

# The best defence

Structured products are still regarded with suspicion in some quarters. In the wake of commentator Janet Tavakoli's trenchant criticisms of the industry, *Structured Products* speaks with some leading US market participants who want to set the record straight

> On June 21, 2006, University of Chicago professor Janet Tavakoli spoke out against the \$75 billion US structured products industry. With substantial coverage in the *Wall Street Journal*, on CNBC, and a follow-up press release, Tavakoli questioned the virtues of structured products as an investment class. Purchasers run the risk of "buying a tricycle at Ferrari prices," she said, adding that "investors can lose more than their original investment." In effect, Tavakoli painted structured products as illiquid, loaded with fees, risky, and remunerative only to the people selling them.

*Structured Products* took the CNBC transcript and convened a roundtable of six high-profile US structured products professionals to assess the merits of Tavakoli's arguments. The roundtable included a diverse cross-section of structured products experts on both the buy-side and sell-side, both structurers and marketers.

Participants included Eric Miller, managing director of US Structured Products for Ixis Capital Markets in New York; Andrew Scherr, director of structured products at Fortis USA in New York; Matt Ginsburg, managing director and head of the customised investment solutions division at Wells Fargo Bank in San Francisco; J Scott Miller, president of Philadelphia-based Blue Bell Private Wealth Management; and Keith Styracula, Structured Products Association chairman. Also present were two prominent structured products professionals who asked to remain unnamed – a senior structurer from a US-based structured products firm and the other a senior marketer for a leading European bank's New York desk.



**"Structured products are not Ferraris; they are more like Toyotas. They are well-designed, reliable vehicles for particular investment objectives"**

Andrew Scherr, Fortis USA

**Tavakoli on fees....** Investors would have to "dissect the note and put it all back together to figure out [the] fees. When I was on the sell side, I loved these products because of the fees I could stuff in them" (*Wall Street Journal*, June 21, 2006)

"[Also] there can sometimes [be] very heavy fees embedded in these notes. You can find that you've bought a tricycle at Ferrari prices. Yet the only person driving a Ferrari is your broker." (CNBC, June 21, 2006)

**Andrew Scherr:** Structured products are not Ferraris; they are more like Toyotas. They are well-designed, reliable vehicles for particular investment objectives. Though carefully engineered, they are 'mass produced'. Production efficiency reduces costs. Competition compresses profits. Like Toyota, the structured products industry responds to market forces. It does not create them.

**Marketing executive:** I would argue that structured products could be the most cost-efficient way of getting access to a foreign market. Our institutional clients have looked at other alternatives, such as mutual funds, exchange-traded funds, swaps and futures – and ended up selecting structured products.

In fact, we can provide exposure for our institutional clients to foreign markets, such as emerging Asia, for as little as 10 basis points a year – and that includes all the fees. This is certainly more efficient than via other more traditional investments.

**Eric Miller:** Structured products compete against (plain vanilla) five-year cash deposits where the banker gets paid over 4%. So to talk about structured products fees where the selling concession has exceeded the issuer's profitability by a good margin is a very dated argument.

**J Scott Miller:** Retail investors should be aware of the fees and expenses attached to structured investments. However, the recently approved active free writing prospectuses mean these fees are more transparent than in the past. Through the use of open architecture and competitive bidding on behalf of the major institutional firms, distributors are able to obtain extremely favourable pricing for their clients. Our fee-based structure doesn't build in any additional sales concessions.

**Structuring executive:** I was struck by Tavakoli's statement that she "loved these products because of the fees [she] could stuff in them". Anyone who cares about the integrity of this industry would be outraged to hear a marketer say something like that on the desk, and may be moved to call their compliance department.

## “Market-linked products, especially principal-protected varieties, provide a way for clients to increase exposure to equities and commodities without adding to portfolio risk”

Matt Ginsburg, Wells Fargo



**Tavakoli on illiquidity...** “If you want to sell [a structured product] before the maturity of the note, you won’t get a very good price.” (CNBC, June 21, 2006).

**Eric Miller:** Investors are made absolutely aware that these strategies are typically buy-and-hold. The fact that the investor will often have to contend with time value embedded in the option component of most notes prior to maturity is misunderstood only by those who have not invested in them. The registered note market is highly regulated and the disclosure is very clear to indicate the payout on the notes is contingent on holding to maturity. To imply that issuers and their financial advisers are pushing these products to clients who don’t understanding the risks involved is simply inaccurate.

**Andrew Scherr:** It is true, as Tavakoli asserts, that there is a certain lack of liquidity with US structured products. This has more to do with the youth of the market in the US and US regulators allowing only highly restricted access to structured products. Having said that, a well-constructed investment has intrinsic value. The bid-ask spread reflects that in an early buy-back scenario.

**Marketing executive:** New competition in the industry has resulted in some compression and the bid-ask spread has tightened to as little as a quarter of a point. It may continue to be a goal of education that investors need to be perfectly clear about the fact that principal protection in most notes is guaranteed only upon the maturity date of the instrument. These are typically buy-and-hold instruments.

**Tavakoli on risk...** “Some products are sold with substantial principal risk. At times, investors can lose more than their original investment. That’s the case I saw with a viaticals market product being marketed recently. Those investors are not aware that not only can they lose the original investment, but they can get a call saying they want further funds from you.” (CNBC, June 21, 2006)

**Matt Ginsburg:** We take the position that structured products can reduce risk in a portfolio. Generally, our clients are extremely risk-averse. Often they are heavily invested in fixed income, but because they are afraid of losing capital they are much less exposed to riskier asset classes, for example equities or commodities. In simple terms, many clients have all their eggs in the same basket, which is a fixed-income one.

Modern portfolio theory says that a mix of investments optimally diversified across asset classes increases returns without increasing risk. But it’s often difficult to convince clients to invest in riskier assets even when they have some understanding of the benefits of diversification.

We believe that market-linked products provide conservative investors with a unique opportunity to optimally reposition their investment

portfolios. Market-linked products, especially principal-protected variations, provide a way for many clients to comfortably increase exposure to equities and commodities without adding to portfolio risk. By increasing exposure to riskier assets without increasing that risk, we are also helping clients to attain the best mix of investments.

**Andrew Scherr:** The magic of financial engineering is that virtually any exposure can be constructed from financial building blocks. Most structured products are engineered to reduce the risk to investors, not to amplify it.

**Marketing executive:** In addition, structured products enables investors to isolate the equity returns from the effects of currency movements. This allows them to have a ‘pure equity’ exposure – which is once again not available via other, more traditional, investments.

**Structuring executive:** In a rapidly expanding market such as structured products, investors view the opportunity to participate as important as the underlying risk-reward profile when it comes to new ‘investable’ vehicles. It’s simple supply and demand. Innovative investment products are always chased by the pent-up demand from retail investors every time the regulators open the door. It’s a propensity for novelty, not ignorance of risk.

**Tavakoli on viatical-linked structured products targeting retail investors...** “Notes linked to viaticals... are highly risky retail products. The retail investor buys a note linked to a pool of life insurance policies and the proceeds are also used to pay the premium payments and hefty fees to the arrangers and brokers. The investor could earn 8% per year, but if the original policyholders do not die on time, the investor must continue paying the premiums, even if his original investment is exhausted. Not only can the initial investment be used up, but the investor may be asked to produce even more funds. The fees for this very risky product were 12.5% upfront as well as further fees for commissions and more.” (Tavakoli press release, June 28, 2006)

**Keith Styracula:** This assertion is totally false on two levels. According to Thestreet.com, Dr. Tavakoli is referring to a private equity partnership targeting qualified purchasers with at least \$5 million in investable assets. This is a life settlement limited partnership that has no structured product attributes whatsoever, nor is it targeted at mass-market retail investors. Once again, we’re reminded that our industry has a lot of work to do in educating people about our investment class.

**Andrew Scherr:** Few structured products structurers would find it prudent to put a rocket engine on a pair of roller skates, such as viatical-linked SPs for retail investors. As I said before, structured products providers build Toyotas, not Ferraris. ■

The June 21 CNBC interview can be seen on the web at [www.structuredproducts.org/cnbc](http://www.structuredproducts.org/cnbc)