Deutscher Derivate Verband

Is investing in structured products a form of betting?

Structured products are securities, just like equities, bonds or investment funds. However, many claim that investing in structured products is nothing other than betting. Some even think the bank gains when the investor loses, and vice versa. But they are utterly mistaken. The bank does not profit from either an investor's gains or their losses on an investment in equities, bonds or investment funds, and the same applies for structured products.

Facts

The bank does not gain anything when the investor loses.

When a retail investor buys a structured product, the bank is never their rival. The bank that issues the product actually enables the customer to invest based on a certain market trend. The bank itself adopts a risk-neutral position and hedges its payout obligation by engaging in countertrading on the capital market. It is of no importance to the bank whether the investor is investing based on rising, falling or sideways markets. The issuer only makes its money from the structuring of the financial instrument and from trading in that product. Consequently, it does not make any financial difference to the bank whether the investor gains or loses.

More on this:
How do banks make money on structured products?

Only satisfied customers reinvest in structured products.

Even though investors' gains or losses have no direct impact on the bank, it is in the bank's interests that investors make good returns on their securities. This is also true of structured products; only satisfied customers will buy more structured products. Experience to date shows that many investors reinvest their money in structured products once their previous products have reached maturity. This applies equally to advised customers and self-directed investors.

→ What exactly is a certificate?

Certificates all have one thing in common. They are derivative securities for private investors and form part of a wider category known as structured products, so called because they are generally made up of several components. Unlike other derivatives, investment certificates are securitised and are thus often referred to as securitised derivatives.

The term 'derivative' comes from the Latin verb 'derivare', which means 'to derive from'. Accordingly, derivatives are financial products whose price is derived from movements in the price of another product, known as the underlying.

Certificates are purchased mainly by private investors, while derivatives such as warrants, futures and swaps are generally only traded by institutional investors.

There are two major categories of certificates: investment products, which are geared to the medium and long term, and leverage products, which are associated with a higher level of risk and a relatively short-term investment horizon.

How are certificates structured?

They are always based on an underlying asset. By way of example, this can be a specific company share, an index such as the German DAX®, a precious metal such as gold, or a commodity such as oil. The value of the certificate at a given time will depend on the price of the underlying. Unlike investment funds, there is no manager to intervene and therefore influence the price, so they are regarded as passive financial products. This also means there are no management fees for certificates.

Certificates always contain one or more option components (as do Germany's popular building savings contracts). These components determine the individual features of each certificate, including its level of risk exposure and whether investors can achieve a return from upward, downward or sideways movements in the underlying.

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Investors choose structured products for security.

Contrary to many people's preconceptions, most investors do not use structured products for gambling. In fact, security is important to German structured product investors, and most of them are risk-averse and invest for the long term. This is backed up by the statistics: in April 2018, more than a third of the total volume of structured products was invested in products with full capital protection. Of the total volume invested by retail investors, 96.9 percent flows into investment products with a medium to long-term holding period. Leverage products, which are more speculative, account for only 3.1 percent of the volume (Source: EDG).

Structured products can be traded continuously.

Unlike trading in most securities types, bets cannot be placed continuously. However, an investor can buy and sell structured products at any time, either on an exchange or over the counter. The buy and sell prices of structured products are updated and published every second by the Stuttgart and Frankfurt exchanges. In over-the-counter trading, the issuers also continuously quote bid and ask prices at which trading is possible. This means investors can also find out the value of their structured products at any time during exchange trading hours.

→ What is a bet?

In common usage, a bet is an agreement between two individuals who have opposing views about a certain event, in which each promises the other to pay a certain amount if their particular assertion is incorrect. By contrast, betting on the outcome of a sporting event such as a football match or horse race is not legally considered a bet, but a gamble, even though the terms 'sports betting' and 'horse race betting' are often used in this context.

From a legal perspective, investing in structured products is clearly not a form of betting.

Lawyers also agree that investing in structured products does not constitute betting. None of the legal criteria that apply to betting are relevant to investments in structured products. They are not games or bets in the legal sense as defined by Section 762 of the German Civil Code (Bürgerliches Gesetzbuch, BGB), because with structured products the costs and benefits are clearly agreed, so they are binding for both the issuer and the investor. In addition, there is no real random element with structured products. The structured product's payment profile sets out in advance the amount the issuer will pay to the investor after a specified change in the value of the underlying. In this respect, a structured product is similar to equities; these are also subject to price fluctuations, and if they are sold, the investor receives the current market price of the equities. Incidentally, equities are one of the most popular underlyings for structure products.

Are all securities investments bets?

With almost all types of securities, the investor speculates on a specific market trend. For instance, equities are only bought if the investor feels the price will rise or that the equities will generate a continuously good dividend yield. Does this make buying equities equivalent to betting? If this were the case, then every investment in securities would be a bet. It follows that structured products are no more of a bet than equities, bonds or investment funds.

Hedging: how does issuers' hedging of structured products work in practice?

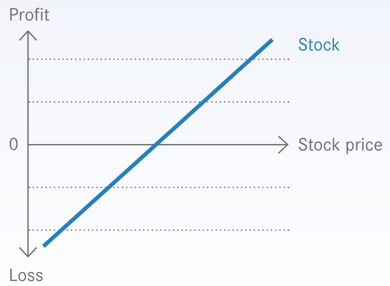
When an investor buys a structured product, the issuer must hedge against the risks involved, for instance directly by means of an equity transaction, or through the futures market. As soon as the investor sells the structured product, the issuer will liquidate also the hedge position.

Owing to the large number and diversity of structured products, every issuer has a kind of overall portfolio of all hedge positions. This is managed electronically via the issuer's trading systems and is monitored by a risk management system especially developed for the purpose.

→ Risk neutrality of the issuer, using the example of a Discount Certificate

Stock +

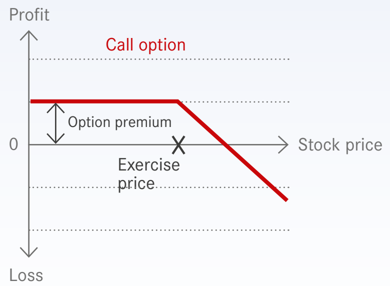
The issuer buys a stock.



The value of a structured product is always based on its underlying asset, in this case a stock.

Call option =

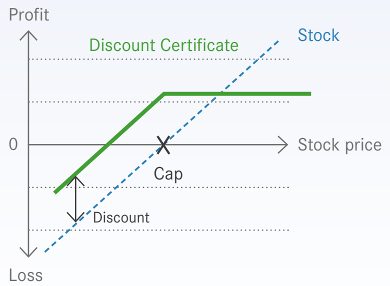
The issuer sells a call option on this stock.



The issuer receives an option premium for selling the call option. In exchange, the buyer acquires the right to buy the stock from the issuer at a predetermined exercise price of X.
As long as the price of the stock is below the exercise price, the buyer will not exercise the right to buy.
If the price is at or above X, the buyer will purchase the stock from the issuer at the exercise price.

Discount Certificate

The private investor buys a Discount Certificate on this stock.



The option premium and the retained stock dividend enable the issuer to sell the investor a Discount Certificate at a lower price than the underlying stock.
The profit of the Discount Certificate is limited by a cap. The cap is equal to the exercise price of the option, since the issuer must sell the stock at this price.

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