SRP

Structured Products Performance Review

France April 2018 - March 2019

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Buy-side survey: key findings

In May 2019, SRP surveyed structured products distributors in France, receiving 29 responses from buy-side market players from sectors including life insurance, private banking, family office, asset management, wealth management, advisory and broker dealing. The survey comprised 12 questions covering the impact of regulation, investor knowledge and preparedness, recent trends in the industry and market challenges going forward.

A non-buoyant market, characterised by scarce autocalling products, low interest rates and volatility, as well as low levels of issuer funding, have been setting the scene against which the French structured products market has been evolving over the last few months.

One-third of responses revealed that market instability and a lack of early product expiration events are the main challenges to address over the next few months. For some, the turbulent markets have made spoting good entry points for new products difficult – for others, the falling markets last year have had a negative impact. Low market levels have not allowed autocalls to expire early, but despite falling, levels are still being perceived as high by investors.

The US-China trade war escalation has impacted equity markets negatively. This means that the speed of rollovers has decreased due to fewer products autocalling, leading to less interest from trading departments because of their existing outstanding positions. Nonetheless, these have increased as distributors and issuers had to focus on attracting new funding for structured products.

Other domains that were identified as challenging included digitalisation, recruitment, automation of tasks and cost reduction, as well as volatility, dispersion and concerns over decrement indices. Eighty-six percent of respondents said regulation had impacted their activity negatively, while the remainder highlighted that conversely, it had helped them and their distribution network.

Against this backdrop, respondents said they would need to 'find attractive autocallable payoffs despite the deterioration in market parameters,' 'find guaranteed capital solutions for corporate cash flows,' 'make French investors aware of the interest in having structured products in their portfolios,' and 'offer innovative solutions in a low volatility environment and with increasingly low yields'.

Sales volumes expectations

Sixty-five percent of respondents said they expected to increase sales of structured products in the next 12 months as they believe that in the current low interest rate environment, structured products are an increasingly interesting investment proposition. Rollovers from expected early expiring autocalls combined with uncertain financial markets favour this asset class, not least due to their ability to beat the low yield of traditional instruments. The success of previous campaigns, as well as fresh inflows, are signs of optimism.

"We have been gaining market share so our sales volumes are increasing, but the size of the pie is decreasing due to fewer autocalling products," said one respondent.

The scarcity of early expiring products is the main reason behind respondents' pessimistic sales expectations for the next year. According to some, 'sales volumes on capital-at-risk products are [already] lower than in 2018' while others expect that the products launched last year will 'struggle to knockout over the next few months'.

The lack of market visibility going forward and investors described as 'less than enthusiastic' round out the picture.

Despite fewer autocalls over the last few months, this type of payoff continues to be very popular with investors, as clients tend to prefer yield-optimisation products against participation structures. Opinions are divided, however, when it comes to growth (athena) or regular income (phoenix) strategies. For over one-third of survey participants, the athena autocall is the better strategy 'because of the higher coupon,' 'because [it is] favoured by the more seasoned investors,' and 'because of the life insurance wrapper which is a growth wrapper'. The phoenix structure also attracted roughly one-third of votes, some of which highlighted the phoenix structure with memory effect for bringing more protection to the client.

Some 20% of respondents acknowledged alternating between both strategies, depending on the market conditions: 'athena with frequent call points or phoenix with a low coupon barrier'. From a wrapper perspective, the athena structure is better housed in a life insurance wrapper while phoenixes are better suited to securities accounts, specified one respondent, as in life insurance it is not possible to have a memory effect on a phoenix.

Securities accounts – a way to simplicity

Most structured products in France are available as unit-linked life insurance wrapped products, because of the tax advantages of the wrapper. Over the past months, the securities account wrapper *(compte-titres)* has regained popularity, being largely used to wrap structured products for optimisation of corporate treasury. The trend is supported by favourable market timing with companies willing to replace maturing low-yield bond investments subscribed in the post-crisis period.

Fifty-five percent of votes, mostly coming from broker-dealers and wealth managers, confirmed an increasing preference for private placements in a securities account. Reasons for this included 'fewer insurer constraints, market timing and lower fees'.

Forty-eight percent voted for the life insurance wrapper, divided equally between public and private placements. As a whole, private placements received three times more votes than public offers.

Costs and performance

Comparability of cost and performance of structured products used to be complex issues even before introduction of the Packaged Retail and Insurance-based Investment Products (Priips) regulation and the key information document (Kid). One-third of distributors said that Priips, which was implemented just over a year ago, has helped them compare the costs between products, though 'with some margin of error' for one respondent and with a lack of transparency for another.

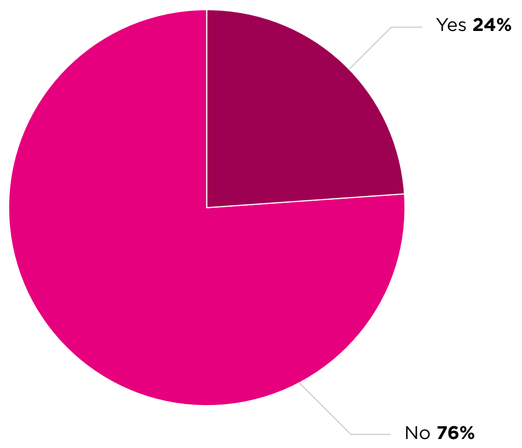
Those who responded negatively said the information contained in the Kid is unreadable and incomprehensible for the end client. Some of the arguments supporting this view included 'costs too complicated to dissociate,' 'not all issuers calculating costs identically' and 'the moment of the hedging'.

Costs in the Kid are disclosed in terms of impact on return (RIY) per year. Clients do not understand this, according to some respondents, even more so as in the rest of the marketing documentation, disclosure is made in terms of percentage of the nominal. The Kid templates are not suited to structured products and calculation methods differ between issuers, said one respondent. The Kid needs to be a lot more understandable for the average investor, with manufacturer costs given separately from distribution costs.

In terms of client preferences regarding disclosure of performance, 44% of respondents said that clients would prefer to see scenarios, while 27% said they would rather see information on past performance. Twenty percent of respondents, from the broker-dealer segment, said it doesn't make a difference.

Investor preparedness

Do investors fully understand the underlying indices with synthetic dividend (decrement)?



Beyond the Kid, do investors really understand what a structured product is? Just over half of respondents said they did. The remaining 45%, representing an insurance company, asset managers, wealth managers, family office consultancies and broker-dealers, said they did not.

Nearly one-quarter of respondents assumed investors understand how underlying indices with synthetic dividend (decrement indices) work. These indices have been very popular in the last couple of years, as the main innovation in the space, after complexity moved out from the payoff formula to the underlying.

Improving investor knowledge will rely on the following: presenting information in layman's terms, continued training and more explanatory videos, and avoid selling overly complex products to avoid this kind of educational exercise. As the whole value proposition of structured products moves from complexity towards simplification, the innovation is not the unique ingredient of a successful product. Offering recognisable types of products, with similar structures, same barriers etc is as important as innovation, as it helps clients get used to the products. Additionally, today's digital tools allow to reach an increasing number of people, which helps extend training sessions and upgrade client advisors.

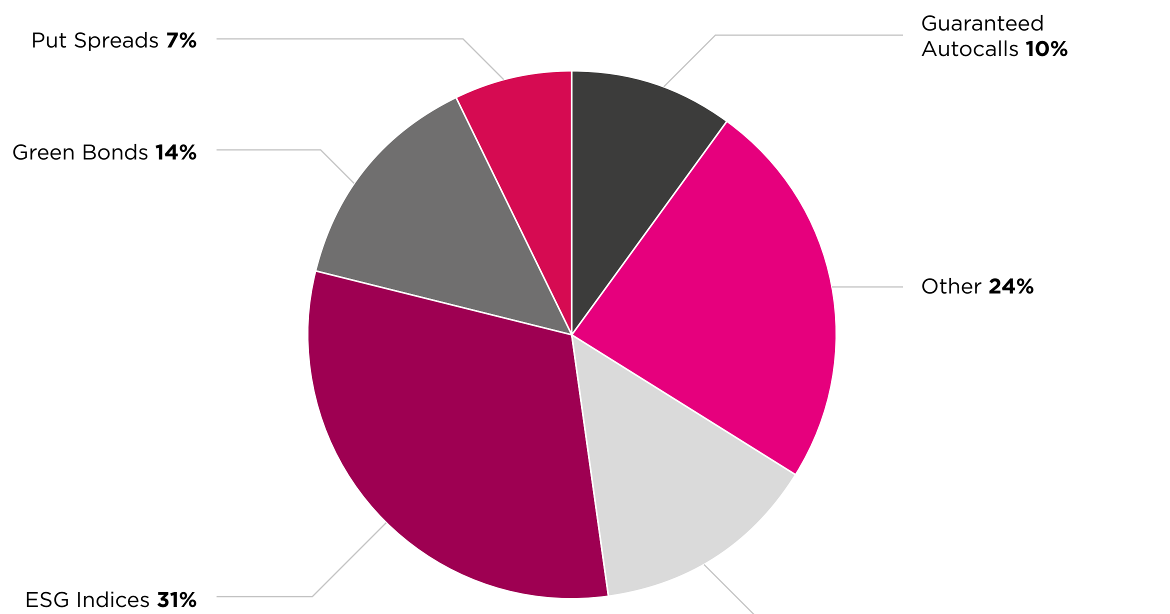
Some of the reactions include 'analysing the relevance of the choice of an underlying,' 'refraining from using indices with synthetic dividends,' 'ensuring product intelligibility,' 'explaining the differences, to show what the product brings and what it costs' and 'harmonising the disclosure of the costs across all marketing documents (Kids, brochures, termsheets, end of year reports)'.

Solutions depend on the type of investor, noted respondents. Innovation is a good thing but it can also lead to misunderstandings for those whose basic knowledge is insufficient. This is where custom quizzes based on investor profiles may help determine their level of knowledge.

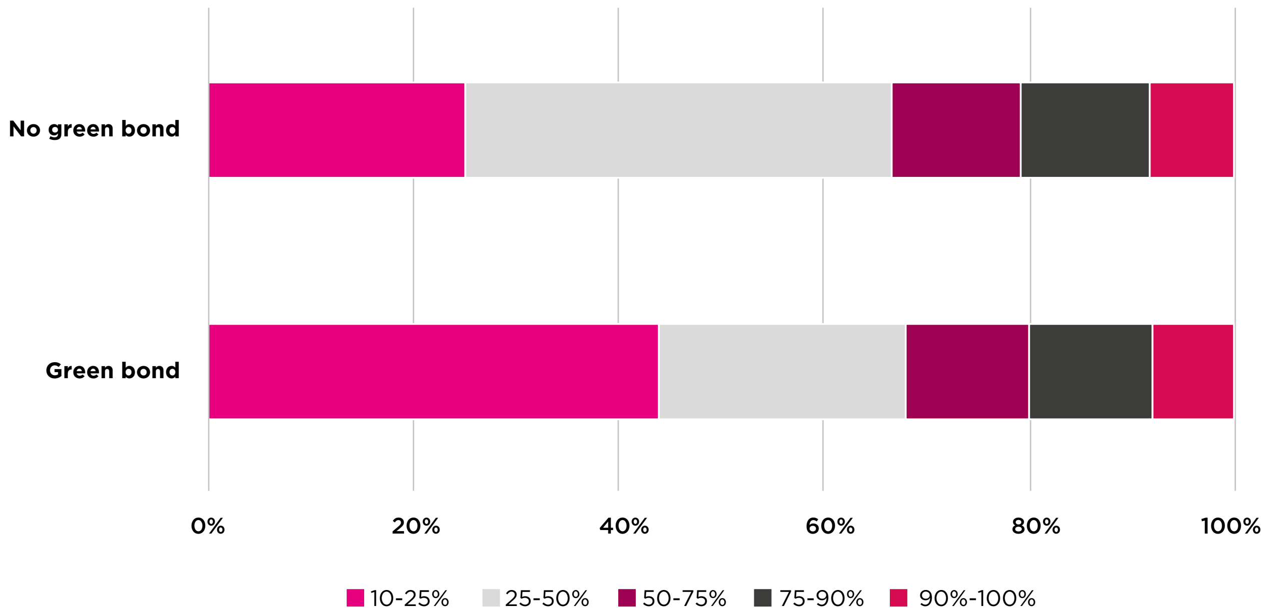
New trends

Environmental, social and governance (ESG) indices were the most prominent investment theme, with 31% of respondents to the survey indicating that it will become a focal point over the next 12 months. Growing challenges in financing the energy transition and the AMF exemption criteria for socially responsible investments have fostered the development of the ESG offer since the beginning of the year. The ESG topic is followed by green bond and decrement indice themes, both of which attracted 14% of votes.

Which theme will be popular in the next 12 months?



Respondents reactions when asked what percentage of financial advisors would invest in an ESG index-linked product (based or not on a green bond)



One–quarter of respondents brought up other themes as important going forward, including negative triggers, lookback features, stock picking and products with double autocall observation and put spread option best timing on three months. The strike-min (or lookback) feature was mentioned twice for its ability to address the risk of market fluctuations.

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Interrogate.

- Monitor & increase your market share
- Carry out accurate trend analysis with comprenhensive product data spanning over 15 years in seconds

Incorporate.

- Import data directly into in-house systems/platforms and interrogate the data and risk more effectively
- Combine data sets with other products and visualise it in the context of the larger business

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Performance analysis (April 2018 to March 2019)

Methodology

This report provides an analysis of the performance of structured retail products distributed in France that matured, expired or paid a regular income between the second quarter of 2018 (April 2018) and the first quarter of 2019 (March 2019). The analysed data includes a total of 629 products and was compiled from the StructuredRetailProducts.com France database, which covers over 7,340 products, of which 2,958 are live year-to-date.

Data collection and criteria

The performance data has been extracted from public sources such as issuer websites and submissions from market players. Additional performance data has been calculated in-house and is based on the performance of the underlying over the investment period.

The calculation of the performance of matured products takes into account the capital return and all interest, fixed or variable, paid during the lifetime of the investment and at maturity.

The value of the coupons is derived from the product description of coupon size and frequency.

Limitations

The returns shown do not take into account management fees in the case of a life insurance or investment contract, or custodial fees in the case of an investment in a securities account. In addition, returns exclude entry/arbitration fees in the case of a life insurance or investment contract, as well as the subscription fee in the case of an investment in a securities account and social and tax levies.

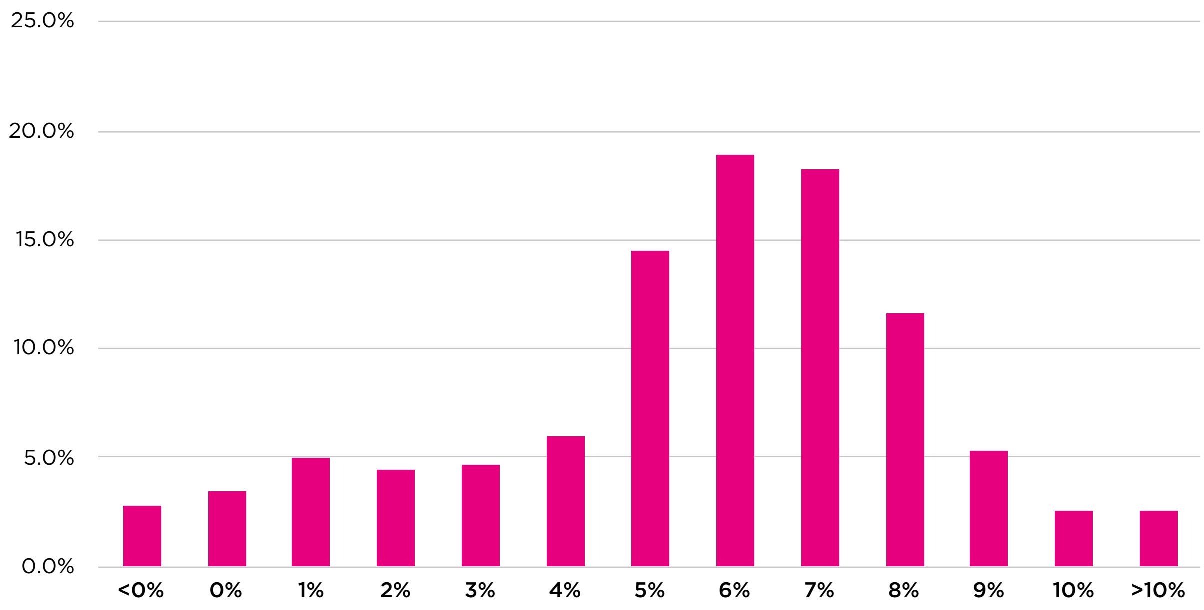
The study analyses only the products for which SRP has collected or calculated the performance (80.5% of the matured products in the database).

Analysis of matured products

Key points

- Matured structured products averaged a 5.59% annualised return between April 2018 and March 2019.
- The analysis covered 318 products (99 reached their maturity date while 219 expired earlier).
- Only 2.8% of the analysed matured products had a negative return.

Histogram of annualised performances - matured and autocalled (April 2018 to March 2019)



The analysis encompasses 318 products that matured or autocalled between April 1 2018 and March 31 2019, of which 99 reached their maturity date while 219 expired earlier.

Ninety-four of these products delivered a positive return at the end of the investment term (3.3 years on average), according to SRP data. Sixty-nine percent of the products returned 5% or more.

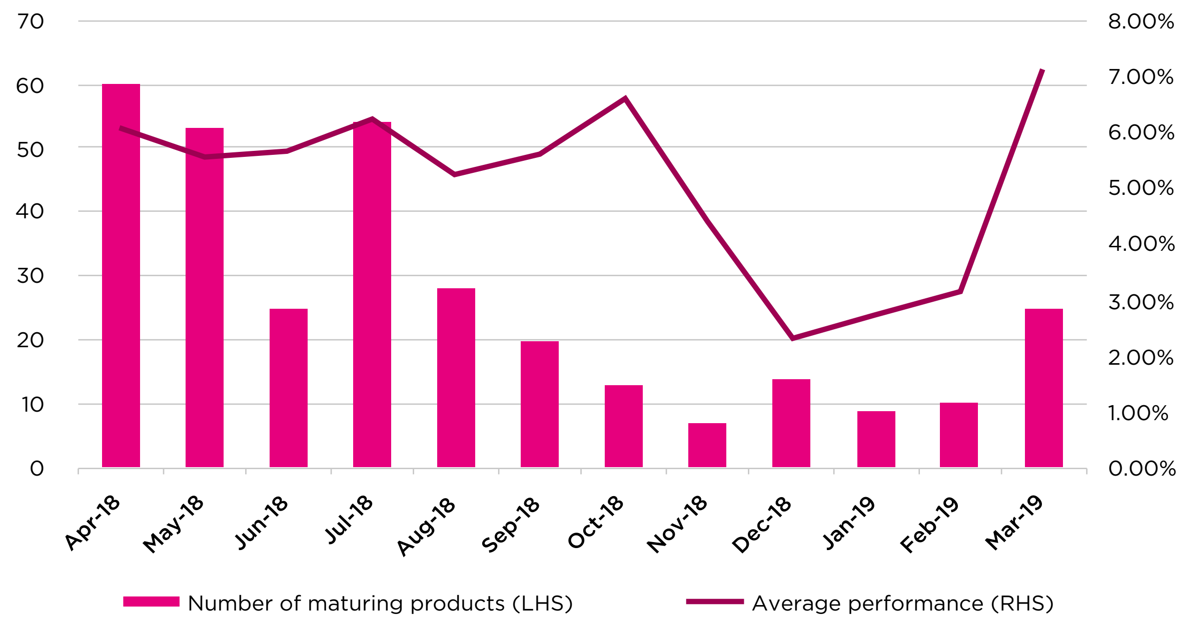
Only 2.8% of the analysed products delivered less than the initial capital, compared with 3.8% which returned the initial capital at the term of the investment. For those negatively performing products, returns were between -0.01% and -6.42% pa, resulting in an average loss of -2.55% pa.

The 48 capital-protected products in the sample delivered an average annualised return of 2.85%. With this type of product, investors recover 100% of their initial investment at maturity (except in case of bankruptcy, default of payment or resolution of the issuer).

Two-hundred and seventy capital-at-risk products matured or were early redeemed in the period in question, returning an average annualised 6.08%.

The 60 fund-wrapped products returned an annualised 4.2% for an averaged investment term of five years and one month.

Historical performance of structured products (April 2018 to March 2019)



Asset class

Asset Class	Number of products	Market share by volumes (%)	Average annualised return (%)
Equity (Single Index)	220	73.40	5.63
Equity (Single Share)	45	2.70	7.36
Equity (Share Basket)	27	13.49	2.65
Equity (Index Basket)	9	0.53	6.03
Fund	8	4.74	4.71
Credit	8	3.71	5.43
Interest Rate	1	1.43	1.32
Grand Total	**318**	**100.00**	**5.59**

Underlyings

Underlying	Number of products	Market share by volumes (%)	Average annualised return (%)
Eurostoxx 50	124	51.84	4.92
Total	25	1.95	7.79
Share Basket (Unspecified)	23	16.03	1.34
CAC Large 60 Index	22	4.19	7.35
SBF Top 80 EW Decrement 50 Points	18	3.02	7.27
Cac 40	13	5.97	5.90
Euro iStoxx Equal Weight Constant 50	13	2.73	6.62
MSCI Euro 50 Select 4.75 Decrement	8	0.45	6.75
Cac 40, Eurostoxx 50	6	0.13	5.29
Managed Funds (Unspecified)	5	4.03	6.72
Orange	3	0.14	9.57
Peugeot	3	0.05	6.83
iSTOXX Transatlantic 100 Equal Weight Decrement EUR	3	1.50	6.11
iSTOXX Europe Centenary Select 30	3	0.20	5.24
Stoxx Europe 600 Oil & Gas	2	0.06	8.09
Renault	2	0.02	2.12
LVMH	2	0.08	6.86
Bouygues	2	0.08	7.56
Other	41	7.52	
Grand Total	**318**	**100.00**	**5.59**

Just under 40% of all maturing products (124) were linked to the Eurostoxx 50 and returned an average annualised coupon of 4.92%. During the period under observation, the benchmark lost 0.29%. The index recovered 11.7% in 2019 Q1, after a tough 2018 for European equities, which saw the index losing 14.34%.

The above comparison once again confirms the value of structured products, though a direct comparison of equity and structured products is difficult due to the specificities of the latter's payoff type (coupon and capital protection). On the one hand, autocallable products have limits on the positive side of returns, but not on the negative. On the other, they do not require any market growth (measured from the initial strike date) to provide their target returns, which means they are more likely to generate a positive return with relatively little volatility.

Autocallable products with conditional protection have been and continue to be the dominant payoff in France. Athena structures are by far the largest category in this study's sample, followed by defensive regular income strategies (phoenix autocalls).

Thirty fully or partially protected products, offering participation in the performance of the underlying with or without cap (capped call, uncapped call), came to maturity, returning below the average of the sample. These payoffs used to protect 90% of the invested capital on average. A higher capital protection rate is generally associated with lower participation on the upside.

Payoffs

Payoff	Number of products	Market share by volume (%)	Average annualised return (%)
Knock Out, Protected Tracker	157	39.81	6.78
Knock Out, Reverse Convertible	33	4.15	5.95
Knock Out, Worst of Option	15	0.55	7.13
Digital	12	7.32	3.73
Capped Call	11	7.57	3.38
Knock Out, Reverse Convertible, Snowball	10	0.18	5.88
Credit Default	8	3.71	5.43
Portfolio Insurance	7	9.42	4.77
Uncapped Call	7	9.63	1.12
Knock Out, Lookback, Protected Tracker	6	0.77	7.29
Capped Call, Knock Out	6	6.61	2.01
Enhanced Tracker	4	0.73	8.06
Kilimanjaro	3	0.36	-0.23
Callable, Uncapped Call	2	0.07	1.54
Protected Tracker	2	0.11	5.54
Other	35	9.03	
Grand Total	**318**	**100.00**	**5.59**

Income products

Key points

- **Three-hundred and eleven live income products paid a yearly, half-yearly or quarterly coupon during the period considered.**
- **Most phoenix products delivered because the difference between the highest point of their underlying indices in 2017 and their low point in 2018 did not exceed 20%.**

Beyond the 69 income products which matured during the analysed period, 281 autocallables paid a coupon without activating the knock-out trigger. Of the latter, 202 were products that missed the autocall observation, while 79 had still not reached their first autocall observation date. With few exceptions, these are products that have not completed their first anniversary but were designed to pay a quarterly (38 products) or semi-annual (34 products) coupon. Ten percent (30 products) of the 311 products do not feature an early redemption mechanism.

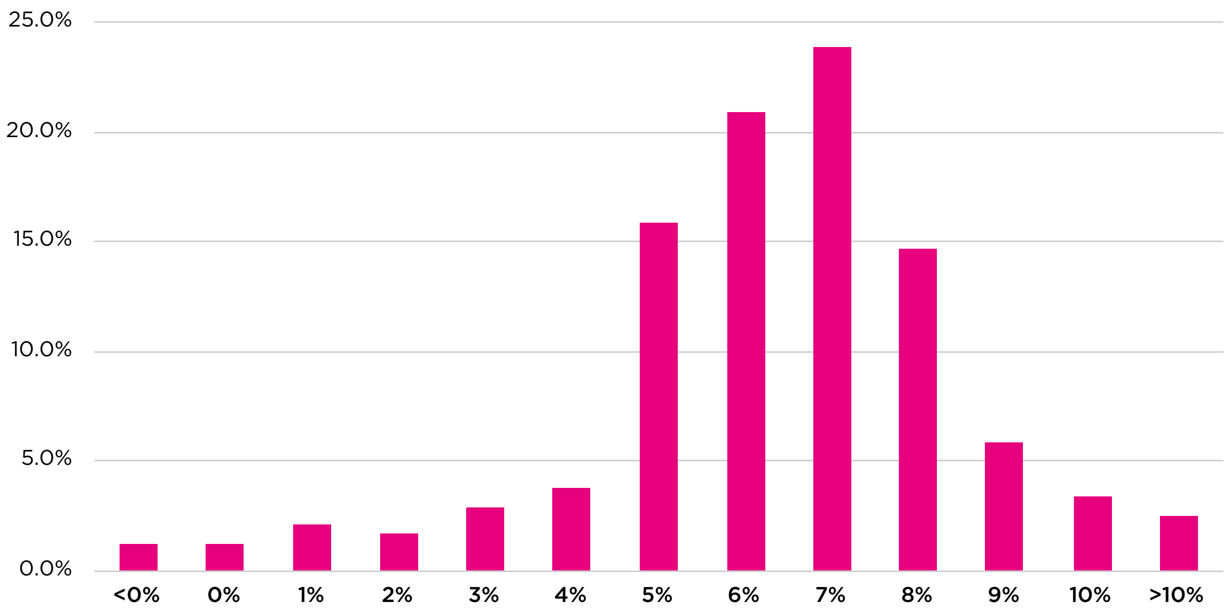
The ability of defensive phoenix autocallables to distribute a coupon, in case of a limited market fall, has made this category very successful during the considered period. The reason is that these products do not need to autocall to pay the coupon. From the 194 products linked to a single index, 47.9% were designed to detach a coupon as long as the underlying does not fall below 80% of its initial level. An additional 40% of these products allow an even deeper fall still paying out the coupon. This means that most phoenix products delivered because the difference between the highest point of their underlying indices in 2017 and their low point in 2018 did not exceed 20%.

Autocallables

Key points

- Only 22.5% of the 967 products with knock-out dates between April 2018 and March 2019 expired earlier.
- Redeemed autocallables returned an average annualised coupon of 6.38% for an average investment term of 23 months.
- Seventy-one percent of all autocallables recorded average annualised returns above 6%.

Histogram of annualised performances - autocalled (April 2018 to March 2019)



Just over 22.5% structured products with call point in the considered period activated the autocall trigger, after a difficult 2018 and start of 2019 for equities.

For 76% of autocalled products, the early redemption occurred on their first observation date. It should be noted however that, with few exceptions, terms to the first call point can stretch from one to several years. For example, 11% of the products in the sample considered their first call point after two years of investment.

Twenty autocallable products reached organic maturity in the considered period.

The table on the next page exemplifies the most used combinations between the underlying and the call frequency within the analysed sample. We can observe that more than half of the products linked to decrement indices considered more than one knock-out observation in a year, typically quarterly or daily (from the first year of investment onwards). By contrast, 67% of the products linked to benchmarks have annual call points. The choice of underlying is naturally correlated to the offered yield. This explains the higher average coupon of products with quarterly observations compared to products that are reviewed annually.

Autocalled products: Frequency of the early exit observations

AVERAGE COUPON & CALLABLE FREQUENCY												
	daily observation		monthly observation		quarterly observation		semi-annual observation		annual observation		less frequent observations	
	average coupon (%)	callable frequency	average coupon (%)	callable frequency	average coupon (%)	callable frequency	average coupon (%)	callable frequency	average coupon (%)	callable frequency	average coupon (%)	callable frequency
Knock Out 1	6.7%	52.3%	6.7%	43.3%	7.3%	15.9%	7.8%	10.5%	6.3%	17.3%	6.3%	17.7%
Knock Out 2			6.0%	3.3%	8.6%	2.2%			6.6%	1.2%	6.1%	9.8%
Knock Out 3			7.9%	3.3%	8.0%	1.5%			7.9%	1.0%		
Knock Out 4			7.1%	3.3%	4.5%	0.7%	5.5%	0.8%	6.1%	0.7%		
Knock Out 5					4.0%	0.7%			7.8%	0.3%		
Maturity					6.9%	0.7%	5.0%	0.8%	6.5%	0.9%	1.8%	25.5%
Live		47.7%		46.7%		78.3%		88.0%		78.7%		47.1%
Grand Total	6.7%	100%	6.7%	100%	7.2%	100%	7.5%	100%	6.4%	100%	4.1%	100%

Most used combinations (underlying and call frequency)

	Daily observation	Monthly observation	Quarterly observation	Semi-annual observation	Annual observation	Less frequent observation	Grand Total
Benchmark	7.0%	5.0%	2.0%	5.0%	67.0%	14.0%	100%
Decrement	19.7%	10.6%	16.7%	4.5%	47.0%	1.5%	100%
Single stock or basket	5.0%	1.7%	31.7%	11.7%	36.7%	13.3%	100%

Decrement indices: does complexity pay off?

Ingenuity is probably one of the most distinctive qualities of the structured products industry. The capacity to come up with a solution, no matter the circumstances, is one of its great qualities. Sometimes, however, creativity can become a weakness, as is the case when explaining complex structures is concerned.

Decrement indices have become one of the industry's simplest innovations over the last four years and are delivering positive returns to investors. But in spite of their success, they have also been subject to criticism because they are difficult to explain.

What is a decrement index?

Decrement (aka synthetic dividend) indices are optimised gauges tracking a benchmark where the future dividend is fixed in advance. Strictly speaking, they reinvest the dividends paid by companies in the benchmark with a constant dividend markdown expressed as a fixed percentage or index points that are subtracted on an accrued basis. In most cases, this dividend is accrued daily based on the performance of the index.

Decrement indices' growing popularity stems from their ability to eliminate uncertainty on future dividends, and enable issuers to offer a potentially higher yield and/or improve capital protection. The million dollar question is this one: is it worth deploying this complex and innovative product in an investment portfolio?

SRP's analysis of autocallable products maturing or knocking out early between April 2018 and March 2019 showed that these products have been delivering what they are supposed to.

Autocalled products: Frequency of the early exit observations

	Number of products	Expected coupon if paid + average strike level	Average barrier level (PDI)	Call Frequency	Average of annualised capital return
Benchmark	354	6.05% - 100.36% of the initial level	60.60% of the initial level	28.25%	5.53%
Decrement indices	283	7.32% - 99.84% of the initial level	59.77% of the initial level	23.32%	7.06%
Strategy and thematic indices	53	6.60% - 99.08% of the initial level	60% of the initial level	20.75%	6.55%

Looking at the autocallable market as a whole, with observation dates during this period (expired and live), we observe that structures linked to decrement indices have increased the average headline rate from 6% to 7.3% while growing downside protection by lowering the knock-in barrier level by 0.83% on average.

The most interesting finding, however, is that products maturing early have increased the return to French investors from 5.5% to 7%, in a market where interest rates are considerably low.

As with any investment however, there is a trade-off that investors accept when opting for products linked to decrement indices. Despite their higher returns, the likelihood of these products being called decreased from 28% to 23% during the 12 months considered. On the other hand, and taking into account the bear market, decrement products have provided significantly better returns in a recovering market, compared with strategy and thematic indices, which featured low volatility and risk control features.

We may conclude, therefore, that decrement indices are delivering value in sideways and bullish market conditions, as they are outperforming and deliver good returns. But what happens if markets crash? The importance of product governance and target market will define the success of these products and how issuers will deliver innovation in the future.

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