When you're really serious about diversity, highly flexible structured products are the way to go.

Mix and Match

By Stephen Phillip Brown

IN THE WORLD OF FINANCE, WALL STREET IS GENERALLY THE doyen—the leader in financial engineering, product development, and implementation. But on rare occasions, Wall Street is the abecedarian—the backwater beginner paddling to catch up. Witness structured products—financial notes synthesized by combining stocks, bonds, indices, currencies, or commodities with derivatives—that have achieved plurality in European wealth management, yet remain unusual in many domestic wealth-advisory niches.

But perceptions are changing. The Structured Products Association (www.structuredproducts.org), an industry trade group, estimates that $49 billion of structured products were issued in the U.S. in 2005, up 57 percent from the previous year. For 2006, the market is expected to grow an additional 25 percent. Leading the charge are investment banks JP Morgan, Citigroup, Lehman Brothers, Morgan Stanley, Merrill Lynch, Bear Stearns, Goldman Sachs and Wachovia.

Many structured products are SEC-registered and trade on the American Stock Exchange. Most, however, are unlisted. "A lot of what you see on the exchanges is just the tip of the iceberg," says Keith Styrcula, chairman of the Structured Products Association. "Many deals are registered but not listed with the AMEX. Others are private placements." According to Styrcula, minimum investment for the unlisted variety ranges from $10,000 to $50,000, with some firms insisting on million-dollar minimums for customized deals.

More advisors are incorporating structured products because of their flexibility and diversity: They can access most asset classes, leverage portfolios, make directional bets, and change payoff matrixes. "We have about 30 percent of our assets and about 75 percent of our clients involved in structured products in some form," says Scott Miller, president of Blue Bell Private Wealth Management in Blue Bell, Pa., adding, "Uses are limited only by imagination."

One popular incarnation is the principal-protected note, a structure that guarantees return of the original investment at maturity, along with a portion of the investment's gain. Another, the return-enhanced note, offers no principal protection and potential return double or treble the performance of the underlying index or security up to a specified cap.

In the world of structured products it needn't be an either/or proposition; characteristics of both notes can be blended into a single instrument. Miller recently used an 18-month buffered note based on the S&P 500 that offered 10 percent downside protection and double the S&P 500 upside with a 13.5 percent cap. "This type of note works well for conservative clients who don't have a lot of tolerance for the market's downside," he says. "If the market falls by 10 percent at the end of the term, they get their money back. If the market is up 5 percent, they make 10 percent."

Monetizing a concentrated stock position is a recurring application. A margin loan accomplishes the task, but exposes the client to margin-call risk and interest payments. For one client, a CEO of a public biotech firm, Miller purchased a three-year note similar to a pre-paid forward contract. "The stock was trading at $13," says Miller. "The note was structured so that the client agreed to sell his shares at $15 at maturity. Downside risk was limited to $12. Three years later, the stock was trading at $2. We saved him a bunch of money."

George Schietinger, director and senior relationship manager at Credit Suisse in New York, recounts a similar tale: "We had a client who sold his hotel to a REIT. He wanted liquidity and an income stream. If he sold the REIT for stock, it would have been a taxable event. We had him sell for operating partnership, or OP—units that were transferable into the stock and were not taxable. We took the OP units as collateral. We guaranteed the dividend for the life of the term, and we gave 90 percent downside protection. Down the road the REIT became a C-corp., the company cut its dividend by about 75 percent, and the stock tanked."

Individual-security structures are gaining favor because of their ability to alter the return structure of the underlying security. For example, Morgan Stanley offers an AMEX-traded SPARQ (stock participation accreting redemption quarterly-pay securities) on Genentech that pays 8 percent interest based on the issue price of $8.037. The security is callable beginning Feb. 20, 2007 and matures Aug. 10, 2007. The exchange ratio is 0.10 Genentech for SPARQ unit. Such structures are ideal for clients who expect a security to rise and want current income during the wait.

An enterprising advisor can also use individual-security structures to replace covered call writing—a curious, and often advocated strategy that generates current income in exchange for holding a stock at current or lower prices (the payoff diagram is similar to a put sale). With the right structured product, current income is generated, and security exposure is retained without the risk of a call (depending on the structure's call feature) if the stock moves higher.

Harvesting losses for taxes is another benefit. Even the most languid stock or index can fluctuate to outlier regions over the 30 days an investor must wait to avoid invoking the wash-sale rule. "We had a client who had SPDRs that were down precipitously, and he wanted to take a tax loss," Schietinger recalls. "We offered a structured product based on the S&P 500 over 18 months with a 37.5

INTEREST IN ALTERNATIVE ASSET CLASSES SUCH AS COMMODITIES, HEDGE FUNDS AND CURRENCIES HAS BALLOONED OVER THE PAST FEW YEARS.

percent cap with two- times upside. The client achieved a significant tax benefit and was in a product with the characteristics of a security that he thought would rebound."

Interest in alternative asset classes such as commodities, hedge funds and currencies has ballooned over the past few years. Supply meets demand with Barclays NYSE-traded iPath Goldman Sachs Commodity Index. The security is very tax efficient—no taxable event occurs until maturity or sale—and is very liquid, trading on the NYSE under the symbol GSP.

In addition to capturing alternative assets, products can be structured to satisfy conflicting payoff and risk exposures on the alternative assets. Steve Braverman, president of Tahoe Advisors, Englewood Cliffs, N.J., used a structured product to gain commodity exposure for a multigenerational family portfolio. "We integrated the central theme—commodity exposure— into an investment process that was customized for each generation," says Braverman. "We did something with the GSCI so that generation-one got a principal protected note, G2 got tax efficiency through straight call options along with principal protection, and G3 got leverage structured with delta-one exposure on the downside, but three times the potential on the upside. Everyone was happy."

For other clients, Braverman uses structured products to manage taxes: "If you are dealing with a hedge fund that isn't quite tax efficient, a structured product can offer a long-term duration that produces long-term capital gains even though the hedge-fund manager might be day trading."

On the currency front, Schietinger implemented a novel strategy for a client: Structuring a bond-type payoff based on currency fluctuation. "We recently had a currency situation where there were four emerging currencies pegged against the dollar," he says. "If that basket went up one penny, the client received an 11.5 percent return. If it went negative, he was fully principal protected."

Of course, no lunch is free. Flexibility and diversity come with a price, lack of liquidity being one. Maturities range from one to five years, and investors should be prepared to hold for the duration. While some issuers will repurchase their issues, there's no guarantee they will, and trading on the exchanges can be thin or nonexistent. "You have the AMEX with a specialist who will make the price, and a large investment bank will make a price as well," says Styrcula. "Smaller retail investors should be able to trade the notes easily, but larger investors looking to trade 5,000-share blocks could run into problems."

Fees, paid up front at a 1 percent to 6 percent clip, are another cost, and one that is sometimes difficult to discern. The fee structure listed in the prospectus may shadow total costs; derivative pricing is complex, and issuers can cap investors' returns in many different ways.

Call risk further muddies the waters. With many issues, investors run the risk of having their notes called early, cutting their expected rate of return. If a note is called, investors are generally paid the amount of interest that has accrued during the period they held the notes, along with a predetermined call price.

Another risk is incurred if the payout is tied to the note's value on a specific date. A temporary decline just before this date could cut return. "Each firm has its own way of structuring similar products," says Richard Mikaliunas, senior vice president of capital markets at the American Stock Exchange. "The final valuation for one firm might be based on the average of the last five trading days. The final valuation for another might be based on the last three trading days."

Some advisors question the validity of paying for downside protection. "When the markets were doing poorly, everything was about capital protection," says Jason Thomas, PhD, chief investment officer of San Francisco-based Kochis, Fitz, Tracy, Fitzhugh & Gott Inc. "But it turns out that if you bought a 100 percent equity portfolio at market peak in 2000 and were diversified across issues, the return was still positive five years later. If you have a longer time frame, the price for capital protection provides little value."

Other advisors question the value of outsourcing a product that can be constructed in-house. On perfunctory analysis, structuring the product in-house might seem more efficient, but for the advisor nescient in derivative pricing and trading, the opportunity costs of product structure and market monitoring could far exceed dollar costs.

"There is always the concept that it is cheaper to build it yourself," says Styrcula. "Obviously, there are commissions and fees built into these products. But there is an advantage to outsourcing. If you have the investment bank bundling the note for you, they can generally trade it more efficiently and build it cheaper than you can. There is an expense to trading and monitoring each individual component within the structure."

A little legwork and chutzpah combined with free-market capitalism can mitigate many of the aforementioned shortcomings. "If you go to four firms and describe what you want, you'd be surprised how efficient the pricing is, especially when dealing with larger dollar amounts," says Blue Bell's Miller. "One company might give a good price on a product with double the upside potential, while another will give you a better price on triple the upside potential. It's a matter of shopping around."

And if you're still in the dark, it never hurts to ask. "It's sometimes difficult to break down the fee structure in some of the more complicated products," admits Ted Rich, an investment advisor with Global Capital Advisors LLC in Winter Park, Fla. "If I don't understand something, I'll call and insist on a detailed explanation. That's usually all it takes."

STEPHEN PHILLIP BROWN, CFA, a freelance financial writer based in Brighton, Colo., has written for *Barron's*, *CFA Magazine*, *The Financial Journalist*, *The Denver Post* and *Rocky Mountain News*. He can be reached at sphillipbrown@consultant.com.