PROSPECT NEWS
Market Newsletters for Professionals

Reprint

The Prospect News
Structured Products Daily
Thursday January 2, 2014

Structured Products

	Current Year	Previous Year
All U.S. Structured Products		
Year to Date:	$50.523 billion in 8984 deals	$55.480 billion in 8711 deals
Quarter to Date:	$10.309 billion in 2241 deals	$9.246 billion in 2186 deals
Month to Date:	$3.114 billion in 689 deals	$2.534 billion in 664 deals
Breakdown of Year to Date Deals		
Exchange-traded notes	$12.522 billion in 891 deals	$20.274 billion in 601 deals
All U.S. Stock and Equity Index Deals	$34.628 billion in 6855 deals	$29.050 billion in 6668 deals
Single Stock U.S. Structured Products	$8.963 billion in 4010 deals	$7.171 billion in 4312 deals
Stock Index U.S. Structured Products	$24.862 billion in 2724 deals	$21.416 billion in 2244 deals
FX U.S. Structured Products	$0.598 billion in 127 deals	$0.941 billion in 163 deals
Commodity U.S. Structured Products	$4.257 billion in 653 deals	$3.936 billion in 643 deals
Interest Rate Structured Products	$1.668 billion in 131 deals	$0.356 billion in 40 deals
Interest Rate Structured Coupons	$46.062 billion in 1561 deals	$100.958 bln in 2712 deals

OUTLOOK 2014:

Sellsiders expect more income products; more volatility would help buffering

By Emma Trincal

New York, Dec. 31 – The search for yield, the need to gain buffered equity exposure, especially if the market corrects, and the need for alpha through sophisticated underliers are among the main themes issuers have in mind for the coming year.

Income-seeking structures

As a first theme, sources predict that income-generating instruments will remain in high demand even if rates do go up.

"If rates continue to remain relatively low, structured notes will remain very appealing for income. I think this trend will continue next year," said Glenn Lotenberg, managing director, head of structured products trading and distribution for Boca Raton, Fla.-based Incapital LLC.

"For an older investor who doesn't want to be in equity markets and is looking for income, structured products is the perfect place for them to be."

The fastest-growing type of product last year was autocallable reverse convertibles, which are traditional reverse convertibles with a contingent coupon and an automatic call feature. Many attribute the success of those products to their ability to offer decent yields even when tied to indexes, which are less volatile than single stocks.

Autocallables with broad-based

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OUTLOOK 2014:

Firms expect volume to grow this year, but rates, volatility remain wildcards

By Emma Trincal

New York, Dec. 31 – Despite the uncertainties awaiting market participants in 2014, including a potential market pullback and the prospect of higher rates, sources are confident that the year ahead will be strong for structured notes issuance.

In fact, the uncertainty itself, which feeds volatility, may be just what issuers need for a boost in volume, they said.

Bank of America

Bank of America, which is the top agent and routinely prices between 25% and nearly a third of the entire market, has a positive prediction for the year to come.

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The Prospect News Structured Products Daily will not be published on January 1 because of the New Year's holiday.

Outlook 2014:

Sellsiders expect more income products; more volatility would help buffering

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Autocallables with broad-based underlyings like the S&P 500 index could continue to attract volume as investors seek high-yielding investments, said Bernd Henseler, vice president, structured products at S&P Dow Jones Indices.

Autocallable revcons

"Autocallable reverse convertibles have been a very hot structure in 2013. Anything with an autocall works out extremely well. We've seen a lot of them. Everybody is doing it. I think we'll continue to see more of those," Lotenberg predicted.

Those were done to get a higher coupon, said Michael Iver, chief executive of iVerit Consultancy and a former structurer.

"With the investor selling an additional call option to the issuer, investors were able to pick up additional yield in a low interest rates environment," Iver said.

"Non-callable reverse convertibles on the other hand, whose coupon depends only on volatility, saw their volume dry up this year."

"I think autocallables will remain popular regardless of interest rate movements," Henseler predicted.

Just as autocallable reverse convertibles were gaining traction in the past year, standard reverse convertibles were on the decline, noted Keith Styrcula, chairman of the Structured Products Association, who attributed this trend to the public's misconceptions about the structure.

"Reverse convertibles, despite some of the discomforts, resonate as a successful experience with many investors," Styrcula said.

"It's a stock replacement strategy. You get a guaranteed payment. If the stock is held, you get a different payout profile.

"It's been one of my frustrations to see how reverse convertibles have been the most misunderstood type of structured products. The critics are usually very misinformed. The real issue is when people think of it or sell that type of product as fixed income."

For Iver, the return to classic reverse convertibles will depend on the level of yield that may attract investors. As such, the main drivers will not only be volatility but interest rates in general.

"The fact that some selective structures

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like reverse convertibles may do better if there is a volatility spike is relative," he said.

"While it's true that volatility makes the coupons look good, the impact on volume will depend on how much volatility will increase in relation to yields. If it increases a lot, then it will make the coupons look great."

The extent of further and more decisive tapering from the Federal Reserve and how the market will react is another factor.

"If more tapering leads the market to react negatively, pushing up volatility, you probably would see fewer of these kinds of autocallable reverse convertible deals. Instead you would see more straight reverse convertibles," Iver said.

"But if the Fed tapering generates a bullish sentiment among investors, you're likely to see a continuation of the autocallable reverse convertible trend."

The types of rates deals next year will depend a lot on the shape of the curve, said Lotenberg.

"If the curve becomes steeper, you'll see much more leveraged steepeners, Libor range accrual [notes], fixed-to-floats," he said.

Investors have been struggling to find yield in a market characterized by a zero-interest-rate policy, said Styrcula. Last year was no exception.

"We've seen a lot of fixed-to-floaters, a lot of steepeners products. Range accruals were relatively popular as well."

The future of protection

Assuming a more turbulent market in 2014, investors are likely to push for more protection. Sellsiders said that structured notes offer enough flexibility to adjust to unexpected changes in the market.

"The protection will vary depending on the investors' views. In some cases, it will involve a simple buffer; in other cases, a deeper barrier may be more desired; and for some investors it may be a market-linked CD with FDIC insurance," said Serge Troyanovsky, BNP Paribas managing director, head of retail distribution North America for structured products.

The past year was particularly challenging for structurers attempting to respond to investors' continued demand for buffers. Several solutions were adopted such as lower caps or downside leverage beyond a buffer. Longer terms were also successfully introduced.

Longer-dated buffered notes

"One of the trends seen in 2013 was the extension of durations as a way to increase the buffers," said Liam O'Neil, head of the Markets Group for Global Wealth and Investment Management of Bank of America.

"Clients continue to ask for buffers. That's part of the reason why our $284.5 million leveraged note tied to the Dow in June was so successful. It was a five-year maturity, but it had a 30% buffer. It was our largest transaction of the year, clearly designed for people who are long-term bullish but worried about a short-term correction."

O'Neil explained that while people still want buffers they are not interested in full protection against the downside risk.

"They'd rather have the first 10%, 20% or 30% of the downside because those products are used as equity replacements and you don't want to sacrifice too much of the upside," he said.

"The trend toward longer-dated notes was partly driven by investor sentiment and partly out of necessity. With interest rates being as low as they are, we found that we had to go out farther in order to provide attractive buffers with a good-enough upside potential. The Dow Jones transaction is a perfect example."

Merrill Lynch financial advisers used to sell products with maturities in the 12 to 18 months range, he explained. But things changed about two years ago when interest rates bottomed, he said. This has led to longer durations of 18 months to two years.

"We like to structure notes to the nearest possible maturity; it's a more equity-like experience. We structure a product to the shortest possible maturity, 14 months for instance, and we encourage the investors to think about this as a buy-and-hold to maturity investment. That said, investors can sell whenever they want as long as they are aware that secondary pricing is impacted by a variety of factors," he said.

A return to shorter durations with acceptable buffers would require higher interest rates, sources said.

"If rates rise in the upcoming year, firms will be able to price products that have not been available for a number of years," Troyanovsky said.

"With higher rates we would be able to shorten the maturities, increase participation and caps, and bring back some of the underlyings that did not price as well in a low interest rate scenario."

Despite efforts to price buffers creatively by changing other terms, such as caps or tenors, the market environment, especially the low volatility, was simply not conducive to buffers last year, said Troyanovsky, who noted that fewer buffered deals were issued.

"I think we're going to see more in 2014," he predicted.

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Risk-on

For the more bullish investors, buffers are not the main focus. They want to use products to maximize the upside often through leverage and preferably without a cap. These investors are attracted to the asymmetrical leverage offered by structured notes – with the leverage generally applied only to the upside – versus exchange-traded products, which multiply both losses and gains.

"I think that 2013 has marked a return to growth products," Troyanovsky said.

"While over the last few years investors really focused on income-generating structured products given the lack of compelling yield-producing alternatives, in 2013 investors took notice of the rising equity markets and embraced growth products to a much larger degree."

Different cookies

The distribution channels are an important factor influencing what types of structures will be popular in any given year, said Lotenberg.

"This market is very diverse, and the choice of products that are being sold depends a lot on the type of distribution channel and clients," he said.

"There are all different kinds of cookies out there, the chocolate chips, the oatmeal, the raisin, the chocolate raisin. ... Selling to retail is not the same as selling to registered investment advisers or high-net worth."

The private bank channel for instance will remain particularly interested in non-principal-protected products, he said.

The retail channel, on the other hand, such as regional banks or independent distribution, will still focus on income and ways to outperform money markets or CDs.

Others may have more specific needs, such as registered investment advisers, who tend to seek an attractive risk-reward trade-off.

"The RIA space wants return enhancement and downside protection with the best combination of both. Buffered return enhanced notes are in high demand in that group. Any way to outperform the benchmark is very popular among RIAs," he said.

'Stories and themes'

Another major upcoming theme for 2014 is "content" versus the structure, sources said.

By content they mean the type of underlying used and the investment theme.

"The year 2014 is going to be all about stories and themes," said Lotenberg.

In the past, the focus was on the structure of the products, said Troyanovsky, such as enhanced leverage on the upside or partial downside protection.

"Now, we are seeing a much greater emphasis on the content within the product. The content could come from a highly rated basket of stocks or a research-based theme. It may come from a dynamic index designed to provide a more flexible exposure to the markets. In many cases, content could be delivered by leveraging on the industry leaders in market research," he said.

The most important trend will be in the selection of the "underlying story," he said.

"To me, the investment process really consists of two parts. The first part is to choose the desired market or sector, and the second one, to identify the structure that will best fit the investment view."

He cited the strong bid for notes linked to the Euro Stoxx 50 in 2013 as an example of a trend derived from a strong "underlying story."

"If investors like the theme, we will see a greater choice of products providing a variety of ways to invest in this theme," he said.

Bank of America's O'Neil agreed that the appetite for European stocks was a central theme of the past year.

"There was a time when we could not give EAFE or Euro Stoxx away," O'Neil said.

"But as U.S. benchmarks reach new highs and confidence in a European recovery increases, investors are drawn to the valuations of European stocks. In just a couple of transactions, we've been able to price around $500 million of longer-dated buffered notes tied to the Euro Stoxx 50."

New wrappers

Investors are also increasingly willing to explore other types of securities than just notes to obtain the benefits of optionality, said Lotenberg.

"We're going into that next phase of the game. Structured products are moving towards other ways, using other wrappers to provide similar derivatives-like benefits, using the same methodology employed with structured notes. And this can be used with equity indexes on the larger scale," he said.

"People are becoming wrapper agnostic. To me, this is one of the big trends that we've seen and will continue to see this year."

Instead of getting the structured notes-like benefits such as leverage or downside protection through a note or a CD, investors are now exploring other types of instruments, or "wrappers," in annuities, exchange-traded funds and unit investment trusts, he explained.

"We're seeing an increased demand for structured UITs, which are derivatives used in a UIT format instead of a note format," he said.

"It's a shift not in size. It's a shift in the wrappers. And it's going to be a major trend looking forward."

Styrcula agreed.

"I see a lot of growth in the UIT sector with structured UITs. These new products are popping up. I've seen notes desks competing to offer structured investments in a UIT format," he said.

Sophisticated indexes

The use of algorithmic indexes designed to give investors access to a specific strategy will also continue to be a major trend, said Henseler.

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"As the main markets have performed very well in 2013, we might see more thematic-driven underlyings," he said. As examples, he listed the S&P Global Infrastructure index and the S&P Listed Private Equity index in U.S. equities and the S&P BMI Emerging Markets Low Volatility index in non-U.S. equities.

Investors will continue to focus on theme-based strategies this year, said Styrcula.

"Investors have shown a strong appetite for notes tied to an index or a basket of stocks picked by stock-pickers within well-established research firms."

Simplicity

While a portion of the market will be looking at those sophisticated indexes to generate alpha, the majority of investors as well as advisers will continue to like structures that are not overly complex.

"I anticipate that we will see next year more simplicity in the way structures are designed," Styrcula said.

Many in fact believe that simplicity is an engine of growth in general as investors who understand a product are more likely to buy it.

Bank of America has some of the easier-to-understand structures, said several market participants who believe that simplicity is one of the key reasons for its success along with a well-trained salesforce.

"Nothing we do has exotic downside risk," O'Neil said.

"We don't do knock-in puts.

"We work with our financial advisers to make them very familiar with our products.

"We do a lot of repeat transactions, and we emphasize simplicity so that our financial advisers are comfortable with the product and able to explain it clearly to their clients."

He gave the example of his firm's Accelerated Return Note, which offers three times leverage on the upside up to a cap and one-to-one exposure on the downside.

"That's about as straightforward a structured note as you will encounter," he said.

The other typical leveraged product is the Capped Leveraged Index Return Note, which doubles the upside up to a cap and has a buffer on the downside with one-to-one exposure below the cap.

"This is not an exotic structure," he said.

"We have never sold a reverse convertible in the U.S. These structures represent too high a risk of being misunderstood and mis-sold.

"Our buffered step-ups are also very popular among investors. Again, it's a very simple payout: If the index is up but less than X, you get X; if it's more than X, you get the upside of the index; if it's down, you lose beyond the buffer. People like it a lot for the simplicity and for the risk reward profile."

Year after year, structured notes issuers adapt their products to new market conditions. The year ahead is expected to bring significant market changes with many expecting a possible downturn in equities and higher interest rates. Whatever the new conditions may be, the most successful structures will be the ones that adjust quickly to the new environment and satisfy investor demand.

"The structured products industry has a variety of tools to design products for diverse market conditions," said Troyanovsky.

"In fact, some of the best products tend to appear in the most difficult market conditions because they are uniquely designed to address challenging markets."