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Structured products' Catch-22

Boundless adaptability makes them both appealing and controversial

By Jeff Benjamin

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The boundless adaptability of structured products is part of what makes these complex alternative investments so appealing.

But it also makes them controversial.

In the current market environment — represented by low interest rates, nervous investors and growing macroeconomic uncertainty — the structured-products industry has turned to various forms of low-yielding, principal-protected products.

One increasingly popular product is the callable step-up note, a fixed-income-linked strategy with a steadily increasing annual coupon payment.

Whether it is held to maturity, which can be as long as 20 years, or if the issuer exercises the option to buy the bonds back, the investor's principal investment is returned.

The risks, as with most structured products and bonds in general, is that the issuer could default, costing the investor both future coupon payments and principal.

Those fears came to reality in 2008 when Lehman Brothers Holdings Inc. went bankrupt, leaving investors in the investment bank's structured products holding worthless paper.

The Lehman collapse is the kind of debacle from which the structured-products industry has been fighting to recover, while an emboldened force of structured-products critics remains determined to keep the industry in check and under more regulatory scrutiny.

“I think we have not gone far enough to protect investors, because this is a high-risk area and it should involve a wider scope of disclosure,” said Louis Straney, an expert witness and founder of Arbitration Insight LLC.

But while opponents such as Mr. Straney campaign for more disclosure and reduced retail investor access, the financial advice industry is generally moving toward structured products as a viable alternative strategy.

Through the first half of 2011, about $30 billion of structured products were sold in the U.S., putting the industry on track to eclipse the $53 billion in sales for all of last year.

By contrast, less than $33 billion worth of structured products were sold during all of 2007, which was considered a good year for the then-burgeoning structured-products marketplace.

Since 2007, market trends have changed little. In terms of issuance, 63% of issued products were income products at that time and 35% were categorized as growth products.

Through June of this year, 58% of issued products were income products, with 40% considered growth products.

During both time periods, 2% of the products were categorized as growth and income blends.

Principal protection, whether linked to the health of the issuing firm or through a structured certificate of deposit, is appealing to Rudy Blanchard, a portfolio manager at Regatta Research & Money Management LLC.

Mr. Blanchard, whose firm has $140 million under advisement, likes the comfort of principal protection for his clients even if it means limiting the upside return over the term of the product.

“It minimizes the behavioral-finance errors,” he said. “Both investors and professionals make numerous repetitive errors in their investment decision-making process — for example, selling at the bottom and buying at the top. But if a client invests in a principal-protected product, holds it to maturity and there is no default by the issuer, then market risk can be effectively managed.”

Structured products are created by investment banks, which often use derivatives instruments to enhance or modify the performance of an underlying investment such as a stock or bond.

Most are sold with commissions of up to 3%, but the industry is also creating fee-based versions of many of the products.

Unlike investment pools such as mutual funds, exchange-traded funds and hedge funds, structured products are created and offered continuously, have specific life spans and can be customized to fit a variety of investment objectives.

One product that continues to draw fire from critics, including regulators, is the reverse convertible, a high-yielding short-term note that can convert to an underlying stock under certain conditions.

In the most basic sense, a reverse convertible is a securitized put option; investors receive a guaranteed coupon payment, regardless of how the underlying stock performs during the duration of the instrument. At the end of that period, in addition to the coupon automatically earned, the investor gets back the amount originally paid for the investment as long as the stock price hasn't fallen below a present “knockout” level.

If that happens, the investor ends up with the coupon payment and the value of the stock at whatever level it happens to be trading.

Of course, in the world of structured products, things can get as complex or as simple as an adviser or investor desires.

“There's no free lunch out there, so you always need to take on some risk if you want some return, but we like the plain-vanilla products,” said Scott Miller Jr., managing partner at Blue Bell Private Wealth Management LLC.

Mr. Miller, whose firm has $270 million under advisement, said he is using structured products for his clients but won't buy any product pegged to something he wouldn't want to own.

“Make sure you understand how the product works and that you would be willing to buy the underlying investments,” he said.

Mr. Miller, who will allocate up to 20% of a client's portfolio to structured products, pools client assets to between $2 million and $5 million in order to shop around the investment banks for the best price on whatever product he is considering.

While the industry has been making major strides toward education at the financial intermediary level, there is no denying the inherent complexity of many structured products.

For starters, the dozen or so investment banks creating the products use no uniform nomenclatures.

Even a relatively straightforward product designed as a cash management alternative has at least three different names in the marketplace.

Marketed as annual-income products, income generators and yield generators, these investments are designed and promoted as an alternative to low-yielding money market funds and certificates of deposit.

The specific structures vary depending on the issuing firm, but the basic idea is to earn income based on the performance of an underlying basket of 10 to 20 stocks.

The nomenclature issue is particularly frustrating to Keith Strycula, president and founder of the Structured Products Association.

“There has been a major improvement of one sort in terms of the jargon used,” he said. “They used to leave the naming to the marketing desk, and everyone kept creating clever acronyms based on animals or planets, but now the lawyers have taken control and it seems to be going in the opposite direction, so you can see that we definitely need some generic standard descriptions.”

Mr. Strycula, who admits that the industry includes “examples of people and products we would prefer not to see in this business,” said that structured products will never be for everyone.

“Structured products are between a plain-vanilla mutual fund and an alternative product, and probably closer to the alternative end,” he said. “But if somebody has an issue with the transparency or the way the performance is calculated, they should probably steer clear of structured products, and if you're unable to understand or become conversant, then this is probably not for you.”

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