Retailisation or sale of complex products to retail investors. November 2013.

The Committee for Economic and Market Analysis (CEMA) of ESMA has published last summer an economic on retailisation in the EU.
The growth of the retailisation in the EU can have implications in terms of financial stability as well as investor protection, and has, therefore, been subject to important policy initiatives. In this sense, the European Commission has proposed a Regulation on Packaged Retail Investment Products (PRIPs), ESMA measures in the area of Undertaking for Collective Investment in Transferable Securities (forward UCITS), such as the Guidelines on Exchange Traded Funds and other UCITS issues, and MiFID measures, such as the technical advice to the Commission as part of the MiFID review, the Questions&Answers on complex and noncomplex financial instruments for the purposes of MiFID's appropriateness requirements, and the Guidelines on suitability in the MiFID.

This report focuses on two subsets of this market: 1) UCITS pursuing alternative investment strategies ('alternative UCITS'), and 2) structured products targeted to retail investors.

Those two classes of products are particularly relevant given the sharp increase in Assets under Management (AuM) and given the size of the structured products market. Indeed, alternative UCITS have experienced a significant growth since 2007, with a 325% increase in Assets under Management from EUR 20bn to EUR 85bn at end-2012. The volumes of structured products sold to retail investors decreased from a peak of EUR 250bn in 2007 to around EUR 110bn in 2012, but outstanding amounts account for around EUR 770bn at end of 2012, mainly linked to the growth and dynamics of the German market.

Notwithstanding the potential benefits brought by these products, trends linked to retailisation have been closely monitored by securities markets supervisors as it could increase risks for the financial system. From a consumer protection perspective, retail investors may face difficulties in understanding the adequate of risk/reward profile of complex products and in making adequate investment decisions, with the risk of unexpected losses that might lead to complaints, reputational risks for issuers and a loss of confidence in the regulatory framework and, more broadly, in financial markets.

1. Alternative UCITSs.

Alternative UCITSs are those who comply with the requirements of the EU legislation but, to certain extend, follow alternative investment strategies. There is no generally agreed definition for alternative UCITSs, they could be defined either as UCITSs that use derivatives or take short positions, or UCITSs that employ a high level of leverage. The report chooses to include in the definition every UCIT that implement hedge-fund like investment strategies such as, for example, long/short movements.

The strategies implemented by some alternative UCITS might not be easy to determine, and, therefore their comparison to a proper benchmark might be challenging for retail investors.

An empirical analysis of the performance of alternative UCITS shows that between 2006 and 2012, average returns were 3% on average for a sample of around 600 funds. However, the volatility of these returns was high, especially during the 2007 to 2008 financial crisis and to a lesser extent in 2010-2011. As a result, risk-adjusted returns, measured by Sharpe ratios, were close to zero, except when computed over the last five years. Those results are robust to the type of strategies implemented by these funds.

In comparison with non-UCITS hedge funds (those which do not comply with the requirements in the EU legislation), alternative UCITS provide lower returns, but expose investors to lower volatility and expected losses during downturns. When alternative UCITS are compared to traditional mutual funds, proxied by equity and bond indices, the risk-adjusted returns are higher for the latter, especially for bond indices. However, since mid-2009, the conditional Value-at-Risk –which measures the maximum expected loss risk define by the Value-at-risk in a period of time- has been lower for alternative UCITS, suggesting that investors in those alternative funds are less exposed to losses when markets are bearish.

2. Structured products.

Structured products can be defined as investment products whose returns are linked to the performance of one of more underlying reference index, price or rate, and are determined by a pre-specified formula that sets out how the product will perform in any possible future scenario.

This study shows that in order to understand the drivers of risks and returns of the investment in structured products, significant financial knowledge and access to market data is required. In particular, the empirical analysis –based on a sample of 76 products sold in the EU- indicates that the products are sold with a significant premium that the retail investor has to pay, estimated at around 4,6 % of the notional value. Moreover, when the issuer credit risk is included, the average premium increases to 5.5%.

Given that retail investors may not possess the knowledge and expertise needed to assess the drivers of the performance of structured products, they could be at risk of facing unexpected losses. In particular, the analysis of the issuer credit risk embedded in structured product may be particularly challenging.

It is important to ensure that appropriate information regarding the characteristics of each product is provided to retail investors. In particular, the information disclosure to retail investors may be improved by including i) a higher degree of transparency regarding the total costs of structured products, including the implicit costs that are embedded in the selling price; and ii) detailed information regarding the specific risks of each.

Regarding actual returns, the performance of structured products, over the last few years has been lower than the risk-free rate. While the results are less negative for products that matured before the financial crisis, the qualitative results in different time periods are similar: on average, structured products delivered a lower return than a risk-free rate investment.

If you want to read the whole ESMA document on retailisation, please, do click on: http://www.esma.europa.eu/system/files/2013-326_economic_report_-_retailisation_in_the_eu_0.pdf