Why structured products demand will stay strong in Asia

New custom indices are boosting demand for structured products, say industry participants at roundtables co-hosted by Morningstar and Hubbis in Singapore and Hong Kong.

Customised equity indices are providing a new lease of life to structured products and that trend is expected for some time to continue, according to product gatekeepers and investment specialists from within Asian wealth and asset management.

Demand for structured products has been relatively robust in the first five months of this year, according to most of the participants.

Falling interest rates had earlier dried up demand for structured products as it became highly expensive to provide a full capital guarantee. According to media reports, structuring remains a challenge as issuers balance with near-zero rates and thin distributor fees.

With rising rates in the US, interest in structured products has revived. With financial markets relatively stable, wealth clients are in risk-on mode, driving demand for products that can deliver outperformance.

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Of course, this time around there is a lot more caution in the kind of structured products being promoted by wealth managers. Structured products suffered a huge dent in confidence after the global financial crisis; yet confidence has slowly come back and with the innovation in index products, demand has jumped.

INDEX GAINS

Globally, there is a huge shift underway from active to passive investments, partly because of the lower costs of passive investing as well as better performance.

In the US, for instance, nearly 40% of US equity assets under management are in the hands of ETFs and index-tracking funds. Even in the US bond market, index tracking products account for one-fifth of the market.

Passives have gained as active managers have struggled to deliver outperformance, or alpha, in a low-rate environment, making it harder to justify the relatively higher fees for active management.

In such an environment, active managers who are slow to react relative to rivals will lose market share at a faster pace.

Some participants pointed out that within a passives framework, investors continue to harbour a desire to beat the market or lower risk profile.

While traditional beta continues to be relevant and appealing for investors, the biggest gains have been seen with customised indices that offer 'smart' or 'strategic' beta.

As one participant explained, strategic beta offers a different risk-reward profile from the overall market: it is defined as a strategy that is passive in implementation but active in design, as opposed to traditional beta, which is passive both in implementation and design.

A strategic beta index typically is tilted towards one or more factors relative to standard market indices.

One big caveat about such customised indices is that investors need to be aware of what the tilt is. Two low-volatility strategies, for instance, may not behave exactly the same way. One strategy could be sector constrained, while the other might not be, so their performance can be different, even though on paper they focus on the same factor.

There are various strategies in the marketplace today that are entirely rules based, which try to exploit different risk premia or investment factors, and can be applied mechanistically across the market, the participants noted. In the US for instance, low volatility products have been extremely popular with investors, while dividends are another big theme. There is a real hunger for yield too.

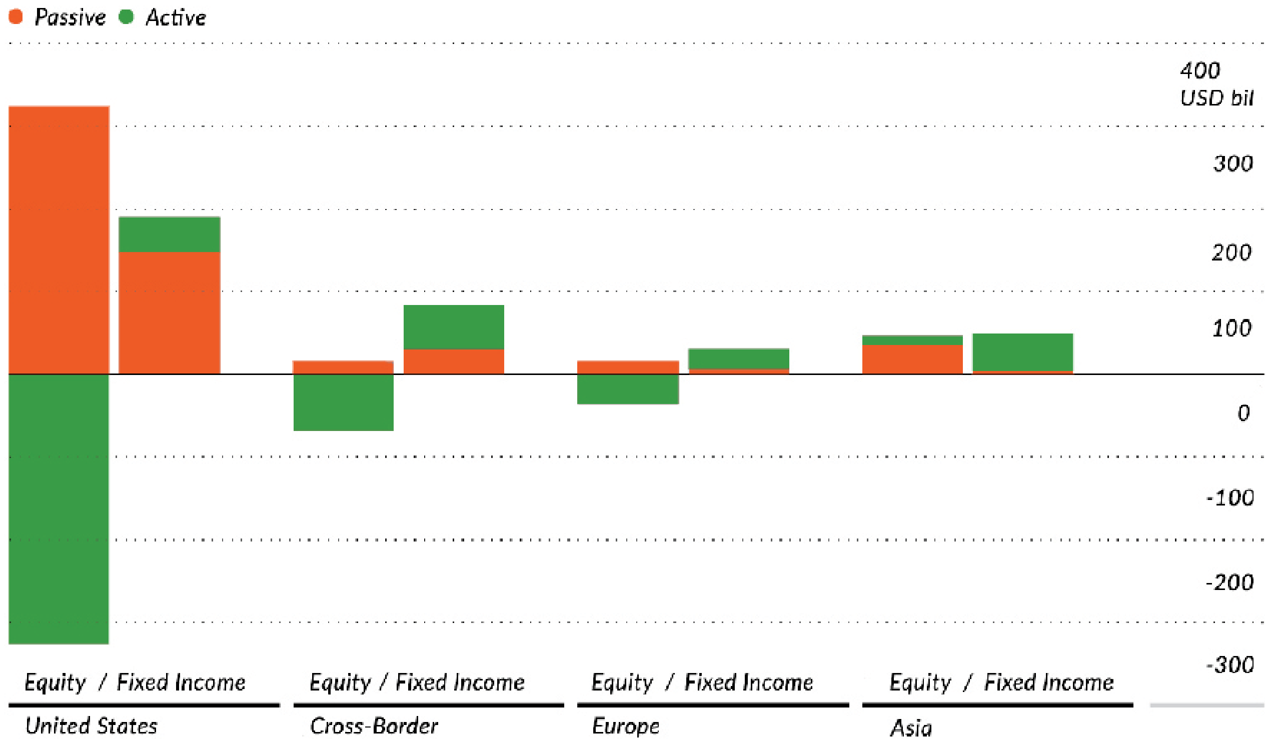
Creating indexes that satisfy different investor needs is an ongoing process with many organisations.

RULES-BASED FRAMEWORKS

Research outfits such as Morningstar, for instance, have a large team of fundamental researchers carrying out company-level analysis in Chicago, Singapore, Hong Kong and Europe.

The fundamental equity ratings are then turned into rules-based passive investment strategies.

ASSET FLOWS - ACTIVE AND PASSIVE FUNDS IN MAJOR REGIONS BY ASSET CLASS



Source: Morningstar

Morningstar also has a proprietary definition of quality, termed economic moat, which is being used to create custom indices. A term that was coined and popularised by legendary investor Warren Buffett, economic moat refers to a company's sustainable competitive advantage that protects its profits from competition and allows it to generate excess returns over a long period of time.

Some of the attributes that make up economic moats are intangible assets such as patents, brands, etc; cost advantages or efficient scale. Morningstar analysts assign moat ratings to stocks and the company builds indices based on these moat ratings. This metric offers a way to define quality not based on backward-looking accounting measures but qualitatively in a rules-based framework.

Increasingly, there is also demand for products not tied to benchmarks, such as outcome oriented strategies, some participants noted. Outcome oriented strategies designed to deliver income or offer downside protection are gaining some ground.

TAKING IDIOSYNCRATIC RISKS

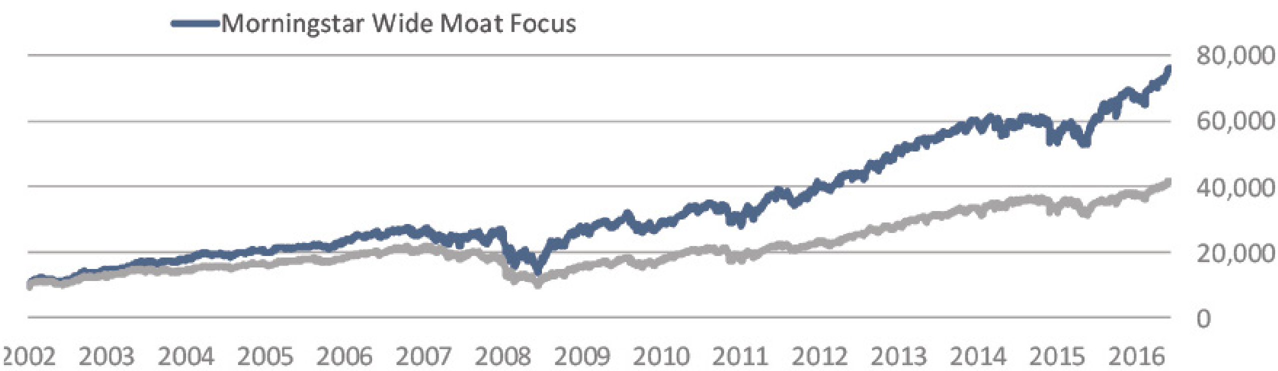
Nevertheless, while index-driven products are becoming highly popular in other parts of the world, Asian clients still tend to take highly idiosyncratic risks by piling into single stocks and bonds. Of course, some of them are more open than others to embracing financial products such as mutual funds and index products.

Education remains key in raising awareness among wealth clients about the role index products play in asset allocation and diversification. Indeed, with the growth of online distribution channels, and passives, the cost of investing in funds has come down significantly – and will continue to drive demand, according to participants.

Recently, for instance, index funds provider Vanguard launched a new investment platform in Europe, which will be marketed directly to consumers, cutting out financial advisers and execution-only brokers. The platform will charge just 0.15% for the first GBP250,000 and there will be no administration charges for investments above that limit. Developments such as these will further add pressure on active managers. ■

MORNINGSTAR WIDE MOAT FOCUS INDEX

Morningstar® Wide Moat Focus Index℠ vs. Morningstar® US Market Index℠



Index	YTD	1-Year	3-Year	5-Year	10-Year	Since (09/30/2002)
	Trailing Annualized Returns (%)					
Morningstar® Wide Moat Focus Index℠	8.0	24.1	10.9	14.4	11.8	15.0
Morningstar® US Market Index℠	5.9	17.8	9.9	13.2	7.7	10.3

Data through March 31 2017. Indexes are unmanaged and not available for direct investment.

Source: Morningstar