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Most Popular Structured Notes Use Leverage for Returns

By Kevin Dugan - Sep 14, 2012

(Corrects assets under management in fourth paragraph of story published Sept. 13.)

The most popular U.S. structured notes tied to stocks this year use leverage to boost returns, as interest rates hover close to record lows and as gains in the Standard & Poor's 500 Index slow.

Of the 50 largest notes this year linked to a stock or index, $2.52 billion, or 61 percent of the total issuance, allow investors to multiply gains, typically until reaching a cap, according to data compiled by Bloomberg. That compares with 40 percent for the 50 biggest similar securities in 2011.

The five largest stock-tied leveraged notes in 2012 have been issued after the first quarter, during a period when theS&P 500 increased less than 2 percent. The U.S. Federal Reserve also has restated the need to keep its benchmark interest rate"exceptionally low" until at least late 2014, and the five -year Treasury touched a record low of 0.5426 percent on July 24.

"If you have a flat market, the leverage allows you to outperform," said Tom Balcom, founder of 1650 Wealth Management, a Lauderdale-by-the-Sea, Florida, investment advisory firm with one-third of its $45 million in assets under management in leveraged structured notes. "People are not expecting gangbusters from the stock markets."

The largest leveraged offering this year came from UBS AG, which sold $946.2 million of one-year notes tied to the Russell 1000 Growth Index on May 16. The securities, which Fisher Asset Management bought, account for 23 percent of the issuance for the 50 biggest equity-linked notes this year, Bloomberg data show.

Russell-Linked Note

Investors receive twice the gains and losses of the Russell 1000, subject to certain adjustments and the possibility of an early redemption. The notes traded at $28.15 on Sept. 11, up 13 percent, while the index has increased 6.7 percent since the securities were sold, Bloomberg data show.

Bank of America Corp. had the second-largest offering, $118.5 million of 14-month securities that yield three times the gains of the S&P 500, with returns capped at 21.06 percent, according to a prospectus filed with the U.S. Securities and Exchange Commission. Investors suffer one-to-one losses if the benchmark declines.

The low levels of both interest rates and the Chicago Board Options Exchange Volatility Index, known as the VIX, are hurting the ability of issuers to create attractive leveraged notes, said Scott Miller Jr., a managing partner at Blue Bell Wealth Management. The VIX dropped to a five-year low in August.

Not as Favorable

"The terms you could get right now probably aren't quite as favorable as the terms you would get in a more volatile environment," said Miller, whose company has about 20 percent of its $200 million of assets in structured notes. More volatility would permit higher caps on returns, he said.

The level of the VIX is derived from the value of options, which are embedded in structured notes. Higher volatility boosts the price of the options.

Banks create structured notes by packaging debt with derivatives to offer customized bets to retail investors while earning fees and raising money. Derivatives are contracts whose value is derived from stocks, bonds, commodities and currencies, or events such as changes in interest rates or the weather.

To contact the reporter on this story: Kevin Dugan in New York at kdugan4@bloomberg.net

To contact the editor responsible for this story: Alan Goldstein at agoldstein5@bloomberg.net