Financial Times - It’s déjà vu all over again

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Many dubious investment products have been sold before

Peter “Yogi” Berra was a baseball player for the New York Yankees, and managed both the Yankees and their New York rivals, the Mets. He’s also famous for a series of deceptively simple witticisms known as Yogi-isms which are often contradictory – as in “Nobody goes there any more. It’s too crowded.” One of my favourites – “It’s déjà vu all over again” – might have been invented for the investment industry.

Time and again we are told that someone has devised a new technique of investing, or a new investment product. The truth is that in this area of human endeavour there are few, if any, new products or methods. By and large, we have seen it all before.

For example, we mostly think that pensions are a 20th century phenomenon. The first state pension was implemented in the UK in 1909, and occupational pension schemes providing benefits for company employees had their heyday after the second world war.

Once you reach retirement you are generally required to use your pension fund to purchase an annuity from an insurer which provides the pension income. Or at least, that’s the theory. Latterly, one of the problems encountered by pension funds has been the general improvement in longevity. Pensioners are living longer, which has increased the liabilities of pension funds and so strained their funding.

Our 17th century forebears would have known all about that. They encountered these same problems over 300 years ago and developed products called tontines to deal with them. A tontine is an investment plan named after a banker, Lorenzo de Tonti, who is credited with inventing it in France in 1653. Each subscriber paid a sum into the tontine, and thereafter received an annuity. Sound familiar? As members died, their shares transferred to the other participants, and so the value of each remaining annuity increased. On the death of the last member, the scheme was wound up.

Tontines were relatively widespread in the 18th and 19th centuries. France established a state tontine in 1689. The English government organised one in 1693. But tontines soon caused problems. Their structure created an obvious incentive for members to kill each other, one reason why they are often used as a plot device in murder mysteries. And just as they have today, governments running tontines tended to underestimate the longevity of the population.

What’s the purpose of this history lesson? It is that you might be well advised to check the history of any investment product you are offered to see how it has fared in the past, even if it was called something else at the time.

Take so-called precipice bonds. Typically, this is an investment product offering an eye-catchingly high yield – 10 per cent is not that unusual. Of course, it’s easy to sell investors something they are desperate for – such as high yield in a low-yield environment – and salesmen use this craving to encourage investors to overlook the pitfalls. The catch with a precipice bond is that the investor may not get all of his or her capital back. The yield is typically supplied by collecting premiums for writing put options (which oblige the option writer to buy at a fixed price) based on a given scenario, such as a fall in the stock market over the period of the bond.

Why the term precipice? High option premiums can be obtained for writing put options on something very volatile which is trading at a record high. Precipice bonds first came to my attention in 1999 at the peak of the dotcom boom, when several such bonds were floated with high yields obtained by writing put options on tech stocks, which were then at record highs.

Investors subsequently lost much of their capital when the options were exercised. The option writers – their bond funds – were obliged to buy the tech stocks at the peak prices at which the options had been struck, even though market prices were by now well below those levels. The investors were metaphorically looking over the edge of a precipice in financial terms at the moment they accepted the risk that tech stocks might fall.

Needless to say, "precipice bonds" is a colloquial term. They were marketed with much more mundane names, such as stock market income bonds, so as not to scare investors or give too many clues to their true risks.

But surely people have learnt that lesson? I'm not sure they have. In January, Goldman Sachs sold "Autocallable Contingent Coupon Buffered Equity-Linked Medium-Term Notes" (here's a clue: what does it do? If you don't understand it, don't invest) yielding 10 per cent plus some upside tied to the performance of Apple's common stock. But if Apple shares dropped, the notes would decline at the same rate. Apple shares were over $500 at the time the instrument was created. They have been below $400 this year. The notes were sold the day before the company announced a set of earnings that sent its share price down 12 per cent. Investors bought a total of $1.75bn of structured notes linked to Apple in 2012.

As the old adage goes: "There are no new jokes, only some people who haven't heard them before."

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