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A Note Tailor-Made to Fit Your Goal

By Ben Levisohn

They're the bespoke suits of the investment world—financial products that can be designed to meet almost any investing goal. They don't look so fancy at first glance. They're bonds, basically, backed by a bank. It's the financial accoutrements layered on that basic frame that distinguish these products and lead to their name: structured notes. I Most of these products share a common foundation in pairing a Treasury or corporate bond with an options contract; the option bets on the direction of a stock or stock index over time. The above-average income some products offer is part of their appeal in a low-rate environment. But it's the options contracts that give a "have your cake and eat it too" aspect to the deal. While enjoying steady income, investors can maintain exposure to the stock market and cap potential losses—and, in a trade-off some notes require, gains.

The use of structured products has grown rapidly, with their total value more than quadrupling, from $28 billion in 2003 to $114 billion in 2007. About half of that $114 billion was sold to individuals by brokers or financial advisers. The number of notes is growing as well. In May, 2007, there were 437 structured products aimed at individual investors, valued at $2.4 billion; in May, 2008, there were 634, with a total value of $4.2 billion, according to data from StructuredRetailProducts.com.

While it's smart to be wary when pitched complex products, it's easy to see why more investors are intrigued. The notes can be designed for almost any goal, from protecting retirement dollars to aiming aggressively at high returns. "There's a seemingly endless amount of them out there," says adviser Brent McQuiston of Scottsdale-based Wealth Trust-Arizona.

Principal protection notes, geared to insure against market losses, are popular now. They let you participate in some of the upside of a stock index, and if the index drops, you don't take a loss. "Investors don't want to lose money, even if it means giving up some gains," says Neel Tiku, a financial planner at Peak Financial Management in Waltham, Mass. Notes that offer double-digit yields, but come with far higher risks than typical fixed-income products, are also strong sellers.

The notes come with undeniable hazards. At the heart of what you're buying is a promise to pay by the issuer of the note—and such promises are only as good as the institutions that offer them. For years, the possibility of bank failure seemed remote, but the run on Bear Stearns (BSC)—a big player in structured notes—and troubles at Lehman Brothers (LEH) have brought the issue to the fore. The risk of another blowup, however slight, has some advisers leery of

buying in. "If a bank collapses, our clients become creditors. We don't want to expose them to that," says Michael C. Walther III, a wealth manager with Balasa Dinverno Foltz in Itasca, Ill.

Liquidity is also an issue. Investors must hold notes to their full term, anywhere from a few months to five years. The secondary market is thin to nonexistent, and if an issuer agrees to buy notes back, expect a big haircut. They can also be expensive. Prepackaged notes—those that banks like JPMorgan Chase (JPM) and Barclays Capital (BCS) usually offer in units of $1,000—typically have commissions of 2% to 3%. To cut costs, some independent advisers pool client assets to create a firm-specific product with commissions as low as .5%. But it takes at least $1 million to pique a bank's interest in a custom deal. Here are pros and cons for some common notes:

PRINCIPAL PROTECTION NOTES

The Draw As the stock market bounces around, investors can't know whether it's readying for a rally or prepping for a plunge. Staying in cash would be safe, but you'd miss any market gain. With a principal protection note, if the stock market drops, your money, which has been invested in a zero-coupon Treasury or corporate bond, is protected. But if the market rises, you can share in the rise, up to a certain point.

The Risks If the market stages a monster rally, you don't take part in the full move. And since the note is illiquid, getting out early would likely mean losing a big chunk of the principal you've tried so hard to protect.

REVERSE CONVERTIBLE NOTES

The Draw With yields low, it's hard to find attractive returns in fixed-income. McQuiston tries to remedy this for more aggressive clients by purchasing notes that provide regular payouts linked to the performance of a stock. A bank creates the note by selling a put option—an obligation to buy a stock if it falls below a set price during a fixed period of time. The bank provides monthly coupon payments, like a regular bond, out of proceeds from the sale of the put. When the note expires, the investor's money is returned. The products offer yields of 10% to 20%, says McQuiston.

The Risks All that yield comes at a price, and that is market risk. The note is built around the performance of a single stock. It has a built-in cushion so that should the shares drop, say, 30%, the investor is unaffected. But if the stock falls below that threshold at any time during the note's life, investors don't get their cash back—they receive only the shares and the loss. And if a stock moves up, the investor doesn't share in gains because returns are fixed.

McQuiston says he's unconcerned about missing the potential upside. He just wants to locate the strongest stocks (current favorites are US Steel and Arch Coal). He diversifies into 30 to 35 different notes, both buying prepackaged products and scooping up discounted notes in the thin secondary market, so that his clients have a broad basket of notes.

COMMODITY-LINKED NOTES

The Draw Many experts say we're in a commodities bubble. Invest now, and you might buy in just before it pops. If it keeps running, though, you miss out. Banks offer prepackaged commodity-linked notes, but wealth manager Walther is weighing whether he should create a note linked to the Dow Jones-AIG Commodity index on his own. With the structure he's contemplating, if the index has a gain, his clients would get roughly 1.5 times that gain, up to a cap of some 40%. The note would cover the first 10% of any downside; investors eat further losses.

The Risks Is 10% downside protection enough? When the dot-com bubble popped, the Nasdaq dropped 34% in two months, after trading at an all-time high in late March, 2000. Walther is negotiating an escape clause to enable clients to get out at any time with a 1% loss of principal. He has yet to go ahead with the purchase, however. Though he considers it unlikely, he worries about another Bear Stearns-type meltdown. He'll wait until the credit markets settle down before he closes the deal.