FUNDHOUSE
investment clarity

FUNDHOUSE RESEARCH NOTE

STRUCTURED PRODUCTS: THE INTERNATIONAL TITANS BASKET OFFERED BY INVESTEC BANK

IMPORTANT

This note is our opinion only and does not constitute financial advice

From time to time we are asked by clients to review investment products outside of the mainstream fund management offerings. It serves a useful purpose for us in that we can help clarify decision making for our clients and at the same time develop a broader understanding of what the average investor is exposed to in the market. Structured products fit in this niche.

This note covers a brief overview of how we consider structured products within an investors universe with specific focus on a recent product that has been brought to market by Investec: the 'International Titans Basket Limited'

RATIONALE: WHEN IS IT APPROPRIATE TO USE STRUCTURED PRODUCTS?

It is important to realise where structured products typically fit in to an investor's portfolio. By their nature, these products are playing to the average investors desires: guaranteed capital to protect against losses; upside participation to generate growth. Much like hedge funds they tend to attract the higher net worth investors looking for most of the good, and none of the bad. Currently we see heightened interest in these products as global risks are elevated and historic returns relatively poor. With cash yields close to zero, structured products fill the gap in an investor's portfolio which is difficult to fill at this point.

But are structured products an investment? By design they are linked to specific payoff profiles over defined periods; they are not open ended diversified portfolios of assets which is the domain of the general investor. The investment question always reverts to: what return can I expect and what are the risks; is it relevant to my client?; and are there better alternatives?

A structured product will be attractive to a client who wants to take a speculative bet on world markets with a set time horizon attached to that bet. They are not a vehicle for long-term investment and should not be marketed as such.

STRUCTURE

Structured Products are typically closed end investments (eg in a company, usually domiciled in a low tax jurisdiction) which use derivatives to generate the returns with the linked capital protection.

Additional instruments such as debt (bonds) are also used to provide components of the overall structure, which in totality makes the evaluation of these products quite complex. We have not yet seen a simple to understand, transparent structured product.

BASIC PRODUCT CHARACTERISTICS: INTERNATIONAL TITANS BASKET

The 'International Titans Basket Limited' is a structured product offered by Investec to South African financial advisers for their clients to invest in. The product promises that the original principal capital invested will be protected (i.e. the client will not receive less capital at the end than what they invested), with a 5% return included in the guarantee. This guarantee is in US Dollar terms and only holds if the product is held for the full 5-year investment period.

In this instance the following parties are involved:

- International Titans Basket Limited: Guernsey domiciled, Bermuda listed company
- Investec Bank: investment advisor to the company
- IFA: investor advice
- A Rated US bank: derivative requirements
- Praxis: Fund administrators

The product is structured in such a way that it is linked to the US Dollar but denominated in Australian Dollars, this is not a typical arrangement and introduces added complexity to this product. A South African investor would have to not only track the performance of the product but they would now also need to form a view on the Australian Dollar. This is not ideal for an investor and is a negative in our opinion for this product.

The product uses derivatives to provide investment growth on their initial capital invested that is linked to the performance of the MSCI World Index in USD. This is an index that tracks developed world market company stock prices. An investment in this index is a bet on the performance of developed world markets over the next 5 years. Developed market areas in the index include the USA, Europe and Japan.

The product will give an investor a maximum of 50% return if held for the full 5-year period as intended. We will go into more detail on what that translates into in terms of annual returns later in this note.
The product is structured in such a way that the investor will receive shares in a company listed on the Bermuda Stock Exchange. (International Titans Basket Limited is the company) This company is then responsible for implementing and administering the structure.

INVESTMENT DETAILS:

An indicative **$100** invested by a client into this product will be allocated as follows:

1. **Fees: $7.50 (7.5%)** is held back for Fees. There is an optional upfront fee of up to 2% (in addition to the 7.5%) on the gross amount invested for investment advice from the adviser. This is payable to the IFA and levied at their discretion. This is the only fee that has an effect on the proceeds an investor will receive over the period. The other fees are wrapped up in the company structure and are estimated to be 1.435% annually, and are paid out of the 7.5% held back initially. Ongoing fees can be split as follows: 0.65% to the IFA, 0.65% to the Investec as the investment advisers and around 0.135% yearly to Praxis Fund Services for administration. There is also a 1% once off upfront fee to 'cover costs' (company setup costs - Investec see this cost being closer to 0.3% due to the scale they have managed to build up in the company), as well as an upfront cost of 0.15% payable to Praxis for

administration. This treatment of fees is the key here because Investec have tried to structure the product in a way that all fees are disclosed before any investment is made, fees are not contingent on performance and can be evaluated before any money is put into the product.

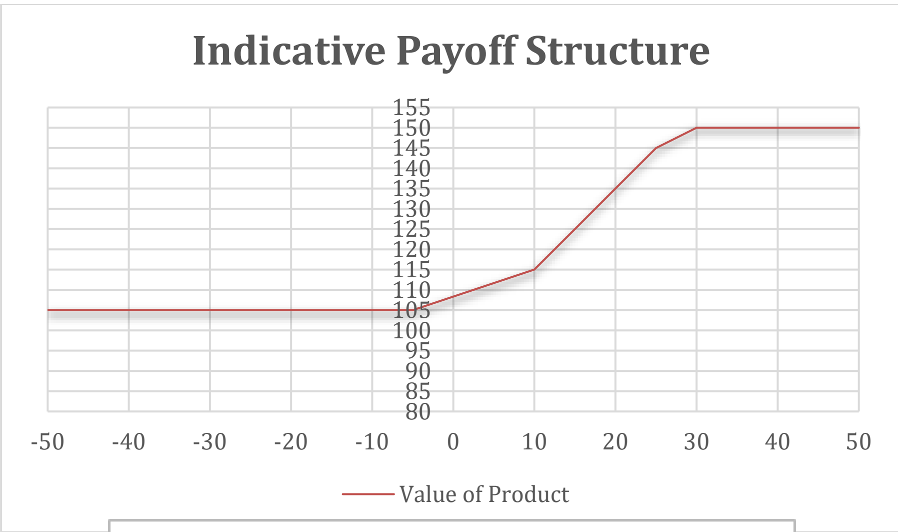
2. **Guarantee: $75 (75%)** is invested in a fixed income instrument (debt/bond) issued by Investec that will grow at 6.5% annually over the 5-year period, which ends up at the $105 guaranteed by the product in the marketing material. This introduces credit risk into the investment. This leg of the investment serves the purpose to provide the capital guarantee on the product.

3. **Growth: The final $17.50 (17.5%)** is used to buy derivatives that provide the upside for the product over the 5-year period. This leg provides the potential growth component of the investment.

PERFORMANCE & RETURNS

In the below figure we show the basic payoff structure of the product with its minimum payoff of $105 and maximum payoff of $150 per $100 invested.

PERFORMANCE WITH FEES TAKEN INTO ACCOUNT



Horizon Axis - % Returns on MSCI World Index
Verical Axis - Payoff in US Dollars after 5-years

We continue our analysis under the assumption that the financial adviser does not take an upfront fee.

The product will give an investor a return over the 5-year period ranging between 5% and 50% in total, net of fees. If the index loses value over the 5-year period, the investor still receives a 5% gain on their investment (or 0.98% per year). On the other end of the spectrum, if the index returns 30% or greater over the 5-year period, the investor will receive a 50% return on their investment (or 8.5% per year).

For context, the long term average return for a global balanced portfolio over 5 years is 46% (+7.9% p.a), with a minimum of -25% (-5.7% p.a) and a maximum of +148% (+20% p.a).

The following table summarises the returns range available to the investor: All returns figures are net of fees.

0% Upfront Fee				
Scenario	Explanation	Nominal Annualised Return	US Inflation 5 year fwd	Real Annualised Return
Min Return	Index Loses	0.98%	1.64%	-0.65800%
Mid Return	Index does 20%	6.19%	1.64%	4.54700%
Max Return	Index does 30%	8.45%	1.64%	6.81000%

Inflation Source: https://fred.stlouisfed.org/series/T5YIFR

Inflation Source: https://fred.stlouisfed.org/series/T5YIFR
'Nominal Annualised Return' – Compounded Annual Return Before Inflation

'Real Annualised Return' = (Nominal Annualised Return – US Annual Inflation)
Investors also need to consider the CGT consequences on exit in 5 years time.

RISKS

The risks that a structured product introduces to an investor are not typical of the standard investment classes:

1. There is credit/counterparty risk on both the Investec Bond which guarantees capital preservation and the US bank with which the derivatives contracts are negotiated (an 'A' rated bank to be selected). The guarantee is as strong as its guarantor.

2. The fact that the product is structured to pay out in Australian Dollars gives the investor an additional variable to watch on the currency versus a straight US Dollar holding.

3. Liquidity risk. The investor is locked in for 5 years, and exit from the product is facilitated on a 'willing buyer' basis and is subject to a 1.25% early exit fee. The risk is that in times of market turmoil there is no willing buyer available which essentially locks an investor in.

4. By buying into this product there is an opportunity cost. It is not possible to quickly access this investment to take advantage of market opportunities as they present themselves.

CONCLUSION

The International Titans Basket is attractive for its capital preservation promise and performance potential in a difficult global investment environment. It is not obvious that a diversified portfolio would provide a better or worse investment outcome over the next 5 years, so on pure performance potential the product should be considered.

The annual real return spectrum ranges between -0.6% to 6.8% over the 5-year period assuming that no initial upfront fee is taken by the financial adviser. One must keep in mind that these returns are not riskless, the 4 key risks mentioned above loom large in our minds when evaluating this product.

This product is suited to an investor who is:

> Very bearish on global markets over a 5 year horizon
> Comfortable assuming counterparty bank risks
> Comfortable investing in a closed end company structure with no/low liquidity
> Comfortable with the performance complexity (derivatives, currency, etc)
> Comfortable with a return driven by global equities only