Why retail investors like complexity - but only go with it as long as it delivers

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New research finds that a combination of forces has benefited end investors in their search for yield.

Structured products can be complex but their performance has a direct link with market size as products with high past returns are helping the market to grow, according to a new research paper by Donghwa Shin (picture), Ph.D. candidate at the department of economics and Bendheim Center of Finance at Princeton University.

Shin's research, Extrapolation and complexity, has found that when investors buy products they rely on past returns rather than analysing specific product details.

"If the past performance of the product is good enough they are more likely to buy [a new product] because they believe that a similar thing is going to happen in the future," says Shin. "I wanted to see whether there was any relationship between complexity and extrapolation."

The study shows that the overall market is growing in size but also in complexity as the growth of one type of product – autocallables, is also increasing very quickly, according to Shin.
"The market share of autocallable products in early 2000 was close to zero per cent but in 2015 these represent about 50% of the global market," says Shin. "Most of the papers in this field say that banks make the products very complicated to deceive investors: if this is true, why do investors keep buying these products?"

According to Shin, there are many ways to understand how products are constructed such as using the Black-Scholes pricing model which is the simplest way to understand the option pricing. It does not, however, capture the very complicated nature of the reality, he says.

"Most people look at products from a building block perspective," says Shin. "Suppose we want to buy Goldman Sachs stocks: in that case we don't do a very detailed analysis of each division of Goldman Sachs but we look at the stock price which is important information. If we have additional information then we combine that stock price with our own view and make a decision."

However, according to Shin, most investors use extrapolation to make this kind of decision as opposed to trying to understand products.

"My conjecture is that investors look at the past return and project it to the future," says Shin. "I found that investors rely more on the extrapolation of past returns rather than try to understand everything in detail. This means that they would consider complex products as long as they have delivered in the past, as opposed to making a more rational decision.

"This extrapolation is quite strong in the structured products market, and investors exhibit stronger extrapolation for complex products which is consistent with our intuition that because structured products are difficult to understand, investors would rely on past performance/return."

These findings explain the rapid growth of sales and complexity in this market, says Shin, noting that despite being a complex product autocallables have delivered a higher return than other structures over the past few years.

"Extrapolation [investors seeking to invest in products that have performed] explains the fast growth in complexity," says Shin. "Manufacturers and distributors are relying on this demand to continue offering these products but this can be misleading, although this is motivating manufacturers to make better products."

Added value

This is “hard to understand” as the general view is that banks can exploit retail investors by making bad products and selling them at a high price, according to Shin.

“If that was the case, products would not perform and banks would struggle to sell them,” he says. “However, my research shows that banks have been delivering products that have performed pretty well, and investors are demanding these products more and more, which in turn is increasing the competition among the manufacturers as well to make better products.”

Because manufacturers have more incentives to deliver better products, the markup of products has also decreased which has resulted in an increasing number of active issuers, as well as better and cheaper products.

“This is consistent with the view that before the crisis manufacturers were not delivering as much value with structured products which suggests there was a motive to exploit investors though it was not a sustainable approach,” says Shin, noting that the research also shows that the market is almost at the same level as prior to 2008 with as many active issuers the market has ever had which suggests also that competition is also increasing.

Since 2013, issuers in the US have been required to provide the fair value of the product to retail investors, and they have been required to disclose more information and be more transparent with investors.

“An analysis of the data provided by issuers shows that manufacturers have understood that any disclosure failings will hurt their reputation and the quality of the information provided to investors has also increased,” says Shin. “So regulation has forced them to be transparent and increased competition has resulted in higher disclosure and better performance.”

Investors chase returns

The third part of the analysis is based on the premise that if investors just chase the best return, banks could charge high markups on products that have performed well. However, the research suggests the opposite because the competition between manufacturers increases and results in cheaper products.

“More and more issuers are selling structured products but the markup has also decreased,” says Shin. “Extrapolation is strong, and the increase in reputational risk and performance has resulted in more demand and better returns. Even though investors do not fully understand the product, this market-based mechanism prevents banks from taking advantage of investors’ lack of sophistication.”

The main conclusion of the research is that there is heavy extrapolation in the market and investors rely very heavily on this. It is stronger around complex products such as autocallables.

“The level of education [among retail investors] is high but, regardless of that, they are not interested in looking in depth at the mechanics of the products,” says Shin. “They just want evidence that it has performed. That’s why the extrapolation of less complex products is not as strong.”

Because of this extrapolation and the higher returns delivered by product issuers, manufacturers are relying on complex products. Finally, despite the evidence that financial intermediaries are taking advantage of retail investors by charging high fees, this pattern is also changing as increasing competition has resulted in cheaper products.

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