A Guide to Retail Structured Products
November 2014

This information is for financial advisers only and should not be presented to, or relied upon by, private investors.
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Introduction

This guide is intended to help advisors gain a better understanding of how to use structured products within their clients’ portfolios in order to better align outcomes with client investment objectives.
A brief introduction to structured products

A widely accepted definition of a structured product is one that delivers a known return for given investment circumstances.

Since the advent of the Retail Distribution Review (RDR), structured products now represent a significant part of the UK investment landscape, with an ever-increasing number of advisers and clients appreciating the benefits of known returns and the protection available in uncertain economic environments.

Structured products appeal to equity-based investors, especially those who suffered losses during the market turbulence of recent years. Understandably reluctant to repeat that experience, investors’ appetite for unlimited market risk has, in many cases, diminished. In addition, there are UK savers who face the eradication of their interest earning power. Both investor groups are considering structured products as they seek to mitigate or control risk, whilst also benefitting from positive returns. In short, never before has structured products’ unique characteristic within the investment arena – targeting the preservation of capital – been so important to investors.

This guide is intended to provide insight into structured products in terms of their design, mechanics, application and tax benefits.

As the market continues to develop and investors see that these products have the same liquidity and benefits of other equity investments, but with a known return profile, whilst offering protection to all but extreme market movements, we expect to see demand continue to grow.
A brief introduction to structured products

Structured products are ‘packaged’ investments that offer clearly defined formulaic returns within a range of investment parameters.

Their formulaic nature means that advisers can explain to their clients the range of returns on offer from a structured product, in any number of given market situations, thereby preparing them at outset for the best and worst case investment return scenarios.

In the current investment climate behavioural finance studies highlight the part that structures can play in addressing an investor’s inclination for ‘loss aversion’. The psychology of ‘loss aversion’ is when investors derive more satisfaction from avoiding losses in their portfolios than they do from making the equivalent gain, the trauma of making the loss stays with them longer then the memory of the gain.

As such, the capital protection element of structured products offers investors access to products that are constructed to minimise the occurrence of outcomes that would cause them the greatest level of investment distress, whilst offering clearly defined returns in a range of market conditions.
A brief introduction to structured products

Structured products can be designed to offer either income, growth or even a combination of both, linked to the performance of an underlying asset class (or classes).

In addition to the investment return they also aim to return investor’s initial capital at maturity, subject again to the specific product investment parameters.

The investment ‘package’ consists of 3 elements:

- A zero coupon bond – this is used to provide repayment of capital at maturity
- Derivatives – these are used to provide the investment returns that are linked to the referenced asset class
- Charges – this covers administrative, commission and management costs.

![Pie chart showing the components of a structured product package]
A brief introduction to structured products

The investment return and repayment of capital at maturity of each product are achieved by offering different levels of risk, return, exposure to, or protection from, the underlying asset class.

When structuring a product, the level of capital protection may be reduced in order to obtain a higher coupon and vice versa. This is known as the risk-return profile.

Characteristics common to most structured products are:

- The range of potential returns at maturity can be calculated at outset
- They have a fixed term ranging from 6 months upwards, although retail products are typically between 3 and 6 years (to be eligible for stocks and shares ISAs they have to have a term of at least 5 years)
- They offer varying degrees of capital protection.

Structured products provide a range of potential investment returns which have a direct correlation to pre-determined elements of risk. For example, regular income returns may be higher than those available from deposit based accounts, but this will be because either payment of the income, or the return of original capital, will depend on performance of an underlying asset.

They can be broadly split into structured deposits and structured investments.

**Structured deposits**

These are cash based, fixed term deposits that offer a variable interest payment linked to the performance of an underlying asset and may be used as alternatives to cash deposits.

**Structured investments**

Designed to offer either investment growth or income, with the return of both the initial capital and the investment return linked to the performance of an underlying asset. May be used as an alternative to, or to complement, equity investments.
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Evolution

1970s
The origins of structured products date back to the early 1970s and the birth of Guaranteed Equity Bonds, which were mainly issued under Life Assurance wrappers.

1982
The market developed significantly after the creation of the London International Financial Futures Exchange (LIFFE) in 1982. LIFFE made the buying and selling of futures and options easier – allowing purchasers to take advantage of the movement in underlying equities or indices without owning the underlying themselves. Once the LIFFE was fully operational the market started to develop rapidly and more complex and varied products started to become available.

1990s
In the late 1990s extreme market volatility combined with the ‘dot-com’ boom led to increasing demand for alternative income products – as equity markets were rising and interest rates were low. When equity markets peaked in late 1999, many of the fixed term products issued in the preceding years lost a significant amount of capital, due to the ensuing bear market and the downside gearing that characterised products at that time. Whilst not all products contained these characteristics the whole sector gained the unfortunate title of ‘Precipice Bonds’.

Early 2000
The industry responded to market criticism by issuing lower risk products, enhancing education of financial advisers on how structured products work and how they can best be utilised in an investor’s portfolio and ensuring all literature clearly describes the risks involved and that it is fair, clear and not misleading.

2008/09
The financial crisis again impacted the structured products market with the collapse of Lehman Brothers, bringing counterparty risk to the fore. Even though the exposure of the overall proportion of Lehman’s debt attributable to structured products was minimal, it led to a level of press exposure that many in the sector would argue was overly disproportionate.
Evolution

The market has developed globally with structured products now becoming a core holding for many investors, whilst the number of products issued has been consistent since 2008 (see below).

According to www.structuredretailproducts.com there was almost £12 billion of annual UK retail structured product sales in 2010, accounting for approximately 10% of the overall UK retail investment sector. This compares to structured product figures from 2001 of a total of £2.64 billion of sales from 191 products.

<table>
<thead>
<tr>
<th>Product types issued</th>
<th>Year End</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
</tr>
<tr>
<td>Growth</td>
<td>778</td>
</tr>
<tr>
<td>Income</td>
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<tr>
<td>Growth and income</td>
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</tr>
<tr>
<td>Totals</td>
<td>913</td>
</tr>
</tbody>
</table>

Source: www.structuredretailproducts.com
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Product evaluation

There are a number of independent structured product research and ratings agencies that provide accessible analysis on structured products from the majority of product issuers.

Future Value Consultants (FVC)
- FVC have been providing a definitive detailed analysis of structured products since 1999
- A report on each product is produced that summarises the key product attributes, including points for and against each product
- Each plan is rated across 4 categories – tax, value, simplicity and return so that they can be compared to other available investments
- Website - www.futurevc.co.uk.

Structured Product Review (SPR)
- SPR is maintained by the ‘StructuredProductReview.com’ team at Lowes Financial Management
- Established in 1971 Lowes have been active reviewers of the structured product market for many years and describe their service as “being run by IFAs for IFAs”
- Each product is reviewed and cross referenced against other plans available at point of review and those that SPR would expect to utilise in the course of their day to day client advising capacity are given a ‘Preferred’ status

Structured Retail Products (SRP)
- Established in 2003, SRP has evolved into one of the leading online resources for the global structured products community
- It has become an invaluable tool for a wide range of institutions involved in the manufacture and distribution of structured products across the globe

All the above site’s email reports on new product releases to subscribers and have comprehensive product archives, research tools, resources and educational pieces.
Product suitability

The starting point for considering the suitability of structured products, in a portfolio, is the investor’s attitude to risk. It should always be borne in mind that the overall package of capital repayment and asset class exposure should be considered as part of the total investor’s portfolio, rather than in isolation.

Structured products that capture full capital repayment at maturity might be particularly suited to more cautious investors. It may be appropriate to place a small part of a medium-risk investor’s portfolio into an accelerator capital at risk product, while the more cautious investors will find products that repay capital at maturity more attractive.

For investors willing to accept more risk, there may be little point in paying for full capital repayment if it is not needed. However, portfolio components will carry varying elements of risk and using structured investments that repay capital in full at maturity within a portfolio can create “space” for higher risk / reward opportunities elsewhere.

Moreover, the emergence of structures providing access to more esoteric markets opens the market to the inherently less risk averse investor. Similarly, if a structured product provides access to a market with higher performance potential, but aiming to provide full capital repayment at maturity, then it is a moot point as to whether this suits a risk averse investor more or less than exposure to unprotected equities in more familiar territories.

Structured products are normally fixed term. That term needs to be suited to the investor’s time horizon, as liquidity may be limited or non-existent (for example; NS&I’s Guaranteed Equity Bond) during the investment period. Similarly liquidity issues may arise on death during the investment term: outside the life assurance area, death does not bring the structured product to an end. This can be particularly problematic where the structured product is held within a pension arrangement, in which case funds must generally be distributed within two years of death. However, more products now give investors the opportunity to sell an investment before the end of the term.

Where the structured product is subject to CGT at maturity, thought should be given to the availability of the annual exemption at that time. It may make sense from a tax planning perspective to choose different terms or stagger the investments to avoid a clustering of gains in a single tax year. The customer’s own preference has a bearing on their selection of structured products. The many structures on offer mean that, for example, there is a crossover point between a capped super tracker product and a pure growth product. The investor and/or their adviser need to take a view on whether that crossover point is likely to be reached.
Section 2

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- Product composition example
- Capital protection
- Capital repayment

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As mentioned in the introduction, the building blocks for all structured products are:

- A zero coupon bond – this is used to provide repayment of capital at maturity
- Derivatives – options are used to provide the returns linked to the referenced asset class
- Charges – this covers administrative, custodian costs and management charges.

Every £1 that is invested is split between the bond, derivatives and other costs to provide the headline returns.

The diagram below gives a basic example of how the initial subscriptions to a simple growth structured product are used.
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Product composition

Zero Coupon Bond

The cost of providing the capital return at maturity via the zero coupon bond is the most expensive element. It is effectively the price paid at outset to return the capital to the investor at maturity. The price of the bond is affected by a number of variables:

- Interest rates – the higher the interest rates and the market’s long term view at point of construction, the cheaper the costs of purchasing the discounted bond
- The bond issuer’s credit spread – the wider the bond issuer’s credit spread the cheaper the cost. This must be balanced against the view that higher the credit spread the perceived higher risk of default of the issuer
- The term of the investment – generally the longer the term, the cheaper the cost as the returns are required over a longer period.

The basic examples below show how the costs of purchasing the zero coupon bond to provide the capital protection at maturity are influenced by the swap rate environment over a 6 year term.

- If 6 year swap rates are 3% and the issuer’s credit spread is 0.5%, the discounted amount required to purchase the bond would be:
  - \( \frac{100}{(1.035)^6} = 81.35\% \)
  - This would leave 18.65% to purchase the options and cover the charges.
- If 6 year swap rates are 6% and the issuer’s credit spread is 0.75%, the discounted amount required to purchase the bond would be:
  - \( \frac{100}{(1.0675)^6} = 67.58\% \)
  - This would leave 32.42% to purchase the options and cover the charges.

Over the duration of the 6 year term, although its value will fluctuate in line with prevailing interest rates, the bond will gradually increase in value from its discounted purchase price to mature at 100%.
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Product composition

Derivatives

Derivatives are securities whose price is dependent upon, or derived from, one or more underlying assets. The most common derivatives are options, futures and swaps. Structured products options linked to the referenced underlying asset class are purchased to provide the headline returns associated with the plan.

There are 2 basic types of option:

- **Call Options** – A call option gives the buyer the right (but not the obligation) to buy the underlying asset at a specified price (the ‘Strike Price’) at a specified time. Buying a Call Option allows the investor to benefit from any rise in the underlying.

- **Put Options** – A put option gives the buyer the right (but not the obligation) to sell the underlying asset at the Strike Price at a specified time. Buying a Put Option allows the investor to benefit from a fall in the underlying. In the case of a knock-in, the option becomes activated when the underlying price hits the barrier level.

The volatility of the underlying asset determines the amount of money paid for the Put Option. The more volatile the underlying asset, the larger the premium paid for the Put Option, as there is more chance that the protection barrier could be breached during the term and the purchaser therefore benefitting.

If an option ‘knocks-in’ it becomes activated when the underlying asset hits the pre-determined barrier level. In the case of a ‘knock-out’ the option will expire and become worthless if the underlying hits the barrier level.

Periods of high volatility generally mean that more call options can be purchased leading to more attractive headline rates.

Charges

The management and other charges are built in at outset and include:

- **Commission**
- **Brochure development**
- **Custody costs**
- **Profit margin**
- **Administration throughout the term.**
Product composition

The use of derivative-style payoffs

It is important to stress that investors are not directly investing in derivatives, but rather receiving a payoff characterised by derivatives – represented mostly by the use of call and occasionally put options.

The provider normally buys the product (or indeed the whole investment package) from an investment bank, and it is repackaged for promotion to retail investors. For the investor, it is important to consider the financial standing of both the issuing investment bank delivering the assets and the provider marketing the product. It is important to understand what recourse investors may have with either party should the need arise. With some structured investments, the product provider and the underlying issuer may be the same company, or part of the same group of companies.
Product composition example

A client is looking for a 6 year, capital at risk, growth product, linked to the FTSE 100.
Swap rates at time of pricing are 5% and the credit spread of the issuer are 0.5%.

- Cost of purchasing the zero coupon bond is $100 / (1.055)^6 = 72.52\%$
- Charges = 5\%
- Premium generated from selling the Put Option (50% barrier with a 1 for 1 downside exposure) = 4\%
  - The sale of this put option will benefit the purchaser if the level of the FTSE 100 at the end of the term is more than 50% below its opening level. If the FTSE 100 does not finish more than 50% below its opening level it will expire and be worthless to the purchaser
  - The potential return for the purchaser of the put option will be on a 1 for 1 basis.
- Total available to spend on the call option to achieve upside participation in any growth of the FTSE 100:
  - $100\% - 72.52\% - 5\% + 4\% = 26.48\%$
- The Call Option will give the buyer the right to benefit in any rise in the FTSE 100 from its opening level. If the price of the Call Option on FTSE 100 is 17.65\% then the plan will offer an upside participation in the growth of the FTSE 100 of:
  - $26.48\% / 17.65\% = 150\%$
- The product will therefore offer 150\% participation in the performance of the FTSE 100 at the end of the term.

Product scenarios

- If at final level of the FTSE 100 is 32\% above its opening level the product will return 48\% to the investor plus their initial capital
- If the final level of the FTSE 100 finishes 63\% below its opening level the product will return 37\% to the investor and 63\% to the purchaser of the Put Option.
Capital protection

Capital-at-risk

Structured capital at risk products have historically been referred to as ‘SCARPs’.

The return of the initial capital invested is not guaranteed and is linked to the performance of the underlying asset. They may offer:

Hard protection

- any loss potentially suffered by an investor is limited and is expressed usually as a percentage of the initial capital invested. For example, a product with a 75% hard protection barrier will protect 75% of the initial investment and only expose 25% to potential risk of erosion, based on the performance of the underlying. This will reduce the potential return the product can offer versus a soft protection barrier.

Soft protection

- capital is secure as long as the relevant underlying/s do not fall below a pre-determined barrier. This is usually expressed as a percentage of the initial level/s of the underlying(s), for example capital will be secure as long as the underlying does not fall by 50% from its opening level.

Capital protected

The return of initial capital at maturity is not linked to the performance of the underlying asset class.

As there is no exposure to capital the participation in the performance of the underlying asset is limited as the costs associated with providing the capital protection restrict the amount available to be spent on the Call Options.

Structured deposits

The returns from the plan are linked to a deposit, which will pay interest in accordance with the objectives of the plan. The return of capital at maturity is not dependent on the performance of the underlying asset class.
Capital protection

Protection barriers
As previously detailed capital-at-risk structured products have a safety barrier built in so an investor’s original capital will be returned in full, as long as the underlying does not fall by more than a pre-determined amount (often 50%). The use of barriers within a structured product increases risk.

Depending on how the structure is designed, the risk may be to capital or to the coupon, or in some structures even both. The risk is most commonly to the capital.

In the case of a knock-in, the option becomes activated should the underlying asset trade at or beyond a pre-determined barrier level e.g. in the case of a structured product this would be when level of the underlying falls to below the product specific barrier, for example, 50% of its opening level.

In the case of a knock-out, the option expires worthless when the underlying price hits the barrier level. They are cheaper than standard options as they offer limited opportunities for profit e.g. participation in the growth of an asset is capped at a level above which point any growth in the asset would result in a loss of the growth participation achieved below this point.

American options
- Allow the owner of the option to exercise the option at any time before maturity. In a structured product, this provides increased risk, with the likely effect being an increased coupon, when compared with a European option.

European options
- Allow the owner of the option to exercise the option ONLY at maturity. Due to this option having a lower risk, it is likely to generate a smaller coupon than an American option.
Capital protection

Example

The diagram below details the performance of an index over the term of a plan recording its opening level of 5,600, the lowest point it reached during the term of 2,607 and its final level of 4,200. The type of protection option type purchased at the start of the plan determines the return of initial capital at maturity.

American 50% knock-in put option

- As the 50% barrier, which in this case would have been 2,800, has been breached during the term and the final level is below the opening level of 5,600, the capital returned at maturity is reduced by the same percentage that the final level of the index is below its opening level. In this instance as the final level is 25% below the opening level 75% of initial capital invested would be returned.

European 50% knock-in put option

- As the final level of the index is above 50% of its opening level 100% of the investment capital would be returned at maturity.
Performance measurement

The investment return from the referenced asset class can be calculated in a number of different ways, including:

- **Averaging** – In this case the level of the underlying is arithmetically averaged over a given period. Averaging has the effect of smoothing the final levels, eradicating any extreme highs and/or lows. This feature can either enhance returns in a falling market or drag it down in a rising market.

- **Look back** – the final level is taken as the lowest point at any time over a defined period.

Performance can be measured:

- **Close of business** – in these instances only the price of the underlying at close of business is used.

- **Point to point** – simply measures the performance of the underlying between the close of business on one day and the close on another.

- **Intra-day** – measures the lowest price of the underlying at any time during the day. The intra-day price is nearly always lower than the close of business price.

These examples are not exhaustive and there are other ways to calculate investment return, protection barriers or pricing.
Some products offer more potential for profit, but will have less potential for capital repayment.

While others will offer more potential to repay capital but will have less potential for profit.
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Popular product variations

**Kick-out or auto-call products**
- Can mature early at set observation points if the performance of the referenced underlying has met or exceeded a pre-determined threshold.
- If the conditions aren’t met at an observation point the plan continues until the next one, when the test is applied again.
- Offer a return (aka ‘coupon’) for each specified period that the plan is in force.
- If the kick-out conditions aren’t met at any of the observation points the plan will run its full term, where the return of any initial capital and investment returns will be calculated, and paid, as per a pre-determined formula.

**Reverse convertible products**
- Also known as income products.
- These are designed to pay an income in excess of the rates available from high street deposit account providers and ahead of inflation.
- The income may be paid monthly, quarterly, half-yearly or annually.
- In order to achieve this return the initial capital invested is usually put at risk, with its return at the end of the product term linked to the performance of a referenced underlying asset.
- There is usually no participation in any appreciation of the underlying asset.
- The maximum return that can be achieved is a full return of initial capital and income throughout the term.
Popular product variations

**Accelerated growth products**

- These offer geared exposure to the upside performance of the underlying asset class.
- They are especially popular in the aftermath of a bear market when there is potential for leveraged exposure to a greater perceived upside.
- In order to achieve this return the initial capital invested is usually put at risk, with the return at the end of the product term linked to the performance of a referenced underlying asset.
- The diagram represents the product profile of an accelerated growth plan with the following profile - upside participation of $2 \times$ growth in underlying asset capped at 15% with a one for one loss on the downside.
Popular product variations

**Capital protected products**
- These products usually aim to return initial capital in full at maturity regardless of the performance of the underlying asset class.
- In addition, they offer the opportunity to participate in the upside performance of the underlying asset class.
- The participation in the performance of the underlying asset call may be either capped or uncapped.
- The final returns may be subject to averaging which restricts returns in a rising market but protects against depreciation in a falling market.

**Straddle products**
- These are also known as ‘bull and bear’ products.
- They offer investors a potential return regardless of the direction that the underlying asset moves from its starting point.
- Maximum returns are often capped.
- Many are capital protected, offering a minimum return of initial capital at maturity.
In the UK retail market the majority of structured products have traditionally been linked to the FTSE 100 Index. This conservatism tends to reduce in rising equity markets and increase during falling equity markets. However, the retail market is increasingly offering new products linked to a wider range of assets, many of which have been available to non-retail investors for some time.

The returns from structured products can be based on the performance of any asset traded on a recognised exchange. In the UK the most frequently used asset class are equity indices with the FTSE 100 Index being the most predominantly referenced. However, the retail market is now offering products linked to a wide range of asset classes, which can be attributed to a combination of the expanding reach of structures and a greater volume of educational resources.

The main asset classes used are:

- Equity indices – predominantly major global indices are used as they are generally less volatile and are the most liquid e.g. S&P 500 (USA), Nikkei 225 (Japan) and DJ EuroStoxx 50 (Europe)
- Emerging market indices e.g. Brazil, China or India etc.
- Commodity prices or indices – used to diversify an investor’s portfolio to give exposure to an asset they may otherwise be difficult to access
- Basket – can link a plan to a basket of stocks, indices or equities. The allocation within the basket can be weighted to deliver the required exposure
- Commercial and residential property indices
- Foreign Exchange
- Interest rates
- Funds – investment funds, tracker funds or hedge funds.
Adding Flexibility

Investment conditions such as interest rates and index and asset price volatility influence the pricing of structured products on offer, so the options listed below may not all be available at any one time.
Issuance vehicles and tax

There a number of common formats for structured product issuance within the retail market and these are summarised below. The detail provided is generic in nature, as each issuer’s programmes vary, and the comments made regarding tax treatment is based on the general market norms, and our understanding of such.

**Deposits**

The simplest issuance format of a structured product. When a structured deposit is made, the capital is placed in a fixed term deposit account, held with an institution known as the ‘deposit taker’. The returns from a structured deposit are generated by sacrificing any potential interest earned over the term for exposure to the underlying asset class. As these are deposit accounts, investors may be entitled to compensation from the Financial Services Compensation Scheme, in the event that the deposit taker is unable to repay any initial investment and interest. Gains made from deposit based investments outside of a tax free wrapper will be paid net and, as with traditional deposits, be subject to **Income Tax**. Where returns are paid gross, it is up to the investor to declare the returns to the relevant tax authority.

With a structured deposit the deposit taker has an obligation to repay the depositor, whilst with a structured investment product, the protection is usually provided by a third party issuer of debt securities, through such vehicles as medium term notes (MTNs), warrants and shares that are covered below.

**Medium Term Notes (MTNs)**

These are a form of corporate debt issued by companies of the issuer that range in maturity term, generally from 3 months to 10 years, and are designed to generate a constant cash flow thereby enabling the issuer to tailor their debt issuance to meet their financing needs.

These are a popular issuance vehicle in the UK structured product market and generally used for products paying a regular income / coupon. Returns under these products are paid gross and are subject to **Income Tax** assessment in the year received.
Issuance vehicles and tax

Warrants

Warrants are derivatives that give the holder the right to purchase securities (usually equities) from the issuers at a specified price within a set time frame. Warrant issuance programmes are commonly associated with growth and kick out/autocall structures. Any gains made outside of a tax fee wrapper by warrant based growth products are usually subject to Capital Gains Tax. It should be noted that warrant-based issuers are not on a permitted investment for holding within a NISA.

Certificates / Excluded Indexed Securities (EIS)

Certificates are another form of security in issue that are designed to provide the capital and investment returns associated with a structured investment. As with MTNs and warrants they are effectively a loan to the issuing bank and their repayment depends on the solvency of the issuing bank and its ability to meet the payments that become due.

Gains made by growth products are usually designed to be subject to Capital Gains Tax whilst income paid by income products is paid gross and subject to Income Tax assessment in the tax year received.

Shares

New products can be issued based on shares in Special Purpose Vehicles or Protected Cell Companies. Many of the structures are based offshore, which means that any dividend income generated will be taxed as dividend income which compares favourably to standard UK rates of tax.

The returns generated on the disposal or redemption of the shares are usually subject to Capital Gains Tax.
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- The use of structures in portfolios  
- Liquidity and secondary markets
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Investing

Retail structured products can be held, subject to minimum investment levels
- By individuals
- In pension funds
- By trustees, companies or partnerships
- As Individual Savings Accounts – ISAs.

By individuals
Investments can be held either individually, jointly, or on behalf of a child under 18.

In pension funds
The trustees, subject to the terms of the scheme, can hold structured products as a permitted investment, within any type of pension arrangement, including SIPPs and SSASs.

By trustees, companies of partnerships
Plans may be held by either trustees, companies and partnerships, subject to the relevant articles of association permitting such an investment.

Individual Savings Accounts (ISAs)
An ISA is wrapper around an investment that allows the investor to make tax-free gains and income. There are two types of ISA:
- Cash ISA – similar to standard savings accounts but any interest earned is tax free
- Stocks and shares ISA – a more diverse range of investments fall under a stocks and shares ISA than a cash ISA including unit trusts, open-ended trusts, individual shares etc. Any gain or income earned within the wrapper is again tax-free.
The use of structures in portfolios

The challenge faced by advisers when constructing a client portfolio is managing the balance between risk and return and ensuring upside exposure is sufficient to meet the stated goals, whilst the downside risk is minimised.

The variety of structured product variations offered by providers means that, subject to an investor’s attitude to risk, they can help investors meet their investment goals as part of a wider investment portfolio.

The clearly defined returns mean that advisers are able to explain to their clients the returns they can expect given a variety of market scenarios. As with any investment, structured products should form part, not all, of an investor’s portfolio.

There are many ways to position structured products in a portfolio, for example:

- A diversifier of underlyings – they can provide low cost, transparent access to a new market or asset class with an element of capital protection that would have otherwise been unavailable if accessed directly
- A risk modifier – using a product to increase exposure to their target market or asset class with a greater degree of capital protection and potentially higher returns if using a geared product
- A hedge against an existing portfolio exposure – if clients are long or short equities structures can be used as a hedge against their positions.

They can provide investment solutions to a range of needs, for example:

- A bullish investor may consider replacing a long passive fund with a leveraged growth plan, as on slide 14 - 'Product composition example', to gain enhanced upside exposure but with the benefit of some downside protection
- An investor looking for income in a low rate environment could achieve a margin over corporate bond yields by taking a broad view on an index e.g. if interest rates are 0.5%, they could invest in a conditional income deposit plan that returned capital at maturity, subject to counterparty risk, but offered an enhanced level of income of 7% p.a. if the FTSE 100 traded within a pre-determined range during set periods throughout the term.
The use of structures in portfolios

- An investor with a bearish market outlook could invest in an autocall structure that paid a fixed annual return if the referenced asset class was at or above pre-determined decreasing barrier levels e.g. 95% of the opening levels at the end of year 1, 90% year 2, 85% year 3, 80% year 4, 75% year 5 and at or above 70% at the end of year 6.

<table>
<thead>
<tr>
<th>Opening Levels</th>
<th>The closing levels of the underlying asset classes are recorded</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year 1 Annual Measurement Date</strong></td>
<td>Are the closing levels of the underlying asset classes equal to or greater than 95% of their respective Opening Levels?</td>
</tr>
<tr>
<td>➔ Yes</td>
<td>The Plan matures early and you receive original capital plus: 10% growth</td>
</tr>
<tr>
<td>➔ No</td>
<td></td>
</tr>
<tr>
<td><strong>Year 2 Annual Measurement Date</strong></td>
<td>Are the closing levels of the underlying asset classes equal to or greater than 90% of their respective Opening Levels?</td>
</tr>
<tr>
<td>➔ Yes</td>
<td>The Plan matures early and you receive original capital plus: 20% growth</td>
</tr>
<tr>
<td>➔ No</td>
<td></td>
</tr>
<tr>
<td><strong>Year 3 Annual Measurement Date</strong></td>
<td>Are the closing levels of the underlying asset classes equal to or greater than 85% of their respective Opening Levels?</td>
</tr>
<tr>
<td>➔ Yes</td>
<td>The Plan matures early and you receive original capital plus: 30% growth</td>
</tr>
<tr>
<td>➔ No</td>
<td></td>
</tr>
<tr>
<td><strong>Year 4 Annual Measurement Date</strong></td>
<td>Are the closing levels of the underlying asset classes equal to or greater than 80% of their respective Opening Levels?</td>
</tr>
<tr>
<td>➔ Yes</td>
<td>The Plan matures early and you receive original capital plus: 40% growth</td>
</tr>
<tr>
<td>➔ No</td>
<td></td>
</tr>
<tr>
<td><strong>Year 5 Annual Measurement Date</strong></td>
<td>Are the closing levels of the underlying asset classes equal to or greater than 75% of their respective Opening Levels?</td>
</tr>
<tr>
<td>➔ Yes</td>
<td>The Plan matures and you receive original capital plus: 50% growth</td>
</tr>
<tr>
<td>➔ No</td>
<td></td>
</tr>
<tr>
<td><strong>Final Year</strong></td>
<td>Are the Final Levels of the underlying asset classes equal to or greater than 70% of their respective Opening Levels?</td>
</tr>
<tr>
<td>➔ Yes</td>
<td>The Plan matures and you receive original capital plus: 60% growth</td>
</tr>
<tr>
<td>➔ No</td>
<td>No growth</td>
</tr>
</tbody>
</table>

No growth is achieved and capital is reduced by the same percentage that the Final Level of the lower performing asset class is below its Opening Level.
Liquidity and secondary markets

One of the common misconceptions about structured products is their perceived illiquidity.

It is now common place, in normal market conditions, for the product counterparty to act as a market maker for the underlying securities and create a secondary market, though this is not guaranteed.

The counterparty will accurately model and manage their positions throughout the product cycle and these will be reflected in the pricing provided.

The creation of a secondary market means that investors can now unwind their holding at a fair price mid-term should the necessity arise. It should be noted though that structured products are designed to be held for their term and as such this should be the assumption made during the advice process. If a plan is not held until maturity investors may not get back their initial investment.

The value attributed to the secondary market price is the theoretical net asset value of the packaged product and its components. The price will be influenced by:

- The performance of the referenced asset class
- Interest rate movements
- The counterparty’s funding requirements
- Volatility.

The counterparty will provide bid-offer spreads to the plan manager.

If there was the necessity for an investor to unwind their position prior to maturity there may well be an administration charge levied to cover the costs of facilitating the unwind prior to the end of the term.
Section 5

- Associated risks  
  Page 38
- Counterparties and counterparty risk  
  Page 40
- Credit ratings  
  Page 41
- Credit default swaps  
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Associated risks

Investors are encouraged to seek advice before committing their money, as it is important that they are fully aware of all the risks associated with investing. Below is an alphabetical list of potential risks inherent in investing in structured products, many of which also apply across the investment spectrum.

**Availability and Residence** – due to local regulatory and legal requirements, not all products described are available in all jurisdictions and some may be available on a limited basis only.

**Cancellation Risk** – the risk that investors decide to cancel the investment after assets have been purchased. They could lose some of their money if the market/s or asset/s to which their contract is linked have fallen since the purchase date.

**Concentration risk** – the probability of loss arising from a high level of exposure to a particular counterparty or group of counterparties.

**Counterparty Risk** - the risk that a financial institution with whom we arrange the assets to provide investment returns does not, or cannot, pay the amounts due, which could cause investors to lose some or all of their money and any investment returns that would have otherwise been payable.

**Early Encashment Risk** - the risk that if an investor decides to encash the investment before maturity they could get less back than they invested. Administration charges for early encashment will increase any losses.

**Inflation Risk** – the risk that inflation will reduce the real value of the investment over time.

**Investment Risk** – The risk that the market/s or asset/s to which the investment is linked fall in value, which could cause investors to lose money.

**ISA Transfer Risk** – if an investor wishes to transfer an existing ISA this must be done in cash, which means their existing ISA manager will sell their investments and they may be charged an exit or transfer fee. There is the potential for loss of income or growth if markets should rise while their transfer remains pending.

**Liquidity Risk** – the risk that investors may not be able to immediately access the value of their investment.
Associated risks

**Pricing Risk** – the risk that a financial institution with whom underlying investments have been arranged may not be able to quote regular prices making it difficult to value an investment possibly delaying any early encashment requested.

**Product Risk** – the risk that the product design could produce a return that is lower than a direct investment in the market/s or asset/s to which the product is linked.

**Tax Risk** – the values of any tax reliefs will depend on an investors individual circumstances. Please note that the levels and bases of taxation could change in the future and these changes may be applied retrospectively.
Counterparties and counterparty risk

The counterparties to structured products are the financial institutions (usually banks) that provide the securities that are designed to deliver the returns described in a structured product plan, including repayment of capital and any investment return / income that may become due.

An investment in a structured product is effectively a loan to the issuing bank and the repayment of any capital return and investment returns as described in the plan brochure depend on the security of the issuing bank and its ability to meet the payments which become due.

Structured products depend heavily on their counterparties and their solvency throughout the term of the plan.

Counterparties are obliged to meet the contractual terms of the securities they issue – but their ability to do so largely depends upon their solvency. The risk that they might default and fail to make any payments that may become due under the terms of their securities, is known as ‘Counterparty Risk’.

Usually the risk of a major financial institution failing to meet its commitments is considered small – but it is possible, so investors must understand the risk and the effect it will have on their investment.

Our brochures will always state the name of the counterparty involved, their credit ratings at the time the brochure is drafted and any other pertinent information relating to their financial strength.

The securities issued by counterparties are usually Medium Term Notes, Warrants, Certificates, or other securities. These are similar to a corporate bond or other debt instrument.

A number of factors can be taken into account when selecting a counterparty for a plan – these include credit ratings and credit default swap rates.
Credit ratings

Credit ratings are recognised indicators of the financial strength of an institution. Credit ratings are assigned by independent organisations, known as credit rating agencies, which monitor the probability of default of financial institutions. The three main credit rating agencies are Standard & Poor’s, Fitch and Moody’s.

The scales and definitions of these three credit rating agencies can be found on the next page.

Standard & Poor’s

- Their highest possible rating is AAA, followed by AA and A. These three ratings along with their BBB rating are generally regarded as investment grade. All of these ratings except the AAA rating can also modified by a plus or a minus. The '+' and '-' markings indicate relative standing within the grade category; for example, A+, A, A- for the A rating. Ratings from BB downwards are provided in respect of other securities.

Fitch

- Their ratings scale is very similar to Standard & Poor’s.

Moody’s

- Moody’s ratings are expressed slightly differently. Moody’s ratings symbols range from Aaa to C, and numerical modifiers 1, 2, and 3 are added to each generic rating classification from Aa through to Caa to indicate relative standing within the grade category.

A credit rating is the opinion of the credit ratings agency. A high rating from one or more of the credit rating agencies is not a guarantee that the counterparty will meet its obligation to pay the amounts due from the Plan.

A rating outlook assesses the potential direction of a long-term credit rating over the intermediate term. Moody’s definition of long term is financial obligations with an original maturity of one year or more, Fitch’s definition is a period of one to two years and Standard & Poor’s definition is typically for a period of six months to two years.
## Credit ratings agencies - Definitions

### S&P Ratings Scale

<table>
<thead>
<tr>
<th><strong>Investment Grade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>AA+, AA, AA-:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>A+, A, A-:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>BBB+, BBB, BBB-:</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Non-Investment Grade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>BB+, BB, BB-:</td>
</tr>
<tr>
<td>Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.</td>
</tr>
<tr>
<td>B+, B, B-:</td>
</tr>
<tr>
<td>More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.</td>
</tr>
<tr>
<td>CCC+, CCC, CCC-:</td>
</tr>
<tr>
<td>Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.</td>
</tr>
<tr>
<td>CC:</td>
</tr>
<tr>
<td>Currently highly vulnerable.</td>
</tr>
<tr>
<td>C:</td>
</tr>
<tr>
<td>Currently highly vulnerable obligations and other defined circumstances.</td>
</tr>
<tr>
<td>CI:</td>
</tr>
<tr>
<td>Past due on interest.</td>
</tr>
<tr>
<td>R:</td>
</tr>
<tr>
<td>Under regulatory supervision due to its financial situation.</td>
</tr>
<tr>
<td>SD:</td>
</tr>
<tr>
<td>Has selectively defaulted on some obligations</td>
</tr>
<tr>
<td>D:</td>
</tr>
<tr>
<td>Payment default on financial commitments.</td>
</tr>
</tbody>
</table>

### Fitch Ratings Scale

<table>
<thead>
<tr>
<th><strong>Investment Grade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>AA+, AA, AA-:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>A+, A, A-:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>BBB+, BBB, BBB-:</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Non-Investment Grade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>BB+, BB, BB-:</td>
</tr>
<tr>
<td>Elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions. But business or financial flexibility exists which supports the servicing of financial commitments.</td>
</tr>
<tr>
<td>B+, B, B-:</td>
</tr>
<tr>
<td>Financial commitments currently being met. Capacity for continued payment vulnerable to deterioration in business and economic conditions.</td>
</tr>
<tr>
<td>CCC+, CCC, CCC-:</td>
</tr>
<tr>
<td>Substantial credit risk. Default is a real possibility.</td>
</tr>
<tr>
<td>CC:</td>
</tr>
<tr>
<td>Very high levels of credit risk. Default of some kind appears probable.</td>
</tr>
<tr>
<td>C:</td>
</tr>
<tr>
<td>Exceptionally high levels of credit risk. Default is imminent or inevitable, or the issuer is in standstill.</td>
</tr>
<tr>
<td>D:</td>
</tr>
<tr>
<td>Has defaulted on obligations and Fitch believes that it will generally default on most or all obligations.</td>
</tr>
</tbody>
</table>

### Moody’s Rating Scale

<table>
<thead>
<tr>
<th><strong>Investment Grade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
</tr>
<tr>
<td>Judged to be of the highest quality, with minimal credit risk.</td>
</tr>
<tr>
<td>Aa1, Aa2, Aa3</td>
</tr>
<tr>
<td>Judged to be of high quality and are subject to very low credit risk.</td>
</tr>
<tr>
<td>A1, A2, A3</td>
</tr>
<tr>
<td>Considered upper-medium grade and are subject to low credit risk.</td>
</tr>
<tr>
<td>Baa1, Baa2, Baa3</td>
</tr>
<tr>
<td>Subject to moderate credit risk. They are considered medium grade and as such may possess certain speculative characteristics.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Non-Investment Grade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ba1, Ba2, Ba3</td>
</tr>
<tr>
<td>Judged to have speculative elements and are subject to substantial credit risk.</td>
</tr>
<tr>
<td>B1, B2, B3</td>
</tr>
<tr>
<td>Considered speculative and are subject to high credit risk.</td>
</tr>
<tr>
<td>Caa1, Caa2, Caa3</td>
</tr>
<tr>
<td>Judged to be of poor standing and are subject to very high credit risk.</td>
</tr>
<tr>
<td>Ca</td>
</tr>
<tr>
<td>Highly speculative and are likely in, or very near, default, but with some prospect of recovery of principal and interest.</td>
</tr>
<tr>
<td>C</td>
</tr>
<tr>
<td>Lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.</td>
</tr>
</tbody>
</table>

### Special

| WR                     |
| Withdrawn Rating       |
| P                      |
| Provisional            |
Credit default swaps

Historically credit ratings have been used as the principal measure of the financial strength of an underlying issuer. However, over recent years Credit Default Swap (‘CDS’) rates have become an additional measure of the financial strength and quality of a counterparty and are now often utilised alongside ratings produced by credit rating agencies.

CDS rate levels are determined by the supply and demand of market participants and therefore do not rely on one single agency to determine a company’s credit worthiness.

A CDS is basically an insurance contract - the buyer makes periodic payments to the seller to effectively insure against a debt default and in return receives a payoff, if the underlying financial instrument/institution does default.

CDS rates are quoted in the market in the format of an annualised spread over the London Interbank Offered Rate (‘LIBOR’), known as the CDS spread. This indicates the percentage amount buyers are willing to pay a seller in order to insure themselves against the likelihood of a credit default event of the underlying issuer i.e. default, bankruptcy, debt restructuring, etc.

CDS spreads allow investors to analyse how risky an institution’s debt is perceived to be by the market, a relevant factor when considering the credit strength of a counterparty.

Companies with higher CDS spreads are considered riskier by the market, as they are considered more likely to default than those with a lower CDS spread, all other things being equal. The CDS spread should widen (increase) if the market perceives that the credit strength / quality of the issuer will deteriorate.

Current CDS spreads of a number of counterparties can be found on the next page.

Capital ratios are another measure of a bank’s strength. These are used by regulatory authorities, with the most widely known being tier one capital ratio, which consists largely of shareholders’ equity. It is the amount paid originally to purchase permanent capital (such as ordinary shares) of the bank and retained earnings (minus losses). It is the core measure of a bank’s financial strength from a regulator’s point of view. This ratio has been the subject of much review recently resulting in the Basel III Accord, requiring banks to maintain a minimum Tier 1 capital ratio of 6% and not pay any distributions or dividends that would affect its capital.
### Credit default swaps

**24 February 2012**

<table>
<thead>
<tr>
<th></th>
<th>1Y CDS</th>
<th>2Y CDS</th>
<th>3Y CDS</th>
<th>4Y CDS</th>
<th>5Y CDS</th>
<th>5Y CDS % Increase in rates</th>
<th>Long Term Credit Rating</th>
<th>Tier 1 Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UK Government</strong></td>
<td>0.11%</td>
<td>0.19%</td>
<td>0.29%</td>
<td>0.55%</td>
<td>0.72%</td>
<td>-5.76% -12.12% 13.97%</td>
<td>AAA AA Aaa</td>
<td>N/A</td>
</tr>
<tr>
<td>Rabobank</td>
<td>0.65%</td>
<td>0.81%</td>
<td>0.97%</td>
<td>1.09%</td>
<td>1.18%</td>
<td>-2.98% -0.36% 75.82%</td>
<td>AA AA Aaa</td>
<td>15.70%</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co</td>
<td>0.49%</td>
<td>0.71%</td>
<td>0.87%</td>
<td>1.05%</td>
<td>1.19%</td>
<td>-1.26% -2.99% 53.13%</td>
<td>A AA- Aa3</td>
<td>12.30%</td>
</tr>
<tr>
<td>HSBC Holdings plc</td>
<td>0.80%</td>
<td>0.91%</td>
<td>1.05%</td>
<td>1.18%</td>
<td>1.31%</td>
<td>-0.46% 3.06% 64.63%</td>
<td>A+ AA Aa2</td>
<td>12.10%</td>
</tr>
<tr>
<td>Credit Suisse Group AG</td>
<td>0.85%</td>
<td>1.02%</td>
<td>1.18%</td>
<td>1.33%</td>
<td>1.43%</td>
<td>-4.81% 8.56% 57.98%</td>
<td>A A (P)Aa2</td>
<td>18.10%</td>
</tr>
<tr>
<td>Standard Chartered plc</td>
<td>0.85%</td>
<td>0.99%</td>
<td>1.14%</td>
<td>1.29%</td>
<td>1.45%</td>
<td>-2.12% -14.13% 68.97%</td>
<td>A+ AA- A2</td>
<td>14.00%</td>
</tr>
<tr>
<td>Deutsche Bank AG</td>
<td>0.81%</td>
<td>1.08%</td>
<td>1.21%</td>
<td>1.43%</td>
<td>1.52%</td>
<td>-6.97% -2.33% 49.12%</td>
<td>A+ A+ Aa3</td>
<td>12.90%</td>
</tr>
<tr>
<td>UBS AG</td>
<td>1.04%</td>
<td>1.22%</td>
<td>1.42%</td>
<td>1.57%</td>
<td>1.68%</td>
<td>-1.13% 2.08% 85.57%</td>
<td>A A Aa3</td>
<td>19.70%</td>
</tr>
<tr>
<td>Barclays Bank plc</td>
<td>0.92%</td>
<td>1.17%</td>
<td>1.35%</td>
<td>1.58%</td>
<td>1.72%</td>
<td>-2.07% 3.58% 40.11%</td>
<td>A+ A Aa3</td>
<td>N/A</td>
</tr>
<tr>
<td>ING Groep N.V.</td>
<td>1.14%</td>
<td>1.34%</td>
<td>1.53%</td>
<td>1.70%</td>
<td>1.86%</td>
<td>-1.95% 3.06% 43.25%</td>
<td>A A A1</td>
<td>12.25%</td>
</tr>
<tr>
<td>Commerzbank AG</td>
<td>1.27%</td>
<td>1.57%</td>
<td>1.66%</td>
<td>1.91%</td>
<td>2.04%</td>
<td>-7.08% -2.16% 12.11%</td>
<td>A A+ A2</td>
<td>11.10%</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>1.37%</td>
<td>1.58%</td>
<td>1.78%</td>
<td>1.94%</td>
<td>2.06%</td>
<td>1.51% -8.25% 104.82%</td>
<td>AA- A+ Aa3</td>
<td>11.60%</td>
</tr>
<tr>
<td>Citigroup Inc.</td>
<td>1.42%</td>
<td>1.86%</td>
<td>2.17%</td>
<td>2.29%</td>
<td>2.39%</td>
<td>0.29% 9.55% 70.02%</td>
<td>A- A A3</td>
<td>13.55%</td>
</tr>
<tr>
<td>Credit Agricole S.A.</td>
<td>1.83%</td>
<td>2.05%</td>
<td>2.20%</td>
<td>2.38%</td>
<td>2.50%</td>
<td>4.38% 1.70% 84.04%</td>
<td>A A+ Aa3</td>
<td>11.20%</td>
</tr>
<tr>
<td>Macquarie Group Ltd</td>
<td>1.75%</td>
<td>1.94%</td>
<td>2.15%</td>
<td>2.41%</td>
<td>2.57%</td>
<td>-1.28% -10.98% 43.45%</td>
<td>BBB A *+ A2</td>
<td>10.70%</td>
</tr>
<tr>
<td>Santander UK plc</td>
<td>1.85%</td>
<td>2.22%</td>
<td>2.42%</td>
<td>2.63%</td>
<td>2.82%</td>
<td>0.46% -0.25% 46.11%</td>
<td>A+ A+ A1</td>
<td>11.50%</td>
</tr>
<tr>
<td>Nomura Bank International plc</td>
<td>1.39%</td>
<td>1.73%</td>
<td>2.02%</td>
<td>2.40%</td>
<td>2.65%</td>
<td>-1.40% -11.79% 74.23%</td>
<td>A- N/A N/A</td>
<td>16.40% *^</td>
</tr>
<tr>
<td>Lloyds Banking Group plc</td>
<td>1.88%</td>
<td>2.24%</td>
<td>2.33%</td>
<td>2.55%</td>
<td>2.67%</td>
<td>-2.88% 2.81% 41.69%</td>
<td>A- A A2</td>
<td>12.50%</td>
</tr>
<tr>
<td>Banco Santander S.A.</td>
<td>2.05%</td>
<td>2.29%</td>
<td>2.43%</td>
<td>2.64%</td>
<td>2.73%</td>
<td>-2.88% 3.29% 13.61%</td>
<td>A+ A Aa3</td>
<td>11.01%</td>
</tr>
<tr>
<td>The Goldman Sachs Group Inc.</td>
<td>2.26%</td>
<td>2.45%</td>
<td>2.55%</td>
<td>2.64%</td>
<td>2.74%</td>
<td>4.12% 13.95% 134.75%</td>
<td>A- A A1</td>
<td>16.00%</td>
</tr>
<tr>
<td>Bank of America Corporation</td>
<td>2.25%</td>
<td>2.40%</td>
<td>2.55%</td>
<td>2.67%</td>
<td>2.74%</td>
<td>-3.09% -6.72% 82.90%</td>
<td>A- A Baa1</td>
<td>12.40%</td>
</tr>
<tr>
<td>Societe Generale</td>
<td>2.12%</td>
<td>2.28%</td>
<td>2.45%</td>
<td>2.64%</td>
<td>2.75%</td>
<td>2.18% -9.65% 107.38%</td>
<td>A+ A A1</td>
<td>10.70%</td>
</tr>
<tr>
<td>Royal Bank of Scotland Group plc</td>
<td>2.00%</td>
<td>2.27%</td>
<td>2.43%</td>
<td>2.64%</td>
<td>2.76%</td>
<td>-2.95% 5.19% 27.65%</td>
<td>A- A A3</td>
<td>13.00%</td>
</tr>
<tr>
<td>Banco Bilbao Vizcaya Argentaria</td>
<td>2.13%</td>
<td>2.34%</td>
<td>2.49%</td>
<td>2.72%</td>
<td>2.83%</td>
<td>-0.79% 4.35% 10.63%</td>
<td>A A Aa3</td>
<td>10.30%</td>
</tr>
<tr>
<td>Merrill Lynch &amp; Co</td>
<td>2.62%</td>
<td>2.77%</td>
<td>2.91%</td>
<td>3.03%</td>
<td>3.06%</td>
<td>-1.91% -8.10% 92.03%</td>
<td>A- A Baa1</td>
<td>N/A</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>3.12%</td>
<td>3.20%</td>
<td>3.31%</td>
<td>3.37%</td>
<td>3.42%</td>
<td>5.26% 11.88% 132.83%</td>
<td>A- A A2</td>
<td>16.10%</td>
</tr>
</tbody>
</table>

- **Source:** Bloomberg. Data sorted according to 5 Year CDS, in ascending order. The percentage increase shows the weekly, monthly and yearly change in 5 Year CDS rates.
- * indicates that the credit rating agency has that company on watch. *+ indicates a possible upgrade, and *- a possible downgrade.
- The ‘u’ in the UK Government rating of ‘AAAu’ indicates it is an unsolicited rating (assigned at the initiative of credit rating agency not the issuer).
- (P) indicates a provisional rating (highly likely to become final after all relevant documents received by Moody’s).
- ^ This Tier 1 Capital Ratio is for Nomura Holdings Inc. as it was not available for Nomura Bank International plc.
- N/A indicates that this data is not available for that company.
Investment checklist

A range of structured product features should be examined.

Term

Structured products usually do not have product terms that can be measured in exact years. In theory there will be four elements to a structured product term:

Offer period

This is the timeframe over which investments may be made – usually around six to eight weeks, during which a nominal rate of interest may be earned or the investment discounted accordingly.

Strike Date

This is the date on which the initial index / asset value is set or, if the initial level is averaged, the first measurement is taken. The strike date is usually within two weeks of the end of the offer period.

Final Date

This is the date when the final index / asset value reading is made. In practice, final readings can be averaged. The gap between the strike date and final date – i.e. the index / asset investment period – is usually a whole number of years.

Payment Date

To allow for the necessary administration, payment of maturity amounts is normally a week or two after the final date. Not all providers quote a payment date. The end result is that, even if an investment is made at the very end of the offer period, the product term will be two to four weeks longer than the index / asset investment period.
Investment checklist

Underlying Asset(s)

The most widely used link, the FTSE 100 Index, is well understood, but other indices / assets may be less familiar. Some points to consider are shown below.

Is accumulated income allowed for?

Most structured products linked to indices take no account of income, either at current levels or anticipated. This can be significant: for example, the FTSE 100’s dividend yield as at 9 August 2012 was about 4.00% (source: Bloomberg). However, ignoring income means the product is often able to offer more growth participation than a product that includes the dividend income. A product linked to the performance of active funds may base returns on accumulation units / shares, which will be reflected in a lower participation rate than an index-linked product.

How diversified are the constituents of the chosen index?

Most indices will offer diversified exposure to an appropriate asset type. But it is worth noting that even for leading indices such as the FTSE 100, the top 10 companies accounted for around half of the index (source: Bloomberg). Also the major stock markets are highly correlated; meaning that if one goes up or down the others are likely to follow.

How volatile is the index / asset?

Volatility will be reflected in product pricing. For instance, targeting full capital repayment will be more costly for the NASDAQ Composite than the S&P 500 and consequently market participation will be lower.
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Investment checklist

What adjustment is made for currency?

Usually in retail product currency is ignored, for example a product linked to the Nikkei 225 will pay a return based on the movement in absolute index numbers. This can produce what looks like surprising results, for example high exposure and full capital repayment. The point that is often forgotten is that a corresponding index-tracking fund would normally be fully exposed to currency movements.

Expectation of potential returns

Several structured investment analysts (for example, Future Value Consultants and some investment banks) calculate probability tables of potential product returns, based on simulated performances. These are very helpful in demonstrating the outlying probabilities and providing reasonable expectation of possible outcomes following investment in a product. These can be more useful than relying on past performance information.

Calculation basis

It is a common, but not universal feature for the final index / asset price reading to be averaged in some way. For example, an index may be averaged on a monthly, weekly or daily basis over the last 12 months of the investment term. Averaging of the initial level is much less common. Averaging is a double-edged sword. It reduces the impact of a sharp downturn shortly before the end of the investment period. However, the opposite is also true: a sharp rise in the final few months is diluted by averaging.

The calculation basis for capital at risk products also varies. For some, the observed barrier is based on closing levels each day, while for others intra-day measures are used. All other things being equal, intra-day involves slightly more risk, particularly if the asset is volatile.
**Investment checklist**

**Credit rating and collateralisation**

The rule here is simple: the higher the credit rating of the issuer, the better. In practice, some product providers may not give a specific rating, for example ‘A or better’ is promised. The wise precaution is to assume in such circumstances the rating will be the lowest quoted.

If the arrangement is collateralised to cover the event of default, it is worth checking what this actually means in practice.

**Capital repayment**

The level of capital repayment on offer, if any, needs to be understood. Any capital repayment carries a cost and the investor needs to be aware of it. Crucially, if there is a risk of capital loss, further disclosure must be made.

**Tax**

Tax is often an important consideration in choosing between two products. As the table on page 16 demonstrated, there is no substitute for a calculation based on the investor’s expected tax position at maturity, even if fate and / or the Chancellor may intervene in the interim.

Clients should consult their own tax advisors for tax advice tailored to their particular circumstances.
**FSCS**

Meteor Asset Management and Meteor Investment Management are covered by the FSCS. Investors may be entitled to compensation from the FSCS in the event that we are declared to be in default and cannot meet our obligations and if an investor has a valid claim against the company.

**Structured investments**

In the event that a counterparty fails to meet its obligations to pay the amount due from the Securities, this will not in itself entitle investors to compensation from the FSCS. Likewise if the performance of a plan does not match any illustrated benefits, investors will not, for that reason alone, be entitled to any compensation under the FSCS.

Investors should be aware that whether they are eligible to make a claim under the FSCS will depend on various factors and that there are limits to the amount of compensation the FSCS will pay. For investments covered by the Scheme, the compensation limit is currently £50,000 per person. Investors would not be covered for any excess amount over the compensation limit of £50,000. If an investment Plan is taken out in joint names the compensation limit would apply to each investor.

**Structured deposits**

Deposit investments made by Meteor on behalf of investors will be through a bare trust. Therefore, investors may be entitled to compensation from the FSCS in the event that the Deposit Taker is declared to be in default and unable to pay the amount due from the fixed term deposit, and where the Deposit Taker is a participant in the Financial Services Compensation Scheme.

Where an investor has made a personal application for a deposit and the Deposit Taker fails to make the payments of interest and/or capital repayment due the investor may have an eligible claim to recover any resulting losses from the Scheme. We will notify the Deposit Taker that the Deposits we make are not for our benefit but represent deposits made by and belonging to individual Plan holders.

Whether investors are eligible to make a claim under the FSCS will depend on various factors, including the size of the relevant Deposits and the laws and regulations applicable to the relevant financial institution (which may vary depending on where they are based). When Meteor act as bare trustee it may, depending on the laws, regulations and the facts at the time, make a claim on an investor’s behalf.

The compensation limit is currently £85,000 per person and this applies to all deposits held with the counterparty and any other member of the counterparties group included under the same FCA registration number. Investors would not be covered for any excess amount over the compensation limit of £85,000. If a Plan is taken in joint names the compensation limit would apply to each investor.
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