

Market-linked CDs bolster structured-products industry

Certificates of deposit that link investment returns to stock market indexes are helping prop up the sagging structured-products industry.

These bank-issued products — sometimes called indexed CDs or market-linked CDs — are gaining appeal among conservative investors drawn to the security associated with a traditional CD and the potential upside of equity market or other benchmark performance.

Some market watchers warn, however, that “there is no free lunch” and that financial advisers and their clients need to understand the various distinctions between indexed CDs and traditional CDs.

“Right now, these are still products that are sold, and not necessarily bought, and the [product manufacturers] can be very creative and theoretically, at least, very reckless,” said Keith Styracula, chairman of the Structured Products Association in New York.

First created more than two decades ago by what was then Chase Manhattan Bank of New York, indexed CDs are in some respects hybrids of bank CDs and structured products, offering specific upside exposure and downside protection.

ATTRACTIVE FEATURE

The fact that they are CDs, and not registered securities like most structured products, is one of the most attractive features of indexed CDs: The principal investment is guaranteed for up to \$250,000 (\$500,000 for joint accounts) by the Federal Deposit Insurance Corp.

The level of FDIC insurance for bank deposits, including CDs, was increased last year from \$100,000, and that temporary in-crease was extended last week to be in place through the end of 2013.

From January through May, indexed-CD sales represented 15.4% of the \$10.8 billion in structured-product sales.

This compares with 6.5% of \$17.7 billion for the comparable period a year earlier and 8.3% of \$14.2 billion during the first five months of 2007, according to Arete Consulting Ltd. of London.

In 2007, before the credit crisis exposed many of the risks associated with structured products, the industry saw record sales of \$107 billion, up from \$62 billion in 2006.

In 2008, total industry sales dropped to \$70 billion, according to the Structured Products Association.

“This is good for helping to get risk-averse clients back into the market,” said Mike Abelson, senior vice president of investments and product management at Genworth Financial Wealth Management Inc. in Pleasant Hill, Calif.

Genworth, which operates a \$15 billion platform that allows financial advisers to build customized portfolios for their clients, began working this month with The Goldman Sachs Group Inc. of New York and other banks to create indexed CDs that can be offered for sale on its platform.

While the FDIC insurance comes with the full faith and backing of the U.S. government, the various indexed CD structures are far from the straightforward products most investors might ordinarily associate with a certificate of deposit.

For instance, the principal is guaranteed only if the indexed CD is held to maturity, which typically ranges from three to five years. And once it matures, the income is taxed as ordinary income, as opposed to the lower capital gains rate with ordinary CDs. Also, while the principal is FDIC-insured, the accrued income is not protected, which means there is a risk associated with the creditworthiness of the issuing bank.

“Coming off of 2008, people are looking for principal protection and we're getting a lot of inquiries from clients, but this is definitely not your father's CD,” said Kevin Mahn, chief investment officer with Hennion & Walsh Asset Management Inc., a Parsippany, N.J.-based firm with \$2 billion under advisement.

Like traditional CDs, the indexed variety does not include a fee charged to investors. However, some brokers do charge commissions when selling them.

Like other structured products, the indexed CDs offer a range of target-performance options, which includes performance pegged to anything from the Dow Jones Industrial Average to inflation: One introduced this month by Barclays Capital Inc., the New York-based investment banking division of Barclays PLC in London, links performance to the consumer price index.

Depending on what the CD's performance is linked to, the majority of an investment will typically be used by the issuing bank to purchase enough Treasury bonds to guarantee the principal. The remaining 30% or so will be invested in derivatives to generate synthetic exposure to the target benchmark.

The derivative exposure is where investors take on the risk, no matter how remote, that the issuing bank could go belly-up. It's not the risk of bank default, but the lower-interest-rate environment in general that concerns Scott Miller Jr., managing partner at Blue Bell (Pa.) Private Wealth Management LLC, which has \$300 million under advisement.

“The low interest rates and high market volatility have made it hard for firms to create a good structure right now,” he said. Mr. Miller said he has seen indexed CDs that are not offering 100% of a benchmark's return and are providing performance exclusive of dividend yields, but at least one product provider insists it can meet investor demand for both performance and protection.

“We strive for 100% index participation,” said Mike Sherzan, president and chief executive of Bankers Financial Services Corp., a Johnston, Iowa-based firm that creates indexed CDs for regional and community banks in 13 states.

“The costs of the guarantees have become more expensive. Without question it is a problem right now,” Mr. Sherzan added.

Even with the recent stock market rally, some industry representatives believe the appeal of indexed CDs could continue to grow for investors looking for principal protection with some potential for upside.

“I think it offers peace of mind,” said Philippe El-Asmar, head of investor solutions at Barclays.

By Jeff Benjamin