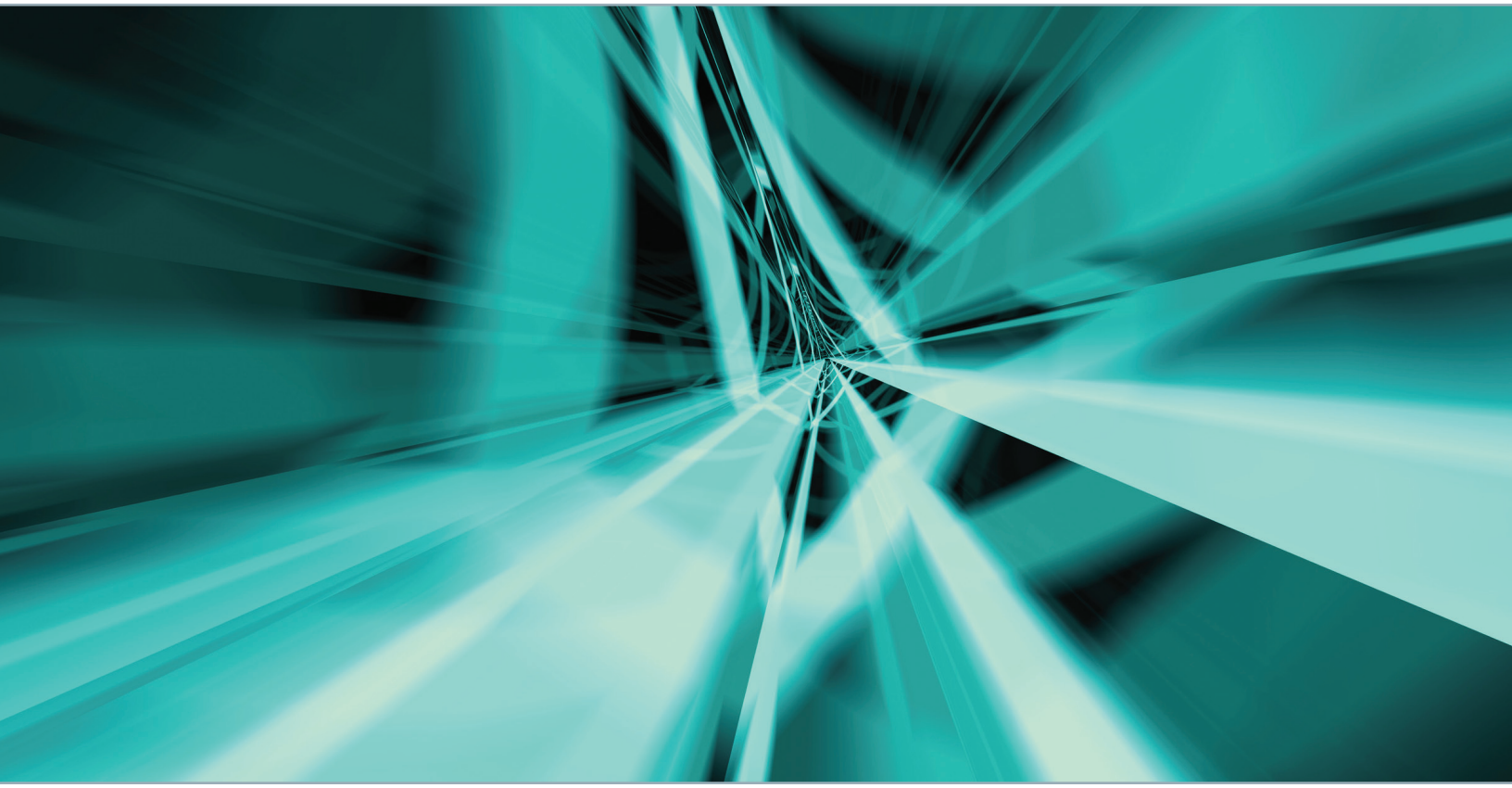
INTELLIGENCE ON DERIVATIVES-BASED INVESTMENTS

Structured products

www.structuredproductsonline.com MARCH 2005



Structured Products and International Private Banking

Merrill Lynch

Product trends in private banking

Merrill Lynch examine what is going on in this ever-evolving market over a decade after it began for private clients

While the general press continues to depict structured products as a new segment, the structured products market for private clients has been in existence for more than a decade. In this article, we aim to identify some of the current trends of this market, which despite its age, continues to evolve rapidly.

The case for structured products is intact

Many observers of the structured products market explain that its recent growth is due to the poor performance of equities in the past few years, low interest rates worldwide, and the difficulty for private investors to access non-traditional markets such as commodities. In our opinion, the primary reason for the recent growth is that structured products can offer features that traditional investments cannot. Incidentally, we believe this is also the reason why private investors should use structured products in the first place. For example, achieving principal protection with equity participation and currency protection is impossible using only traditional investments. A GBP-denominated, principal-protected note linked to the S&P 500 index – a pretty standard product in the UK - does exactly that. Another example where structured products are indispensable is when investors want to express non-directional market views, say a stable equity view over the next few years, or when expressing views on the volatility of certain markets or the correlation between several markets. Structured products can also be used to track systematic trading strategies, help investors reduce the risk of concentrated positions, and allow for leverage in investments that do not naturally lend themselves to it, such as fund of hedge funds, to name a few common examples. There are numerous reasons why investors may want to use structured products, but the key to all of them is that they can incorporate features that do not exist in traditional investments. Provided this is the main reason why investors use them, we anticipate that the structured products market will continue growing for many years.

Value proposition inversion

From financial engineering to all-round solutions

Early stages - 1990´s	Now
- Innovation	- Service
- Access to capital markets	- Pre-sale advice
- Performance potential	- Idea generation
...	- Liquidity
...	- After-sale support
...	- Dedicated research
...	- Actual performance
...	- Wider range of products
...	- Ability to combine asset classes
...	- Enhance characteristics of A.I.
- Service	- Transparency / openness
	- Innovation

Value proposition inversion

When structured products were first offered to high-net-worth investors in the early1990s, the value proposition was centred on innovation, access to capital markets and potential for performance, while service was typically last on the list, if mentioned at all. And service meant providing an institutional service, ie, very limited after-sale support with perhaps a Reuters page and a phone number. Warrant investors also received a summary of offered structures and a glossary of 'often-used terms'.

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HNWI increasingly demand institutional service

Characteristics	Institutions	Sophisticated HNWIs
Mindset:	- Unemotional attitude toward investing - Ratio/fundamentals driven - Long-term goals while realizing short-term gains - Close relationships with investment objects (B2B) - Solution approach vs. product approach	- Rational, increasingly less emotional attitude toward investing - Service and access to advice and solutions key - Cash flow and liquidity important (vs. Overall yield for institutions) - Price pressure - greater transparency, e.g., through "RFP" - Financial solution approach vs. product approach
Methodology:	- Documented strategy to reach specific goals - Consistent approach, following a strict discipline - Goals-driven approach to reach long-and medium-term objectives - Strategic asset allocation for balances risk management and appropriate diversification - Frequent rebalancing (dynamic asset allocation) - Frequent consolidated-performance reporting	- Greater adherence to "wealth management process" - Rigorous financial planning to set goals and allocate assets - Diversification across asset classes, sectors and geographies - More frequent tracking of progress to goals (closer to dynamic asset allocation) - Run family/business like an institution with mission statements, communication guidelines, continuity plans, etc
Products and Services:	- Preferred access to advanced products and markets to better balance portfolios (execution as important as idea generation) - Demanding solutions; product and service customization - Higher ratio of alternative investments to balance portfolios and yield higher returns - Close attention to tax sensitivity	- Increasing demand for comprehensive solutions - Non-correlated product classes to balance portfolios to achieve higher total return: alternative investments, managed products; real estate - Tax efficiency services - Wealth transfer - estate planning, trust - Global wealth structuring (across jurisdictions) - CFO services (tax/legal/accounting)

Source: Cap Gemini and Merrill Lynch Executive Briefing, March 2004; Cap Gemini Analysis, 2004

Since then, the structured products market has evolved markedly and gone through major changes. The number of private investors using them has gone up by at least one order of magnitude, and many providers are working to improve their clients' overall experience. We at Merrill Lynch, believe that the value proposition for structured products has inverted. Now service comes first, both pre-sale and after-sale with, of course, the assurance of impeccable execution. Pre-sale service ranges from helping clients design solutions that suit their needs to giving them full access to research, providing them with pricing tools and helping them perform comparative analyses. Equally as important is after-sale service that, first, includes liquidity supported by several sources (Reuters, Bloomberg, internet pages, etc), but also the ability to answer questions about previously launched products and providing periodic updates on performance, liquidity and volumes. For example, the Merrill Lynch quantitative research team offers a quarterly publication dedicated to structured products issued by Merrill Lynch in the past with performance data, market data and explanations allowing investors to connect both. Second comes actual performance, not potential or hypothetical performance – an increasingly important point as more and more 'smart products' are maturing without delivering the returns they were claiming to produce. The structured products market is, after all, a growing part of the investment industry, an industry where performance is key; even if it has to be measured in risk-adjusted terms. Other criteria include accessing a wide range of payoffs, markets and asset classes, enhancing the characteristics of AI investments, and still, of course, innovation. But while innovation is still part of the value proposition, it no longer seems to occupy the pole position.

Adapting to changing client needs

As the Merrill Lynch/Cap Gemini 2004 World Wealth report points out, HNW investors increasingly mirror the behaviour of institutional

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investors on many levels. Private clients are becoming more and more rational and price-sensitive, and they are increasingly looking for comprehensive solutions rather than products. Their methodology increasingly adheres to a carefully thought through wealth management process with rigorous financial planning to set goals and allocate assets. They seek diversification across and markets, sectors and asset classes and use consistent performance measurement techniques to track their performance versus stated goals. This means providers need to change their product offerings in several ways. First, product providers must ensure they offer comprehensive strategies that take into account all the relevant elements of the client's financial objectives. Second, they must be aware of the key areas surrounding the solutions they offer – tax, regulatory, accounting – and be ready to adjust their proposals in accordance to them. This is where wrappers, a key area of focus at Merrill Lynch, become critically important. Last, product providers must offer what we refer to as a 'personalised institutional' service, that is, service that combines the speed and accuracy required by institutions with the personalised touch required when dealing with individuals.

Products in tune with solid research views

In our view, an important aspect of the design of structured solutions is to ensure that new products are in line with our relevant and credible research publications. At Merrill Lynch, we use reports – such as the year ahead and the monthly RIC (research investment committee) report – as anchor points to most of our launches.

For example, some of the themes recently highlighted by our research include gradually rising inflation, diverging global interest rates, high levels of corporate cash (especially in the US) and thus a trend towards higher dividend yields, and a fairly positive environment for commodities and most emerging equity markets.

Some product trends

These themes reconcile well with some of the product trends we are seeing at the start of this year, namely:

Gradually rising inflation – inflation-protected investments linked to equity or other markets are in demand again as inflation expectations are gradually rising.

Volatility bear market – the recent decline in equity volatility does not, in our opinion, mean that a rally is likely to happen in the short term. We believe equity volatility is likely to stay muted this year. The spread between implied and realised volatility, however, is still palpable, which bodes well for strategies that systematically sell options.

Correlation bull market – even after the correction of the past few weeks, single-stock correlation remains high versus historical standards within the main equity indexes (S&P 500, DJ EuroStoxx 50, Nikkei 225). Likewise, inter-index correlation is higher than its historical mean. We believe equity correlation is likely to remain high in 2005, and we have already issued several products allowing our clients to express this view.

Positive trend for emerging markets – despite low interest rates, we see increasing demand for partially protected investments linked to emerging market equities.

Currency-protected equity investments – interest rate differentials between the higher-yielding markets (UK, US) and lower-yielding markets (euro-zone, Japan) are creating a renewed interest in currency-protected investments. The captured carry can translate into higher equity participation or guaranteed returns, or both.

Commodity-linked products - strong performance in many commodities markets, coupled with low correlation to other assets, has rekindled interest in commodity-linked investments. The Merrill Lynch Commodity Index is up by more than 22% in USD terms since January 2004.

Enhanced AI/hedge fund-linked investments – the recent deceleration of hedge fund returns is causing many investors to look into ways to enhance the performance of their hedge funds/fund of funds holdings, either through moderate leverage or systematic option selling. At the same time, we see increasing demand for enhancing the liquidity of existing hedge fund-related positions.

Conclusion

The structured products market for private clients is no longer a nascent area. It is a maturing market where the right experience, and working with experienced partners, is becoming increasingly important. Service and actual performance have superseded innovation and potential performance as the prime success factors for product providers. While the growth curve of this market may be near its inflexion point, we see substantial growth ahead for participants who are able to deliver the service and performance required by today's private clients, whose expectations increasingly resemble - and sometimes exceed - those of institutional clients. ●

Merrill Lynch has been offering structured products to private clients, private banks and third-party distributors since 1993. Today, Merrill Lynch provides structured products linked to equity, bonds, currencies and commodities to private clients and third-party distributors around the globe, with dedicated pre-sale and after-sale service.

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