

## Punting with Financial Products

Despite the publicity in recent years about financial institutions selling unsuitable financial products to retail investors, the behaviour has not stopped. ASIC should take action to prevent sales of a number of investment products designated as “deferred purchase agreements” (DPAs) by “large, reputable” and other financial firms. UBS, Societe Generale, and a number of small investment advisers have offered such products (with the latter presumably white-labelling products from larger institutions).

Notably, there appears to be no public information on the outcomes of past investments in such products. In some cases they may well have been good. But the inability of a retail investor to assess the expected return and risk makes them unsuitable products.

To illustrate imagine investing in a financial product where the final return in two years depends upon both the share prices of some US companies such as Amazon, Twitter, and Facebook (the “reference” assets) at that time, and the paths the share prices have taken over those two years. The precise relationship between your payoff and the share price behaviour is very complex (as illustrated later), and you could lose a lot or gain a lot.

While explicit formulae are specified to determine the payoff, the likelihood of a retail investor or self-managed fund trustee (the target market for these products) being able to understand these sufficiently to accurately assess expected return, risk, and value for money is very low. A finance specialist with the aid of good computing power could probably do it in a couple of days. But, realistically, the internal workings of these products are no clearer for the average investor than the workings of a poker machine!

To make things even more obscure, the contracts involved are classified as DPAs. This occurs because the value of the payoff in two years is settled by the financial product issuer delivering an equal value of shares in some specific company unrelated to the reference assets involved (such as Telstra). The DPA refers to the fact that the issuer has entered a contract for future delivery of some (uncertain) number of Telstra shares, for a payment by the investor at that time which is equal to the value of the investment’s payoff.

Actually, in most of these products, the issuer will agree to sell those Telstra shares on behalf of the investor, rather than deliver them, and provide the cash proceeds to the investor. Does something smell fishy? Why have this roundabout way of generating a cash outcome for the investor?

The answer appears to lie in the bowels of tax legislation. The receipt involved in a DPA (of more than a one year term) is treated as a capital item for tax purposes, meaning that profits or losses are treated as capital gains (taxed concessionally) or capital losses, rather than as normal income. Thus, if an investor on a 50 per cent tax rate received \$12,000 from an initial investment of \$10,000, the tax on the \$2,000 profit would be \$500 (since only half of the capital gain is included in taxable income) rather than \$1,000.

Actually, for those with suspicious minds, there may be another reason for structuring the investment product as a DPA. For some unknown reason, the Product Disclosure Statement (PDS) of a DPA does not need to be lodged with ASIC!

Why are these products so hard to value? Consider an illustrative (simplified) typical structure.

First, over the two years there will be quarterly “memory call” dates specified. On any call date, if certain conditions are met, the product may be terminated by the issuer by repaying the investor their principal plus a prespecified dividend amount. The product cannot be terminated at a call date if there is at least one share whose price has never been above its issue date value either at that, or an earlier, call date.

Second, if at any time the price of any single reference asset falls below 65 per cent of its value at the product issue date a “kick in” event occurs. This triggers a specific formula being used for the final payoff which also depends on the values of reference assets at that final date. A likely outcome is that the final return depends on the share price of the worst performing reference asset, such that a large loss could occur if that share price was less than its issue date price.

Third, if no “kick in” occurs, the final payoff will be the larger of some specified minimum positive return and the absolute return of the worst performing reference asset. If all reference assets have a positive return, it is likely that a call event will have occurred such that the product has been terminated earlier. But if one has a negative return, the formula is relevant and the investor’s return will reflect the (absolute) return of the reference asset which has deviated most from its initial price (if that deviation is above the specified minimum).

Complicated? Certainly! The issuer can model these possible outcomes and determine how it might hedge its risk by derivative transactions in the reference assets (and the exchange rate if they are overseas stocks), and how setting of the various terms will affect its likely profit. But the chances of the retail investor being able to do likewise and determine whether the product offers fair value seem very unlikely. Nor, for that matter, are the financial/client advisers likely to have the technical skills needed to properly assess expected risk and return and product suitability for their client.

The introduction of Design and Distribution Obligations for financial product manufacturers and distributors to show product suitability for the target market has recently been deferred till 2021. Once they come into operation it seems unlikely that such complex products would meet those requirements and cease being offered. In the interim, there looks to be a good case for ASIC using its recently acquired Product Intervention Powers to stamp out such offerings.

**Kevin Davis**

**Professor of Finance, University of Melbourne**

**11 June 2020**