of what's proven to work 99% of the time."

A lack of standardized solutions that met these criteria led Brinton Eaton to consider developing a customized structured note. They started by screening investment banks to minimize counterparty risk. "We wanted to deal with just top-tier banks," Miccolis says. "Geography didn't matter as much to us as financial strength, and we were looking at banks that had strong deposit-based commercial banking presence; they weren't purely investment banks and had good credit ratings. But also, we were looking at the rankings other banks put on those banks by virtue of credit default swaps. We looked at CDS spreads among the banks and were just interested in those top-tier banks."

The design and negotiation process with prospective banks started in late 2008 and early 2009. It soon became obvious the ideal solution would involve a long–short volatility investment on the S&P 500; the long–short approach would minimize clients' carrying costs. After agreeing on a product design, the firm began implementing the strategy in client portfolios in February 2010. "All the various volatility-based tail-risk hedges we have since implemented have that common theme—that it's long one sort of volatility, short another form," Miccolis says. "One family of solutions works off realized volatility, and in that particular case, they go long daily and short weekly volatility."

Several incidents, such as the flash crash in May 2010 and the Japanese tsunami, have tested the strategies, and Miccolis says they have worked as expected. The cost to client portfolios has been roughly 1% of the notional amounts involved, but a number of the positions generate modest alpha during normal markets to offset that cost.

Brinton Eaton has since modified its approach to deliver the same hedges through its own 1940 Act fund (the Giralda Fund) that uses swaps instead of notes with banks. Both approaches produced the desired results, but using swaps reduced the firm's exposure to counterparty risk. Regardless of the vehicle selected, Miccolis recommends that advisers do their analysis before contacting the banks they're considering as issuers. "Decide what you want—and don't want—in advance, and then stick to your guns," he says. "Don't just be a passive buyer of whatever they're selling. You decide what you want, and you demand that they design it for you. And then deal with more than one bank, because there's lots of healthy competition in this area."

Scott Miller Sr. with Blue Bell Private Wealth Management, an RIA firm in Blue Bell, Pennsylvania, says the majority of the structured notes his firm uses for clients are based on the S&P 500 and include a buffer structure. The firm uses a reverse inquiry process to solicit competitive bids from investment banks for the note features they want. "We're actually never buying off of a calendar offering," says Miller. "We go to multiple investment banks, we give them the amount of downside protection that we want, and we give them the length of time that we want. We usually keep it pretty short term, 12 months and 1 day to maybe 13 months, so if we make money, it should qualify for long-term capital gain. We believe that by going to those investment banks with a competitive-bid basis we're getting the best possible prices for our clients."

A common criticism of structured products is that they are simply overpriced combinations of derivatives and debt that a competent adviser could replicate at a lower cost for clients. It's true that the products can be reverse-engineered to identify their components, but is that approach a viable strategy for most wealth and investment managers? Jeffery Nauta, CFA, a principal at Henrickson Nauta Wealth Advisers in Belmont, Michigan, is skeptical about the do-it-yourself approach. His firm works with a consultant who acts as the intermediary with the investment banks to design custom notes for the firm's clients. The consultant collects proposals from the banks; Henrickson Nauta then evaluates the proposals and the bidders' creditworthiness.

"Being a CFA charterholder, I understand the underlying exposures and how to structure that," says Nauta. "But for a few million dollars [of client assets], it's not something we would want to do." He lists two reasons: "complexity" and "comfort level with the client."

"They hire us to manage money, not necessarily manage option exposures—that's never been our value proposition," says Nauta. "Certainly, it's not hard to understand the structure on some of these and what the underlying bank is doing. Sometimes, you have to play them against each other, but assuming you can get good pricing from the banks, I think they bring some value, depending on the product."

Nauta also adds that banks often can create the structure for less than it would cost an adviser. The listed options that an adviser would use have high trading costs and are American options, exercisable throughout their term. Most of these structures use European options, which are less expensive, so a portion of the banks' fees are offset in cost savings.

Other advisers disagree that an advisory firm, even a mid- to large-sized RIA, can get good pricing from the banks. Jason Whitby, a senior financial adviser with Investor Solutions in Miami, contends that the playing field between advisers and banks is inherently uneven and tilts in favor of the banks. "I would say essentially trying to customize a structured note (1) you're assuming that your forecast is better than everybody else's, (2) you're doing risk reduction on security versus portfolio, and (3) you're really thinking you're somehow equal to investment banks," he argues. "And I would say there's no way. I don't care really who you are. It's too asymmetrical. They're at least as smart, educated, informed, resourced, and funded as any adviser out there."

"And so," he continues, "I've got to think that JP Morgan has an advantage or Goldman Sachs has an advantage, and even a little advantage is going to be quite painful."

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