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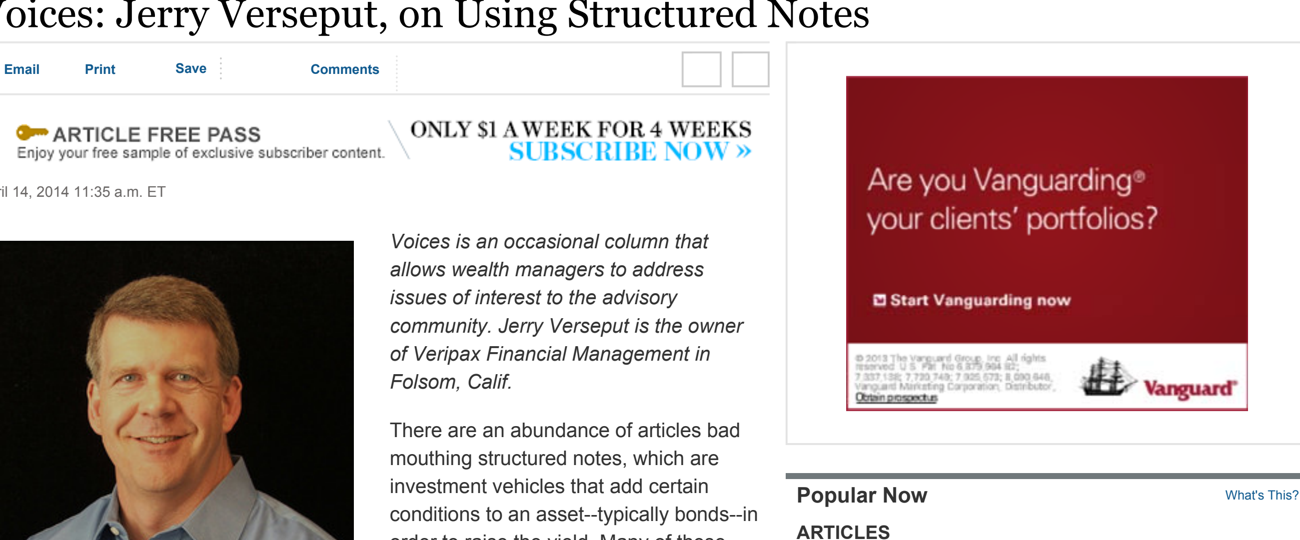

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Jerry Verseput

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Voices is an occasional column that allows wealth managers to address issues of interest to the advisory community. Jerry Verseput is the owner of Veripax Financial Management in Folsom, Calif.

There are an abundance of articles bad mouthing structured notes, which are investment vehicles that add certain conditions to an asset--typically bonds--in order to raise the yield. Many of these articles are filled with bad information amplifying the risks of structured notes.

Typically these articles go into detail about how your principal is not protected in a structured note and why that's awful. I look at that and think, "Yeah, just like a stock or a bond." With any investment vehicle, achieving a higher rate of return requires some form of risk.

With traditional bonds, you have to take on more credit risk to raise the yield, and go with a company that has less of a likelihood of being able to pay your money back. But structured notes allow advisers to choose different forms of risk in order to get a higher yield. I can have some credit risk, and some market risk.

There are two primary models of structured notes. Barrier notes base their returns on the performance of one or more stock index. As long as the indexes stay above a certain level, the note will pay a high interest rate between 8% and 8.5%. If it's below that barrier when the note expires, you only get part of your money back. But I say that if 20 years from now the market is down 50%, we've got other problems.

Meanwhile, steepener notes base their returns on the steepness of the yield curve. Typically they take the prevailing 30-year interest rate minus the two-year or five-year interest rate, and multiply it by four or five with a 10% cap. There have been a few occasions when the two-year rate has actually been higher than the 30-year rate. On those days the note doesn't create interest.

You can also do combinations of structured notes, which allows you to move risk around strategically, like chess pieces. I just did a structured note with a 50% S&P barrier and a steepener contingency. This leads to another criticism that I often read about structured notes: they're complex. That's true. You can have multiple moving parts. But how many people have read the prospectus on a mutual fund? Those things

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are hundreds of pages. What distinguishes structured notes is that they give advisers much more flexibility about where to place a client's risk.

Because of their complexity, structured notes can be vulnerable to adviser abuse, which is another complaint I often hear. There may be brokers who earn a fee selling these things who tend to minimize or even misconstrue the risk. But the problem is that this criticism tends to focus on the product itself, rather than saying there are some advisers who market it badly. An adviser worth his salt is going to explain the risk to clients.

Advisers should avoid getting caught up in the disproportionately bad press surrounding structured notes. They are one of the few investment vehicles that allow you to control not only the amount of risk, but the type of risk, so specifically.

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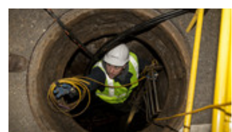

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