ATLANTIC HOUSE

Explaining a Defensive Autocall

The purpose of this note is to explain how a type of structured investment known as a Defensive Autocall works.
Assumptions:

- An autocall coupon of 7.25%
- Payoff barrier levels reduce 5% each year
- Capital protection is at a 60% barrier
- The maximum term of the autocall is 6 years
- We will link our autocall to the FTSE 100 index
- The autocall costs the investor 100p on day 1

The flow chart at right illustrates the different possible outcomes for the investment. It shows that this structured investment has a maximum possible life of 6 years, but that it can **redeem early** on any anniversary of the start date.

Whether or not it does depends on the FTSE 100 being above specified levels on each anniversary, as illustrated. For example, it shows if:

- One year after the start date the FTSE 100 is above its initial level the structured investment redeems and pays the investor:
  1. A 7.25p coupon
  2. 100p of initial investment

  Equalling a total of 107.25p.
- Put another way, if after year 1 the FTSE 100 has risen at all, the investor receives an 7.25% return.

You can follow the flow chart to see all the different possible outcomes and the corresponding minimum FTSE 100 level required to generate that outcome.

Date	Question	If Yes
Start date	Investor invests 100p	
Start date + 1 year	Is FTSE above **100%** of initial level?	Structured investment matures and pays back **107.25p**
Start date + 2 years	Is FTSE above **95%** of initial level?	Structured investment matures and pays back **114.50p**
Start date + 3 years	Is FTSE above **90%** of initial level?	Structured investment matures and pays back **121.75p**
Start date + 4 years	Is FTSE above **85%** of initial level?	Structured investment matures and pays back **129.00p**
Start date + 5 years	Is FTSE above **80%** of initial level?	Structured investment matures and pays back **136.25p**
Start date + 6 years	Is FTSE above **75%** of initial level?	Structured investment matures and pays back **143.50p**
	Is FTSE above **60%** of initial level?	Structured investment matures and pays back **100p**

If No at each step, proceed to the next question. If No at the final step: Structure investment matures and investor loses **1p for every 1%** the index has fallen by start date and end date

The FTSE 100 can fall up to 25% from its initial level and will still pay the investor an uncompounded return of 7.25% per annum.

If the FTSE 100 falls by more than 25% to 40% of its initial level, the investor receives initial investment of 100p only.

However, if the FTSE 100 falls more than 40% from the initial level by the final observation date, the investor could lose a lot of capital invested, unless the structured investment has already redeemed early.

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Too good to be true?

No, there is a risk that the index will rise by more than 7.25% per annum, and your return is capped at 7.25% per annum (non compounded), so there is a chance that this structure will underperform the index, in addition you are forgoing any dividends paid on the index. Capital is also at risk. If the structure never redeems early and the index finishes below 60% of its initial level then capital will be eroded. You are taking less risk on the downside than you would be through owning the index outright because you have this protection down to 60% of the initial index level, but your capital is at risk nonetheless. Simply put, compared with owning the index, this structure gives away any potential upside above 7.25% per annum in return for a degree of capital protection and a good chance of receiving that 7.25% return.

What are my risks?

In addition to the equity market risk explained at left, your number one risk is the strength of the issuing bank, otherwise known as credit risk. Do you believe the bank will be capable of paying you back when the returns become due? The risk you have against the bank is the same as you would have through owning a Senior corporate bond, as owners of this structure will be ranked alongside Senior, unsecured and unsubordinated corporate bond holders in the queue of creditors. While Lehman Brothers did file for bankruptcy, for example, we believe authorities around the world would do everything it takes to avoid a repeat of this. Furthermore, we believe it's also important to distinguish between stronger and weaker counterparties. Considering where the equity market would be if the banking system did fail is also important. An imploding banking system would almost certainly coincide with plummeting equity markets, so any equity investment would likely lose a lot of money.

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