The Alchemy of Structured CDs

SYNOPSIS

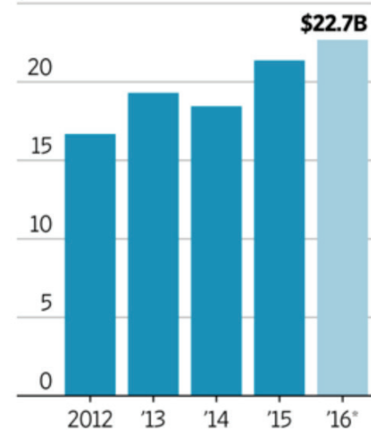
- A structured certificate of deposit pays a portion of the return of a benchmark instead of a fixed interest rate, and the principal is guaranteed from loss.
- Although such an investment sounds attractive, any structured product must be approached by investors with heavy skepticism.
- The risk/return relationship is as fundamental to our world as gravity, and anyone or anything offering you big returns with no risk is bad news.

THE RISE OF STRUCTURED CDS

A structured certificate of deposit (CD) is similar to a traditional CD in the sense that it takes an investor's money and locks it up for three to ten years. Both are FDIC insured up to $250,000, which protects an investor in the event that the issuing bank was to go under, but that's about where the similarities end.

Whereas a traditional CD pays a fixed interest rate, structured CDs pay a portion of the return from a basket of investments or an index such as the S&P 500. Therefore, if the index surges over the holding period, an investor can potentially do much better in a structured CD than a traditional one at a fixed percentage rate (particularly in a low interest rate environment).

These products have actually been around in one form or another since the 1980s, but this chart in the next column from a recent Wall Street Journal (WSJ) article shows that their popularity has surged over the last five years.



Upon first glance, structured CDs appear to be like a no-brainer because they offer exposure to the upside of an index like the S&P 500 but also shield an investor from the downside.

Their rise in popularity is primarily due to two drivers:

1. **Chase for Yield:** Since income is no longer attainable in traditional CDs and other ultra-low risk investments, investors are so desperate that they are willing to explore these exotic options for any chance at a return higher than zero.
2. **Fee Income**: Regulations and this whacky interest rate environment have made it tough for banks to make money from loans. The fees that they earn from selling these structured products is a high margin business at the moment, so management teams are pushing their sales teams to sell them far more today than in years past.

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Upon first glance, structured CDs appear to be like a no-brainer because they offer exposure to the upside of an index like the S&P 500 but also shield an investor from the downside. However, a deeper dive will give us a clearer picture of how these products work.

STRUCTURED GARBAGE

I was introduced to structured CDs about five years ago, and after hearing the sales pitch, I was skeptical from the very beginning. However, it's always best to approach new ideas with an open mind, so I gave them a shot.

After completing my objective analysis of the benefits and drawbacks, my intuition proved to be correct and concluded that a better name for these products would be "structured garbage".

There are so many problems that it's tough to decide where to start. In the spirit of brevity, I have only listed what I consider to be the most egregious issues with structured CDs:

- **Lack of Oversight**: They are not required to be registered with the Securities and Exchange Commission (SEC), and the brokers who sell them are also not required to be licensed. Meaning, there is no real performance data to analyze, and the regulators are mostly ignoring those who sell them and the victims that own them.
- **Huge Front-End Loads:** Up-front fees range from 3% - 8% of the principal, so an investor has a sizeable hurdle from day one to overcome just to break even.
- **Withdrawal Penalty:** The most common penalty for early withdrawal from a conventional five-year CD is a year's interest. Structured CDs will cost you much more and in the form of a chunk of the principal.
- **Phantom Income**: Many structured CDs only pay their return at the end of the contract. However, the issuing bank could still slap you with an annual 1099-INT for "accrued income," which is interest earned, but that has not yet been paid. Said another way, you pay taxes on income that you have not even received yet in nonqualified accounts.
- **Diversification Issues:** The benchmarks used for many structured CDs are often nothing more than a basket of 10-20 stocks. The lack of diversification exposes investors to potentially far more volatility.
- **No Dividends:** Believe it or not, but those that are benchmarked against an index like the S&P 500 exclude the dividends in the return calculation. For example, if the S&P returned an average of 5% with a 2% dividend yield, then it would only pay 3% total.
- **Complex Returns:** Most of these utilize incredibly complex payout formulas governed with floors and caps and then average the value after accounting for these adjustments

Let's combine the last two points to see how the banks skew the outcome to their favor. A structured CD cited by the WSJ offered a floor of 30% and a cap at 5% based on the returns from a basket of twenty stocks. If 18 of these stocks were up 25% and two were down 25%, after removing dividends, then the return of the basket is 20% for the year.

However, since the structured CD caps gains at five percent, those 18 home runs become singles. Losses are allowed to run six times larger than gains, so add everything up and the actual return to the investor is a total of two percent.

The issuers would likely counter that the first $250,000 is guaranteed by FDIC insurance, so the worst-case scenario is that an investor would get his/her money back. While this is technically true, it's important to understand that the initial value is net of fees.

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For example, if an investors gave a bank $100,000 to put into a structured CD that had a 5% up-front fee, then the amount that goes into the CD is $95,000. The FDIC insurance would only cover the $95,000 to leave the investor with a $5,000 loss. Oh, and speaking of the FDIC, they are also not a fan of structured CDs. Back in the spring of 2012, they issued a warning to investors regarding these products.

NOTE*: The same WSJ article cited an example of this complexity from a recent lawsuit. Documents related to the structured CD, including a description of how the return was calculated, totaled 266 pages and used calculus, hypothetical back-tested data and flowcharts. Nothing investible should ever be this complicated.*

IMPLICATIONS FOR INVESTORS

Structured Finance is a segment of the financial services industry that has been around for a while, and its goal is to create products that generate a return while eliminating the inherent risk within an investment. They attempt to do so by utilizing complicated strategies that often require a Ph.D. in mathematics to follow.

This modern-day alchemy often tries to disprove the most fundamental concept of investing, which states that earning higher returns requires a commensurate amount of risk. They may as well be trying to disprove gravity.

Structured CDs are not the first attempt at generating higher risk-free returns, and they will not be the last. They are also likely here to stay since the regulators seem to be more occupied with trying to jail billionaire hedge fund managers for insider trading than protecting every-day citizens from getting ripped off by banks.

Hence, it's up to you to shield yourself, and working with a financial advisor who acts as a fiduciary with your best interest in mind is a great first step because not all structured products are bad.

Just be sure that you understand how they work prior to investing, and if it sounds too complicated, then simply pass.

The bottom line is that there is no way to receive the return from an investment without carrying the risk, and anyone who tries to tell you otherwise is either inexperienced or attempting to rip you off.

Sincerely,

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