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JOURNAL REPORTS

Structured Notes Get a Bad Rap

Adviser Says These Investment Vehicles Give Investors Flexibility on Where to Place Risk

By **JERRY VERSEPUT**

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Structured notes, investment vehicles that add certain conditions to senior bank notes to raise the yield, get a bad rap. However, much of the criticism focuses disproportionately on the risks rather than the benefits.

Typically, critics focus on the credit risk or lack of principal protection in a structured note and why that's awful. I hear that and think, "Yeah, just like a stock or a bond." Achieving a higher rate of return with any type of investment requires some form of risk.

With traditional bonds, you have to add credit risk to get more yield. That means betting on companies that are less financially sound. Structured notes allow you to choose a different form of risk to get a higher yield. You will always have credit risk, but you can add market risk, too.

Two common types of structured notes are "barrier" or "contingency" notes and "steepeners." Some barrier notes offer yields in the 7% to 10% range as long as an underlying stock or stock index stays above a certain level. If the index is below the barrier level when the note expires, you incur the same loss as the index. I prefer notes with a 40% to 50% safety margin. My thinking is that if 20 years from now the market is down 50%, we've got other problems.

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"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 or more, with typically a 10% cap. On a few occasions, the two-year rate has actually been higher than the 30-year rate. On those days, the note doesn't accrue interest.

Structured notes can be crafted in practically unlimited ways, which leads to another criticism: They're complex. They are. And some are good and some are bad. But structured notes also 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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