

Private Client Structured Investment Trends

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The business of servicing private clients has never been more interesting or more challenging. Technology has revolutionised the industry in terms of the competitive environment and the nature of private clients the industry strives to service.

A new breed of private client is emerging. These clients are tech savvy, more financially astute and are using the web regularly for investment education, evaluation and competitor comparisons.

Armed with their greater financial acumen these clients are far more demanding and want greater involvement in the investment decision making process. This can create opportunities within existing private client organisations however these institutions must ensure they have the right people and product range to meet the new private clients' requirements.

Many private client organisations when asked where they expect their future growth will come from invariably answer "the new economy". Most believe their businesses will attract a more entrepreneurial clientbase. Too many organisations however are still relying on traditional investment products, a comparative lack of technology and old school relationship managers, leaving them ill equipped to meet the challenges of attracting yet alone servicing and retaining the new breed of private client.

One distinguishing characteristic of many prospective entrepreneurial clients is the fact that they may be asset rich but cash poor. With the bulk of their assets tied up in stock and stock options they are not going to have the liquid assets many investment management

focused private client organisations look for.

The challenge is how to unlock the wealth of those clients. How do you provide them with a value added service which frees up capital and gives clients the opportunity to diversify their risk? Increasingly the answer is through the application of derivative based solutions.

Private banks are naturally reluctant to lend against clients' concentrated stock portfolios, especially if the shares involved are highly volatile technology stocks and are the sole form of collateral against the loan. If, as happened earlier this with many tech stocks, the stock drops suddenly, the bank may find itself undercollateralised, and holding a large stock position in an illiquid stock in a falling market.

One solution is to combine any loan with the client entering into a zero cost collar. This is a simple option transaction in which the client buys a put option on his or her shares to provide protection against any share price depreciation and simultaneously sells a call option on those same shares to offset the cost of the put protection. This structure combined with stock held as collateral by the private bank ensures

- ◆ the bank has limited its downside exposure
- ◆ the bank is always adequately collateralised

This certainty obviously makes banks far more willing to lend against comparatively illiquid or volatile stock positions and means these asset rich cash poor clients suddenly become more attractive. They offer the potential to earn good margins from well secured lending, additional margins can be generated from the collar.

transaction and clients may be interested in investing a portion of the borrowed funds into other investment instruments in order to diversify their portfolio, hence giving the opportunity to earn transactional and/or asset management fees.

So how in practice does an equity collar work and how does an organisation that doesn't have its own inhouse derivative trading operation offer such a product to its clients?

Let us assume a client owns stock worth \$25m from a company he founded and has floated on the stock exchange. The client wants to monetise \$5m, being equivalent to 50,000 shares in AnEbiz.com at the prevailing share price of \$100.

The client borrows \$5m for 5 years at USD Libor plus 100 basis points, secured by 50,000 shares held in custody by your bank as collateral. Simultaneously, the client buys a 3 year put option with a strike price of \$100. This ensures that if in 3 years the stock price is lower than \$100, the combination of the stock held as collateral plus the payout on the put option will ensure the principal value of the loan is fully covered.

To offset the cost of the put the client sells a call option with a strike price of 115%. This enables the client to still benefit from any stock price appreciation up to 15% from the current level but above 15% his returns are capped in that gains on the shares will be offset by losses on the call option.

In reality the bank may look for more than 50,000 shares as collateral plus a collar on the higher number of shares to ensure interest charges are fully covered as well.

If the bank does not have inhouse derivative capability the collar part of the above transaction

<p>can of course be outsourced to a specialist derivatives provider. The private bank will deal as principal with an investment bank and simultaneously books back-to-back transactions with the private client. The key consideration is to ensure that the trade confirmation documentation provided to the client is a mirror image of that provided by the specialist derivatives counterparty.</p> <p>Another monetisation strategy favoured by the large Swiss private banks and private client operations of some investment banks is the prepaid forward. Such a strategy may be suitable where a client has a lockup period on selling their stock although the specific terms of any restrictions must be looked at in depth.</p> <p>A client enters into an agreement to sell their stock at a preagreed price today for delivery at some preagreed time in the future (for example in 3 years time) which is beyond the sale restrictions period. Typically, with a forward sale the sale proceeds would be exchanged at the forward settlement date (i.e. in 3 years), however as the name suggests the prepaid forward discounts those settlement proceeds back at prevailing interest rates to give a present value. The client therefore receives the present value today, has a future obligation to deliver a preagreed number of shares or monetary value in 3 years and the bank secures the future obligation by holding the shares.</p> <p>The client still effectively owns the shares, retains voting rights and dividend rights up until the future settlement date.</p> <p>Once again the private bank has provided its client with liquidity which may then be put to work in other types of investments creating a second potential income stream.</p> <p>So where is this new found liquidity likely to find a home? Much of this can be determined by the advice the private bank offers its client. These clients are willing to learn and are often very keen to look at alternative investments.</p>	<p>If a client is looking to monetise a certain proportion of his stock holdings due to specific cashflow requirements such as needing funds for a property purchase there could be an opportunity to monetise a greater proportion of stock so your client can diversify his holdings and reduce his overall portfolio risk.</p> <p>Depending on the client's risk/return preferences the options are of course innumerable. If however the client's primary requirement is wealth preservation followed by secondary needs of investment diversification and potential yield enhancement then in the current market environment various principal protected structures may be of interest.</p> <p>These products can combine the security of a term deposit plus the opportunity to earn attractive returns linked to equity, bond, foreign exchange or commodity markets.</p> <p>The concept behind principal protected products is quite simple. The investor foregoes all or part of the interest they would normally receive on a term deposit in order to have the potential to earn higher returns. If for example a bank's client can invest \$100 today for 12 months at 6.50% they know they will receive \$106.50 when their deposit matures. If instead they invest \$100 in a principal protected product the bank places \$93.90 on deposit at 6.50% to protect the initial principal. Over 12 months this \$93.90 grows to \$100 repaying the initial investment. This is called the "capital guarantee element" of the structure.</p> <p>If the bank has only invested \$93.90 of the initial \$100 what happens to the balance? Firstly the bank takes out its fee, which will typically be between 0.50% to 1.00% per annum depending on the complexity of the product and the size of the investment. For our example we are assuming a fee of 1.00%. We have now accounted for \$94.90 of the original investment.</p> <p>The remaining \$5.10 is used by the bank to purchase an option.</p>	<p>This option offers the potential of a return in 12 months time if a certain event happens such as</p> <ul style="list-style-type: none"> ◆ The FTSE 100 equity index appreciates over the 12 months. ◆ The Euro currency remains within a fixed trading range versus the US Dollar ◆ The Nasdaq Composite equity index falls over the next 12 months <p>The option gives the investment structure its "market linked element". The question of how much exposure the client has to the market to potentially generate returns is a function of what is called the "participation rate".</p> <p>Let us assume the client wants to benefit from possible appreciation in US shares over the next 12 months and purchasing a call option on the S&P 500 equity index costs 10.20%. If the client's bank buys 1 option and the S&P 500 goes up 20% in 12 months the option payoff or value at maturity would be 20%. However, after providing for the capital guarantee element and their fee the bank only has \$5.10 or 5.10% available to spend on options.</p> <p>The participation rate is simply how much money is available to buy options divided by the cost of those options – in this example 5.10 divided by 10.20 or 50%.</p> <p>With this structure the client will receive back at maturity the initial investment plus 50% of any appreciation in the S&P 500 equity index. If the market appreciates by 25% the client receives a return of 12.50% whereas if the market declines the client receives back his or her initial investment and is protected against market losses.</p> <p>So how does the structured product development process evolve within private client organisations? The starting point is typically relatively short dated 100% principal protected structures using simple options or option combinations linked to foreign exchange or equity markets.</p>
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With equity markets most institutions start with structures linked to individual equity indices, followed by baskets of indices. Next come structures linked to baskets of individual equities often with some sectoral theme and now institutions are looking at some of the new sectoral indices that have been created. In addition, the market's capacity to handle structured products linked to mutual funds, multi manager funds and hedge funds is expanding slowly but surely, combining active management with a traditionally passive structure.

Providing derivative based solutions and investment products to your private clients can be a challenging and complex business although not as complex as many would lead you to believe. It is however imperative to ensure staff are adequately trained to

- ◆ recognise the risks and benefits of various structures
- ◆ ensure appropriate selling and minimise reputational risks
- ◆ respond proactively to client requirements
- ◆ feel confident in introducing new products to clients
- ◆ have a greater awareness of the competitive environment in which they are operating
- ◆ ensure the business is adequately supported either internally or through outsourced service providers

As staff and clients expand their knowledge and confidence the range and applications of products can expand also.

As the various examples of derivative usage discussed in this article illustrate, derivatives don't have to be the dangerous risky instruments many would lead us to believe. Used correctly they can offer you enormous flexibility in servicing your clients and enhancing your client relationships. They can be used to provide private banks and clients alike with security and certainty as well as the potential for enhanced returns

Private client organisations which embrace the use of derivatives are and will continue to be far better equipped to meet the challenge of servicing private clients effectively and profitably. Those that do not will find it increasingly hard to compete for new business in the future.