optimistic voices predicting a return to earlier highs in the market. They supported their optimism with data like growth in the economy, cited historical precedents, showed graphs of time to recover and cited decoupling theories.

The other camp, the pessimistic one, said the secular bear market has begun in India at last. Time for emerging markets to submerge a little?

Who is right? Nobody knows for sure.

In such a scenario, what if an investor was told there was a way he could profit if the markets went up but not lose his capital if they were to go down from here?

Sounds too good to be true? But, this is precisely the payoff guaranteed by a class of products called structured products.



What are structured products?

These are essentially debt-like securities backed by a guarantor (bank).

Like a debt instrument, the structure has a face value, a term to maturity and a return of principal (either wholly or partially) at maturity.

Unlike a debt instrument, the return from the structure depends on the terminal value of the embedded option; there is no guaranteed periodic coupon payment. Instead, the structure usually makes one payoff at maturity.

There are mainly two types of structured products:

1. The CPPI DPI (constant proportion portfolio insurance dynamic portfolio insurance) type of structured products
2. The bond plus option type of structured product

CPPI/DPI structure: In this type of a structure, initially 100% of proceeds are invested in underlying equity based investments. In the event of weak returns, the manager who is actively managing the structure pulls some portion of that capital from equities and assigns it to a zero coupon bond whose function is to deliver the investor his principal at maturity. The investment is structured so there is usually enough capital to afford

buying the guarantee (zero coupon bond) throughout the life of the investment, thus assuring a return of principal.

Bonds plus option structure: This plain-vanilla zero-coupon type of structure is seen more commonly in India today. The differences between the CPPI type of structure and this are as follows:

- i. First, the structure is not actively managed as compared to the CPPI structure.
- ii. Second, the division of corpus in the structure happens at the beginning of the structure itself between bonds and equity linked instruments.

Typically, these equity linked instruments could be derivatives such as calls or puts. The derivative portion is the one that gives these structures their oomph, while the bond portion ensures that the investor gets back his principal.

What to watch out for:

- These structures are issued in the form of a debenture, which is given a rating by the rating agencies. It is not a good idea to invest in a debenture with a rating other than AA or AAA. Stated another way, the financial solvency of the guarantor needs to be assessed carefully.
- Investors should carefully check the tax treatment of these structures, as they are typically considered as interest income and thus taxed at a higher rate than capital gains. Proceeds arising from early redemptions or sales, however, are taxed as capital gains. One should consult his tax advisor to understand the tax treatments better.
- One should look carefully at the fees charged. These could be an upfront fee, an annual management fee, especially in the case of CPPI structures. There could be an in-built fee as well.
- There is never any assurance that a secondary market will develop; liquidity is a serious concern. So, those investors who feel there might be a possibility they may need the money prior to maturity should not invest in these.

Suitability for investors:

Investors who could look at investing in structured products are:

- 1) Those that might be nearing retirement but may not have a huge nest egg. Such people cannot afford to lose capital at this point, but may still need to take a more aggressive stance in their investments than fixed income would deliver if they are to meet their financial goals.
- 2) Structures can be built around alternative investments with a typically large ticket size. Those who don't have enough could contemplate investing in structured products built around these alternative investments
- 3) Structured products could even be appropriate for an investor with a speculative style of investing. Indeed, there are structures that can deliver greater than 200% return of the Nifty with none or partial principal protection.

In conclusion, despite this list of cautionary points, structured products serve a purpose. In these turbulent times when the investor is unsure, sitting on the sidelines is not an option and debt gives only limited returns, structured products could be the answer.

There are various types of structured products -- Auto-callable, Knock-out, Shout, etc -- which are all subsets of the basic strategies described above.

One should carefully match his needs to the features and benefits offered by the particular structure before taking the plunge.

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