

Financial Newsletter

Capital Conserved Investment Management Evolution from Structured Notes to Structured Investment Solutions

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Structured products have been in existence for a long period of time. Traditionally, Asian and European centers have utilized these. However, since 2003 the growth of structured products in the U.S has been strong. Between 2003 and 2007 structured product issuance in the U.S has grown from \$ 28 billion to more than of \$ 100 billion (Structured Products Association website). We attribute this growth to a low interest rate environment and an increase in geo-political tensions. Investors were looking for relatively high return with assurance of safety of capital. Structured products met both these criteria. Here was a product which enabled investors to participate in various markets with the relative safety of a large financial services corporation – until the recent financial and credit crises. The hitherto negligible risk of default of a financial institution has become a very important factor, especially after the debacle of Bear Stearns and Lehman Brothers. These events raised concern amongst investors that the issuers may not necessarily be able to return their principal or pay out the appreciation of the note.

Today, the credit of the issuer is a major concern. However, it is important to distinguish these products from the credit products that have been the cause of the credit crises. Unfortunately, structured notes are often put in the same bucket as the structured credit products. Structured notes do offer an interesting alternative in today's volatile and choppy markets. Structured notes come with various risk-return profiles. The permutations are endless. The end result is usually different levels of principal protection, ranging from 0 to a 100% protection of principal. The type and level of protection affects the expected returns. At the most basic level structured notes are a combination of a fixed income instrument and a derivative that provides exposure to an underlying market; Equity, Currencies, Commodities to name a few.



Structured notes are extremely useful in satisfying the asset allocation of a portfolio. For example, a structured note designed to benefit from the upward movement of an emerging market index is useful in satisfying the emerging markets equity bucket. They are also valuable in addressing a theme, such as bearish U.S \$ against other currencies. Due to their risk characteristics, these are ideal to express a view in volatile markets, where other 'long only' alternatives may prove too difficult to monitor or hold onto. Recent stock market or commodities activity is a case in point.

Structured notes do suffer from certain limitations. Firstly, these products are designed for holding till expiry. This raises the concern regarding liquidity. Often, the issuer can buy these back from the investor at the prevailing market prices, but

often there is no secondary market. In the U.S one may have to address the issue of 'phantom income' for protected notes. The holder of these may have to pay taxes on the phantom income, even if the investor does not liquidate the instrument, thereby creating a cash flow concern. (Please consult your tax advisor on this matter). As mentioned a more recent constraint has been the worry regarding the issuer's credit.

On balance, the concept of structured products is appealing in many cases. However, if we can remove or reduce some of the concerns, the value of these solutions will grow. For the ultra high net worth client, the concept can be used to create a customized note. Taking this discussion a step further is the concept of capital preservation and alpha generation to provide similar results as

a structured note. We call this the **Structured Investment Solution**.

Take the case of a 100% principal protected note. It can be decomposed into a zero coupon bond that will grow to the face value of the note at maturity, and an option component linked to one or several asset classes that will provide potential return for the note at maturity. Whether the investor actually receives the face value and potential payout of the option is dependent on the issuer of the note. Recent, well-publicized events highlight this fact: Lehman issued 100 percent principal protected note which were sold to UBS clients and were only worth about 14 cents on a dollar. The investors of these notes become general creditors, just like other unsecured lenders to the bankrupted entities.

One solution for the sophisticated investors is to manage the bond component and the option component separately and to synthesize the payoff of a structured note, without actually purchasing the packaged note from a specific issuer. By doing so, the bond component can be customized to suit one's particular credit risk tolerance and tax preference. For investors demanding highest credit quality, the bond component can consist of US Treasury securities; for investors demanding lowest possible taxable income, the bond component can comprise of triple tax free municipal obligations; and for



investors with high tolerance to credit risks, the bond component can be made of corporate bonds, even further enhanced by sovereign credits for higher yield. Meanwhile, the option component, the alpha engine of the investment, can be invested in a variety of asset classes. In this case the premium is paid upfront and the benefit gained is the leveraged upside at maturity when the linked asset classes perform.

For example, a tax sensitive investor, with a two-year investment horizon, requires capital preservation, but also desires exposure to the US equity market. With \$100 capital, the investor can allocate \$95 to the purchase of appropriate triple-tax free municipal bonds which currently yield about 2.5%, and \$5 to buy 2yr at-the-money listed SPYDER (S&P500 Exchange Traded Fund) calls. At the end of the two-year investment horizon, the municipal bond investment, along with reinvested coupons received over the two years, will be worth roughly \$100. The initial \$5 premium invested in SPYDER calls will give you about a quarter of the positive return on S&P 500, i.e. if over the two years the S&P 500 goes up 40%, the investor will receive 10% multiplied by the notional amount of \$100, or \$10 in return. This is the alpha portion of the portfolio. The value of the portfolio would be \$ 110. If S&P 500 is below the current level, then the investor will lose his initial \$5 investment. The value of the portfolio would be \$100.

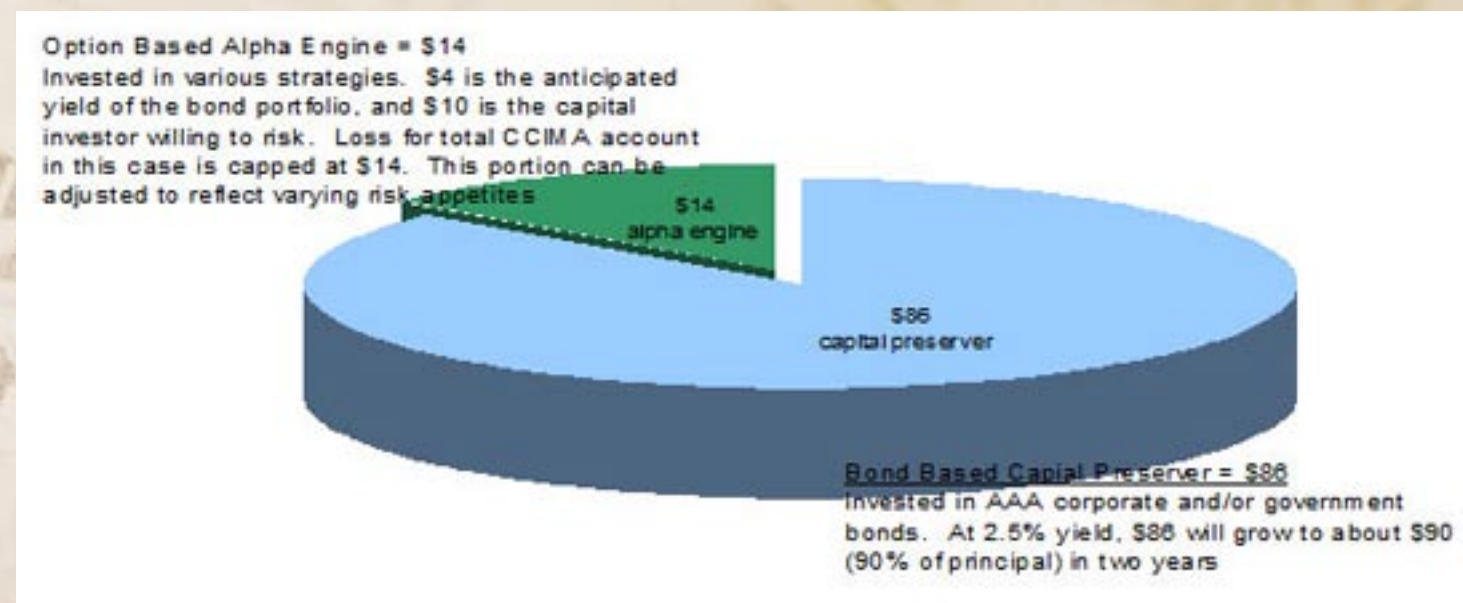
Despite there being no specific guarantee by an issuer, the benefit of this arrangement is multifaceted. First of all, it eliminates much of the single issuer credit risk, and relies on municipal government for the bond obligation. Secondly, there should not be any phantom income issues because the investor is investing in triple tax free municipal bonds. Thirdly, the payoff on the option (if listed on the options exchange) is backed by AAA-rated Options Clearing Corporation. Moreover, any gains on the option will be likely treated as long-term capital gains, rather than ordinary income on a principal protected note. In addition, this investment strategy adds flexibility and customization for a sophisticated investor. (For detailed tax advice, please consult your tax adviser).

Taking this discussion one step further, we can create the Capital Conserved Investment Management Accounts (CCIMA). These accounts are essentially capital conserved through a portfolio of customized fixed income instruments, and generating alpha through a portfolio of macro theme based option instruments. If an investor has a slightly higher risk appetite and is willing to risk 10% of the capital, the investor can create a 90% Capital Conserved Investment Management Account.

Let's look at a more detailed example. Let's assume that a sophisticated investor wants to invest \$10 million in CCIMA and would like to have a minimum of 90% of this money back in two years. In this case, \$8.6 million will be invested into a customized bond portfolio which, at 2.5% yield, will grow to roughly \$9 million in two years time for the capital conservation. The remaining \$1.4 million is divided into, say, seven lots of \$200,000 each. These seven lots are then invested in seven macro theme based strategies through bought options. These options are structured to take full advantage of asymmetric risk/reward opportunities in macro investing. The maximum loss is always capped at the amount paid for each option. The upside is often heavily leveraged to generate significant returns for the entire portfolio. Some examples



of macro themes are yield curve steepening and flattening trades; U.S \$ against baskets of currencies; various commodity plays; emerging market equity baskets; multi-index range knockouts; consumer staple vs. discretionary; large cap value vs. small cap growth. Investor should proactively monitor these trades and evaluate exit strategies when appropriate.



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