

North America: time for structured products

The US and Canada may have lagged behind Europe and Asia, but a booming market shows that investors are catching up quick

While still lagging behind more mature European markets, the structured products industry in North America is catching up and expanding dramatically. After three years of strong growth, structured products markets are expected to increase by 20% in the US and by 40% in Canada.

Why have structured products developed further in Europe than in the US or Canada? Traditionally, European investors were fixed-income investors and did not invest directly in pure equities. When the returns of the equity markets became attractive, Europeans used structured products to gain exposure to the equity markets.

In North America, the story is somewhat reversed. Equity ownership has long been a tradition in the US, and the returns over many decades have shown that equity markets tend to outperform fixed-income markets over a long time horizon. This was considered a well-known fact, and equity ownership was particularly in vogue during the equity market boom in the 1990s. Investors preferred direct investment in equity markets via stocks or mutual funds as opposed to getting partial exposure through structured products. Many investors did not value the benefits of structured products, such as 100% principal protection.

The view on structured products in North America changed fundamentally after the steep market decline of 2000–2002. Many investors felt the impact of the market decline personally and became more cautious of the equity markets, thus placing a premium on capital protection. With the market trending sideways, many investors were enticed into allocating a portion of their portfolios to structured products. This led to increased demand for principal-protected investments, such as equity-linked notes. Investors were ready to forego unlimited upside potential in exchange for lower risk, regular income, or a capped but easily achievable return.

The growth of the structured products marketplace was also helped

by the exponential growth and diversification of buy-side investors. Interest in structured products comes not only from traditional players, such as broker-dealers, but also from retail networks, wealth managers, hedge funds, foundations and family offices.

As a result of this growing investor appeal, competition between issuers has tightened in the last three years, placing research and innovation at the heart of structured product development.

Innovation made simple

In the 1990s there were only a few types of structures, including the popular equity-linked CDs that provided exposure to broad market indices as well as to specific market sectors. Changes in market conditions since then have been a major factor in driving structured products providers to be increasingly innovative.

The range of structured products available in North America has broadened significantly, both in terms of underlyings and payoffs, while still focusing on transparency and simplicity. It is indeed highly important to know the target market in order to select products that are likely to succeed there. Whereas many European or Asian investors are willing to look at more exotic structures for their higher returns, American investors prefer more transparent and easy-to-understand products.

In the US today, there is a variety of structures, ranging from one-year reverse convertibles on single stocks to 10-year notes offering exposure to the equity markets, as well as notes linked to several different asset classes. Products are increasingly linked to commodities, mutual funds, hedge fund indices, FX, interest rates and inflation. In current market conditions, investors have been seeking to extend the scope of investments outside pure equities or bonds to benefit from the performance of other markets and obtain diversification opportunities through multi-underlying exposure.

Hedge fund and commodity-linked structured notes are particularly

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popular among high net-worth and institutional investors seeking absolute returns not correlated to traditional equity or bond markets. Over 30% of investors who invest in hedge funds today hold structured products in their alternative portfolios. Moreover, continued growth is expected in this segment, with growing interest in new geographic market underlyings. Oil and currency-linked structures are also some of the most notable structures recently launched in the US.

Product diversity is also strong in Canada. As an underlying, mutual funds and hedge funds are increasingly used, along with single stocks, indices and baskets of such assets. Innovation on the structuring side is developing rapidly to provide investors with value-added yet straightforward payoffs.

Examples of successful products

In Canada, *Stellar Coupon* structures, developed by BNP Paribas to address investors' needs for income generating products, proved highly successful. One of the variations is a five-year 100% principal-protected note, linked to a basket of well-known equity indices, which pays a variable annual coupon based on the performance of the underlying indices. In this structure, if the indices rally by more than 10% in year 1, and then never move afterwards, investors could get 10% returns in each of the five years. Additionally, such products typically have a minimum guaranteed return of 1% to 2% per year. BNP Paribas was a pioneer of the Stellar Coupon concept, used by many Canadian issuers afterwards.

In the US, three recent BNP Paribas products were especially designed for today's markets.

In the first product, *Galaxy*, investors were willing to take advantage of the currently low volatility. They specifically wanted to bet on the increase in volatility in the markets, as opposed to taking a view on the direction of the equity markets themselves. To address their needs, BNP Paribas developed a three-year 100% principal-protected product, with an annual coupon linked to the monthly moves of the S&P 500 index, providing a minimum payout of 2.5% in each year. This solution was designed so that if volatility in the markets picked up significantly, investors would have an opportunity to receive an annual coupon of 5% to 6% or more.

In the second product, *Triathlon*, investors sought exposure to a multi-asset portfolio, but were not quite sure how to allocate their investments across different asset classes. To address their needs, BNP Paribas designed a five-year 100% principal-protected product, linked to three different allocation schedules: aggressive portfolio (with 70% exposure to equity markets and 30% exposure to other asset classes, including bonds, commodities and money markets); balanced portfolio (50%/50%); and defensive portfolio (30%/70%). At maturity, investors receive 100% participation in the winning strategy, as well as 100% capital protection. This type of structure is designed to work under diverse market conditions and seeks to enable investors to receive the most profitable asset allocation with the full benefit of hindsight.

In the third product, a *best-of Asian* based on a lookback option, investors wanted to lock-in the returns of the equity markets during

the life of the note. Investors had seen markets go up and down and wanted to capture the peak of the market while keeping 100% principal protection. To address their needs, BNP Paribas designed a three-year 100% principal-protected product linked to the performance of the S&P 500, with returns computed on a monthly basis, offering investors the highest return reached over the life of the note.

Opportunities to come

New product ideas based on diversification and yield enhancement will be designed in the years ahead. Issuers such as BNP Paribas constantly introduce new products that complement traditional portfolios of American investors, which often consist of a mix between equity (highly concentrated in US stocks) and fixed-income portfolios. Products will be designed to give investors access to new equity markets, such as Europe, Asia and emerging markets, as well as to new asset classes, such as commodities, to protect investments with a minimum yield in case of an increase in inflation. These products could be used to supplement core holdings and let investors take advantage of the opportunities available across the globe and asset classes.

BNP Paribas, world leader in structured products

With outstanding capabilities in product origination, execution and service, BNP Paribas ranks among the leading players in structured products worldwide, recognised by its peer groups, clients and financial press. BNP Paribas has won some of the most prestigious awards in the industry, including *Risk* magazine's "Best Equity Derivatives House of the Year" award in 2004.

BNP Paribas is well positioned to take advantage of its leading presence in structured markets throughout the world and to bring the best product ideas and best client service to the United States and Canada. Benefiting from local issuance capabilities in Canada through BNP Paribas (Canada), BNP Paribas has one of the largest exotic trading teams on Wall Street, able to price numerous structures. BNP Paribas also has an established leadership in alternative investments, reinforced by the purchase of certain Zurich Capital Markets business lines, as well as the development of innovative payoff structures and new underlyings for alternative investment.

BNP Paribas' goal is to help investors understand the intricacies of structured products and how they can best use these portfolio tools. When investors think of structured products they think of BNP Paribas, an outstanding innovator and leading market player. ●

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