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THE FEVER FOR STRUCTURED PRODUCTS

Mar 1, 2008 12:00 PM, BY BRIAN WARGO

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Long a Favorite of Investors in Europe, structured products are rapidly gaining popularity in the United States. Last year, $114 billion in structured products were issued in the U.S., according to the Structured Products Association. That's a 78 percent jump over 2006 — and dwarfs the $32 billion in structured products issued in 2004. Previously the sole purview of sophisticated high-net-worth investors in the U.S., they have begun filtering into the mainstream. The retail market bought some $58 billion — or about half — of the structured products issued in 2007.

Structured products combine financial instruments, typically bonds and derivatives, into a package that allows investors to bet on the direction of stocks, bonds and other investments. They are used to both hedge and to speculate, and typically pay an interest or coupon rate substantially above the prevailing market rate. Many of them also cap or limit upside returns, particularly if principal protection is offered.

One reason demand has picked up so much over the last three years is that a number of new financial institutions have entered the market, says Kumar Doraiswami, managing director and head of sales for Natixis Capital Markets. There are 30 active issuers today, up from 10 five years ago. That has improved liquidity and helped to cut transaction costs — two issues that have long concerned investors and advisors, he says. The increased number of offerings, and the accompanying press coverage, has also helped generate greater awareness of the benefits and risks of the (relatively new) instruments, says Philippe El-Asmar, managing director and head of investor solutions for the Americas region for Barclays Capital.

El-Asmar believes structured products will continue to win greater appeal, particularly those that give investors exposure to attractive but risky markets, such as emerging equities or commodities, but protect them on the downside. Those frustrated with a 3.5-percent return on bonds, for example, may appreciate a product that protects their principal while giving them 80 percent of the upside in the market, he says.

Current market conditions could also enhance their appeal. Randy Pegg, executive vice president of Colorado-based Fixed Income Securities (FIS), says the U.S. structured-product industry witnessed tremendous growth during the market correction of 2000 to 2001 as more investors realized they could protect their downside, yet remain invested for some upside.

The same reasoning may now be at play, according to Pegg. “We have experienced increased demand with the recent market sell-off,” he says. “Investors have learned that to make money in the market, you must be in for the up days. When they know they have principal protection, investors can stay invested longer and still sleep at night — especially during turbulent times.”

EYES ON YOU

Still, there are plenty of challenges facing the structured products industry. Considering the growing popularity of structured products, the industry has drawn closer scrutiny from regulators, who question their appropriateness for retail investors, and are concerned about how firms disclose risk. Last summer, Massachusetts regulators sent notices to Bank of America Investment Services, Morgan Stanley, Citi Group Global Markets, Wachovia Securities, Linsco/Private Ledger and Cantella & Co.

Meanwhile, FINRA has warned members that brokers may not fully understand the structured products investments they recommend. Whether they understand them or not, financial advisors and investors have long had concerns about transparency, fees and liquidity.

While industry executives claim the fees are often lower than those on ETFs and mutual funds (they typically range from 25 basis points to 150 basis points up front), others say derivative pricing is much more complex than that. Ultimately, they claim, it's impossible for investors to determine exactly how much the issuers are charging them because they can cap returns in so many different ways.

Virginia-based Securities Litigation and Consulting Group, a financial-economics consulting firm, agrees that structured products can be too complex and opaque for retail investors and some registered representatives to understand. The firm described them as inferior to traditional portfolios of stocks and bonds.

“They are horrible investments for retail investors,” said Craig McCann, a former SEC economist and founder of the firm that is conducting a follow-up study to one released in December 2006 that panned structured products. McCann argues that portfolios of stocks and bonds will yield more at maturity than equity-linked notes.

“Simple portfolios of bonds, stocks or the S&P 500 will beat structured products 99.5 percent of the time because of the heavy profit built into the pricing.” Investing in structured products only makes sense three to six months after they have been issued and are available on the secondary market where they reflect their true value, McCann says. They are overpriced 5 to 6 percent at their offering, he adds.

There are also problems with liquidity, McCann says. Investors who sell $5,000 to $10,000 of the products won't have any problem finding buyers on the secondary market without affecting the price, but someone with $500,000 won't be able to do that like they would with a blue chip stock, he says.

“It is not the very sophisticated who are buying these products,” McCann says. “The smart money is not buying these products. Only people who are captive customers of brokerage firms are buying these products.”

DO YOU KNOW YOUR STUFF?

Are critics right? Do you know how structured products work? Do you know how other advisors are using them? At least one advisor says he recommends them mostly to older clients who have accumulated wealth and are looking for diversification and wealth protection, rather than for younger investors who may be more focused on fat returns.

“I think people who should use structured products are equity investors who are not super greedy,” says Scott Miller Jr., managing partner at Blue Bell Private Wealth Management, a fee-only RIA in Blue Bell, Pa. Miller's firm has made some big bets on structured products: Some 40 percent of Blue Bell's $300 million under management is invested in the vehicles. “In my opinion, it is for anyone who wants equity exposure for a portion of their portfolio, and is willing to give up returns for downside protection. It lessens some of the risk in the market. It doesn't eliminate it, but it lessens it.”

The following is a rundown of the basic features that a few popular structured products offer:

1. **Principal Protection**
   Principal protected investments, the most conservative of structured products, are designed to protect against losses at maturity but enable people to participate in some equity-market gains. Some offer full upside protection or have a cap. No dividends or interest are paid.

   Principal protection products tend to mature within one to seven years, and investors must hold them until maturity to guarantee the principal's return. Maturities shorter than five years typically cap returns. They are issued as registered notes or certificates of deposits in $1,000 denominations, and can be linked to a variety of underlying assets, including an equity index like the S&P 500 or a basket of equities, commodities or currencies.

   Principal protection products are primarily for investors who are not bullish on the stock market or, not surprisingly, for those who want principal protection.

2. **Buffered Return-Enhanced Notes**
   Typically linked to the performance of a market index, buffered return-enhanced notes are issued as senior unsecured debt obligations that typically mature within one to five years, and trade in $1,000 increments, according to JP Morgan. Investors give up any dividend or interest income, and gains may be taxed as long-term capital gains as long as the investment is held un-hedged for more than a year.

   These instruments feature a buffer that provides for partial principal protection. The buffer can range from 10 to 15 percent. One with a 10 percent buffer will return the entire principal if the index has declined by 10 percent or less at maturity. But if the index losses surpass 10 percent, some principal will be lost. This product is especially good for those who want to invest in more volatile and hard-to-access asset classes, but protect themselves somewhat on the downside, say advisors and executives. The best way to take advantage of the buffer, and minimize the negative of the cap, is to have a multi-layered ladder of notes that expire on a monthly basis, says Miller.

3. **Return-Enhanced Notes**
   Return-enhanced notes are geared towards those who are moderately bullish on the market through the note's maturity date. The investor forfeits his right to participate in market gains over that period in exchange for a payout at maturity that may be two or three times the return of the benchmark index, such as the S&P 500 or Nasdaq 100. Many of these notes mature in one to three years, and generally trade in $1,000 increments. They are subject to a cap, and provide no protection against market declines. In addition, there is no dividend income.

4. **Reverse Convertibles**
   Reverse convertibles are linked to a particular stock, basket of stocks or index, and pay a fixed coupon that provides some protection from financial loss. The registered notes mature within one year or less and trade in $1,000 increments. These products typically carry a coupon of between 10 and 20 percent. Unlike a direct investment in a stock or bond, the upside is limited to the coupon amount.

   The coupon is determined by the volatility of the underlying stock, or basket of stocks, as well as the amount of financial protection offered. The dividend yield of the underlying stock will also factor into the coupon rate: The higher the dividend, the higher the coupon rate. Once determined, the coupon rate remains fixed regardless of how the underlying asset performs. The frequency of the interest payments varies; it may occur periodically throughout the term of the note, or may pay in full at maturity.

These instruments also offer a buffer, ranging from 20 to 30 percent, which protects the principal if there is a decrease in the value of the underlying security. The buffer disappears, however, if the security closes below the buffer level at any time during the life of the note.

If that occurs, and the stock does not close above its initial level on the final observation date, you may receive actual shares of the underlying asset or the cash value of the shares, along with accrued interest. Those linked to a commodity or index offer cash. Reverse convertibles are recommended for income-oriented investors who are neutral to moderately bullish over the short term, who believe the return on the underlying security will be lower than the coupon rate at maturity, and who are comfortable with some downside risk.

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