SPONSOR'S STATEMENT

BARCLAYS CAPITAL

Fund-linked derivatives: structuring alpha

Richard Ho and Antti Suhonen of Barclays Capital explain how utilising specialised structuring technology can improve the efficiency of investment exposures to multiple asset classes and sources of alpha to deliver truly bespoke solutions

The complexities in today's investment landscape are more involved than ever. End investor disenchantment with standardised asset management techniques is rife. Competition is high – not only within the well-populated traditional asset management sector – but from outside as well, with the advent of structured product solutions, the proliferation of alternative investments and the growing accessibility of hedge fund investing.

At the same time, returns from traditional markets and instruments have been lacklustre. Equity markets have, until recently, produced desultory returns; credit spreads have been compressed to previously unimaginable levels, and interest rates have provided little respite either. Conditions have improved since the well-known equity market collapse of 2000–2001, but even this upturn has failed to reassure many investors. End-investors, from retail and high net worth clients, right through to corporate pension funds are demanding increased surety as well as additional returns. Not only that, but they are scrutinising their traditional fund investments more closely than ever. Far from being satisfied with the traditional "beta" – or benchmark-meeting investment criteria, investors are focusing on risk-adjusted returns and managers' added value or "alpha". They are seeking out new investment types, looking to allocate sizeable portions of their portfolio to non-traditional markets, including tailored forms of protection and liability matching. All of this could potentially put a strain on asset managers' time, distracting them from the application of their core expertise at a time when investors are scrutinising this more closely than ever.

Traditional fund managers are responding to these new challenges admirably by taking a more active role and stepping up to the challenge of hedge funds by adopting some of the investment methodologies of hedge fund managers, and using asset allocation strategies more actively than in the past. They are also beginning to take on the trend for liability-driven investment, by devising investment solutions that better match particular investor's liability profiles. But the rising demand for bespoke solutions that combine alpha and beta required for tailor-made risk-reward profiles and liability matching required by some investors may be a bigger challenge.

The fund-linked solution

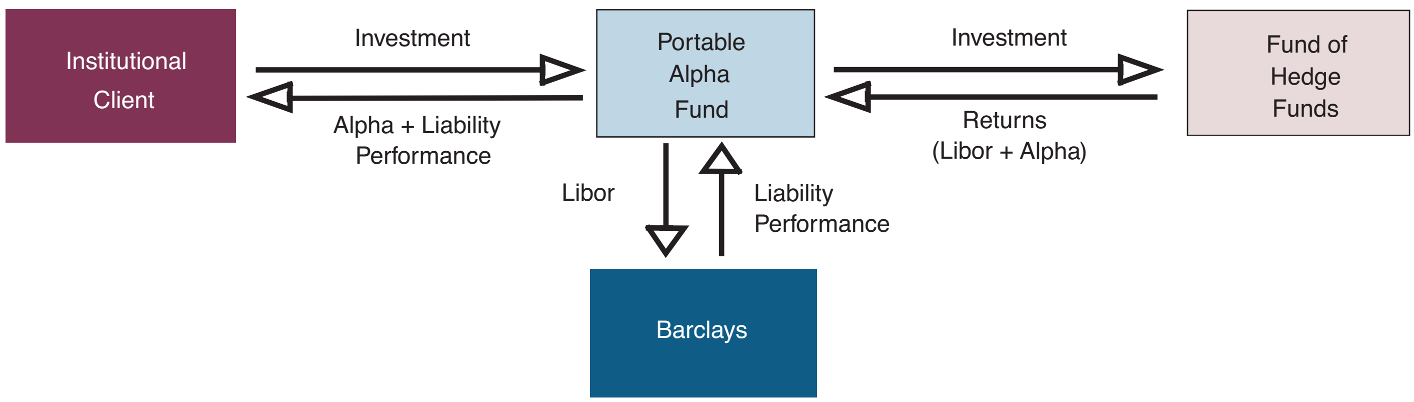
Fund-linked derivatives or structured fund products can do much to help in this task as they can be tailored to match the risk-reward, liability or cash flow profiles required by investors whilst combining the desired sources and magnitude of alpha and beta.

Says Richard Ho, head of fund-linked derivatives at Barclays Capital in London: "Funds derivatives provide customised access to investors interested in the managers and asset classes of their choice. Utilising specialised structuring technology means we can improve the efficiency of investment exposures to multiple asset classes and sources of alpha to deliver bespoke solutions. There are a vast number of permutations with the careful application of the new and emerging investment strategies and product technologies."

As an example, fund-linked derivatives can be used to deliver principal protection on a mutual fund or a range of mutual funds, which would allow the sponsoring managers to reach a new range of investors that are unhappy investing in equity-based mutual funds on an unprotected basis. Says Antti Suhonen, head of fund-linked derivatives structuring at Barclays Capital: "We can also structure the products to enable the managers to switch between asset classes depending on market conditions, allowing them to really leverage their core expertise. For instance, we recently constructed a large-scale product for one of our clients, which included a rebalancing between emerging market debt and equity. With Barclays Bank PLC behind the deal as a AA-rated guarantor to protect the capital of the fund, the investors have a further level of investment comfort."

Alternatively, for institutional investors with real return-linked liabilities and the need for performance to minimise funding gaps, fund-linked derivatives can combine long-dated inflation exposures with alpha returns from hedge funds. Says Ho: "Fund-linked derivatives can provide a single entry point investment strategy for investors, and an attractive delivery tool for asset managers. Not only can the end-investor's liability and alpha/beta-driven requirements be addressed in the product, but the end investor and provider avoid all the complexities normally involved in managing these disparate elements as well as the operational burdens entailed in trading the supporting derivative contracts. By engaging in a fund-linked transaction the managers and investors face only one counterparty, one mark-to-market price and have a single point of entry on their balance sheets."

Example: embedding liability-matching characteristics into alternative assets



The example above shows a solution developed by Barclays that not only covers the particular liabilities faced by the client, but also delivers alpha from a chosen investment manager and fund. Says Suhonen: "By combining an inflation element with direct exposure to the performance of selected asset classes, we were able to deliver a tailored solution in an efficient format. The client was able to access both alpha and beta in a bespoke manner, and the investment manager benefited from being able to offer the same underlying product to a large number of investors."

Reaching a wider universe

Structured products – especially those aimed at the private banking and retail sectors – have been growing tremendously, presenting asset managers with additional competitive challenges at an already difficult time. Many investors have also turned away from traditional mutual fund investing, in favour of the array of widely marketed structured products. Fund linked derivatives offer fund managers an alternative way of squaring up to this behavioural shift, by tapping into the new interest through partnership with fund-linked derivatives providers. "Of course asset managers can compete in the structured product market by branding and distributing traditional structured products in fund form, but competition is strong, product differentiation is difficult and the managers may not be utilising their core competence to the full. An interesting alternative, we believe, can be for them to take a more meaningful role by looking to build structured solutions incorporating active asset management," says Ho.

Adds Suhonen: "The structured fund solution is attractive for asset managers and potentially a superior alternative to the traditional 'structured product', as it allows them to focus on and demonstrate their core competencies. The products ensure that their traditional active management strengths are not only utilised, but are visibly demonstrated.

With fund-linked derivatives, managers may also expect to grow their investor bases. They can be used to customise the products delivered to end-investors, thereby giving scope to identify new and emerging pockets of interest for which tailored fund-linked products can be delivered. What is more the products can be delivered in a variety of forms or wrappers – in over-the-counter derivative form, as a fund vehicle, or even as a note. Managers can market 'standardised' solutions to a number of investors with similar appetites and liability profiles, or make marginal adaptations to the solution to suit other investors with slightly different requirements. Another alternative is to re-wrap the product in note or fund form to tap into different investor bases. "By offering the products in these different wrappers, fund managers can ensure they are tapping into the wide demand from a good range of new and existing end-investors. And, far from cannibalising their traditional business, fund-linked derivatives enable portfolio managers to focus on what they do best – running their funds, leaving investors with the best of both worlds," adds Suhonen.

"Increasingly, the role of the investment manager is either to deliver beta economically and efficiently or to provide demonstrable alpha within his or her own area of expertise," says Ho. "By using these solutions they can go one step further in meeting the more challenging requirements of today's investors – such as liability-matching, principal protection or leverage. Fund-linked derivatives offer an effective way for them to utilise their own strengths and alpha and beta combinations to meet investors' particular risk-return objectives," he adds. ■

If you are interested in partnering with Barclays Capital to deliver fund-linked derivative products and would like to discuss these opportunities further, please do not hesitate to contact us.

CONTACTS

Richard Ho, head of fund-linked derivatives

T: +44 (0)20 7773 8063

E: richard.ho@barcap.com

Antti Suhonen, head of fund-linked derivatives structuring

T: +44 (0)20 7773 9478

E: antti.suhonen@barcap.com