Perspectives

Response to Jan. 27 Structured Products Article

By Eric Greschner | Posted: 04-06-11 | 07:27 AM | E-mail Article

I would like to applaud Morningstar's efforts to educate your readers about structured products.

Like any investments, structured products have their strengths and limitations. It is only healthy for investors, practitioners, and academics to debate the pros and cons of different investments and strategies.

However, to facilitate that discussion, it is critically important that any information being conveyed is factually correct.

For that reason, I want to address some of the items discussed in a recent article posted on Morningstar.com and to complement this with a practitioner's perspective.

A brief background on my qualifications: I am a national trainer at YourFinancialCoaches™, a company that provides live and online financial education and certification programs to financial professionals. I also teach a national certification class on structured products and am an author of an upcoming book called "Win in Any Market." I am also a portfolio manager for a fee-only RIA that manages portfolios for individual investors, and provides consulting for individuals and financial advisors. Finally, I act as a Third Party Investment Advisor for Registered Representatives of 12 brokerage firms.

There were 11 assertions made in the article that were either erroneous, incomplete, and/or would have benefited from a portfolio manager's perspective.

1. "A structured product or note is an investment vehicle that promises to pay a certain yield over a period of time."
There are two issues with the statement.

a. **"A structured product or note"**: A structured product can come in multiple wrappers, including FDIC insured Certificates of Deposit, SEC Registered Notes, annuities, and funds. Only one of the four possible wrappers for a structured product is a note.

b. **"...promises to pay a certain yield"**: Contrary to this assertion, whether designed for income or capital appreciation, the majority of structured products actually have a variable payout, depending on the performance of the underlying asset and the structured product's design. Thus, only a small set of structured products pay a fixed and predetermined yield over a certain period of time.

2. "...unlike a CD, there is no government guarantee involved".

A large percentage of principal protected structured products are actually issued within an FDIC insured wrapper. Thus, even if the underlying asset that the structured product is linked to falls to zero and the issuing entity experiences bankruptcy, an investor will receive 100% of their nominal principal back at maturity, up to applicable limits for FDIC insurance.

3. "Often, they are no more than masked loans that investors make to banks."

When an investor invests in a structured product, it is a loan to the issuer. It is typically unsecured. However, this is neither masked, as it is fully disclosed, nor is it uncommon as is implied.

Quite to the contrary, an unsecured loan is the same thing as buying a traditional corporate bond, which is also an unsecured loan to a company.

The structured product, if issued in an SEC Registered Note wrapper, is typically issued by a highly rated issuer, frequently AA or above.

Like traditional corporate bonds, it also has a higher claim than preferred stocks or individual stocks against the issuer's assets.

Moreover, more and more SEC Registered Notes are being offered that are collateralized, i.e. government bonds are set aside with a third party to protect an investor's principal against the unlikely event of a default. Thus, proper collateralization actually makes them safer than many corporate bonds.

4. "Since thousands of these products have been pitched with principal protection guarantees, they appear to be secure. Yet the underlying valuation of the derivatives is not transparent, and you could lose money."

When a fully principal protected structured product is constructed, its design and the components used to build it are selected to avoid this very issue. An understanding of how they are built will quickly reveal that in the event they are held to maturity and counterparty risk in not an issue, they are built so this will not happen.

When a fully principal protected structured product is built, there are two primary goals:

1. Provide an investor with their nominal principal back at maturity, even if the underlying asset that the structured product is linked to depreciates.

2. Generate profits for the investor if the underlying asset appreciates.

To achieve goal 1), the issuer buys a zero coupon bond at a discount that will accrete enough interest to grow to the structured product's issuance price, i.e. par on the maturity date.

Thus, 100% of the nominal principal protection is provided at maturity even if the underlying asset the structured product is linked to depreciates.

To achieve goal 2), the issuer takes what is left over after buying the zero coupon bond and buys "at the money" call options, i.e. the derivative component, with the same maturity as the zero coupon bond.

In the event the call options expire worthless, i.e. the underlying asset depreciated, the zero coupon bond will accrete to par at maturity. Thus, regardless of the performance of the derivative portion, an investor will at least receive their nominal principal back at maturity.

In the event the call options expire "in the money," i.e. the underlying asset appreciated above the strike price, in addition to the return of principal, an investor will also enjoy capital appreciation.

Moreover, the statement confuses the implicit costs to the issuer in order to build the structured product, in which a valuation can be derived and varies during the term, with what is actually received at maturity by the investor.

The costs to buy the derivative, as well as the zero coupon bond component, are determined and fixed at inception, not during the term or at maturity.

At maturity, an investor will receive exactly what is promised, i.e. 100% nominal principal protection plus any profits in the underlying asset according to the terms of the prospectus.

5. "Banks and brokers love them because they can sell them to income-oriented investors starved for yield."
Many financial professions use structured products as we do to complement our traditional fixed-income portfolios or to act as alternatives. Structured products can provide a unique solution in a fixed-income portfolio.

For example, portfolio managers can diversify traditional non-path dependent bonds with path dependent structured products that are linked to baskets of stocks or commodities, which can also often generate a substantially higher coupon than what can be achieved on traditional fixed income investments.

They can also be used to hedge or speculate while providing principal protection or asymmetrical leverage, i.e. only in the direction that generates profits.

Moreover, portfolio managers use them, along with other vehicles, as another tool to potentially profit in rising, falling or flat interest rate environments.

Finally, portfolio managers also utilize them, often in conjunction with other vehicles, to provide non-linear exposure and diversification to emerging markets, corporate bonds, municipal bonds, as well as REITs and property indices.

Fixed-income structured products are not panaceas for every market environment. However, from a portfolio manager's perspective, they can provide yet another valuable tool in our arsenal.

6. "It also doesn't hurt--at least to those selling them--that they carry high commissions and fees."
Like many investments whether mutual funds, annuities, bonds, and CDs, some are sold with commissions and some are sold without.

For investments that are sold with commissions, some are high and some are low, according to the product being sold and the firm selling them.

Other structured products are distributed fee-only, i.e. without commissions to Registered Investment Advisors, such as ourselves.

One needs to shop around like you would for all other vehicles to make sure that, as a fiduciary, one is obtaining the most efficient structures or vehicles for your clients.

7. "The worst part about structured products is that you lock up your money for years in hopes of getting a better return..."

Depending on the structure and strategy, the maturities of structured products can vary from as little as three months to eight or more years.

8. "Yet they are actually wagers that limit your upside and downside."

a. **"...Limit your upside"**: Some structured products have caps i.e. a maximum return whereas many do not.

Those that do have caps will limit returns in a sustained bull market and will result in underperformance.

Thus, in a structural bull market, caps should be avoided in favor of a structured product without caps, many of which can often provide unlimited and leveraged upside exposure. Another viable option or complement, of course, in this market environment is to simply invest directly in the underlying stock, ETF, or a mutual fund.

Moreover, caps are not always negative. For example, oftentimes a portfolio manager may believe, based on his or her research, that the returns for the underlying asset will be mild to moderate. In such a scenario a portfolio manager may exchange a structured product with a maximum return for one that provides greater profits on any positive price movements in the underlying asset below the cap.

For example, consider a structure that provides 300% leverage to any profits in the underlying asset in exchange for a maximum return of 20% with a 13-month term. If at maturity the underlying asset appreciated 5% in price, an investor's return is increased to 15%. Thus, the acceptance of a cap in a mild to moderate bullish environment can actually outperform by a significant margin a vehicle--such as a mutual fund, ETF, or individual stock--as well as a structured product without caps in certain scenarios.

Finally, many structured products, such as the one listed above, can be utilized where the symmetrical nature of leverage seen with leveraged ETFs or mutual funds, etc. is eliminated, i.e. any price depreciation is only sustained on a 1:1 basis. Thus, in the example above, if the underlying asset depreciated 5% in price, an investor will only experience a 5% loss, not a 15% one.

b. **"...limit your downside"**:

Some structured products limit the downside, i.e. principal protected, and others do not, putting capital at risk.

Still others have partial principal protection which can "buffer" the investor from the first losses up to a certain percentage (10%-30%) should the underlying index fall. Resultingly, if the index is down 20% and the buffer is 10%, your actual loss is only 10%. The investor is ahead of the underlying index.

9."So no one really knows what will happen until you reach your maturity date."

There are multiple methods of calculating the performance of the underlying asset. The one the author refers to here is the point-to-point method. The author is correct that an investor will not know what they will receive until the maturity date for this type of structure.

However, there are other structures where this is not the case. For example, in the fixed-income realm, many have variable coupons that are paid biannually as current income. An investor will know what the amount is every six months. They will not need to wait until maturity.

Other structures such as the cliquet with a 0% floor locks in gains over multiple sub-periods, i.e. monthly to annually. An investor will know what they will receive at a minimum on an ongoing basis. Thus, an investor in this type of structure will have greater visibility as to what they will receive at maturity than a buy-and-hold investor in the same underlying asset the structured product is linked to.

10. "You'd be much better off in low-cost exchange-traded funds"
Ironically, many structured products utilize ETFs and ETNs as their underlying assets for the very same reasons advocated by the author, i.e. their lower costs due to passive management and indexing. Moreover, many use direct investments in the individual shares, which are even less expensive than an ETF or ETN.

Moreover, investors who use structured products or the options strategies many are modeled after are not investing in them for the limited linear payoffs that can be generated with a direct investment in the underlying asset. A linear payoff refers to the following:

i. If the underlying asset rises, you make money.

ii. If it the underlying asset is flat, you do not make any money.

iii. If the underlying asset falls, you lose money.

Structured products or option strategies can be built to utilize the same linear list of i, ii, and iii, or can be completely inverted if an investor wishes.

For example, in addition to i, ii, and iii, an investor's payoff options can expand dramatically to now include:

i. If the underlying asset rises, you make more money than the underlying asset. (Upside asymmetrical leverage structures)

ii. If it the underlying asset is flat, you make money. (Range accrual or digital strategies, etc.)

iii. If the underlying asset falls, you make money. (Bearish structures)

Many of these can also be built with principal protection.

11. "…or hedging a position with options contracts."
As fiduciaries, the least expensive and most effective approach to either hedging or monetizing a position is always the primary goal.

Thus, doing it yourself outside a structured product wrapper is an option that should always be explored. This may be the most attractive method, especially if options are utilized for a short to intermediate time frame and are plain vanilla, exchange traded, and liquid.

The cost of doing it yourself should also be compared against structured product offerings from different issuers. In doing their due diligence, many investors will find that structured products, in certain situations, can often be the less expensive route.

Oftentimes, it is cheaper to buy a structured product and to benefit from an issuer's wholesale pricing, especially for long-term hedging requirements.

Moreover, if you want to implement a more specialized strategy or utilize automatic and built in optimal market timing and asset allocation structures that use exotic options, such as ladders, cliquet, lookback, rainbows, etc., it may be less expensive and easier to go with a structured product.

Many financial advisors do not have easy access to the OTC derivatives market nor are skilled at building and hedging complex strategies. Thus, a structured product can be easier, faster, cheaper, and safer than doing it yourself.

In sum, a fiduciary should price the cost of doing it yourself as well as shop around among different issuers. It would also be prudent to obtain independent pricing on any structured products they are considering to make sure they are getting a good deal. In some cases, doing it yourself may be a better deal, and other times it may be better to utilize a structured product.

--Eric Greschner

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