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## **The One Investment You Don't Need**

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If you have a “structured note” in any of your investment portfolios, please read this commentary. If you don't, congratulations – you've avoided an opaque, illiquid, costly, and tax-inefficient investment.

We don't put structured notes in client accounts. However, we've seen several accounts transfer in with them, and the industry sold over \$50 billion of these securities last year, which leads me to suspect that some readers of this commentary may have a structured note lurking in an account somewhere. At the very least, owners of these things should ask their financial advisor a few pointed questions, for reasons that will become clear in a moment. (These securities may be listed on your brokerage statement as “structured products.”)

First, what are structured notes? (Again, if you don't know, and don't own any, count yourself lucky.) These securities are notes (debt) that have a specific maturity date, and which are packaged with derivatives to give the owner exposure to the return of an asset or basket of assets. For example, a structured note could be linked to the return of a single index like the S&P 500, a basket of indexes, a basket of stocks, a basket of commodities, or even a currency relationship. Typically, the structured product has a customized payout – it may be principal protected, or have a “buffer” that limits downside risk in exchange for capping upside potential.

The ability to gain exposure to the return of unusual assets – perhaps a basket of currencies against the U.S. dollar – and the customized payout profile are the usual selling points of structured notes. Certainly, added diversification can be a benefit, and hedging against potential losses is appealing to many investors after what the market did in 2008-2009.

However, you don't get something for nothing in any walk of life, and this is especially true on Wall Street. If, for example, you want a structured note linked to the S&P 500 that is principal protected – instead of just buying an S&P 500 index fund – be assured that the benefit of downside protection will carry a cost. Some of these costs are explicit, in the form of fees and higher taxes, and some are implicit, in the form of illiquidity and complexity.

### What's My Return?

The biggest problem with structured notes is that that your returns may be calculated in very strange ways. Generally, these securities are marketed as having a return that is “linked” to a security, or a basket of securities, but that linkage is often not well understood by advisors and owners.

Let's look at a real-world example of a structured note issued last year by a large U.S. bank. This note has a term of six years, is principal-protected, and the return is linked to the value of a global index basket made up of the Dow, the Nikkei, and the Euro Stoxx 50. You might think that the investment return would be based on the compounded total return of those three indexes over six years. That would be simple and logical.

However, structured notes are almost always based on price returns – not total returns – so you wouldn't get the benefit of dividends. This is a big deal, since dividends generated about half the total return of the S&P 500 over the past 80 years, and generated even bigger proportions of total return in many other

markets. So, a price return will *always* be lower than a total return – often substantially. I strongly suspect most advisors who recommend structured notes are not aware of this.

But at least over six years the holder of this structured note will get the benefit of compounded price returns, right? Nope. The final value of the index basket, oddly enough, is not simply the ending price of the basket in six years – instead, it's the arithmetic average of the index basket's year-end values.

This is beyond weird. Imagine buying Apple today for \$335, and six years from now, it trades for \$500. You would make about 50% on your investment, regardless of whether Apple was temporarily higher or lower between now and 2017. But using the cockamamie return calculation of the structured note described above, you would need to average Apple's closing price at year-end 2011, 2012, 2013, and so forth, and use that average value to determine your investment return. Without boring you with the math, I will simply note that the average price of an asset that generally rises in value over time will *always* be lower than its final price.

I doubt more than 5% of the advisors who recommended this particular note could fully describe how its returns are calculated, and I did not cherry-pick a particularly oddball structured note. These securities are almost always complex, and not terribly investor friendly. There's nothing intrinsically wrong with complexity if you benefit from it in some way – but in this particular case, the complexity just robs the note holder of dividends and of compounding, two very important sources of investment returns.

#### Fees

Most structured notes that I have seen have an initial fee of around 3.5%. Usually, this is not called a “commission” – which allows an advisor to say with a straight face that the security doesn't have a commission – but it may be called an “underwriting fee,” a “structuring fee,” or a “distribution fee.”

While a 3.5% fee may not sound like a lot, bear in mind that many structured notes have capped upside which investors accept in return for limited (“buffered”) losses, or for principal protection. If, for example, a structured note is capped at a 15% return, clipping 3.5% off of your initial investment means your after-fee return is limited to 11%.

#### Liquidity

Structured notes have very limited liquidity. Usually, the dealer will buy one back from a holder who absolutely must sell, but only at a significant discount.

Like complexity, there's nothing intrinsically wrong with illiquidity – after all, many hedge funds and all private equity partnerships “lock up” their investors for some period of time. But the investor who gives up liquidity should expect something in exchange, which is typically a higher expected return than he or she could get on a more liquid security.

With structured notes, however, the investor trades away liquidity in exchange for less volatility, not in exchange for higher returns. If lower volatility is the investment objective, it's pretty simple to achieve it by simply altering the asset mix – holding more cash, or more bonds – without sacrificing any liquidity. (And without getting clipped 3.5%, I might add.)

#### Taxes

So, we have a complex, illiquid security that may not deliver you the return you expect, and which will cost you 3.5% to purchase. But as they say in late-night infomercials – “Wait, there's more!”

If a structured note is principal protected, it is treated as debt of the issuing institution for tax purposes. So, the investor's return is taxed at the ordinary income rate, not at the more favorable long-term capital gains rate. For a high-net-worth investor in a 30%+ bracket, this is not small potatoes.

This tax treatment essentially adds insult to injury. Instead of receiving a favorably-taxed stream of dividends that compound over time, the structured note investor receives a punitively-taxed stream of interest income that does not compound. Quite the deal.

### Not Our Cup of Tea

At the trust companies, we prefer investments that are liquid, transparent, and low cost. Structured notes fail all of these tests, so we don't use them. Yes, these securities can give investors exposure to unusual assets – but similar exposure can often be achieved via low-cost ETFs. Yes, these securities offer lower volatility – but generally at a very high implicit and explicit cost.

If you have a structured note or structured product in any of your investment accounts, it might be a good idea to ask your financial advisor a few questions:

- 1) How is the return on this security calculated? Ask for specifics, since a return that is “linked to” an asset or basket of assets could be calculated in a variety of ways. Inquiring about total returns (which include dividends) versus price returns (which don't), and asking how the ending value of the reference asset or basket is calculated would be two good places to start.
- 2) What is the tax treatment of this security? Specifically, ask whether it qualifies for the favorable 15% long-term capital gains rate, or the higher rate attached to interest payments. Also, if the structured note does not have periodic payments, ask whether you have to pay taxes on “imputed income.” (Much like a zero-coupon bond, some principal-protected structured notes require the holder to pay taxes on assumed interest that has not actually been received.)
- 3) What fee did I pay to purchase this security? Are there any ongoing fees?

If the answers you receive are not what you expected, or if your advisor has trouble coming up with them, you may want to reconsider whether the purported benefits of structured notes outweigh their many shortcomings.

### Postscript

You may enjoy this recent [interview](#) with yours truly on Morningstar.com about beating the market through better investment behavior.

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