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Hedging equity portfolios with Structured Products

We have long advocated the use of structured products as a hedging strategy for investors to protect against potential falls in their equity/fund returns. This is because with structured products, unlike other forms of equity investment, capital gains can often be made without any growth in the underlying asset itself. In addition, most structured products come with some level of conditional capital protection. To see the benefits of hedging risks through the use of structured products, we have looked at how one of our Supertracker plans would have protected clients holding a range of direct equity investments.

The example used is a 6 year 2 week investment, linked to the FTSE 100 which provides investors with a potential 2% for each percentage point the Final Level of the Index is above 75% of its Opening Level. The investment return is capped at 50% but, in return, the investor is only exposed to losses if the Final Level of the Index is below 60% of its Opening Level. The amount the investor would lose will equal the percentage that the Final Level of the Index is below its Opening Level. As with all structured products, the client is at risk to counterparty exposure.

We think a Plan like this can be effective for nervous investors who want to still participate in equity growth but wish to limit potential downside risks. To test this hypothesis, we back-tested the 5 simple illustrative portfolios below to see how they would have performed based on every daily 6 year rolling window cycle between 31 December 1985 and 8 June 2017 (the biggest sample we could obtain). This resulted in 6441 historical simulation cycles.

- P_1 tests the above structured product only in the 6441 available simulation cycles
- P_2 tests the performance of the FTSE 100 Total Return Index, representing an equity proxy taking into account accumulated dividends
- P_3 tests an equally weighted portfolio of P_1 and P_2
- P_4 tests the performance of the FTSE 100 Price Index, representing an equity proxy ignoring dividends
- P_5 tests an equally weighted portfolio of P_1 and P_4

	P_1	P_2	P_3	P_4	P_5
	Structured Product	FTSE 100 Total Return Index	50/50 P_1 and P_2	FTSE 100 Price Index	50/50 P_1 and P_4
Average Return	45.05%	72.54%	58.80%	37.22%	41.14%
Annualised Return (pa)	6.40%	9.52%	8.01%	5.42%	5.91%
Cycles resulting in capital loss	0.00%	6.86%	2.70%	22.23%	5.76%
Worst simulated result	0.00%	-17.27%	-8.63%	-30.01%	-15.01%
Average loss	N/A	-5.90%	-3.80%	-11.19%	-6.79%

Meteor Research Department, 8 June 2017

Notes: It should be recognised that the economic conditions that existed at the time the Plan being used for comparison was constructed, would not have existed historically. In some cases, the Plan terms might have been more or less favourable depending on the economic conditions at the time. Some economic conditions may not have allowed for this Plan to be available at all.

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We see from the hypothetical simulations discussed overleaf, that long only equity with dividends (P_2) would have produced a higher return than the structured product (9.52%pa compared to 6.40%pa). We see also that the structured product, hypothetically, would have never lost money, whereas the equity proxy did on 6.86% of the 6441 holding periods, with the worst loss at -17.27%.

It gets interesting when we see that if instead of holding one or the other, the investor held an equally weighted portfolio (P_3) the number of times we would have lost money goes down to 2.70% and our worst result over any 6 year period would have been a loss of 8.63%, effectively halving the worst loss from holding P_2 only. This is because half of our money is in the structured product which, in this cycle, would have prevented a loss, giving the investor 100% of the money invested in the structured product back. On top of these benefits, we also see that the annualised rate of return was, although less than 9.52%, still highly competitive at 8.01%.

If we ignore dividends the argument becomes even more compelling. The price return only index (P_4) would have lost money in 22.23% of the simulated cycles with the worst result being a 30.01% loss. An equally weighted portfolio of P_1 and P_4 lost money in only 5.76% of the cycles, almost four times less than P_4. In addition, the annualised return of P_5 at 5.91%pa is actually greater than the price return index investment which has an annualised return of 5.42%pa.

Advisers are finding new ways to utilise structured products in a diversified portfolio all the time. Hedging against the risk of volatile markets under the heavy backdrop of geopolitical tensions globally is just one way that investors can benefit.

To discuss this subject further with a member of the Meteor team, contact sales@meteoram.com

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Meteor Asset Management Limited
55 King William Street
London EC4R 9AD
Tel +44 (0)20 7904 1010
Fax +44 (0)20 7283 1355
Email info@meteoram.com
Web www.meteoram.com