Structured notes offer too-good-to-be true returns

Marketing hype makes structured notes sound like a sure thing. Read the fine print and you might come away with a slightly different conclusion.

April 7, 2013 *By gcrawford*

4 MINS

Here's an investment that sounds just too good: You get 150 percent of the upside of the stock market but only 90 percent of the downside. That's the promise of structured notes issued by companies including JPMorgan Chase & Co., Bank of America Corp. and Goldman Sachs Group Inc.

Such hybrid securities, which have maturities like bonds but are linked to asset classes such as stocks, currencies and commodities, are increasingly popular. That's especially true for notes linked to the stock market, which has risen 16.5 percent in the past year and 116 percent since the March 2009 bottom. Some $10.1 billion of structured notes tied to the S&P 500 were issued in 2012, the highest amount in three years, according to data compiled by Bloomberg.

Downside Buffer

Consider one of JPMorgan's 18-month Buffered Return Enhanced Notes (BRENs), which are linked to the S&P 500. Issued on October 26, 2012, the note matures on April 30, 2014. For that time period, it promises to deliver 1.5 times the S&P's gain when the note matures. So if the S&P is up 6 percent as of April 30, an investor in the notes would get a 9 percent return.

The note also provides a downside buffer of 10 percent, so that if the index falls less than 10 percent below its initial price on October 26 — 1,411.94 — then shareholders lose nothing. Any loss greater than 10 percent is on the note holder. So if the index is down 20 percent, you're down only 10 percent.

That doesn't sound so bad until you read the fine print in the note's prospectus: "The notes are designed for investors who seek a return of 1.5 times the appreciation of the S&P 500 Index up to a maximum return of 14.00% at maturity. Investors should be willing to forgo interest and dividend payments and, if the Ending Index Level is less than the Initial Index Level by more than 10%, be willing to lose up to 90% of their principal."

A few things in those sentences should give investors pause. First, there's that 14 percent cap. Since market returns tend to be lumpy, there are often years where the market is up 26.5 percent, like 2009, and other years where it does next to nothing, like in 2011, when it returned 2.11 percent. Capping the upside at 14 percent could mean giving up a lot of return in a strong year.

And if the market returned just 2.11 percent over the life of the note? That would translate into a 3.16 percent return. Alternatively, if the market was down 20 percent when the note matured, the note would absorb the first 10 percent of the loss, and the rest would come out of the investor's principal. The reward doesn't seem quite worth the risk.

What's more, forgoing dividends is a big deal. Although only 2.2 percent currently on the average stock, dividend yields have accounted for 40 percent of investors' returns historically.

Credit Risk

It gets worse. Unlike traditional index funds, which hold a diversified basket of stocks, structured notes are primarily exposed to the credit risk of issuers. In 2009, securities lawyer Jacob Zamansky won the first of several arbitration cases against UBS Financial Services for selling structured notes issued by Lehman Brothers. The notes, which were designed to be 100 percent "principal protected" — meaning holders should not have been able to lose money — lost most of their value when Lehman went bankrupt.

"Investors were led to believe there was no way they could lose money, that the only downside is that they'd get the return of their principal," Zamansky says. "UBS never explained to them in writing or in conversations that these principal protected notes were subject to the creditworthiness of the issuer. There are hundreds of cases like this because of this miscommunication."

In an e-mailed statement, UBS spokeswoman Megan Stinson says, "UBS maintains that the Lehman Brothers structured product offering materials adequately disclosed credit risk, and that the vast majority of its Lehman structured product sales were conducted properly."

Unfortunately, there's an incentive for brokers to be less than forthcoming about the risks of structured notes. They get commissions anywhere between 1.5 percent for a standard S&P 500 note to 10 percent for more exotic notes tracking custom benchmarks.

These commissions aren't so easily detectable to investors because the issuer of the note pays the commission to brokers, rather than the investor paying, say, a front-end load to get into a mutual fund. Unless you read a note's prospectus, you wouldn't necessarily know the broker has an incentive to sell it to you.

Do-It-Yourself Notes

The real costs of issuing these notes are difficult to measure because the the cost of hedging and leveraging are baked in. That said, it's likely that diligent investors could get similar results more cheaply themselves.

In the case of Lehman's principal protected notes, it would be fairly easy and cheaper to replicate their protective features by assembling a mix of bonds, cash (which plays a role in some notes) and call options on the S&P 500. Zero coupon bonds that pay no interest but increase in value until they mature could replicate such a strategy when combined with options — without the credit risk of being potentially exposed to the next Lehman Brothers.

Structured notes are not always a bad investment — almost any investment can be attractive at the right price. Financial planner Kerry G. Mayo of Capital Financial Advisors in Clifton Park, New York, buys structured notes for clients at a discount to their issued price on what's known as the secondary market. Mayo is a fee-only planner so he doesn't seek commissions. Rather, he buys notes on exchanges from brokers whose clients have paid full price for them and now want to get out for whatever reason.

Because the notes are highly illiquid — meaning they don't trade very often — Mayo can get them on the cheap when investors panic and look for a buyer of last resort. So, unfortunately, the best way to make money on these notes is to buy them from those sorry they invested in them in the first place.