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STRUCTURED PRODUCTS WALL STREET'S NEWEST IDEA

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The market for structured products has quickly become the latest boom for Wall Street, international banking firms and broker/dealers alike. Annual structured product sales comprised only a small portion of the investment offering line-up in 2003 with approximately \$28 billion in sales. Sales in 2007 jumped a whopping 78% to a total of \$114 billion. According to the Structured Product Association, a New York based trade group, this huge increase in demand pleased and surprised everyone involved.

What is a “Structured Product?” In the most general sense, structured products involve the use of some type of derivative to meet an investor’s specific need or investment outlook. Structured products are most commonly used as a portfolio enhancement tool to increase returns while limiting the amount of risk taken. Structured products can take on any number of forms.

For example, some structured products may resemble a **fixed income security**, such as a zero coupon bond, which guarantees that part or all of your principle will be returned at a defined maturity.

Another type of structured product behaves as an **option-like instrument**, which may provide an additional payoff on top of the fixed income payment at maturity. This additional payoff would be linked to the performance of an underlying asset and may take the form of coupon payments at pre-defined intervals or a one-time payment at maturity.

Structured products are custom-tailored to meet the needs of investors seeking different types of strategies. More strategies are being created every day, but here are a few of their most common forms:

Protection - Protect the portfolio by hedging the risks of existing investments.

Enhancement - Increase a portfolio’s return while controlling risks.

Diversification - Diversify with adjustable risk/return profiles and market cycle optimization.

Market View - Allows investors to exploit a market view with more flexibility.

Growth - Capitalize on the market upside while protecting the downside.

In 1992, we saw the advent of structured products. They began at the institutional level and have now funneled down into smaller institutional accounts and individual investor accounts as well.

CAPTRUST'S VIEW ON STRUCTURED PRODUCTS

Like many ideas coming out of Wall Street, while the initial concept may be sound, the real challenge is in the execution. As we have said before, especially on the subject of hedge funds, "The devil is in the details."

More to the point, we would be disinclined to recommend structured products for the vast majority of our clients. Why the opposition? Here are a few reasons why:

- First and foremost, all structured products are backed by the creditworthiness of their issuer. This means that once a product reaches its maturity date, an investor will be looking to the issuer, such as UBS, Citi, or BNP Paribas, for payment regardless of the outcome of the investment.
- Secondly and just as important, there is absolutely no guarantee of liquidity until the product's "maturity date."
- Thirdly, there is no reliable stream of income, although with some structured products payments may or may not be paid at certain intervals.
- Fourth, if the underlying is an index, the structured product's performance is linked to the performance of the index only and does not take into account the dividends that are paid by the individual securities within that index.
- Lastly, there is the matter of fees. There are two types of fees charged on structured products. Distribution Fees are earned for developing and distributing the structured product and are disclosed in the offering document. However, there are also structuring fees charged on each product that are used to hedge the payment obligation of the product. These fees are not disclosed in the prospectus and are "embedded" in the terms of the structured product.

These are only a few of the drawbacks that we see with structured products. How many investors would be willing to give their money to a bank, such as UBS, for the privilege of betting on the S&P 500 and then wait two years to see if they are right?

While this may be a bit of an over-simplification, it is possible that an investor could be right and still lose their money. In recent months, we have seen the failure of Bear Stearns and IndyMac. Today's headlines are abuzz about Freddie Mac, Fannie Mae, Lehman and Bank of America hitting new lows. Now more than ever, especially with structured products, the credit-worthiness of the issuer is critical.

In addition to the concerns we have already outlined, another factor that gives us pause is the cost associated with structured products. We have had conversations with the issuers of structured products and have either been told there are "no costs" or the costs have been "factored in." This kind of vague answer always gives us cause for concern. Would you trust a car dealer who said that he didn't know what he paid for a car, nor did he know what he'd get paid when he sold it? The truth of the

matter is that the costs are roughly 1.5% - 2.0%. This does not include opportunity costs due to lack of liquidity of a structured product. Needless to say, many of the same investments could be put together by investors themselves, with lower costs, assuming they want to do it themselves. It also goes without saying that the firms offering structured products can make a lot more money than by just recommending stock or bonds.

As fund manager Mohamed El-Erian wrote in the Financial Times, the biggest banks are changing their business models to grab more of the high fees generated by developing and offering structured products.

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