INTRODUCING PROGRESSIVE RISK

It has become an accepted fact that structured products use Barrier or Down-and-In puts. This structure is very effective at reducing the chance of loss. But when there is a loss, the loss will by design be significant. These down and in puts are a form of financial brinksmanship, and generally our analysis suggests that the risk/return profile is attractive.

However, there is an alternative. Before barrier options became omnipresent, structured products typically used a short put or put spread to enhance returns. This alternative structure is effective at reducing the chance of loss and has the added benefit of offering a more "progressive" risk to capital rather than the binary risk of barrier options.

With a down and in put (which are almost always struck at 100) the maturity value gaps down from 100% if the worst index is above the barrier to a value equal to the strike of the barrier (at best) if the worst underlying closes below the barrier level. In the case of a product with progressive risk, the maturity value is reduced from 100% if the worst index closes below the high strike. There is no binary discontinuity in the payoff. The relative benefit of the progressive risk product is at its maximum if the worst index closes just below the barrier/high strike.

In the tables below we show indicative terms and analysis for two products that have two unusual features

- Firstly, the products use "progressive risk" as opposed to barrier options. We have used 2.5 leveraged 65%/25% put spreads.
- Then we have replaced the final fixed Autocall payment with geared participation to the performance of the worst performing Index from 65% of its initial level (long a 2x geared 65% strike on a worst of call).

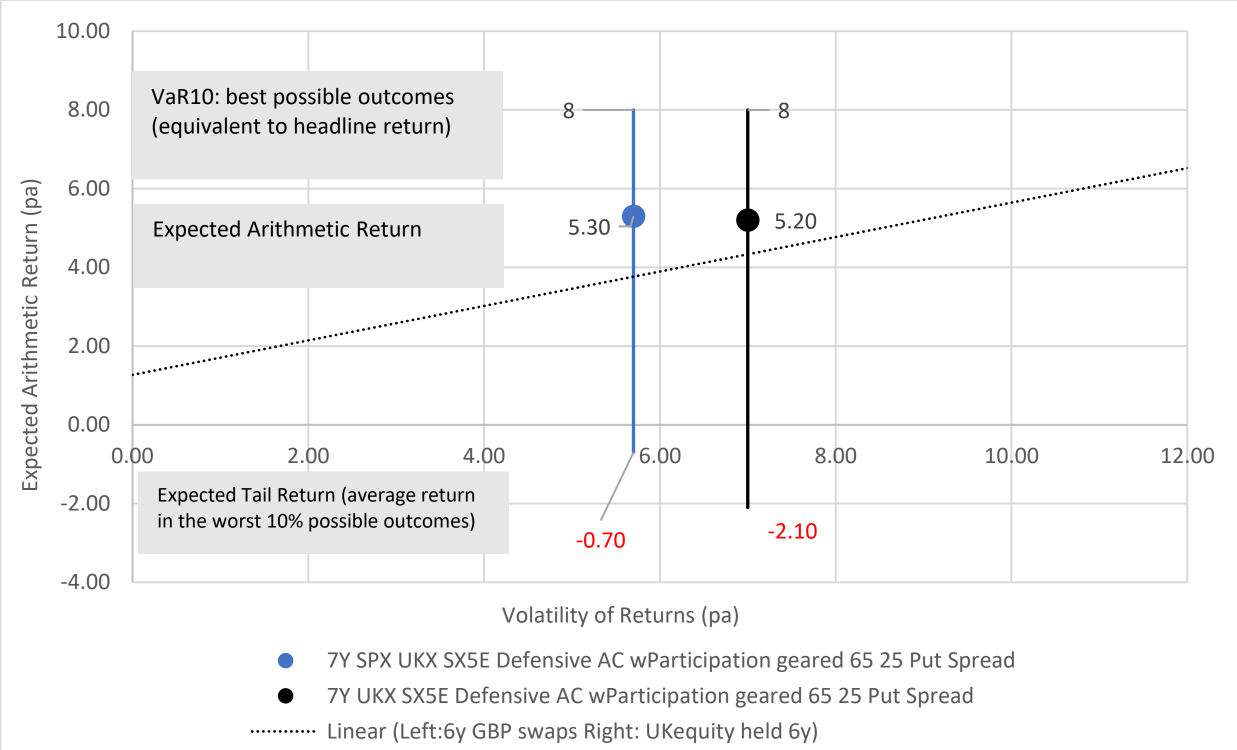
INDICATIVE TERMS		
Issuer	A rated Issuer	
Type	Enhanced Return	
Shape	Autocall with Final Year ITM Participation	
Expiry	7 years	
Name	7Y SPX UKX SX5E Defensive AC with 2.5x 65 25 Put Spread	7Y UKX SX5E Defensive AC with 2.5x 65 25 Put Spread
Underlying	UKX SPX SX5E	UKX SX5E
Autocall Triggers	Y1-6: 85%	Y1-6: 90%
Accrued Return	8% pa if autocalled Y1-6	8% pa if autocalled Y1-6
Final Year Return (if note not redeemed in Y1-6)	200% upside from 65% strike on worst performing index	200% upside from 65% strike on worst performing index
Capital at Risk (progressive risk)	250% geared 65-25% puts spread	250% geared 65-25% puts spread

ANALYSIS		
Expected Return	5.3% (historic: 6.9%)	5.2% (historic: 6.7%)
Volatility of Returns	5.7% (historic: 1.9%)	7.0% (historic: 2.4%)
RiskScore	4.1	4.3
Probability of Loss	4% (historic: 0.1%)	4.6% (historic: 0.1%)
Average Payoff When There is a Loss	60.3 (historic: 99.3)	61.1 (historic: 99.3)
Expected Tail Return (worst 10% simulated outcomes pa)	-0.70%	-2.10%
CVaR95 (payoff in the worst 5% simulated outcomes)	69.7% (historic: 107.8%	64% (historic: 107.8%)
Probability of Strict Gain	96% (historic: 100%)	95.40% (historic: 100%)
Conditional Strict Gain (pa)	7.40%	7.30%
VaR10 (best 10% simulated outcome pa)	8%	8%
Expect Maturity	1.7 (historic: 1.7)	1.9 (historic: 1.9)

The real benefit of the progressive risk in these products can be seen in the historic analysis. In the rare instances where there is a loss, the loss is small. If these products had used a 65% barrier, the loss would have been at least 35%.

Replacing the final Autocall payoff with a leveraged call struck at 65% offers investors unlimited upside potential. The final payment will be 70% if the final level of the worst index is the same as the initial level.

The chart on the next page plots expected return and volatility of the two products on an efficient frontier (made up of cash and FTSE 100 TR Tracker). Both products are above the efficient frontier and so offer a better risk/return profile than a basket of equity and cash with a similar level of risk.



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