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PRIVATE BANK

INVESTMENT THEME

October 2017

Structured products - how to invest

What are structured products?
Structured products are investment products that combine two or more financial instruments, of which one is often an option. The purpose of a structured product is to create a specific risk stance in a specific market situation. In addition, structured products can open up possibilities for investors in markets that cannot easily be accessed with other financial instruments. The suitability of a structured product as an investment will vary, as it will depend on the investor's personal risk appetite, their market expectation, and the prevailing market situation.

What types of products are there?
It is not easy to get clear overview of the multifaceted world of structured products, not least because every provider (issuer) has their own terms for the various different types of products and the strategies these products pursue. As an additional factor, the terms "certificate" and "derivative" are frequently used synonymously alongside the term "structured products". In order to facilitate an overview of this product category, the Swiss Structured Products Association (SSPA) has drawn up its own neutral classification, the terms of which we will adhere to in this article. This will make it a bit easier for interested investors to get to grips with the six main groups and more than 20 product types.

Key terms
To provide a better description of structured products, we must first explain a few specialist terms:
Basket: This is a group of securities that serve as the underlying (instrument) for a structured product and have been bundled together for this purpose.
Cap: The term "cap" is used to describe the limit to the potential return of a structured product. The profit or loss on a product may be limited, whereby the investor participates in the performance of the underlying only as far as this "cap".
Delta: This term is frequently used in the quantitative assessment of options. The delta coefficient measures the change in the price of an option for the change in the price of the underlying by one currency unit. The resulting value indicates the price sensitivity of the instrument in question. The delta will lie between 0 and 1 in the case of a call option, and between -1 and 0 in the case of a put option.
Future: A future is a standardized forward transaction that commits the contracting party to purchase (buyer) or deliver (seller) a certain amount of a particular underlying at an agreed price at a fixed point in the future.
Leverage: The leverage of an option describes the relationship between the return potential and the capital invested. For example, a leverage of 10x means that the investor's entire capital will be lost in

the event of a loss of 10% on this leveraged position, or that the investor's capital will be doubled with a profit of 10%.
Strike (exercise price): The price specified in the product at which the holder can acquire the underlying ("call option") or sell the underlying ("put option") either at or prior to the expiry of the option.

How they work
Structured products are essentially financial products consisting of an underlying instrument and a derivative component. The two elements are combined to create a stand-alone security. The underlying in question may take the form of equities, currency pairs, indices, commodities, or indeed baskets combining multiple underlyings. The derivative component is either a financial forward contract (future) or an option. This derivative component will have one of two functions: Either it has the effect of lowering the risk or the costs, or it serves to generate additional income (yield) potential. In many cases, this results in the product exhibiting non-linear price behaviour.

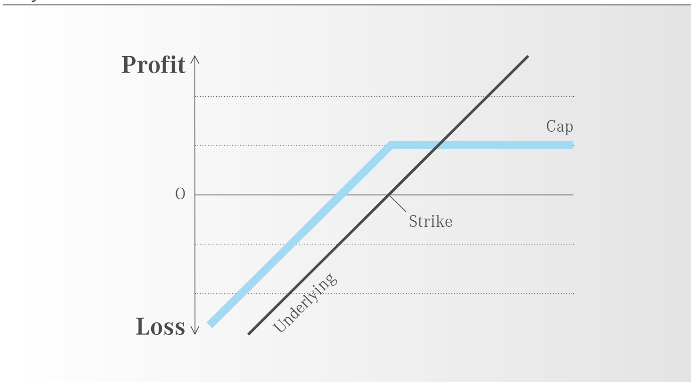
Depending on the way the product is designed, the underlying and the derivative can be combined in different ways. A feature common to all structured products is the fact that profits or losses are limited beyond a predefined price level. An exception in this respect is the participation product, which seeks to replicate the development of a benchmark index as closely as possible.

Finally, the majority of structured products have a fixed term. Depending on the way they are designed, products will be redeemed at the end of the term either at their value at that point, or at a predefined value. However, with some products it is also possible that these securities will expire worthless at the end of their terms, insofar as an event previously defined in the agreement has (not) come to pass.

It goes beyond the remit of this paper to present every single product type here. We will therefore concentrate first of all on two popular structured products that are suitable for market situations in which prices are not rising or falling strongly: Discount Certificates and Reverse Convertibles. For information on other types of structured products, please visit http://www.svsp-verband.ch/en/structured-products/#section-knowledge.

Discount Certificates
These are certificates that enable the investor to acquire the underlying instrument at a discount to the market price. At the same time, the investor's participation in rising prices is limited on the upside. This ceiling, typically known as the cap, is defined from the start. The benefit of this product for you as a client is the fact that you can participate in the upside performance of the underlying product at a lower price. You do not profit from price gains above the exercise (strike) price, but in return you receive a comparatively high coupon that will depend on the volatility of the underlying. The coupon is explained by the structure of the product: One part of the product comprises a put option on the underlying. The premium received through the sale of this put option together with the standard capital market interest rate produces the above-average return when compared with a normal bond.

Payoff Chart Discounter



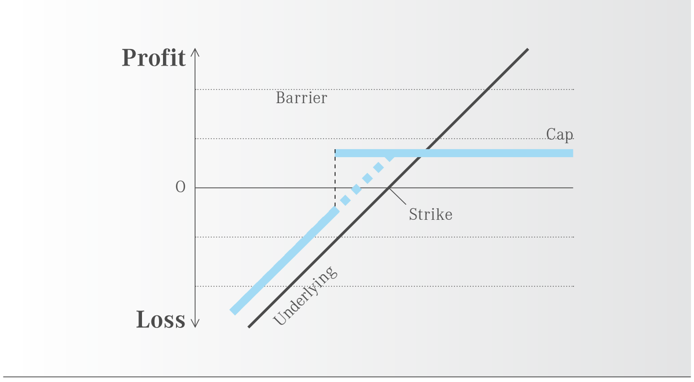
Source: Swiss Structured Products Association (SSPA)

As the product was acquired at a discounted rate, i.e. below the actual strike price, in the event of negative performance investors have a greater cushion (risk buffer) before the product ends up in the loss zone. However, this effect becomes less pronounced as the losses of the underlying become more extreme. As long as the price of the underlying fluctuates only a little or has risen only moderately by the end of the term, investors achieve a higher return than if they had invested directly in the underlying itself. These products are therefore suitable for situations in which the underlying is only expected to fluctuate slightly from its current price. By acquiring this product, you are taking on the equivalent position of the seller or writer of a put option (short position).

Barrier Reverse Convertible
These instruments are structured in a very similar way to Discount Certificates, and rank among the most popular products of Swiss private investors. These products also allow investors to acquire the underlying more cheaply. And here too, participation in positive price development is limited to a predefined cap.
The key difference is that an exercise price (strike) and a lower-lying barrier are determined when the security is constructed.
The decisive factor for the return on this product is whether this barrier is touched during the term of the product or not. If the barrier is not touched at any point prior to expiry, i.e. the market price has al-

ways been above the barrier price, the coupon determined in advance is repaid together with the nominal value of the security. The barrier therefore has the effect of increasing the probability of full repayment of the invested capital.
If the barrier is touched, the structured product becomes a Reverse Convertible. In this case, it is the exercise price at the end of the term that dictates whether redemption takes the form of cash or delivery of the underlying to the custody account of the investor (i.e. physical delivery). If the price of the underlying at expiry is below the exercise price, the holder receives either the underlying (e.g. shares) or (in the case of non-deliverable underlyings, e.g. a basket) the equivalent value in cash. In all scenarios the coupon is paid out, however.

Payoff Chart Barrier Reverse Convertible



Source: Swiss Structured Products Association (SSPA)

Benefits
Generally speaking, structured products can be used to reduce risks when added to an existing portfolio. Depending on the way they are structured, they can have the effect of reducing the overall volatility of the portfolio, i.e. the magnitude of price fluctuations. Equally, these products can also be deployed for purposes of capital protection in certain market situations.
With structured products, certain market expectations can be backed with investment decisions in a targeted way. Be it for strategies involving individual securities, industry sectors, or entire markets, customized products are available for almost any situation that other financial instruments would find it difficult to replicate.
Structured products can give the investor attractive additional returns, particularly in markets in which no clear direction is apparent. Leveraged structured products offer disproportionate return potential – but with a corresponding higher degree of risk. Broadly speaking, products exist for every kind of risk appetite, from capital-protected products that seek to preserve the investor's capital right through to leveraged products that scale up the profit potential and risks of the underlying instrument.

Risks
Structured products are created individually by a product provider or issuer. As bonds, they constitute subordinated liabilities of the issuer. This means that the investor is also exposed to issuer risk.
Every structured product has its own risk profile, and is therefore suited to a very specific market situation or expectation. The market risks to which the underlying is exposed may be augmented or reduced by the product’s characteristics.
The use of leveraged products can significantly increase both the return and risk of the investment. This is because a structured product will react more strongly than its underlying to price fluctuations.
If you acquire structured products in foreign currencies, it is important to take into account the exchange rate risk, i.e. the relative change in the value of the currency of issue against your domestic currency. However, some products allow you to hedge this risk ("quanto" products).
As structured products are very specific instruments, you should check their liquidity prior to an investment. Due to the specific way they are structured, the market liquidity of structured products can be lower than that of other financial products. In other words, you may be restricted in your ability to buy or sell the product at any point, and in any market situation. In the case of less popular instruments, investors must therefore be able to handle a certain degree of price uncertainty in the absence of prices being fixed on a daily basis.
Depending on the type of product and the way it is structured, the way it functions or behaves in different market situations may be difficult to understand. It is therefore a good idea only to make investment decisions by yourself in respect of straightforward products, and to seek advice from your client advisor in the case of more complex products.

What should you look out for?
The choice of issuer and their credit rating is an important aspect. When you acquire a structured product, you are essentially accepting the redemption and performance promises made by the issuer of this product – which means you are exposing yourself to a risk. For the issuer of the underlying (e.g. a listed company), there is no increase in risk as a result of the issue of a structured product.
As with other investment decisions, it is important that investments in structured products fulfil two key requirements. Firstly, the investor must understand how the product works – how its risk and return profile will play out in different market situations. Secondly, the risk of the product must be compatible with the risk appetite and risk tolerance of the investor. If investors do not feel comfortable with the risk they are taking on by acquiring a particular structured

product, this is the wrong product for them.
If you would like to know more about the way in which structured products can be used, or if you have any other questions in respect of these instruments, your client adviser will be happy to assist. Are you not yet a client of Maerki Baumann & Co. AG? By all means get in touch with our experts at beratung@maerki-baumann.ch or +41 44 286 25 25.

Summary

- Structured products are combinations of fixed-income instruments and derivatives.
- These products can be selected very specifically for different market situations and risk appetites.
- With a structured product, it is important to have a good understanding of the product's functioning and its opportunity/risk profile.

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(Editorial deadline: 2 October 2017)

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