Fund-linked derivatives forum

Fund-linked derivatives are increasingly being used by institutional and retail investors. Three leading investment banks answer key questions, such as who should invest in fund-linked derivatives, how they are priced, and current regulatory issues

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WHO SHOULD INVEST IN FUND DERIVATIVES?

Any kind of investor may be attracted to fund derivatives. In as much as funds (ie, mutual funds, hedge funds or funds of hedge funds) are widely distributed, fund derivatives also involve a wide range of counterparties. However, Calyon usually distinguishes between individuals and institutions.

- The growth of the hedge fund industry stemmed originally from high net worth individuals' extraordinary appetite for placements seeking absolute alpha. It is therefore logical that products linked to hedge funds are notably successful in the private banking business.

- Another typical example of parties using fund derivatives are pension funds or charitable institutions. Because of regulatory issues, minimum rating requirements or specific risk constraints, these investors request total or partial guarantees. The only way to achieve a fund exposure is to work through fund derivatives that are embedded into notes or funds. Banks also frequently use fund derivatives for their own account. Wrapped into a bond and benefiting explicitly from a capital guarantee, fund derivatives allow financial institutions to enlarge and maximise their use and gain access to the vast world of international funds without having to support limits imposed by various prudential or Cooke ratios.

IS THERE A RECIPE FOR A "GOOD" STRUCTURED PRODUCT ON FUNDS?

A structured product is a way to establish another link between a manager and an investor (or pool of investors). Therefore, for a structured product to be efficient, it needs to:

- meet the objectives of the targeted investor (regulation, risk management, leverage, the never ending search for alpha.…) and
- be consistent with the management philosophy of the investment manager.

This last point is critical: the constraints resulting from the creation of a structured product (investment guidelines, transparency, delta hedging) have to be such that their impact on the management of the fund should be minimal. Otherwise, the performance (and therefore risk profile) could be impaired. To achieve such alignment, Calyon equity and fund derivatives chose to strongly co-ordinate the fund derivatives production and marketing process around three poles:

- a team dedicated to the coverage of hedge fund and fund of funds;
- the production "engine" constituted by Calyon trading group and Crédit Agricole Structured Asset Management (CASAM). CASAM provides structuring activities and managed accounts;
- Calyon sales teams are based around the world answering the needs of investors (banks, insurance companies, private banks, pension funds).

WHAT HAVE FUND DERIVATIVES BROUGHT TO THE ALTERNATIVE MANAGEMENT INDUSTRY AND TO THE ALTERNATIVE MANAGERS?

Fund derivatives have contributed significantly to the growth of assets managed by hedge funds and fund of funds. Specific structures can indeed be used by managers to reach investors who would not otherwise allocate to this asset class.

ARE HEDGE FUND DERIVATIVES RISKY PRODUCTS?

Hedge fund derivatives are the best solution for investors attempting to minimise risk while investing in hedge funds, as they transfer part of their risk to Calyon in its role of structured product provider. Investors benefit not only from the favourable risk profile of options, but also from Calyon's own risk analysis through its due diligence on the funds as well as through the guidelines imposed on the underlying fund. For products related to funds of funds, liquidity and diversification guidelines are imposed on the fund managers so that risks (liquidity and market risk, fraud risk) are minimised to the benefit of the investors.

HOW ARE FUND DERIVATIVES PRICED?

Fund derivatives raise multiple complex pricing issues. The usual log-normal diffusion is not sufficient in itself to describe the behaviour of the underlying fund or basket of funds; in particular, for some products such as CPPIs or options on CPPI the risk for the guarantor lies at the far end of the distribution for large negative returns. Jump models are then necessary to account for this risk. Other concerns are the correct estimation of both the cost of discrete time hedging due to the liquidity of the underlying fund, and parameters influencing the pricing (volatility, jump magnitude and frequency) because of the lack of reliable historical data.

WITH THE RECENT HEDGE FUND BLOW-OUTS, WHAT KIND OF PROTECTION FOR FUND DERIVATIVES MAY BE ENVISAGED ?

Credit Agricole (CA) Group has merged its main structuring forces to ensure the greatest efficiency in managing this kind of issue. Consequently, CASAM has become the sole supplier within the CA Group in terms of structuring on fund derivatives, gathering expertise in fund derivatives, and in hedge funds as underlying funds. Moreover, a managed account platform has been developed offering simplified access to hedge funds investment by providing investors with transparency, independent valuation and risk control on top tier hedge fund managers.

ARE THERE ANY REGULATORY ISSUES THAT INVESTORS SHOULD BE AWARE OF?

Investors should consider the fund derivative product with care to assess if the structured product is an eligible asset in respect to its applicable rules on investments. Local rules may restrict the marketing of these products; for instance, the French regulator prohibits the "indirect active marketing of foreign non Ucits funds". However, the European rules, which are opening up the financial markets, may conflict with these local stringent rules. The European directives focus mainly on the information to be disclosed to investors, in particular the risk factors of the products. The recent Prospectus Directive illustrates this trend. The notes listed or offered to the public in Europe can be linked to any fund(s) (even foreign non Ucits funds), provided that the prospectus gives the investor detailed information of the payout and the risk attached to the product. ■

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WHO SHOULD INVEST IN FUND DERIVATIVES?

Fund derivatives are certainly not restricted to a limited universe of investors. In the late '90s, they were widely used by private banks and high net worth individuals to get a secured or leveraged access to hedge funds allocation. More recently, retail networks from banks and insurance companies have multiplied launches of structured notes of funds linked to mutual as well as hedge funds, with a peak reached in 2003/2004. Finally, since 2000, the number of institutions investing into structures linked to fund of hedge funds has soared, to represent the bulk of the fund derivatives business in 2005.

WHY ARE FUND DERIVATIVES ATTRACTIVE TO INVESTORS?

Fund derivatives appeal to investors because it is possible to make the transition from an investment concept to a tailor-made product that perfectly matches the specific requirements of the investor For instance, an institutional investor may be inclined to invest in a given fund of hedge funds, provided he gets full protection of the capital invested via a structured note, be it for financial or regulatory reasons. Also, a leveraged certificate can boost the returns of an investment in a fund of hedge funds, at a time when the return and volatility of global diversified portfolios are widely regarded by investors as being too low.

WHAT ARE THE BENEFITS OF FUND DERIVATIVES?

The benefits of fund derivatives can be divided largely into four broad categories. First and foremost, the benefit of calibrating the risk-return profile of an investment in a given fund; ie, providing protection for the downside of a risky investment or increasing the expected returns while leveraging the investment. Secondly, they enable investors to tackle all sorts of regulatory, fiscal, accounting or specific constraints that make a direct investment inappropriate for their respective situations. A certificate or a capital-protected note in Germany has a much better tax treatment for institutional investors than a direct investment in an offshore fund of hedge fund. In Belgium, no hedge fund-linked investment will be proposed to the public unless it is wrapped up in a capital guaranteed structure. Thirdly, fund derivatives make the investment process much easier and safer. Fund-linked structures allow for a smooth settlement of a transaction and most fund-linked securities can be listed and transferred via exchanges and clearing houses. Their denominations are adapted to the targeted clients. In particular, via retail products, investors have easier access to the hedge fund industry with a minimum investment as low as one thousand dollars. Finally, fund-linked derivatives help alleviate operational, fraud and headline risks for investors.

This is achieved via the heavy due diligence banks carry out on the underlying funds, but also in a more formal way via the guarantees in capital or limited recourse on the leverage they provide, and because they substitute themselves to the client to hold the hedge funds on their balance sheets.

WITH THE RECENT HEDGE FUND BLOW-OUTS AT BAYOU AND MAN, ARE HEDGE FUND DERIVATIVES A RISKY OPTION?

Hedge fund derivatives embed various specific risks, which include operational risk and fraud at the underlying hedge funds that banks hold on their books to hedge the derivative instruments they sell to their clients. They traditionally mitigate the risk while giving preference to underlying assets, such as funds or baskets of funds that diversify away the individual hedge fund risk. More recently, some derivatives houses such as SG have shown interest in taking the risk to structure around well-known single hedge funds. The risk is linked to the quality and diversification of the underlying portfolio. In that respect, the risk of the investor is very much linked to the quality of controls/due diligence/eligibility criteria implemented by the structuring bank, in particular when the portfolio is concentrated over a small number of names. One route that dramatically reduces the hedge fund risk when a portfolio is concentrated is to invest through managed accounts, provided that such managed accounts are controlled by large, established entities (preferably asset managers that are part of top-tier financial institutions, in order to avoid replacing the hedge fund risk by a platform risk). ■

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WHO SHOULD INVEST IN FUND DERIVATIVES?

Fund derivatives offer potential benefits to every member of the investment community. On the one hand, structures based on traditional, long-only funds have enjoyed a sustained commercial success for several years now. Significant volumes have been placed in the retail market where the flexibility and high potential upside of these structures have appealed to investors. Banco Santander, being at the forefront of innovation, has consistently encountered widespread commercial success with mutual fund-linked structures.

On the other hand, structures based on alternative (hedge) funds have traditionally been favoured by private banks and, increasingly, institutional investors. In our view, there are two main reasons for that. The first is historical: private bank clients were the first to allocate to hedge funds and, as with all lasting relationships, the degree of comfort grows as time goes by. As private clients are more 'knowledgeable' of the asset class, they would tend to prefer structured derivatives, which provide a higher potential return through the assumption of a greater degree of risk.

As for institutional investors, the low returns available through traditional investments combined with certain structural issues (eg, low funding status of pension plans) have increased the interest for alternative assets as a source of uncorrelated returns. The crucial element is for us to be able to provide such investors with a product that will not only correspond to their expectations in terms of return and risk, but that will also have the legal form, the liquidity or the credit rating that best address their needs.

As most asset allocation studies emphasise the benefits of a moderate (say 5% to 15% of an overall portfolio) allocation to non-traditional assets, it may make sense to rephrase the question as "Who should not invest in fund derivatives?" Two possible answers: do not invest in fund derivatives if you are looking only to make a quick return, since you would need an investment horizon consistent with a full economic cycle to appreciate the benefits of your investment, Also do not invest in fund derivatives if this is going to be your only investment, as the diversification benefits will be lost.

WHY ARE FUND DERIVATIVES ATTRACTIVE TO INVESTORS?

I think most of the success of fund derivatives can be explained by the effects of size, reputation and versatility. Firstly, the size effect: fund derivatives permit exposure to a relatively large number of quality underlying funds. That is true for retail products on mutual funds such as Santander "Superselección", which gives access to a pool of best of breed mutual funds without the need for the investor to constantly monitor and rebalance their portfolio. In the case of alternative assets, a structure based on a fund of hedge funds managed by a reputable asset manager will provide exposure to high quality hedge funds, which would otherwise either be closed to new investors, or require significant minimum investments by potential shareholders (of the order of several millions dollars).

Secondly, the reputational dimension: fund derivatives providers tend to be established, high profile financial institutions. Whether the instruments at hand are in securitised or over-the-counter form, investors have a higher degree of comfort dealing with these institutions, than with say a special purpose vehicle incorporated in an offshore, loosely regulated, jurisdiction.

Thirdly, the diversity: at the underlying level, hedge funds are notoriously polymorphic. Fifteen years ago, global macro was by and large the prevailing strategy of the hedge fund universe. It accounts nowadays for less than 12% of the industry's assets under management. New strategies are emerging every day, which may or may not become prevalent in the future. The election of a flexible underlying – eg, a fund of hedge funds where the manager exercises discretion within agreed investment guidelines – should provide investors with the benefits of the newest strategies or investment techniques."

Fund derivatives allow a tailor-made risk profile, in accordance with each investor's ability and willingness to assume risk, from leveraged structures magnifying the returns of the underlying, with little or no guarantee in capital, to structures with full capital and/or minimum yield guaranteed. In between are delta one structures, useful for tactical asset allocation, or portfolio enhancement products, such as "cash plus" or portable alpha.

Finally, through fund derivatives, a wide array of payouts can be constructed. We notice a polarisation of the liquidity conditions offered by hedge funds. On the one hand, the success of managed account platforms and liquid investable indexes, and on the other, a tightening of the redemption terms offered by hedge funds, mostly to avoid SEC registration. For less liquid underlyings, static structures or dynamic allocation processes (eg, CPPI) will continue to be preferred. For more liquid underlyings, optional structures with more or less exotic payouts are possible. Coupons and early termination structures also enjoy some success, and we have recently priced for a European institution a target redemption note on a diversified basket of funds, with attractive coupon levels. Nonetheless, we have noted a tendency to revert to more simple payouts, in line with the general equity derivatives market. ■