Capital protection in structured products – what are the choices?

Sophie Barnett, vice president at Morgan Stanley, looks at the different types of capital protection that investors can achieve through structured products

> Despite markets rebounding once again in recent months, many investors remain nervous. As a result, they might look for ways to limit losses in their portfolios should markets turn once more. Capital-protected structured products are one way to achieve this. They can be added to a broader portfolio to help limit downside exposure while retaining some upside potential. But what different types of capital protection are available and at what cost?

With interest rates well below long-term averages, full protection is very expensive to provide. Counterparty risk is also a consideration – since the Lehman Brothers demise, many investors want the highest-quality issuers providing the protection. This is more expensive and, therefore, reduces the providers' scope to offer a competitive return potential. Providers like ourselves face a dilemma: how do we construct a product that offers a good balance of protection and performance potential?

One widely used solution is 'soft' or 'contingent' protection, whereby investors' capital is protected as long as the underlying asset does not fall below a predetermined barrier. This can be observed continuously or at maturity only. Soft protection is cheaper than full protection, as investors are asked to take on additional risk. As a result, soft-protection products typically have greater return potential. For example, we have two products launching in May 2010 that offer the same payout, but one provides full protection (FTSE Protected Growth Plan 33) and the other soft protection (FTSE Kick-Out Growth Plan 3). Both offer the chance for early exit after three years, otherwise investors receive participation in any FTSE Index growth at the six-year maturity. By offering these two products side by side, we can see exactly how much more full protection costs than soft protection. In this case, it costs 30% on the early exit return and 10% participation at maturity. Investors have to decide whether they are willing to take on the additional risk in return for the greater return potential.

But soft protection is not suitable for all investors. Some might not want to take the risk that the protection barrier is breached. Instead, there is a new breed of simple payout where investors are only exposed to a fraction of the downside that might be appealing. For example, investors in our Tracker Plus Plan only lose one-fifth of any negative FTSE Index performance. In return for accepting 20% of their capital at risk, investors receive a leveraged return if the index performance is positive.

This 'limited downside' solution may appeal to investors who would typically look at tracker-type investments such as exchange-traded funds (ETFs). As with any investment product, investors need to ask themselves whether they are comfortable with the credit quality of the institution providing the payout. Regardless of the level of protection on offer, this is worthless if the issuer defaults. However, unlike an ETF, this new solution is designed to outperform the underlying asset on both the downside and upside. Moreover, the upside leverage could be enough to compensate investors for any foregone dividends.

One of the key benefits of structured products is their flexibility. For years, we have seen products offering different upside exposure, including fixed payouts, early exit features and varying degrees of participation in an underlying asset's performance. We have also seen innovation relating to counterparty risk, with structured deposits and collateralised products proving popular with investors. More recently, we have seen greater innovation in terms of downside exposure, driven by the high cost of full capital protection. As well as fully protected products, investors now also have the choice between soft protection and limited downside products. As market uncertainty remains, these different degrees of protection can be useful for investors looking to limit the risk of loss in their portfolios while still retaining some potential for returns.

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