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IN DEPTH

36 PROTECTION: Situation critical
37 TAX RELIEF: Silence is golden
38 TAXATION: How to navigate the taper caper
39 ORACLE: Corporate USA back to strength

INVESTMENT

Structural problems

JOE BUNTING

Structured products mean different things to different people. Generally we might consider them to have helped power the inexorable rise of the financial services sector in recent decades – of great service to the public good.

Individually, however, many of us will have had experience at some point or another of structures with outcomes far from good. The truth probably lies somewhere in between. Getting to the heart of the structure itself is often the problem, and this can undermine confidence and lead to losses.

Revolution

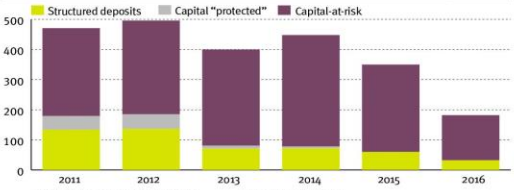
Legal, tax and financial engineering has enabled a revolution in the investment industry since de-regulation in the 1980s. Insurance bonds, special purpose companies, unitisation, personal equity plans (Peps), wraps, self-invested personal pensions (Sipps), Isas, real estate investment trusts, venture capital trusts, enterprise investment schemes, exchange-traded funds (ETFs), credit default swaps (CDS), contracts for difference (CFDs), derivatives – they have all been at the forefront of industry innovation and sophistication.

But there are some elements of 'structure' that warrant closer scrutiny. At the risk of being simplistic, a distinction can be usefully drawn between two main groups of structured products: those which facilitate access, ownership and transfer and are broadly legal and tax-driven in design; and those which package and tailor investment risk and return profiles. The first group involves a focus of legal and accounting expertise, and generally should serve long-term solutions or capital sums of sufficient scale over which the costs can be amortised economically. The beneficiaries should be expected to continue to benefit from such structures over the full term, even though their personal circumstances may change in the meantime.

The second group involves a focus on financial engineering more than the legal or tax basis of the structure. Whether guarantees, enhanced returns, embedded derivatives, leverage, opaqueness, or sheer complexity are involved, living with these kinds of structure for the full term can become uncomfortable. Investment markets and appetites for risk tend to shift around a fair bit for most investors. There comes a point in every cycle where investors look more closely at the risks of a structure and are less interested in the returns that attracted them in the first place. It is at this moment that the real risks and value of a structure can be a challenge to define, liquidity diminishes, and losses are realised.

While all boats rise on the flow of the economic tide, the need to understand the fundamental or intrinsic value of assets becomes much keener when it starts to ebb away – something akin to Warren Buffett's homely 'swimming trunks' analogy.

The easier you can get at that, the better, but any elements of structure and complexity make it harder. Consider the opaqueness of value (risk) in crises of the past: mortgage banks and securitisations (savings and loans banks, 1980s); emerging market loans (1980s), structured return caps, floors, collars, ranges, knock-outs and knock-ins (1990s); split capital trusts (1990s); special purpose vehicles and the whole panoply of off balance sheet financing vehicles that led us into the vortex of our own Great World Debt crisis of 2007. This recent one has been given many rather euphemistic names – 'the credit crisis', 'subprime crisis', 'sovereign debt crisis', and 'Great Recession' – but apparently it has consistently been 'unprecedented' in its nature. And yet so many features have been seen before, and probably will be again – Lord Mervyn King's new book will likely feature on many a reading list this summer.



Structured product launches in the IFA distribution space

Source: StructuredProductReview.com Data as at 27 May 2016

Regulation

The regulatory response to the Wall Street Crash of 1929 was the Glass-Steagall Act, which separated commercial 'socially vital' banking on Main Street from the more speculative 'markets trading' banking of Wall Street: the one to physically maintain the payments system and lend in an economically critical and regulated capacity, ('systemic' and guaranteed as such by the State); and the other to design, manufacture and trade financial products, without guarantees for, by implication, the less vital or useful purpose of mere speculation and profit. The US economist JK Galbraith, who chronicled The Great Crash (published in 1955), dedicated a whole chapter to the kinds of structure and 'innovative design' that in hindsight today appear to have been at the centre of most crises since – the marvels on that occasion being the Shenandoah and Blue Ridge corporations. It's well worth a read and, notably, it took him a generation to find his perspective on those events and their aftermath, including a world war.

There are many 'structured' products that have become an ubiquitous part of the investment landscape, yet which, for some, echo similar precedents: variable bank capital instruments such as contingent convertible capital instruments (CoCos) are now banned for sale to retail investors; we probably have not heard the last of insurance mis-selling; Libor, currency and gold-fixing inquiries are ongoing; emerging markets debt issuance is again sounding alarm bells; mortgage-backed securities, CDOs and special purpose vehicles are all back in business; controversy surrounds ETFs; the merged incentives of 'insurer and assassin' in credit derivatives are integral to the modern bond market; recent moves to bid pricing for some of the UK's leading property funds recall the illiquidity and damage in the sector in the aftermath of 2008; black box hedge funds and multi-asset absolute return funds can be so complex as to leave even the experts at a loss to understand their workings.

Traditionally, structure was priced to yield a premium return in order to compensate for all the 'difficulties' of investing in them. Come crunch time, investors who were the buyers of the returns become the sellers of the structure and capitalise losses permanently. The really useful structured products are best designed and bought for the long term – caveat emptor, if you ever need a change of horses on the way.

Joe Bunting is managing partner of Tellsons Investors and advisor to FP Tellsons Endeavour

KEY POINTS

- Legal, tax and financial engineering has enabled a revolution in the investment industry since deregulation in the 1980s .
- Living with various kinds of structure for the full term can become uncomfortable.
- There are many 'structured' products that have become an ubiquitous part of the investment landscape yet which for some echo similar precedents.