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Advisers Gain Access to Complex Structured Products

By DAISY MAXEY

NEW YORK—Increased access to structured products is offering independent investment advisers new ways to generate yield and protect skittish clients. But the often complex risks and costs frequently aren't easy for advisers to explain, or clients to grasp.

"These structured products, used appropriately, are fine," said Zvi Bodie, a professor at Boston University School of Management who specializes in investments. "It's just that, in general, ordinary people have a hard time understanding the risks that they're exposed to."

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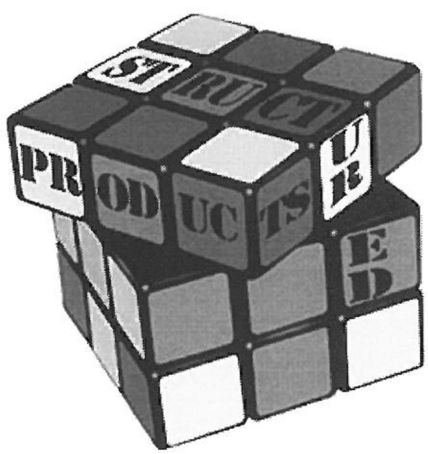
Structured products can take various forms, but are generally complex and opaque investments packaged by investment banks based on derivatives, such as options, indexes, commodities or swaps. They may offer higher returns and some principal protection if held to maturity, but they can also be costly and may present credit and illiquidity risks and it can be difficult to price them accurately.



Long popular in Europe, structured products were once used only by institutions and the very wealthy in the United States. But that has changed dramatically over the past few years.

Overall, there were $49.38 billion in sales of structured products in the U.S. in 2012 and $56 billion in sales in 2011, according to StructuredRetailProducts.com, an online database for the industry. In 2012, 10,784 structured products were launched after 9,679 were launched in 2011, the data provider said.

Now, banks are working to make them available to a wider market, and not just to their own clients or through other banks and large brokerages. In February, for example, Goldman Sachs said it was partnering with CAIS to bring Goldman's institutional-level structured products to independent and registered investment advisers via an online global alternative-investment exchange. CAIS launched the exchange, which allows advisers to trade alternative investments, last year to bring private vehicles to the public.

Some advisers see the vehicles--which may offer higher returns and some principal protection--as a way to generate yield in a low-interest-rate environment and to temper risk in a volatile period. But the fear is that investors who don't fully comprehend the risks they do face.

The products have already come under some regulatory scrutiny, and the Financial Industry Regulatory Authority recently said they remain on its radar.

Steve Foldes, chief executive of Foldes Financial Management, a Miami, Fla.-based registered investment adviser managing $530 million, likes structured products called buffered notes, which put a cap on gains but offer protection against a market decline by using options. The biggest challenge is communicating what they are to clients, he said.

His clients' first reaction often is, "That sounds too good to be true." So he explains that, like any bond, these products entail credit risk and don't pay dividends.

Even after explaining how they work, some of his customers, feeling burned by the 2008 financial crisis, still won't go near the notes. But he believes that, in virtually every instance, the notes have been a benefit to clients who agreed to invest in them. He typically gets banks to customize the product to meet a specific investment profile and to compete on pricing, he said. He also uses several different note providers to hedge the risk that a bank may run into financial trouble.

Mr. Foldes doesn't like some structured products, such as reverse convertible securities, which he said are being sold with "huge commissions." These are generally short-term high-yield instruments generally linked to an underlying stock equity index or basket of indexes. They pay fixed, regular interest and principal at maturity based on the price of the underlying stock. But if the stock trades below a certain level at maturity, investors receive their interest and shares of the lower-priced stock rather than cash.

"If things go the wrong way, you can lose a fortune," he said.

J. Scott Miller, chief investment officer at Blue Bell, Pa.-based Blue Bell Private Wealth Management, a registered investment adviser managing more than $200 million, has been using buffered-return enhanced notes linked to the Standard & Poor's 500 index for about six years. But as market volatility had declined in recent weeks, the notes being offered are less attractive and he's using them less, he said.

The structured-products industry enjoyed healthy growth until 2007, when products linked to Bear Stearns suffered losses, Mr. Miller noted. Then Lehman Brothers, which had issued structured products, collapsed in 2008. "They really slowed down in that period," he said.

Today, as the market grows again, there are too many complex structures for products that the average investor can't understand, Mr. Miller said. Some are "very, very difficult for anyone to model and value," he said. "We don't get involved in the exotic products," he said.