

Investments that don't fit the bill

Despite plenty of criticism, sales of structured products continue to rise. But can they really deliver what they promise to offer? *Which? Money* investigates

WHAT YOU'LL LEARN

■ What a structured product is ■ How your returns are linked to the stock market ■ The difference between a structured deposit and an investment

As an investor, you might think a product paying high returns with low or no risk to your money is the investment holy grail. But does such a thing exist? Sales of structured products (SPs), which claim to be the solution, have been on the increase, with £13bn ploughed into them in 2009. Many banks and building societies now offer them as an alternative to fixed-rate savings accounts and low-risk entry to investment.

But are they actually good value for consumers? We lift the lid on the structured product world and show how many of them, arguably, just aren't fit for purpose.

What are they?

In their basic form, SPs are fixed-term investments, generally lasting between three and six years, paying either a fixed or variable rate of interest. This is linked to a benchmark, usually a stock market index like the FTSE 100.

In reality, they're far more complicated. SPs can broadly be split into two camps:

■ **Structured deposits** These offer protection to your capital up to the Financial Services Compensation Scheme (FSCS) limit (see p15).

■ **Structured investments** Some of these carry the risk of loss to your capital, using third-party institutions to meet their investment aims.

Structured deposits

Structured deposits (SDs) have become increasingly prevalent among banks and building societies in recent years. They are pitched as cautious investments and aim to deliver much higher rates of interest than a traditional fixed-term account – sometimes as high as 8% a year.

When your money is held in SDs by a bank, it's used to buy several underlying investments that deliver the returns the products promise. The majority of your investment is placed in a debt 'security', such as a corporate bond (effectively, a loan to the bank in return for a fixed interest rate). This then pays enough interest over the term of the plan to repay your original capital.

To get a return linked to the stock market, a derivative is purchased with the remainder of your cash. In the case

of SDs, the bank purchases a call option derivative. For more details on derivatives, see 'Money made simple', p34.

If the stock market has risen, that gain in the index is added to your investment. If it falls, the option is worthless and you get no interest, and, therefore, no return on your original capital.

Crucially, these products are covered by the FSCS up to £50,000 (this is expected to rise to £85,000 from 31 December 2010).

How do they work?

Few SD providers show how these complicated products work. Despite this, they can be sold without any advice by banks and building societies.

But the complexity of SDs doesn't stop there. For example, Newcastle Building Society's Capital Secure Account is a six-year plan. It promises – no matter what happens to the FTSE 100 – that you'll be paid a minimum of 11%, or 1.75% annual interest, for all six years of the plan, plus the return of your original investment. If the FTSE rises, they claim that you could receive up to 7.46% per year.

So how is it calculated? Well, the level of the FTSE is recorded when you first invest, then again six months later. If the index has risen, the increase is capped at 4.5%. So if the FTSE has risen by 25%, you only get 4.5%. Conversely, if the FTSE has dropped, losses are capped at -4.5%.

This process is repeated for 12 consecutive six-month periods over the six-year term. Your gains and losses in each of these periods are combined and the total is the rate of interest you're paid. The maximum gain you can make is 54%, or 7.46% annually. However, if your total is below 11%, Newcastle pays you the minimum 1.75% annual rate.

But not all SDs act this way. Some offer a fixed rate if the FTSE 100 rises, or nothing if it falls. The final levels are often calculated through averaging, by which the average return of the index in the last six months or year of the plan is used to calculate your return.

Do they deliver?

These products might appear to be a good deal – offering potential for huge growth and your money back if the index falls. But one of the major risks if the markets dip (and you receive no

interest after tying your money up for a number of years) is that your investment could suffer a loss from inflation. This means the real value of your money would be worth less when your plan matures.

In our research, we found many SDs offered by banks and building societies have historically delivered very poor value and some have never achieved the maximum returns they advertise.

We looked at the historical performance of the FTSE 100, and other relevant stock market indices, and back-tested a selection of products sold by banks and building societies, either currently or recently available, to see what they would've

MANY STRUCTURED DEPOSITS HAVE DELIVERED VERY POOR VALUE

delivered. This is shown on p16.

There are some really poor performers. Over the past 20 years, the Protected Capital Accounts offered by Credit Suisse (sold through six building societies) would have never delivered the maximum return they advertise. Neither has Newcastle's product. In fact, the five-year Credit Suisse product would have delivered the minimum return (2.38% annual interest) almost half of the time in the past 25 years.

A number of SDs have a minimum return of 0%, yet have paid the maximum a high proportion of times, like the Britannia Capital Bond (even then the maximum can still be low). But they offer either the maximum growth or nothing at all. Using our back-testing model, no return would have been paid about 20% of the time.

What's put at risk here is the certainty of returns, like those you could get from a fixed-rate savings bond. If you had invested in the Nationwide product on 1 September 2004, and it matured on 1 September 2010, your investment would have received an annual return of just 1.42%. According to Moneyfacts, a five-year fixed-rate savings bond paid annual interest of 6.05% in 2004.

Which? online

Visit www.which.co.uk/investments for more on investing your money.

In the magazine

Turn to p34 for an in-depth explanation of derivatives.

Other problems

We found problems with some of the variable-rate SDs. The Credit Suisse products sold by Barnsley, Cambridge, Chelsea, Leeds, Saffron and Yorkshire Building Societies (and formerly Stroud & Swindon), as well as Newcastle, advertise the maximum rates of growth prominently in their literature, despite our back-testing showing that, historically, these would have never been achieved. We believe this is misleading to consumers.

As we have shown, SDs use complex financial tools to deliver returns. Of the products we analysed in the table, only one firm, Ulster Bank, made any mention of the use of derivatives (see p34 for more).

The Financial Services Authority (FSA) carried out a review of SDs in October 2009 and issued guidance on what information consumers should see in product brochures. This included prominent publication of 'the names and... logos of the respective parties to avoid creating a misleading impression that the firm promoting the structured deposit is also the deposit-taking firm.'

But we found that Britannia, Lloyds TSB, Newcastle, Northern Bank and Skipton all failed to explicitly say they were the deposit takers for their plans.

Which? takes action

We contacted the building societies that distribute the Credit Suisse product, and Newcastle, and asked them to justify their promotion of products that, we believe, are clearly not up to scratch.



The volatility of the FTSE can adversely affect your investments



As mutual firms owned by their members, we think they have a duty to ensure that their customers are not exposed to poor products.

Yorkshire Building Society said 'the minimum return figure [is] displayed ahead of the maximum return in all financial promotions' and that 'it carries a larger font size than that used when noting the maximum return.' This was reiterated by Credit Suisse.

All the building societies and Credit Suisse accepted they'd not carried out any consumer testing of their product literature to ensure the material was clear, fair and not misleading.

But Coventry Building Society, which now owns Stroud & Swindon (S&S),

said that S&S branches would no longer be selling the Credit Suisse product. It's now writing to its customers to ensure they're happy with their investment and that they understood the terms when they invested.

Which? says

From the evidence of this investigation, banks and building societies, where over three-quarters of SPs are sold, appear to be providing an inadequate service to consumers. Cautious savers, in search of a decent interest rate, run the risk of being enticed by attractive headline rates and the lure of risk-free investment into products that have historically delivered poor value.

Money Helpline

If you have enquiries about structured products or other financial matters, call our helpline on **01992 822848**

What's more concerning is that many of these complex products are sold without any advice. We believe it's the collective responsibility of banks, providers and regulators to ensure consumers aren't exposed to risky investments marketed as cautious.

We want to see the FSA take action and better regulate structured deposits immediately, so that any sold in high street institutions have to be done so with full financial advice and suitability assessment.

We urge consumers to avoid investing in structured deposit plans sold by high street banks without taking independent financial advice. We've written to the FSA with our concerns and urged it to better regulate structured deposits.

STRUCTURED DEPOSITS

The performance of a range of structured products offered by high street banks and building societies, currently or recently available for investment had they been available in earlier periods, against the

historical prices of applicable stock market indices between 1984 and 2010 unless specified otherwise. Products are ranked by those that have paid the maximum return the least amount of times.

THE PERFORMANCE OF STRUCTURED PRODUCTS FROM 1984 TO 2010

| STRUCTURED DEPOSITS | PRODUCT DETAILS | | HISTORICAL PERFORMANCE SINCE 1984 | | | | |
|--|-----------------|--------------------|-----------------------------------|-----------------------------|-------------------------------|-----------------------------|-------------------------------|
| | TERM (YEARS) | MIN INVESTMENT (£) | AV. AER (%) | MIN RETURN | | MAX RETURN | |
| | | | | MIN AER PAID BY PRODUCT (%) | NO. OF TIMES MIN WAS PAID (%) | MAX AER PAID BY PRODUCT (%) | NO. OF TIMES MAX WAS PAID (%) |
| CREDIT SUISSE PROTECTED CAPITAL ACC ^{a b} | 5 | 3,000 | 3.16 | 2.38 | 48 | 6.96 | 0 |
| CREDIT SUISSE PROTECTED CAPITAL ACC ^{a b} | 6 | 3,000 | 3.45 | 2.50 | 39 | 8.15 | 0 |
| NEWCASTLE BUILDING SOCIETY CAPITAL SECURE ACC ^a | 6 | 1,000 | 2.98 | 1.75 | 30 | 7.46 | 0 |
| NATIONWIDE L&G STOCK MARKET LINKED SAVINGS BOND ^c | 6 | 3,000 | 3.09 | 0 | 26 | 7.58 | 7 |
| SKIPTON CAPITAL PROTECTED DOUBLE ASSET BOND ^a | 5.5 | 3,000 | 5.19 | 0 | 21 | 7.65 | 49 |
| BARCLAYS WEALTHBUILDER ^a | 6 | 5,100 | 3.73 | 0 | 7 | 4.63 | 58 |
| LLOYDS TSB OLED FIVE YEAR STERLING DEPOSIT ^a | 5 | 10,000 | 4.40 | 0 | 8 | 5.39 | 58 |
| HSBC STOCK MARKET LINKED SAVINGS ACC ^a | 3.75 | 3,000 | 3.23 | 0 | 26 | 4.28 | 75 |
| BRITANNIA CAPITAL BOND ^a | 4 | 500 | 3.06 | 0 | 24 | 4.00 | 76 |
| BRITANNIA CAPITAL BOND ^a | 5 | 500 | 3.51 | 0 | 22 | 4.40 | 78 |
| NORTHERN BANK CAPITAL PROTECTED PLAN ^a | 5.5 | 2,000 | 4.06 | 0 | 21 | 5.03 | 79 |
| BRITANNIA CAPITAL BOND ^a | 6 | 500 | 3.95 | 0 | 19 | 4.87 | 81 |
| RBS/NATWEST NAVIGATOR PLAN ^d | 5.5 | 3,600 | 10.20 | 0 | 0 | None | n/a ^e |
| ULSTER BANK RIGHT TRACK BOND ^a | 5.5 | 2,000 | 4.62 | 0 | 21 | None | n/a ^e |

Term The length of the plan **Minimum investment** The minimum that you must invest to participate in the plan **Average AER** The average annual effective rate of interest each product has delivered during the back-testing periods **Minimum AER** The minimum that can possibly be paid by the product when it matures **Maximum AER** The maximum that can possibly be paid by the product when it matures

a Based on FTSE 100 returns between April 1984 and September 2010 **b** Currently distributed by Barnsley, Cambridge, Chelsea, Leeds, Saffron, Yorkshire and formerly Stroud and Swindon Building Societies **c** Based on FTSE 100, S&P 500 and EuroStoxx returns between June 2002 to September 2010 **d** Based on RBS Navigator Index returns between October 2000 and August 2010 **e** There is not a maximum limit as the maximum return is based solely on stock market performance

Structured investments

The more sophisticated variants are structured investments (SIs).

They are diverse in what they offer – some are designed for growth, others for income. For example, Morgan Stanley's FTSE Protected Growth Plan pays 100% of any rise in the FTSE 100 after six years, or 15% after three years if it's risen by at least 10%. Walker Crips' Annual Growth Plan pays 8.25% annually if the FTSE 100 is above the start level.

SIs split your money between buying debt securities and derivatives, but these are from a third-party bank, known as a 'counterparty' (see box, right).

Different types

There are two types of SI:

■ **Capital protected** These products claim to return your original capital on maturity and the growth of a chosen benchmark. However, you may lose some or all of your capital if the company backing them defaults. A proportion of your investment is invested in a debt security from a counterparty, like a corporate bond or warrant, and the rest is invested in a call option on the benchmark. These are generally known as 'growth products'.

STRUCTURED INVESTMENTS CARRY SIGNIFICANT RISKS

■ **Capital-at-risk** These offer greater growth or income potential by introducing the risk of loss to your money. The counterparty places most of your money in the debt security, buys some call options to achieve growth and, additionally sells some put options.

This means the counterparty has sold some of the protection, usually 50%, on your investment. The money raised by doing this is used to buy more call options and, therefore, can increase growth.

But if the benchmark index drops by more than 50%, you begin to lose your investment, normally at a rate of 1% for every 1% lower the index has fallen. See 'Money made simple', p34, for more.

A good investment?

SIs may be suitable for investors who understand what they're getting into, and who've taken professional advice.

Ian Lowes, a chartered independent financial adviser (IFA), believes investing in several SIs with multiple maturity dates can be extremely useful in a portfolio, which, for example, can be timed to meet capital gains deadlines. And as their performance tends to differ from shares (equities), they can increase diversification and help spread risk over your portfolio.

However, we're not convinced they're suitable for the mass market. Although SPs claim to offer the promise of fixed returns or capital protection, these attractive features can evaporate in the worst market conditions.

What about the risks?

There are significant downsides in addition to the counterparty and inflationary risks. First, SIs don't invest directly in the stock market to which they're linked. Therefore, you don't get the benefit of dividends paid by the underlying companies within that index.

SPs also have a 'liquidity risk'. In an investment fund, you can get your money out at any time, but SIs are fixed-term plans, meaning it's difficult to exit without losing some of your investment. You can also remain invested directly in the stock market to allow your money to recover if it's fallen. With an SP, you get what's left at the end of the plan.

However, the secondary market for these products is widening and there are more investment products that make a provision for an early exit.

Finally, returns are often capped or participation is limited. Some products only offer a proportion of stock market growth while others, like Investec's FTSE 100 Growth Plan, give you exposure to 100% of the stock market, but cap returns at 50% of your investment.

Economist John Kay isn't a supporter of SPs. He believes there's greater benefit from investing a larger proportion of money on deposit and placing the rest directly in the stock market to replicate the capital protection and growth that SIs purport to offer, while providing the windfall of dividend income.

COUNTERPARTIES



The FSA has issued strict guidance since the collapse of Lehmans

Counterparties are used to protect the value of your original investment. But this so-called capital 'guarantee' is only as good as the counterparty itself. If the counterparty fails, you risk losing all of your money.

In 2008, investment bank Lehman Brothers went bust, which had a damaging effect on structured products. Providers like DRL, NDFA, Arc and Meteor, who all used the bank as the counterparty for their structured products – unbeknown to most investors.

Crucially, the use of counterparties isn't covered by the FSCS. Many investors in Lehman-backed plans were mis-sold them on the back of the promise that their money was guaranteed.

Since the bank's collapse, the FSA has issued strict guidance to advisers and providers to highlight the potential 'catastrophic risk' that counterparty failure poses to investors. It also stated that the use of the term 'guaranteed' cannot be used when referring to all

structured products.

Recently, providers have improved the way they communicate the risks of the investments to investors. And some now use a variety of counterparties to mitigate the risk of failure.

Yet, the recent crisis in the Eurozone has shown that banks are still under financial strain. And before the credit crunch, no one believed that banks such as Northern Rock or Lehman Brothers could ever fail. This shows the risk of counterparty failure is very real.

Our research has shown that there are still some providers that may be potentially misleading consumers around this issue. Santander regularly uses the term 'guaranteed' in its product literature, despite using a subsidiary as a counterparty. This means that if Santander were to go bust, investors' money would be lost, negating that 'guarantee.'

Santander told us it believed its products were clearly named and fairly described. We disagree.