Blue Sky
ASSET MANAGEMENT

Guide to Understanding Counterparties

Structured products
Europe Awards 2008
Best in the UK

www.bluesky-am.com

Contents

About Blue Sky Asset Management

Blue Sky Asset Management (BSAM) is an award winning investment firm specialising in research-backed structured investments for retail and institutional investors. The firm was established in 2007 by a team of directors with industry leading experience, gained through senior positions held in major banking and global asset management institutions, at the forefront of the structured investment industry.

Blue Sky Asset Management works closely in collaboration with leading global investment banks and institutions to design and develop innovative structured investment solutions for professionally advised investors. Industry awards gained by Blue Sky Asset Management include 'Best in UK'*, 'Best Research Process'** and 'Most Useful Industry Website' for investors in the UK***. Notably, the firm is recognised for its emphasis in championing client-centric structured investments based upon investment quality, not sales quantity.

Structured products Europe Awards 2008 Best in the UK

Professional Adviser STRUCTURED PRODUCT AWARDS 2008 Winner

BEST RESEARCH PROCESS

Professional Adviser PPR STRUCTURED PRODUCTS AWARDS 2009 Winner

BEST RESEARCH PROCESS

Source: *Structured Products Europe, 2008; **Professional Adviser, Protected Product Review, 2008 and 2009; ***The Financial Times, 2009.

Introduction

Structured investments provide investors with the opportunity to invest in stockmarkets and other asset classes with pre-defined risk and returns potential. Since the early 1990's, structured investments have evolved rapidly worldwide and are now regarded as mainstream investment solutions by many investors. In the UK, in 2009, nearly 100 providers issued approximately 1000 products, collectively responsible for retail sales of over £10billion*. Sales volume of this magnitude reflects the diversity of offerings - and demonstrates the wide appeal and flexibility of structured investments to add value in many ways in investor's portfolios.

Investing with the benefit of defined risk and returns potential clearly empathises with the interests of many investors. Especially during periods of stockmarket uncertainty or volatility, structured investments can quantify and specifically state the levels and types of investment risk that may apply to an investor's capital and/or investment returns - providing innovative and compelling investment solutions, as alternatives or complements to traditional investment funds. However a key risk borne by investors in structured investments is 'Counterparty risk'.

Counterparties are the institutions that issue ie, provide, the securities that deliver the investment returns, including repayment of capital, of structured investments. At its most basic, the simple fact is that structured investments depend entirely upon their Counterparties - in particular, their solvency throughout the investment term. This guide aims to provide an introduction to the role and relevance of Counterparties in structured investments, and offers an overview of relevant 'due diligence' considerations for advisers and investors who may be considering investing in structured investments, including Blue Sky Asset Management's investment Plans. It also provides a description of Blue Sky Asset Management's approach, in general terms, in certain areas, in relation to Counterparties.

Further information, including the Blue Sky 'Counterparty Platform' and Blue Sky 'Counterparty Observers', are provided on the Blue Sky Asset Management website: www.bluesky-am.com.

Structured investments can quantify and specifically state the levels and types of investment risk that may apply to an investor's capital and/or investment returns. However a key risk borne by investors in structured investments is 'Counterparty risk'. Counterparties are the institutions that issue the securities that deliver the investment returns, including repayment of capital, of structured investments.

Source:* StructuredRetailProducts.com

Counterparties

Blue Sky Asset Management works with leading global investment banks and other major financial institutions in developing structured investment Plans for investors. Different banks/institutions specialise in different global markets and asset classes, presenting potentially different strengths, benefits and advantages. Blue Sky Asset Management operates with total independence, and seeks to deal with the leading institutions in each market, leveraging their specialisation, with particular emphasis on maximising the value of investment thinking, pricing and service. After an analysis of investment issues and investment opportunities, the institutions selected by Blue Sky Asset Management issue the securities (ie the financial instruments or assets) that deliver the investment features of Blue Sky Asset Management's structured investments.

These institutions are commonly referred to as 'Counterparties'. Counterparties are therefore responsible for the repayment of capital at maturity, subject to any stockmarket risk; any protection from stockmarket falls (whether it is total, ie no stockmarket risk, or a defined level, ie utilising a protection 'barrier' linked to the underlying Index/asset); and any growth or income potential provided by a structured investment.

The securities that Counterparties issue are usually Medium Term Notes, Warrants, or other securities, which are similar to a corporate bonds and other debt instruments - often referred to generally as 'bonds'. In effect, an investment in a structured investment is a loan to the Counterparty, in exchange for the returns of the Plan, which are specifically structured to match the investment objectives (ie features) and fixed maturity of the Plan.

Counterparties must meet the contractual terms of the bonds that they issue - and their ability to do so largely depends upon their solvency. The risk that they might fail to meet the terms of their bonds is known as 'Counterparty risk', sometimes also referred to as 'credit risk'. A Counterparty failure during the investment term of a structured investment Plan, for instance through insolvency, such as bankruptcy, administration or liquidation, is likely to cause a 'default', ie the Counterparty will fail to make payments due during the investment term and/or to repay their debts, ie the bonds, at maturity. Usually the risk of a major financial institution failing to be able to meet its commitments in this way can be considered small - but a default or failure puts a structured investment, and any growth or income potential it provides, at risk - so the risk must be understood by investors.

In addition to considering the investment capability and service of different banks/institutions, assessing the financial strength of prospective Counterparties is an important aspect of Blue Sky Asset Management's Counterparty evaluation and selection process. The following pages provide background information regarding recognised methods of assessing the financial strength of an institution, ie measuring their 'creditworthiness'.

Understanding Credit Ratings

Structured investments are not risk free - but they do generally define risk, usually quantifying and specifically stating the levels and types of any risk(s) that may apply to capital and/or returns. However, as already detailed, a key risk borne by investors, in structured investments, especially capital protected structured investments, is Counterparty risk. This specifically refers to the risk of the Counterparty issuing the securities backing a structured investment defaulting on its obligations (for instance through insolvency) during the investment term, or at maturity.

Credit Ratings are recognised indicators of the financial strength of an institution. Credit ratings are assigned by independent organisations known as Credit Rating Agencies (CRAs), and the three leading CRAs, designated as Nationally Registered Statistical Rating Organisations (NRSRO's) by the US Securities and Exchange Commission (the SEC), are Standard and Poor's, Moody's and Fitch Ratings.

Ratings are normally in the form of letter designations, such as AAA, A+, BB, C, etc. These provide investors in the debt securities of these institutions, such as a bond, with an indication of the institution's strength and ability to meet its obligations in repaying both the principal capital and any income due from the security.

A brief overview of each agency and the ratings designations utilised by each is provided on the following pages. It should be noted that credit ratings are agency opinions of an issuer's overall financial capacity (its credit worthiness) to meet its financial commitments – but in the context of structured investments credit ratings do not apply to any specific financial obligation. It is also worth highlighting that Credit Rating Agencies are not infallible - and indeed have come under regulatory scrutiny and general criticism recently. A credit rating is not, therefore, a recommendation to purchase, sell, or hold a financial obligation, and a rating is not a comment on, or implied suitability of, any particular structured investment Plan, for any particular investor.

Credit ratings are a recognised indicator of the financial strength of an institution. Credit ratings are not, however, a recommendation of, or implied suitability of, any particular structured investment Plan, for any particular investor.

Standard and Poor's

Standard & Poor's (S&P) is perhaps the most well known Credit Rating Agency (through its US-based S&P 500 Index, etc). S&P dates back to 1860, when Henry Poor published information about the financial and operational state of U.S. railroad companies. The company as it is known today was formed in 1941 with the merger of Poor's Publishing and Standard Statistics. In 1966 S&P was acquired by The McGraw-Hill Companies, which now encompasses the Financial Services division that publishes financial research and analysis on stocks and bonds.

S&P Rating Designations

S&P issues both short-term and long-term credit ratings, rating institutions/bonds on a scale from AAA to D. Intermediate ratings are also offered at each level between AA and CCC (i.e., AA+, AA-, A+, BBB+, etc) to show relative standing within the major categories (+ indicates the higher end of the rating category, - represents the lower). S&P also offers guidance (termed a ‘credit watch’) as to whether an institution/debt obligation is likely to be upgraded (positive), is (stable) or is likely to be downgraded (negative).

AAA	The highest rating assigned by Standard & Poor's. The capacity to meet financial commitments is extremely strong (the world's major companies and governments).
AA	Differs from AAA only to a small degree. The capacity to meet financial commitments is very strong.
A	Rated 'A' means somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than higher-rated categories. However, the capacity to meet financial commitments is still strong.
BBB	'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to meet financial commitments.

Website: www.standardandpoors.com

Moody's

Moody's Corporation is the holding company for Moody's Investors Service which performs financial research and analysis on government and commercial entities. Moody's was founded in 1909 by John Moody who, similar to Henry Poor's, offered investors an analysis of security values through publishing a book that analyzed the railroads and their outstanding securities. Moody's claims that it was the first to rate public market securities. In 1913, Moody expanded his base of analyzed companies, launching his evaluation of industrial companies and utilities and 'Moody's ratings' become a factor in the bond market. On July 1, 1914, Moody's Investors Service was incorporated.

Moody's Rating Designations

Moody's issues both short-term and long-term credit ratings, rating institutions/bonds on a scale from Aaa to Caa. Intermediate ratings are also offered at each level between Aa and Caa (i.e., Aa3, Aa2, Aa1, Baa3, Baa1, Caa2, etc) to show relative standing within the major categories. 2 indicates a mid-range ranking; 3 indicates the lower end of the generic rating category.

Aaa	Judged to be of the highest quality, with minimal credit risk.
Aa	Judged to be of high quality and subject to very low credit risk.
A	Considered upper-medium grade and subject to low credit risk.
Baa	Subject to moderate credit risk, considered medium-grade and as such may possess certain speculative characteristics.

Website: www.moodys.com

Fitch Ratings

Fitch Ratings is a part of the Fitch Group. The firm was founded by John Fitch on December 24, 1913 in New York City as the Fitch Publishing Company. Fitch is the smallest of the ‘big three’ NRSRO’s, covering a smaller share of the market than S&P and Moody's, although it has grown with acquisitions and frequently positions itself as a ‘tie-breaker’ when the other two agencies have ratings similar, but not equal, in scale.

Fitch Rating Designations

Fitch issues both short-term and long-term credit ratings, rating institutions/bonds on a scale from AAA to D. Intermediate ratings are also offered at each level between AAA and CCC (i.e., AA+, AA-, A+, BBB-, etc) to show relative standing within the major categories. (+ indicates the higher end of the rating category, - represents the lower). Fitch also offers guidance (termed a ‘rating outlook’) as to whether an institution/debt obligation is likely to be upgraded (positive), is (stable) or may be downgraded (negative).

AAA	The highest credit quality, denotes the lowest expectation of credit risk. Assigned only in the case of exceptionally strong capacity for payment of financial commitments, highly unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality, denotes expectation of very low credit risk. Indicates very strong capacity for payment of financial commitments, not significantly vulnerable to foreseeable events.
A	High credit quality, denotes expectations of low credit risk. The capacity for payment of financial commitments is considered strong, but may be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
BBB	Good credit quality, indicates that there are currently expectations of low credit risk. The capacity for payment of financial commitments is considered adequate but adverse changes in circumstances and economic conditions are more likely to impair this capacity. This is the lowest investment grade category.

Website: www.fitchratings.com

Different Credit Rating Designations

Credit Rating Agencies assign ratings based upon views of ‘worst possibilities’ in the ‘visible’ future, as opposed to the past record or the present status of the institution/bond. Long term ratings (as defined by the Credit Rating Agencies - which are the ratings referred to in this guide and shown on the Blue Sky Asset Management ‘Counterparty Platform’) are therefore a reflection/appraisal of the long-term financial outlook and credit risks for institutions, as assessed by the Rating Agencies.

The table below highlights the differences and similarities in the credit rating symbols of the three main Credit Rating Agencies – detailing the long term rating scales for investment grade debt.

Standard and Poor’s	Moody’s	Fitch Ratings
AAA	Aaa	AAA
AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-
A+ A A-	A1 A2 A3	A+ A A-
BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-

In addition to noting the obvious (but sometimes confused) differences between the different Credit Rating Agencies and their symbols it is also important to note that even institutions with the same credit rating from the same Rating Agency do not present absolutely equal credit strength/risk. In a broad sense institutions might be alike in their financial position, but as there are only a limited number of rating designations available, for use in grading thousands of risks, the symbols cannot reflect the numerous shadings of risk that actually exist.

Understanding Credit Default Swaps

In addition to credit ratings, another instrument used to assess the credit strength and quality of issuers is credit default swap (CDS) spreads. CDS's are credit derivatives that were introduced relatively recently, in 1997, in the 'over-the-counter' market (where buyers and sellers of the derivatives trade directly with each other, rather than via recognised exchanges).

Generally, a CDS is a swap agreement/transaction between two parties, in relation to loans, bonds or other debt instruments issued by a company (often called the reference obligation). At a basic level, the buyer of a CDS usually owns the reference obligation, and pays a fee to the seller, for a CDS, to get protection against credit risk. In exchange for paying this fee, the buyer of the CDS will be compensated by the seller if a credit event impacts upon the reference obligation. Potential credit events include default, bankruptcy, debt restructuring, etc. If such credit events occur, the seller of the CDS will receive the reference obligation (now in distress) and the buyer receives cash to compensate the credit loss. CDS providers include financial institutions, ie banks and hedge funds.

Credit default swaps are quoted in the market in the format of an annualised spread, over LIBOR, known as the CDS spread. For example, the CDS spread quoted for a bond issued by XYZ company may be 100bps. If the CDS buyer wants to protect US$10 million investment in an XYZ bond, then the buyer has to pay the CDS seller an annual fee of US$100,000 (typically paid quarterly).

As a CDS provides protection, ie insurance, against a credit event impacting upon a debt instrument, the CDS spread should widen, ie increase, if the credit derivatives market perceives that the credit strength/quality of the issuer of the debt will deteriorate and, vice versa, if the market perceives the credit strength/quality of the issuer will improve it should narrow, ie decrease. This makes economic sense - the CDS will cost more if the perceived risk of a credit event, eg a default, in respect of the reference obligation increases (or vice-versa).

Credit analysts use CDS spreads as an additional indicator and tool to assess the credit quality of corporates, including financial institutions that issue structured investments. Structured investments are often issued as debt on a bank's balance sheet, and hence the CDS spread is a relevant parameter to examine, within an overall analysis of the credit strength of Counterparties.

It is important to note, however, that just like credit ratings, CDS spreads should not be relied upon in assessing the credit risk of a Counterparty in isolation (especially bearing in mind that credit quality is only one factor that can affect the CDS spread).

Disclosure of Counterparty Details

Following regulatory guidance provided by the UK's Financial Services Authority in 2009, the literature for structured investments is now expected to detail the identity of the Counterparty that is providing the assets that back any Plan. In addition, basic information regarding the Counterparty's financial strength (for instance their credit rating and any further pertinent information) is required.

Blue Sky Asset Management details underlying Counterparties explicitly and any other relevant information in its Plan literature – and provides further due diligence input to Professional Advisers during the offer period for any Plan. This guide dovetails with our Plan brochures, to offer further explanation of relevant information, highlighting additional issues relating to understanding Counterparties. Blue Sky Asset Management also provides the Blue Sky 'Counterparty Platform' and Blue Sky 'Counterparty Observers', which offer credit rating, credit default swap levels and other credit-risk related information and updates (which can be freely accessed via the Blue Sky Asset Management website: www.bluesky-am.com).

Blue Sky Asset Management readily confirms details of all Counterparties that have previously been utilised in openly available Plans. As an independent firm we ensure that such disclosure is possible – and we will not utilise any Counterparty that prevents or is not supportive of full disclosure of their involvement at the point of marketing any Plan.

Professional advisers and prospective investors should always ask for - and expect to be provided with - specific Counterparty details prior to investing in a structured investment Plan.

Compensation Scheme Rules

Blue Sky Asset Management utilises external Administrators and Account Managers for our structured investment Plans. During the offer period for any Plan, all investments received are dealt with in accordance with Client Money Regulations, with the Administrator/Account Manager holding investments in ‘ring-fenced’ Client Money Accounts, pending the Strike Date, ie start, of any Plan. At the Strike Date all the investments are used to purchase the underlying securities provided by the Counterparty, which are then held by the Account Manager in a ring-fenced Nominee Account, for the beneficial ownership of investors, throughout the investment term of the Plan.

Both Blue Sky Asset Management and our Administrators/Account Managers are regulated by the FSA and are covered by the Financial Services Compensation Scheme. Investors in any Plan should understand, however, that whilst Financial Services Compensation Scheme (FSCS) rules may apply in the event of the insolvency of the Administrator/Account Manager, the Scheme rules do not normally apply solely because a Counterparty defaults upon their obligations. This is because whilst the securities themselves may be covered by the Compensation Scheme, if the Issuer is FSA regulated, the obligation of the Counterparty is simply to issue the securities - and the possibility, or risk, of their default is inherent in the securities (the same as the possibility of a price fall is inherent in an equity).

It should therefore be understood by investors in structured investments that the Financial Services Compensation Scheme (FSCS) does not cover performance related issues in respect of investments, which means that Counterparty default, ie the insolvency of a Counterparty, or significant falls in an underlying Index or Asset, resulting in a breach of any Plan’s level of defined protection, would not result in compensation being available through the FSCS.

It should also be understood by investors in structured investments that Plan assets (ie the underlying securities) are held on their behalf and they do not have any direct legal interest in the securities or any direct rights against the issuing Counterparty, in the event that the issuing Counterparty defaults, ie becomes insolvent.

There is a distinction to be made with regard to FSCS rules and structured deposits - as the default of a licensed deposit-taker, that meets the conditions of the FSA's compensation scheme rules, may qualify for FSCS protection.

Financial Services Compensation Scheme (FSCS) rules may apply to the insolvency of an Account Manager, but do not normally apply in the case of Counterparty default, ie Counterparty insolvency, which is considered a ‘performance issue’.

Blue Sky Asset Management’s Approach to Counterparties

Blue Sky Asset Management operates with total independence from all Counterparties, without any institutional bias, providing a significant benefit and advantage to investors. This is distinct from the majority of structured investment providers, who are often linked to an internal and solitary bank or Counterparty.

Blue Sky Asset Management's approach to Counterparties places emphasis on balancing and combining various aspects of evaluation, selection and monitoring. Credit ratings and credit default swap spreads are both important indicators of the credit quality and financial strength of Counterparties, however Blue Sky Asset Management does not place over reliance on either indicator, especially in isolation - and both are taken into account, with similarities, differences and/or anomalies considered and assessed. Further, in addition to assessing headline indicators of corporate strength, ie credit ratings and credit default swaps, Blue Sky Asset Management considers financial ‘fundamentals’ and wider aspects of Counterparties’ background. This includes Group, ie parent company, aspects, such as jurisdiction for regulatory purposes and the strength of the Sovereign State, where relevant, and the specifics of how individual Counterparties manage their derivatives business, their structuring capabilities, and their commitment to post-sales service for investors.

In addition to the specific aspects of ‘understanding Counterparties’, in terms of their role and relevance in structured investments, together with the input that is offered regarding sensible consideration of Counterparty due diligence and assessment, two general points are worth highlighting in conclusion in this Guide:-

- **A ‘Flight to Quality’**: Discerning investors should seek providers and structured investments that utilise Counterparties that are highly rated and regarded, taking into account various and combined factors in a balanced approach. Higher headline rates on structured products can be achieved by providers who utilise (or are internally linked to) weaker Counterparties – but investors should differentiate between headline rate driven products and potentially better value investment integrity.

- **Diversification**: As with any type of investment, prudent investors should also seek to diversify their portfolios – which in terms of structured investments most importantly means considering the underlying Counterparty, and limiting, or diversifying, exposure to or reliance upon any single Counterparty. Blue Sky Asset Management’s independence of all Counterparties facilitates potential diversification of Counterparty exposure through the range of institutions that we work with.

Blue Sky Asset Management emphasises the importance of advisers and investors adopting a balanced approach in their consideration of structured investments, assessing Counterparties sensibly, carefully and prudently.

Consult an Independent Professional Adviser

Blue Sky Asset Management encourages investors to make intelligent investment decisions that can impact positively upon long term investment performance. We believe that advised investors make better investment decisions - and we therefore provide our Plans through independent wealth management firms and investment advisers who select investments on merit to meet precise investor needs and interests. We recommend investors discuss their investment needs with an independent Professional Adviser before making investment decisions.

Blue Sky Asset Management Ltd
International House
1 - 6 Yarmouth Place
Mayfair London W1J 7BU

Tel: +44 (0)20 7096 7100
eFax: +44 (0)20 7096 7101

www.bluesky-am.com