Deutscher Derivate Verband

Are structured products too expensive?

Are securities really good value? Or do high, possibly hidden, costs diminish the returns to the investor? Will the investment maintain its value? These are some of the questions retail investors understandably ask themselves when comparing different financial products. However, the costs associated with structured products are very transparent – unlike some other securities. When the costs are examined, it is clear that anyone under the impression that structured products are expensive is mistaken.

Costs involved in buying a structured product

There are many ways for an investor to buy a structured product, and each involves different costs. A retail investor can buy a structured product through an investment adviser in a bank, or as a self-directed investor – without investment advice – from an online broker.

In both cases, the investor buys the structured product either by means of direct over-the-counter trading or on an exchange. To what extent the bank earns anything on further services, apart from the issuer margin, depends on whether it has an internal distribution or branch network.

Capital Protection Products with Coupon	0.14 % p. a.
Uncapped Capital Protection Certificates	0.73 % p. a.
Reverse Convertibles	0.65 % p. a.
Express Certificates	0.66 % p. a.
Credit Linked Notes	0.37 % p. a.
Discount Certificates	0.50 % p. a.
Bonus Certificates	0.52 % p. a.
Outperformance/Capped Outperformance Certificates	0.93 % p. a.
Warrants	1.96 % p. a.
Total	**0.36 % p. a.**

Source: 2013 EDG study 'Issuer margins for structured products'

Sales commission

Sales commission only has to be paid by investors who buy the structured product as advised investors through a distribution partner or through the issuer's internal branch network, if it has one. In this case, investors normally buy the structured product after receiving advice. The sales commission paid by the investor covers this advisory service. The investor must be told how much will be charged in sales commission. The structured product issuers display this in their product information sheets.

Front-end load fee during the subscription period

A front-end load fee can only be charged for structured products acquired within the subscription period, as with investment funds. This fee varies from issuer to issuer and depends on the category of the structured product. The front-end load fee has to be displayed in the product information sheet.

Expected issuer margin

Regardless of where and how an investor buys a structured product, the price always includes what is known as the expected issuer margin. It is important to know that this margin is not the same as the issuer's net profit. The expected issuer margin includes the expected profit, but it also covers all the issuer's operational costs. These include personnel costs, exchange listing fees and/or trading system expenses. Incidentally, the reason it is called the 'expected' issuer margin is that the amount is not certain at the time of the sale and is only based on estimates, owing to unpredictable market events. This is just the same as in other areas of business: an airline selling tickets today for flights next summer does not know either the future price of aviation fuel or what the terms of the next wage agreement will be. Nevertheless, it charges a price for a ticket, based on certain assumptions, that takes into account the expected costs and profits. For a long time there was no reliable information on the margins of structured product issuers. For this reason, in November 2013 the European Derivatives Group (EDG) conducted an academic study in which the issuer margins of nine categories of structured products were calculated. The study found that the average expected issuer margin was 0.36 percent per annum – much smaller than widely assumed. This is in spite of the fact that the margin includes all the operational costs of the issuer. The reason for this is obvious: more than 30 issuers are offering structured products on the German market. This means issuers face tough competition for individual retail investors.

→ To EDG study: 'Issuer margins for structured products'

Cost transparency for structured products investors

With every financial product, the expected return is undoubtedly one of the chief buying criteria. However, by displaying the costs, issuers can offer investors an additional guide. For this reason the DDV members agreed to include the issuer estimated value (IEV) in the product information sheets relating to their investment products with effect from May 2014. The IEV is shown either as a percentage or in euro.

Investors interested in finding out the expected issuer margin for a structured product can easily calculate it by simply subtracting from the price of the structured product the IEV and, where applicable, the sales commission, which is also displayed.

Costs incurred in trading on the secondary market

Bid-ask spread

Retail investors wishing to buy a structured product after the subscription period or to sell it before maturity, either on an exchange or directly over the counter, can find out the value of the structured product at any time during exchange trading hours. The Stuttgart and Frankfurt Exchanges publish and update every second the buy and sell prices of all structured products listed on the exchanges. The issuers also continuously quote bid and ask prices at which trading is possible in over-the-counter trading. The bid price is always equal to the selling price and the ask price is equivalent to the buying price of a structured product. As a rule, the ask prices are higher than the bid prices, as with equities or exchange-traded funds (ETFs). As a hypothetical example, if an investor were to buy and sell a structured product simultaneously, he or she would make a loss equal to the difference between the bid and ask prices. This difference is termed the bid-ask spread. This is a kind of fee charged by the issuer for its hedging costs and for facilitating continuous trading of structured products. In general these spreads are very small. Some products, such as Tracker Certificates, are even traded without a bid-ask spread.

Exchange fees, transaction costs and securities account charges

All investors, whether advised or self-directed, need a securities account with a bank or an online broker for every financial instrument they buy. This means they incur securities account fees in addition to the transaction costs for buying and selling any type of security. If a retail investor or an adviser acting on behalf of a customer acquires the structured product on an exchange rather than directly through over-the counter trading, an exchange fee is also incurred. The investor can find out from the bank or online broker at any time whether securities account and transaction charges or exchange fees are payable, and how high they are.

→ Structured product price components

Model price of product components	
–	financing income
+	expected hedging costs
Issuer estimated value (IEV)	
+	expected issuer margin*
+	selling costs (commission)
Structured product price	
+	front-end load fee, where applicable
Acquisition price for the investor	

* The expected issuer margin includes the operational costs of structuring, market making and settlement of the structured product as well as the expected profit for the issuer.

The **issuer estimated value (IEV)** is comparable to the manufacturing costs of an asset, which mainly include the material and production costs of the individual product components.

To structure, or 'manufacture', each structured product, the bank needs certain **product components**. These include underlying assets such as equities, fixed-income securities, commodities, currencies and typically warrants. The bank buys these on the capital market: equities typically on a stock exchange and warrants on a derivatives exchange (such as Eurex).

In theory, retail investors could trade on the markets and derivatives exchanges themselves, but this would be extremely difficult and would also involve high costs and trading risks.

Also, retail investors are not automatically allowed access to the derivatives exchanges, where as a rule only professional securities traders operate. The sum of the prices for the individual product components is the **model price** of a structured product. However, this model price does not include any transaction costs.

In practice, such transaction costs are also incurred by banks when they buy the individual product components, although they are significantly lower than the costs for retail investors. These costs are called the expected **hedging costs**.

Because the bank has already bought the individual product components, it assumes a completely neutral position, whichever way the market moves. It neither gains from its hedging position if the buyer of the structured product suffers a loss, nor loses if the investor makes a profit. However, it is always eager for investors to make a profit from their structured products and reinvest in further products.

Also subtracted from the model price is any **financing income** for the issuer. When retail investors buy structured products, they are making money available to the bank on which it can generate some income – similar to money deposited in a savings account.

The **expected issuer margin** includes the operational costs incurred by the issuer for structuring, market making and settlement of the relevant structured product as well as the issuer's expected profit.

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