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Are all structured products bad?

Paul Gambles, Managing Partner, MBMG Group, expresses his concerns about structured products and the reality that few industry players truly understand such products.

THERE IS NO DOUBT ABOUT THE MASSIVE POPULARITY of structured products in the past few years. Advantages include the flexibility of the structure, protection and the possibility of enhanced returns, but are the people selling and buying structured products really aware of their full risk exposure?

A large number of the structured products clients are encouraged to invest in have issues. For example, it's very different creating a structured product in a low interest environment. Years ago profit might have been due to the high interest rate carry built into the product. Take that away today and the dynamics change dramatically. "The massive explosion is concerning to me because - because the why is unanswered?" says Gambles. "What concerns us is really the conflict of interest that goes into most of the structured products particularly if offered by private banks," he continues. He maintains that if clients are made aware of all the risks and if they fully understand them, they might never invest in structured products.

One of the reasons why there has been such an explosion in structured products is the very high profit margins it offers to sellers. Whether it's mis-representation or simply a lack of client understanding, that wide-spread misunderstanding causes concern. It's not transparent - profit margins are so difficult for most investors to unpick and understand, and rarely are they told how much profit is built in for the distributor.

Gambles genuinely believes that there is a place for structured products - and that is when they perform an economic function in a client's portfolio, but too often they do not. "Short volatility products have little utility in a portfolio, and that's what concerns us. The correlation is so extreme, what we see is when the portfolio is going to go down, structured products will go down exponentially. The client gets all of the risk and only participates in part of the upside."

Gambles is concerned that clients and structured products sales people don't understand the risks. "They can give what seems to be a fixed return because they haven't gone wrong yet." He believes the industry doesn't get it.

Gambles believes that neither regulators nor investors are understanding the risks involved in these products and they probably will not until they go wrong again. It's very likely that clients do not read the full prospectus of the products they are investing in and they are not being made aware of all the key points by their advisors. They key question to ask while making an investment decision is "Why do these products exist?" and sadly, it's the question that is always left unasked. ■

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