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Do-it-yourself structured notes

By Robert N. Gordon

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As discussed in earlier columns, there are two types of structured-note products — those without a principal guarantee and those that guarantee the return of principal as a worst-case scenario.

Profits from notes that don't guarantee principal are typically taxed as capital gains. Any payoff above the invested capital on a principal-guaranteed note is taxed as interest.

Earlier, too, I discussed two note products of the non-principal-protected variety.

One of these is a structured note designed to pay a higher rate of interest if tax rates on individuals rise.

The other are exchange traded notes. ETNs are not mutual funds, although they trade like exchange traded funds. The similarities in form between ETNs and exchange traded funds — but the apparent disparity in their tax treatment — is causing a dust-up in Washington.

It has been reported that the Investment Company Institute in that city has made it a priority to have the apparent advantage of ETNs changed.

But let's turn our attention away from the unprotected-note world and look at a product on the other side: principal-guaranteed structured notes.

Such notes, in the form of certificates of deposit tied to the stock market, may be just what many investors are looking for — a seemingly safe way to bet on a risky asset, all in a simple package.

Principal-guaranteed structured notes products pay an interest rate on the amount invested that is calculated based on an index or asset price. They are available as exchange traded notes, as over-the-counter privately negotiated contracts or as CDs.

For financial advisers sophisticated enough to forgo the available products and build the note in its component parts, there are several benefits: lower cost, higher-rated counterparties and significantly better tax treatment.

Here's how to do it.

First, consider what the note issuer is buying in order to deliver to the investor the promised return with limited risk.

An adviser can replicate the principal guarantee by purchasing a zero-coupon bond due at the maturity of the note. Today, a five-year U.S. Treasury zero costs about 80 cents on the guaranteed dollar.

Next up is the possible payoff tied to an index or asset. The issuer (or in this case, the do-it-yourself adviser) will have about 20 cents on the dollar left to buy an option to produce the promised return.

In the example of a CD linked to the Standard & Poor's 500 stock index, the issuer would buy an at-the-money call on an S&P 500 exchange traded fund. The triple-A Options Clearing Corp. in Chicago guarantees these listed options.

By purchasing these two instruments, the adviser can offer the investor the upside of the market with no downside.

Let's take as an example Islandia, N.Y.-based EverBank's MarketSafe Gold Bullion CD, which was mentioned in a recent edition of The Wall Street Journal.

This is a five-year certificate of deposit guaranteeing the purchaser's money back if gold de-clines, and a payoff if gold rises.

Today, a five-year U.S. government zero-coupon bond costs 83 cents on the dollar and an at-the-money call option on gold costs about 15 cents on the dollar.

If an adviser bought these instruments himself instead of EverBank buying them to offer a CD, the adviser would save 2%, investing just $98 instead of $100. The investor also would be better off with the U.S. government guaranteeing the principal and a triple-A rating behind the options.

Once we consider tax advantages of the do-it-yourself approach, the choice is clear. Remember, in a principal-guaranteed structured note, any payoff above the amount invested in the CD is taxed as interest income at the highest rate — there are no capital gains from an investment in a principal-guaranteed note as there are in notes without a guarantee.

Going back to the EverBank gold example, therefore, if the price of gold rises and profits from the CD increase, these gains are taxed as interest at 35%. Had an investor instead bought a gold option, any appreciation would be considered a capital gain and be taxed at 15% if held long term and 35% if held for less than a year.

Note also that long-term gains on gold bullion are still taxed at 28%, while gold options aren't.

Another issue investors and advisers should consider when exploring structured notes is just how the interest rate is calculated.

According to the offering information on the EverBank website, the return is calculated using the semiannually averaged return as if the investor had held gold. This is known as an Asian option, which is generally much less expensive to purchase than conventional options.

The payoff from an Asian option is not necessarily worse than a simple payoff, but it probably will turn out to be less than what the investor expects.

For example, say gold goes up 40% over the next five years at an even 4% every six months.

If an investor purchased a conventional at-the-money call option on gold, he would expect the 40% payoff. But if the Asian-option method based on a semiannually averaged return were used, the payoff would be only 22%.

Alternatively, if gold were to spike up and then later revert to a lower close at maturity, the investor would receive some interest if the Asian option were used but none using the conventional call.

As always, the devil is in the details.

While on the subject of analyzing the payoffs and calculations associated with structured products, I'd like to take note of reverse convertibles. Sporting tantalizingly high stated interest rates, these structured notes do not offer principal protection and are the economic equivalent of writing naked puts.

While there's nothing wrong with partaking in the risks and of writing uncovered put options on individual equities, I'd like to make sure the buyers of reverse convertibles know what they're getting into.

For those willing to take the risks, reverse convertible notes are a very simple way to get that exposure without complicated margin calculations and their inevitable cash flows.

Principal-guaranteed structured notes, by contrast, are a very simple way to increase market exposure without complicated margin calculations and their inevitable cash flows.

Structured notes can be quite helpful in an asset allocation context to both professional investors and to those less sophisticated. The note's simplicity is its most attractive feature.

For the average investor, a principal guarantee can allow entering an asset class that the investor otherwise may have avoided.

For the professional, notes can offer an easy way to capture the payoff of a strategy or mix of payoffs that would otherwise have too many moving parts to exploit on their own.

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