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Structured Products Are More Available, but Awfully Confusing

By DAISY MAXEY

High yield plus protection of principal can be a hard combination to find. Increased access to so-called structured products gives independent investment advisers another place to look. But they need to take a *close* look.

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The name tells you one thing advisers and investors need to know about these investments: They can be hard to understand.

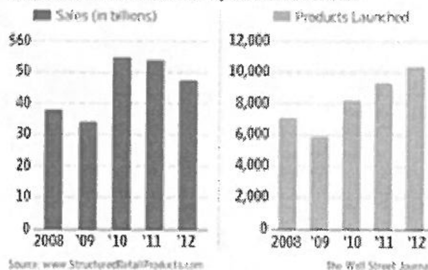
Structured notes with principal protection, for example, may have complicated payout structures, and some investors may be surprised to find they don't offer complete downside protection.

"These structured products, used appropriately, are fine," says 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."

Wider Access

Structured products can take various forms, but generally they are packages of investments, put together by investment banks, to suit various risk/reward profiles.

They often include debt securities linked to indexes or to derivatives such as options, futures or swaps. They may offer higher returns than fixed-income alternatives and some principal protection if held to maturity, but they can also be costly and may present credit and illiquidity risks.



Long popular in Europe, structured products were once used only by institutions and the very wealthy in the U.S.

Their popularity suffered when the financial-markets crisis that started in 2007 shook some investors' confidence in their issuers, but sales bounced back in 2010, before slipping in the past two years. (However, the number of products launched has risen.)

Now, investment banks are working to sell them to a wider market, and not just to their own clients or through other investment banks and large brokerage firms.

In February, for example, structured products from Goldman Sachs Group Inc. were made available to independent registered investment advisers on the CAIS online alternative-investment exchange.

Steve Foldes, chief executive of Foldes Financial Management, a Miami-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 says.

'Too Good to Be True'

His clients' first reaction often is, "That sounds too good to be true," he says. So he explains that these products have some of the same drawbacks as traditional bonds: They involve credit risk and don't pay dividends.

Mr. Foldes typically gets banks to customize the product to meet a specific investment profile and to compete on pricing with alternative investments, he says.

He also uses several different note providers to hedge the risk that a bank may run into financial trouble and not be able to meet its obligations.

Some Are Risky

J. Scott Miller, chief investment officer at Blue Bell Private Wealth Management LLC, a registered investment adviser based in Blue Bell, Pa., that manages more than $200 million, has been using buffered-return enhanced notes linked to the Standard & Poor's 500-stock index for about 10 years.

As market volatility has declined in recent weeks, the notes being offered are less attractive and he is using them slightly less, he says.

But he stays away from some structured products regardless of market conditions. Some are "very, very difficult for anyone to model and value," he says. "We don't get involved in the exotic products."

Mr. Foldes also doesn't like some structured products, such as reverse convertible securities, which he says are being sold with "huge commissions" that eat into investors' returns. They also carry substantial market risk.

Reverse convertible securities generally are short-term, high-yield instruments linked to a stock, stock index or basket of indexes.

They pay a fixed interest rate at maturity, but the amount of principal the investor gets back depends on what happens to the price of the underlying stock or stocks.

If an underlying stock, for instance, is trading at a certain level below the purchase price at maturity, investors don't get their principal back in cash—they receive a reduced amount of principal in the form of shares of the stock.

"If things go the wrong way, you can lose a fortune," says Mr. Foldes.

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