Investors in income funds may have noticed a slice of the asset allocation pie on their fund fact sheets being represented by structured notes. But while money managers are including these instruments in their client portfolios, their often opaque nature can make them hard to understand – which may make investors feel uneasy. So, let's break it down:

What exactly are structured notes, and how do we manage the associated investment risks?

by Dalya Abromowitz

What are structured notes?

When you invest in fixed income, you have access to a range of different investment instruments. For example, bonds issued by government or corporates, which can pay interest at a rate that's either fixed for the course of your investment or which 'floats', and changes as local interest rates change. In addition to standard instruments such as these, you can also choose to invest in derivatives. These are instruments that derive their value by referencing other instruments. An example of a derivative that's quite commonly used is an interest rate swap. This involves two parties agreeing to exchange a series of interest rate payments on a set investment amount. One will pay interest on that amount at a fixed rate, while receiving interest calculated at the floating rate. The opposite will be true for the other party.

A structured note packages a bond or a bank deposit and one or more derivatives into a single instrument. As they are generally issued by banks, they can almost be thought of as making a bank deposit, with the interest you'll earn being linked to the performance of the underlying components. This will include interest earned on the bond in the note or on the money being deposited, as well as an investment return from the derivative.

Why invest in structured notes?

A structured note allows you to express a market view (for example, that interest rates are likely to rise or fall) efficiently, by bundling two or more instrument purchases into one. We invest in structured notes for two key reasons:

1. **To implement interest payment profiles that we believe will enhance returns (or reduce risk) for our clients**. For example, if we believe that interest rates are on an upward trajectory, we could overlay an interest rate swap on a bond, packaged into a structured note. By using the swap to convert our interest profile from fixed to floating, we could capitalise on an interest rate upcycle.

2. **To implement broader investment views**. For example, some of the notes we are invested in allow us to access the higher yields currently offered by offshore bonds. It can be difficult to access these bonds directly, so we do so through a credit derivative within a structured note. This gives us the same underlying exposure we would have had if we were invested in the bond itself.

How do we manage our investment risks?

1. **The notes we invest in are transparent and reference tradable underlying entities**. We choose to invest in structured notes with underlying components that are liquid, transparent and actively traded. Illiquid underlying components pose significant risk, potentially leading to unexpected losses if it is difficult for the issuing bank to accurately price them.

We only invest in notes that include government bonds and liquid derivatives that can easily be priced (such as interest rate swaps).

2. **We diversify exposures**. When investing in a structured note, you are exposed to the credit risk of the issuing bank in addition to the credit risk of the underlying components. To mitigate this risk, we diversify our structured note investments across South Africa's Big 5 banks, which are known for their conservative risk management practices. We prefer some banks over others due to their capabilities and differentiated offerings. In addition, we invest in an array of structured note types to express different views at different times.

   Finally, we impose strict limits on structured note exposures within our funds, both in terms of overall exposure and exposure per individual note.

3. **We update our fair value assessments regularly**. We assess our structured note valuations regularly to make sure they remain accurately priced. We ask issuing banks to send us daily pricing updates and verify the valuations we receive against established benchmarks.

   We believe that structured notes can play a valuable role in enhancing returns. However, including these instruments in client portfolios requires an understanding of the potential risks, so that they can be managed responsibly. By prioritising transparency, liquidity and diversification as part of and a strict thorough risk assessment, asset managers can navigate the complexities of structured notes while serving – and safeguarding – the interests of their clients.

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