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SFC InvestEd

Dr Wise's Column
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Retail Structured Notes – Buyer Beware

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Key Messages:

Before placing an order for any retail structured note, an investor should:

- read all offering documents –marketing materials do not have full information;
- understand that a note linked to a basket of shares is riskier than one linked to a single share; and
- be aware of and prepared for the worst-case scenario.

As it was raining heavily last Sunday evening, I had to cancel an outdoor lawn-bowling practice with my teammates, James, Christopher and William all of whom are creative executives in advertising agencies. We went for reflexology instead, as William had never tried and would appreciate company for his first visit.

Warm, relaxing footbaths were brought to us soon after we were seated comfortably in massage couches in a secluded area. William spotted a glossy leaflet about reflexology lying on the magazine rack next to him and decided to study it before his reflexologist arrives to begin "working" on his feet.

Seeing that William has settled down nicely, James commented, "These leaflets are similar in style to those we prepare for issuers advertising retail structured notes. Short and glossy with punchy banner headlines."

"Those headlines always catch my eye, especially those figures stating the maximum potential return", James exclaimed, "but I always read on to better understand the fundamentals, whether my capital is protected and what risks are associated with it."

At this point, James and Christopher asked for my advice. "You are indeed becoming more prudent," I replied. "The notes market is more sophisticated nowadays and there are a variety of structures to suit different investment objectives and risk appetites."

"For instance", I continued, "using a basket of shares as the underlying asset is now commonplace. Return on these equity-linked notes typically depends on the performance of the underlying shares on specified dates. For those who hold a neutral to bullish view and believe that all underlying shares will close at or above a specified level (usually known as strike prices) on pre-determined dates in the future, they will get their principal back in cash together with periodic interest payments if their forecasts turn out to be correct. However, if the closing price of any share in the basket is below its strike price, investors will receive shares in the worst-performing company on maturity. The value of these shares could be substantially lower than the amount they originally invested".

I added, "Daily accrual notes, with the interest amount linked to the daily performance of the underlying asset during specified observation periods, are also becoming increasingly popular."

Christopher then asked for more information on how daily accrual notes work as his colleague had told him that he could get a competitive return by investing in these products.

"For example", I continued, "suppose it is an investor's opinion that all underlying shares in the basket will continue trading at or above their respective strike prices, which are usually fixed as a percentage of the initial prices, and the investor is also prepared to take delivery of the worst-performing share in the basket if its closing price on the final valuation date is below its strike price. In this case, the investor invests in a daily accrual note.

The amount of interest payable in respect of an observation period will be calculated by reference to the number of trading days during such period on which all underlying shares close at or above their respective strike prices as compared with the total number of trading days during such period. No interest will accrue on those trading days during an observation period on which any of the underlying shares closes below its strike price."

"Wow", said James, "that is a much more complex structure than I imagined. How can you work out your likely return?"

At this point, I took out my personal organiser and started showing them a hypothetical example* of how interest amounts are determined:-

"Let's assume that (i) the principal amount of a non-callable note is HKD50,000; (ii) the interest rate is 8% per annum; and (iii) the term of the note is 12 months with 6 observation periods.

Observation period	Total number of trading days in the observation period	Number of trading days in the observation period on which the closing prices of all the underlying shares are at or above their respective strike prices	Interest rate payable in respect of the observation period	Interest amount payable in respect of the observation period
1	40	28	8%*2/12*28/40 = 0.93%	HKD50,000*0.93% = HKD465
2	40	24	8%*2/12*24/40 = 0.8%	HKD50,000*0.8% = HKD400
3	38	0	8%*2/12*0/38 = 0%	HKD50,000*0% = HKD0
4	44	18	8%*2/12*18/44 = 0.55%	HKD50,000*0.55% =HKD275
5	40	38	8%*2/12*38/40 = 1.27%	HKD50,000*1.27% = HKD635
6	42	42	8%*2/12*42/42 = 1.34%	HKD50,000*1.34% = HKD670
		Total	**4.89%**	**HKD2,445**

Further, let's assume that, on maturity, the investor receives 100% of the principal in cash because all underlying shares close above their respective strike prices. In this example, total return is just 4.89% over the 12-month term of the note. You have to be aware that the actual return on these daily accrual notes can be much less than the stated per annum rate if you don't forecast movements in the underlying shares correctly."

I also reminded them that it is possible for investors to be stuck with an investment that (i) pays no interest during the life of the note and (ii) results in their taking delivery of shares in the worst-performing company, if any underlying share within the basket closes below its strike price on all valuation dates.

"Ouch", William suddenly cried out. Not knowing whether he was reacting to the therapy or our conversation, we all glanced at him in bewilderment. William then clarified that he was commenting on what I just told James and Christopher. William went on to say, "It would definitely be painful to be stuck with the worst case scenario if you are not prepared for it. We should read all the offering documents as only limited information can be found in marketing materials."

"Absolutely", I agreed, "it is imperative that you do not simply rely on the marketing materials. Detailed information about the issuer and the payout mechanism of the notes are set out in the offering documents. You must read these documents thoroughly; in particular pay attention to the sections regarding (i) how the notes work; (ii) risk factors and (iii) hypothetical examples to ensure that you fully understand the nature of the product and the risks involved.

For instance, those who invest in notes linked to a basket of shares need to appreciate that they are subject to a greater risk than those who invest in notes linked to a single share since they are exposed to the price fluctuations of a greater number of shares. In addition, they should realize that they will not benefit from the strong performance of the other shares in the basket if the closing prices of the worst performing share continue to stay below its strike price on valuation dates.

We must always bear in mind what the worst-case scenario could be. Investors who buy equity linked notes must be prepared to receive shares in the worst-performing company upon maturity, the value of which could be substantially lower than the original investment amount."

Before we knew it, our reflexology sessions were over. We all felt rejuvenated and energized. "Let's go to dinner", William gestured with his head, "my treat". "What a wonderful way to wrap up a rainy Sunday", I thought to myself as we headed towards the cashier.

**The example is purely hypothetical and for illustrative purposes only. It must not be relied upon as any indication of what the performance of any note might actually be.*

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