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Record turn-out for Chicago Board Options Exchange panel on “Opportunities in New Exotic Financial Instruments”

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Over 100 participants attended a recent panel on Opportunities in New Exotic Financial Instruments - Closed-end Funds, Hedge Funds and Structured Products.

The event was organised by the Chicago Board Options Exchange and was co-sponsored by the Structured Products Association and the quantitative industry group QWAFAFEW. The panel discussed the convergence of hedge funds, closed-end funds and structured products technology before what was a record crowd for a QWAFAFEW event.

The topic is of growing interest in that individuals and portfolio managers recently have invested tens of billions of dollars in such instruments in order to boost their risk-adjusted returns or diversify their portfolios.

The panelists for the meeting were: Keith A. Styrcula, chairman of the structured products association, and VP, JPMorgan Chase equity derivatives; John Larkin, managing director, HFR (hedge fund research) asset management; and Paul C Williams, managing director of Nuveen Investments, while the moderator for the evening was Matt Moran, VP, CBOE, and a member of the Chicago QWAFAFEW steering committee.

Many investors have explored opportunities in new financial instruments such as certain closed-end funds, hedge funds and structured products, which recently have attracted billions of dollars in new investments. The panel expressed bullishness on the potential for future growth in these products. One of the factors that is driving this growth is the fact that many investors are dissatisfied with the recent performance and yield on “traditional” financial investments such as stocks (eg the DJIA, Russell 2000 and Nasdaq Composite indexes are all down this year) and traditional long-term fixed income instruments (eg the recent yield on 10-year Treasury notes has hovered around 4 per cent).

Other topics covered included the recent work done on a certificate of deposit linked to a hedge fund index, with 7-year maturity, 100 per cent principal protection, FDIC-insurance up to USD 100,000, investor suitability requirement, and an investment minimum of USD 50,000 (or USD 25,000 for an RIA), as well as work done on a hedge fund index short share class.

The panel also noted that the number of closed-end funds doing covered call writing is expected to rise from zero in June 2004, to 25 in July 2005 and that while such funds have raised more than USD 10 billion in the past year, there is potential for much more growth in the future. Investors are looking for 8 per cent to 10 per cent yield with such funds (which can under-perform when stocks do well).

In addition, the approximate market share breakdown of investors in closed-end funds is 95 per cent individual investors and 5 per cent institutional investors.

The panel also discussed the Structured Products Association’s ongoing efforts to foster more innovation and best practices, as well as noting that US investors - unlike their European counterparts - are accustomed to taking on investment risk and usually do not ask for the principal protection feature in structured products. Marketing efforts for structured products in Europe though, have been very successful.

In regard to tax efficiency of structured products in the US, the panel noted that upside products can be pretty tax-efficient, but products with downside principal protection can be tax-inefficient because of issues such as phantom income and OID. European products with downside principal protection, however, can be tax efficient under European tax laws (all investors should check with tax counsel for tax advice).

Background notes: This was the 27th meeting of Chicago QWAFAFEW (Quantitative Work Alliance for Applied Finance, Education & Wisdom) www.qwafafew.org. Steering committee members of Chicago QWAFAFEW include Sanjay Arya, Morningstar; David Barone, Turning Point Securities; Adam Cohen, Zacks Investment Research, Inc; Dr Barry Feldman, Prism Analytics; Matthew Moran, Chicago Board Options Exchange; Ranga Nathan, InvestMatrix Inc; David O'Brochta, UBS; Richard Seefeldt, BRI Partners LLC; and Hilary Till, Premia Capital Management, LLC.

Keith Styrcula, chairman, and founder of the Structured Products Association, is a senior marketer in JPMorgan's Structured Solutions group. His career started in 1991 when he joined CSFB's Legal Department from Fordham University School of Law to oversee legal, regulatory and compliance issues related to First Boston's derivatives effort. While practicing as a derivatives attorney, he was a member of the FIA Law & Compliance Executive Committee, the SIA Options and Derivatives committee and served on the Business Conduct Committee of the Philadelphia Stock Exchange. He moved to the business side of equity derivatives in February 1997, reporting to the head of equity derivatives at SBC Warburg (renamed UBS following the merger). At UBS, he created the first structured product linked to the Dow Jones Industrial Average (issued by IBM). He returned to CSFB in July 2000 to launch the structured products platform for the newly acquired DLJ Private Client Services group, which placed USD 1.2 billion in its first year. He founded the 1100-member Structured Products Association TM in August 2003.

Paul Williams, Managing Director, Nuveen Investments, LLC, currently directs the firm's new product development efforts in connection with closed-end funds. Nuveen is the industry's leading sponsor and manager of closed-end exchange traded funds with total assets under management of USD 52 billion. Over the past five years, Nuveen has launched over 50 new funds, with assets (including leverage) totalling approximately USD 24 billion, comprising portfolios targeted to the municipal bond, preferred securities, convertibles, value equities, emerging market sovereign debt and REIT markets and equity based index option strategies He has been closely associated with the development of Nuveen's asset management business since the late 80's. He originally conceived the leveraged municipal bond fund and in recent years has played a key role implementing the strategic diversification of Nuveen's closed end fund complex. Previously, he managed Nuveen's municipal research department, which supports the firm's municipal portfolio management operations. His earlier career was devoted principally to municipal investment banking, where he helped establish Nuveen as a leader in education and water utility finance, and in the application of innovative strategies using variable rate debt, advance refundings, and public facility contract obligations. He received his BS degree from the Wharton School at the University of Pennsylvania and completed the Advanced Management Program at the Harvard Business School.

John Larkin, managing director, HFR Asset Management has over 10 years of experience in the hedge fund and alternative investment area. He served as the co-head of third party distribution for Citigroup Alternative Investments offering their first registered fund of hedge fund. Prior to that, Larkin was creator and head of the Private Investment Group at Merrill Lynch providing product and servicing of alternative investments to institutions and UHNW families (