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High inflows show US playing catch-up

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Structured products, long popular in Europe, are now taking hold in the US as markets spook investors and baby boomers look to protect their wealth. Last year, assets in structured products climbed to $114bn (£57bn, €72bn) in the US, up from $64bn in 2006, according to the Structured Products Association.

Last year, Merrill Lynch was the top issuer with $6.1bn in sales followed by Citigroup with $3.1bn, Morgan Stanley with $3bn, Barclays with $2.6bn and UBS with $2.3bn. These numbers represent the above firms selling only their notes and not competing firms' notes. Some examples of structured products are: principal-protected notes, index-linked notes, performance-leveraged upside securities and reversed-convertible notes.

This year's inflows are so far keeping pace with last year, says Philippe El-Asmar, head of solution sales for the Americas at Barclays.

Structured products, formerly investments mainly for the wealthy, have since come down-market and are now available in the retail space.

Generally these products are created by combining or snapping-on additional financial products to a traditional security, such as a bond. These snap-on products can be selected to have low correlation to the underlying investment, which gives the advantage of increasing diversification of the final structured product. If one component of the structure deteriorates, other components will serve to offset or dilute this loss, providing a safety net to investors.

The primary driver behind the high inflows into structured products seems to be that brokers and registered investment advisers (RIAs) are embracing the investment for the first time. Fred Wright, chief investment officer of Atlanta-based RIA Smith & Howard Wealth Management, says the firm was not well versed in them until early 2007 when the issuers began pitching their products.

"Brokers and RIAs are taking more time to understand structured products, which helps them become more popular," says Mr Wright. "They are great for reducing risk while having return potential." While he believes the popularity of structured products will continue to grow, he does see a short-term problem. "The only thing holding them back is that they are a derivative," he says. "That means they are tied to other instruments such as an index or a basket of commodities or currencies and right now derivatives are a dirty word because of the credit crisis."

Structured products can also present liquidity risks as these products are often customised to the unique needs of the investor. That level of customisation can make them more difficult to exit or sell.

But right now, an uncertain marketplace is driving interest in structured products. High volatility is prompting investors to grab products such as principal-protected notes that offer downside protection with some upside potential. In addition, retail investors are now able to gain access to investments that they otherwise would not have had exposure to, such as commodities, currencies and real estate. "In 2000, when the market was solid, people did not want structured products because they did not want to cap the upside and didn't feel they needed protection," says Scott Miller, a managing partner at investment management firm Blue Bell Private Wealth Management. "Now they are willing to give up some of the upside in return for downside protection."

He points out that baby boomers are playing a supporting role in the structured product boom as they plan for retirement and take more of a conservative investment approach. According to the US census bureau, there are an estimated 78m baby boomers in the US with the oldest now past 60 years of age. As more baby boomers age and look for protection of assets, structured products could benefit greatly.

Despite the meteoric rise in the US, Europe is still well ahead in terms of assets. The US has a higher bar when it comes to investing in sophisticated investments, such as hedge funds. Hedge fund-linked products are one example of a popular European structured product, says Thomas McGavin, head of the structured finance practice at global law firm McDermott Will & Emery.

In the US, hedge fund-linked products are not being offered on a retail basis despite the potential to increase returns. "Europe has a different regulatory regime," he says.

Paul O'Dowd is a reporter on FundFire, an FT publication