Building trust

Italian investors appear to be mistrustful of structured products. *Gabriele Susinno* explores the key issues driving the Italian market and finds that transparency and simplicity could be the keys to success for 2005

Gabriele Susinno

The Italian market for institutionally managed saving products accounts for €910 billion, as reported last December by the monthly report of Assogestioni[1]. While bull markets of the 1990s encouraged investors at all levels to see themselves as "perspicacious geniuses" with a personal, dynamic involvement in their actively managed accounts, the recent bearish phase means that retail market behaviour is now more of a mixed bag, displaying both conscious risk aversion and a moderate desire to gamble[2].

Structured products are an extremely flexible and powerful tool to satisfy such changes in the nature of demand, and enable tailor-made solutions that can match current market sentiment. Unfortunately, many Italian investors are still perturbed by the spate of recent financial scandals, which added a dash of indignation to their exisiting concerns over the bear market and an uncertain geopolitical situation.

Crisis of confidence

According to a recent survey by Ente Einaudi[3], the total value of Italian savings fell by 3% in 2004, with increasing liquidity parked in current accounts instead of being invested in active financial instruments. More than a year after the financial scandals on the Italian market – such as those at Cirio and Parmalat, or ones concerning the lack of transparency on a couple of "zero cost" conditional coupon products[4] – legal rules forcing providers to offer more transparency to retail investors have yet to be strengthened. And some of the perpetrators of the above scandals are still around.

Following a market overview we completed recently, it seems that adverse feelings towards capital guaranteed products and their sophisticated derivations are common among traditional asset managers and their clients

A pervasive lack of confidence seems to have reduced Italian retail investors' willingness to trust in more sophisticated financial products. Indeed, the proportion of retail savings invested in funds is sticking at a level of 11%, despite the encouraging results obtained in all sectors of managed funds last year, while the housing and real-estate market is rocketing.

The question, therefore, is how to attract these reluctant investors. The answer? Give them guarantees. Indeed, following Taversky and Kahneman's basic concept of behavioural finance, according to which "people assume less risk to obtain gains than they do to avoid losses", Italian banks and saving institutions have bet on the convergence between finance and insurance. The Italian golden period of hybrids and insurance-type instruments, such as unit/index-linked policies with exotic guarantees, began almost synchronously with the bursting of the speculative bubble.

Allowing participation in the potential gains of a renewed bullish phase while protecting against the risk of a falling market, these

The profile of the average retail investor in the financial Italian market is changing rapidly, with an increasing demand for transparency and a limited element of easy-to-understand sophistication

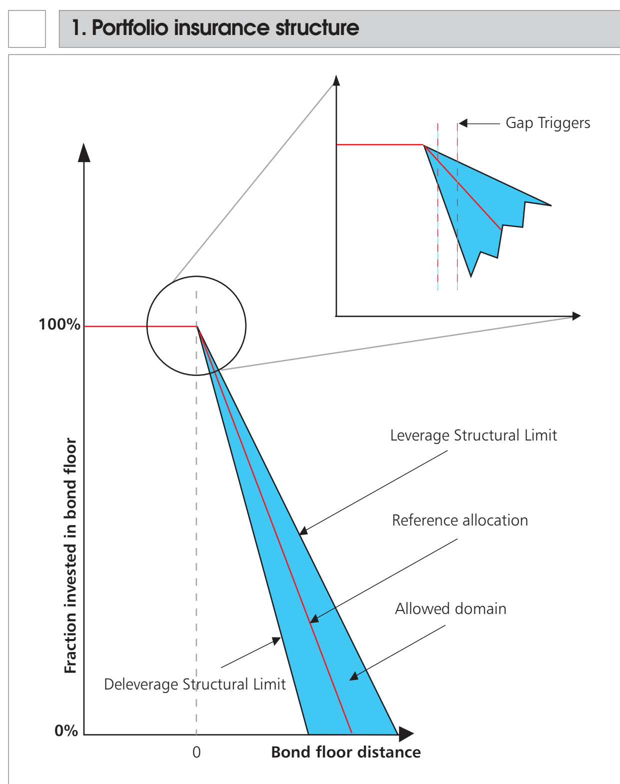
products satisfied market demand in the wake of the dot.com boom. This is a period that can be described as the constant proportion portfolio insurance (CPPI)[5] era. The idea is to dynamically structure a fund with a vanishing probability to be under a certain structure of attainable targets (the guarantee) at maturity (figure 1). In that case, the financial guarantee for a potential shortfall at maturity is worthless if one neglects gap risks (tail events) which are, in the mean time, partially protected by some gap triggers. The seller of the financial guarantee is almost hedged since the validity of the guarantee is conditional on the respect of strict, contractually predefined management rules and limits (see figure 1).

Rules

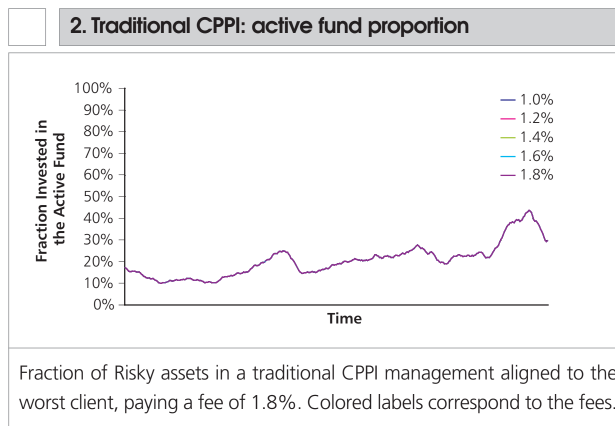
Contractually predefined rules and limits are sufficient for a dynamic manufacturing of the financial guarantee. Structured as such, the contract solves a complex problem of giving a guarantee on an actively traded account since, in the absence of a gap event, the financial guarantee is worthless. The alternative is to enter into complex and expensive vacation/passport structures[6].

In several cases, following our study, however, we found a minimum set of dynamic asset allocation strategies needed to limit the risk of a head-on collision of the funds' net asset value (NAV) with triggers, was not in the competencies of traditional broad-gauged

1. Portfolio insurance structure



2. Traditional CPPI: active fund proportion



Fraction of Risky assets in a traditional CPPI management aligned to the worst client, paying a fee of 1.8%. Colored labels correspond to the fees.

index funds managers. Nor was it in the investment boards, and even less in the advisers called to assist investment committees. Indeed, in most cases the nitty-gritty traditional views and expectations, jointly with a stringent tracking error relative to a predefined benchmark, have contaminated precise hedging statements with the unhedged risk of the prediction not being fulfilled.

And what is even worse, the structure of guarantee costs, management fees, and the low level of interest rates, has the side-effect of a residual small market exposure. Finally, managing financial guarantees in a cohort aligned to the fees of the worst client, for instance the client with the smallest investment in the structure (thus paying the highest fees), reduces both the potential gains of the bank and those of its wealthiest clients which are entitled to lower fees since they have bigger invested capitals (see, for example, figures 2 to 5).

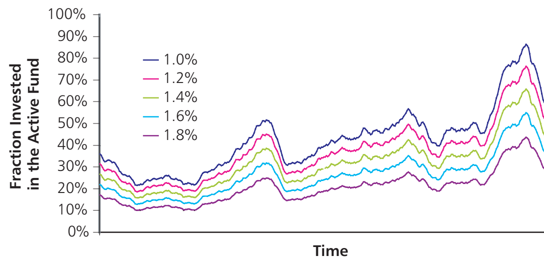
Costs, market evolution and even management failures have often transformed these products in a relatively expensive static bond investment for the retail client. Following a market overview we completed recently, it seems that adverse feelings towards capital-guaranteed products and their sophisticated derivations are common among traditional asset managers and their clients. As of today, there are impressive statistics of apparently attractive products which end up locked in an expensive zero-coupon in a matter of months, forcing the institutions to reinvent marketing strategies to keep their clients faithful.

Perfect solution?

But it is not all doom and gloom. Capital-guaranteed total return products seem to be the magic wand that can resolve the issue. Indeed, the lack of directionality of benchmarks only increases the popularity of total-return instruments. They currently cover more than 10% of the Italian institutional offer shadowing traditional benchmark followers. And 2005 will probably confirm the success of hedge fund-linked products on the Italian market place.

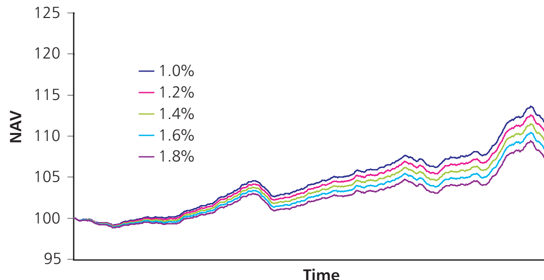
In hindsight, the real winners have been the structurers that were active in the Italian market from the beginning. The retail banks and

3. Personalised CPPI: active fund proportion



Fraction of Risky assets with a CPPI structure aligned to the clients quality. Colored labels correspond to the fees.

4. NAV corresponding to fig.2

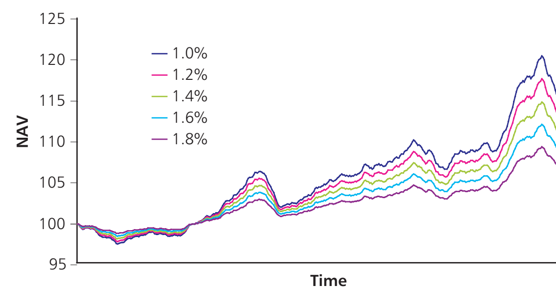


Colored labels correspond to the fees.

insurance companies which acquired the structures in order to sell them to their clients have also done well. But they must face the lack of appeal for their products, with most of the returns ending up swallowed by heavy commissions. They are earning commissions today, but are probably losing future clients in the process.

Finally, the profile of the average retail investor in the Italian financial market is changing rapidly, with an increasing demand for transparency and a limited element of easy-to-understand sophistication[7]. Given the rapid evolution of the total return market is conceivable to assist, in 2005, to an enhanced shadowing of traditional benchmark constrained products with an increasing market share of a variety of alternative investments. In any case efficiency, transparency, and simplicity will be the keys to market success for 2005 Italian structures.

5. NAV corresponding to fig.3



Colored labels correspond to the fees.

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