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The Hedging Game

Structured products' risk-reward ratio is worse than you think.

By John F. Wasik

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Choosing a structured product - some of the most illiquid, complex and opaque retail offerings coming from Wall Street - is like peeling an onion. Your eyes may water at the cost and complexity. Notes with stated yields and maturity dates are sold aggressively to income-oriented investors drawn by the ever-popular hope of better returns with less risk. While hardly a household name, they are hot sellers: Structured products with a face value of more than \$52 billion were sold last year in the U.S., and sales are growing 24% a year, according to structuredretailproducts.com, which follows the sector.

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Many investors, such as buyers of Lehman Brothers' principal-protected notes, have not wound up in the winner's circle. Lehman's structured products became worthless after the firm failed. The biggest seller, UBS, has denied any wrongdoing. Overall, investors have lost more than \$113 billion in structured products since 2008, according to a study by Demos and the Nation Institute. Many were packaged with bond mutual funds and other investments pitched by brokers as "safe and secure."

Some financial planners are leery, for a long list of reasons. As Steve Podnos, a CFP and M.D. at Merritt Island, Fla.-based Wealth Care, puts it: "These rocket scientists have figured out how to minimize a client's return. You give up liquidity, there's not much secondary market, you're a creditor and you don't own the underlying investment."

You can protect your clients by evaluating products they may already own or urging them to allow you to take a close look at any temptations. Structured products were among "the most difficult product areas for new clients to understand," according to a 2010 survey by Prudential and NMG Consulting.

In peeling the onion, start with a definition: a structured product uses a derivative (typically a zero-coupon bond, or put or call option) to box the range of movement in the value of a stock, bond or index - limiting losses or capping gains. They are sold by nearly all major bank and brokerage houses, but you can't check their prices on Morningstar or most anywhere else. Many guarantee you can get some or all of your principal back, plus the return of the underlying investment. Complex formulas determine payment timing. "When Wall Street builds a better mousetrap, investors should know they are the mouse," says David Hultstrom, a CFP and CFA at Financial Architects in Woodstock, Ga.

OPAQUE PRICING

Hedging always comes at a price. Commissions and other costs, which are difficult to ferret out, range from 1% to 8%, and may rise to 10% for products with puts and calls, according to several planners. Hultstrom most recently dissected a Wells Fargo note linked to the S&P 500 that matures in August 2014.

The bottom line? A four-year lock-up period, a cap of 60% to 70% of the return of the S&P 500 over that period, and taxation as income rather than capital gains. (He could not discern the embedded costs and commissions from the prospectus.) Investors didn't hold any shares in an S&P 500 Index fund. Instead, they essentially became unsecured creditors with a cap on gains. The only plus side was a floor that Hultstrom found inadequate. The formula in the prospectus for the underlying return was daunting. It declared "the possibility of a return of an 8% contingent minimum return so long as the ending level of the index does not decline by more than 40% from the starting level."

In other words, "If the ending [index] level is less than the threshold level, you would lose some, and possibly all, of the original offering price," Hultstrom says. "In exchange for protection that isn't as good as simply investing a

portion of the portfolio in bonds, the investor gives up any significant upside." In addition to a bond position, he notes, a client could buy call options on the S&P Index - not necessarily at a higher price.

"The options [within the notes] are artificially created by the [issuing] investment bank," Podnos explains, "so you don't know what they are paying for them. There's no way to know what the options cost. You have to have a PhD in finance and math to see how much risk is being off-loaded by the bank."

Adam Friedman, a vice president at Chicago-based Incapital, one of the largest third-party distributors of structured products, counters that not only do structured products give advisors and planners the "ability to customize risk," but they also "access to certain asset classes, particularly in commodities." While standard options strategies are available - and may save clients money - they can be limited and not allow advisors to accommodate specific risk profiles, he adds.

As for expenses, Friedman notes that advisors often can get competitive pricing when issuers bid to be on a large platform such as Incapital's. "I always tell advisors to shop and compare. We expect issuers to compete on price."

LOOK BEFORE YOU LEAP

Fiduciaries and their clients should carefully consider the following risks:

* **Creditor risk.** If issued as senior debt obligations or unsecured notes, structured product payments depend upon the financial health of the issuer. Principal may be lost in some products, depending upon the formula used in the payout and other conditions. An exception is FDIC-insured notes.

* **Liquidity.** As FINRA notes in its Investor Alert, even if an issuer "states it intends to maintain a secondary market, it is not required to do so." Your client could be locked up for several years. If a broker or issuer promises to buy back the note, it may be at a steep discount.

* **Underlying investment risk.** Structured products can be linked to nearly any index or stock, which may lose value.

* **Tax risk.** Since structured product proceeds don't qualify as capital gains in most cases, ordinary income rates apply - unless the products are held in a tax-deferred vehicle such as an individual retirement account.

* **Conflicts of interest.** An issuer may have relationships with brokers and advisors. In the case of the Lehman-UBS principal-protected note sales, UBS was lending Lehman money before the firm collapsed. Bank or broker analysts may even downgrade the underlying stock upon which a note is based, causing the value of that issue to drop.

* **Call risk.** As unsecured debt, an issuer may be able to call the note. Such provisions, buried in prospectuses, could cancel future payments.

* **Options risk.** Since investors don't know how the embedded derivatives are priced, planners may not be able to predict how the note will perform. There are also costs associated with the options.

* **Index risk.** Many products linked to stock indexes may be based on a price-only index, meaning investors will not receive the added return of dividends.

* **Expenses.** Commissions, underwriting fees, options expenses and other embedded costs may not be readily disclosed. Upfront expenses alone may range from 1% to 10%. FP

John F. Wasik, co-author of iMoney, is a Reuters columnist. He received a grant from the Nation Institute for a study of structured products.

A SAMPLING OF STRUCTURED PRODUCTS

Structured CDs are essentially plain-vanilla CDs with an equity-index wrapper. They offer a stated yield plus a limited chance of more gain from stocks. These notes are tradable, typically insured by the FDIC, and can have attractive rates. Rick Luedtke, a CFP in Toledo, Ohio, with Ameriprise Financial, bought CD notes issued by HSBC that were linked to a basket of stocks in March 2009. "It was a good time to buy, and the notes returned 14% the following year," he says. When a newly retired, highly risk-averse client came to him with a large 401(k) balance invested entirely in cash, Luedtke recommended that he put 15% of his retirement funds into three structured CDs. A CD linked to the Russell 2000 had a potential 60% return over a four-year term. The other two CDs provided annual income for the next six years linked to the performance to a basket of equities. The client agreed that the stocks had a good chance of outperforming ordinary CDs, which were paying less than 2%, and he liked the comfort of FDIC insurance for his principal.

Fdic-Insured Structured Notes are linked to stock market index options, which can provide market gains along with guaranteed (and insured) principal and interest.

principal-protected notes are, in effect, unsecured loans to a bank, which "guarantee" return of principal using derivatives. The most infamous were the notes issued by Lehman and sold by major brokers. When the firm collapsed in 2008, the notes became worthless and investors are still trying to get their money back. Wall Street has since shied away from the principal-protection label and offered products such as "buffered notes," which

also may use options to hedge risk and limit upside. They carry credit, interest rate, market and options pricing risk.

Reverse Convertibles, or Revertibles, typically pair a high-yielding bond with a put option. An investor doesn't own the underlying asset and pricing is opaque. FINRA has issued enforcement actions against some brokers selling these instruments to unsuitable buyers. The regulator notes that "even if the yield keeps pace with or surpasses inflation, you could wind up, when the note matures, with shares of a depreciated or even worthless asset that you otherwise would not have purchased." -*J.F.W.*

PRICE TAG TRANSLATION GUIDE

It's not easy to glean the costs of structured notes. Consider these disclosures in the prospectus of Wells Fargo Access Securities, Medium-Term Notes, Series K Equity-Linked Securities/Notes, linked to the S&P 500 Index and due Aug. 29, 2014:

What it says: "The original public offering price of the notes will also include the costs of hedging our obligations under the notes." From page S-5 in one of many supplements in the pricing prospectus reads:

What it means: There are embedded costs for buying derivative contracts to protect the issuer, but not necessarily the buyer. The prospectus doesn't specify how much these contracts cost or what kinds of contracts they are.

What it says: "The hedging activity discussed above and the agent discount or commission and structuring and development costs may adversely affect the market value."

What it means: There are four or five levels of expenses in this note, but they are not spelled out. They will lower the value of the note.

What it says: "The maximum commission ... may not exceed 8%." From page S-27 of another supplement, Plan of Distribution.

What it means: That's in addition to the other costs noted above and doesn't give an exact number. By comparison, plain-vanilla bonds sell with a 1% commission or less. -*J.F.W.*

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