

# Risks of investing in complex products

# **Key messages**

- If you do not understand the key features of the product being offered, or the key risks involved, do not invest. Instead, consider seeking professional advice on what investment is suitable for you.
- Be aware that sometimes the name of a product may not reflect the features of the product. Be wary of promises of 'high', 'guaranteed', 'hedged' or 'absolute' returns. These promises often turn out to be misleading.
- Be careful if you need to access your money before the product is due to pay out.
- Before you invest, understand what the total costs are. The cost of an investment will impact the return you are likely to achieve. Also, there may be similar, less complex products with lower costs available.

## Why are we issuing this warning?

During this period of historically low interest rates, investment firms have responded to the search for investment returns by offering complex investment products. Some of these products are designed to allow retail investors access to different types of assets (equities, bonds, commodities) and investment strategies that were previously only available to professional investors.



Complex products are often aggressively marketed. Advertisements sometimes use enticing slogans such as 'absolute return', 'guaranteed', and 'hedged growth', or advertise returns far in excess of deposit account returns that are currently available from banks. These headline promises often turn out to be misleading, or mean something different to what you may have understood.

Investors often do not understand how these complex products work. More specifically, the associated risks, costs, and expected returns are in many cases not immediately apparent or easy to understand.

Some complex products require a high level of knowledge to evaluate and assess the risks. They also need active management and monitoring over time. Active management and monitoring is often too time consuming, impractical and difficult for retail investors. You should consider these difficulties when thinking about investing in complex products.



Organisations that are classified as professional investors should consider whether they are adequately equipped and have the expertise to perform the necessary level of active management and monitoring.

# What 'complex products' are we talking about?

Complexity is a relative term. Many elements can make a product difficult to understand. A product is likely to be considered complex if the product:

- is a derivative, or incorporates a derivative (a derivative is a financial instrument where the value is based on the value of another financial instrument, or of some other underlying financial asset or index, such as foreign currencies or interest rates they are often included in a financial product to produce or enhance a certain investment strategy, as well as to hedge, or offset, certain risks);
- has underlying assets or indices that are not easily valued, or whose prices or values are not publicly available;
- has a fixed investment term with, for example, penalties in case of early withdrawal that are not clearly explained;
- uses multiple variables or complex mathematical formulas to determine your investment return;
- includes guarantees or capital protection that are conditional or partial, or that can disappear on the happening of certain events.

The following specific products are examples of products that should be considered as complex: asset-backed securities; types of bonds such as convertible or subordinated; certificates; contracts for difference (CFDs); credit linked notes; structured products; and warrants.



# What are the main risks and disadvantages of investing in complex products?

Although complex products can provide benefits to you, there are certain risks and potential disadvantages involved in investing in complex products. These risks and disadvantages may not be apparent, or easy to understand. You need to be fully aware of these risks and ensure you sufficiently understand the key features of a product in order to make informed investment decisions.

#### Liquidity risk

Liquidity risk is the risk that you will be unable to sell the product easily if you need to do so before the end of its term. If your product is not liquid, which is often the case for complex products, it is highly probable that you will have to sell the product at a heavy discount from purchase price (and you will therefore lose money) or will not be able to sell it at all.

#### Leverage risk

'Leverage' is a term used to describe ways or strategies to multiply potential gains and losses, such as by borrowing money or using products like derivatives. It may be suggested to you that you invest with leverage in order to possibly achieve higher returns, but you must keep in mind that leverage can easily multiply losses too.



#### Market risk

Market risk is the day-to-day risk of losses arising from movements in market prices. Complex products can expose you to several market risks because they are often designed to invest in separate underlying markets (for example, in shares, interest rates, exchange rates, commodities).



#### Credit risk

Credit risk is the risk that the issuer of the product or a firm it deals with defaults and is unable to meet its contractual obligations to repay your investment.

Certain instruments are rated by credit rating agencies. If you are considering investing in a rated instrument, you should ensure that you understand what the ratings mean. A low rating will tell you that there is a higher risk of the issuer defaulting, and you will not get back the money you invested. A high rating indicates that the chances of an issuer defaulting are much lower, but it does not necessarily mean that the investment will provide the return you expect. You should also be aware that the rating of an issuer may change during the lifetime of the product.

## **Cost of complexity**

Complex structures within a product can mean the product has a higher cost because you are paying for the product's underlying features. Also, fees and commissions are usually built into the structure of the products, and are therefore not readily apparent.

## Further information

Always check if the firm you are in contact with is authorised to do investment business in your country. You can do this on the website of the firm's national regulator. If a firm is not authorised or regulated, it is more likely not to comply with investor protection rules and you may not have access to complaints procedures or compensation schemes

A list of all the national regulatory authorities, and their websites, is also available on the ESMA website at http://www.esma.europa.eu.