VOICES

Lynch of Twenty-First Securities Says Using Options Leads to Better Terms Than Notes

Michael Lynch is a vice president at **Twenty-First Securities Corp.**, where he replicates structured notes using options, exchange-traded funds and other financial instruments. He says that by using equity Flex options, investors can get better terms with less credit risk. He spoke to Kevin Dugan by phone and through e-mail.

Q: How long has Twenty-First Securities been replicating structured notes?

A: For several years. On an annual basis, we execute a couple hundred million dollars of transactions. We strip away the single entity counterparty risk of the issuer by using ETFs and equity "Flex" options to get the same customized payoff. In the replicated note, the counterparty is the Options Clearing Corp., which is rated AA+ by Standard & Poor's.

Q: Can you explain equity Flex options?

A: Flex options are customized, standard options, traded on an exchange. The investor can pick any strike price they want down to the penny. The investor can pick any expiration date they want going out 15 years. The options can be American style or European style.

The nice thing, the customized options can be held in any standard brokerage account. If the investor wants to get out early, they are not beholden to the counterparty that took the other side of the initial trade. The Options Clearing Corp. stands in the middle, so we can do full price discovery on the way in and full price discovery on the way out.

In the past, Flex options were only really used for larger trades because the minimum used to be 250 contracts covering 25,000 shares. Now there really is no minimum.

Q: What kind of notes do you often end up replicating?

A: Three types. There are the pretty straightforward ones that we can easily replicate. Then there are the middle-of-the-road structures where maybe we can't get quite there, but we think we can get very close. For example, there are reverse convertibles that we replicate that don't quite give the exact same payoff, but the replicated structure is extremely close.

We would note that we think reverse convertibles should really be marketed as if they were naked puts sales, and the purchaser should have a firm understanding that they are not buying a bond that pays a juicy coupon. People may buy a reverse convertible, then end up with 10,000 shares of GM in their account and say, "What the hell happened?"

Then there is the third type of structured note, the ones we can't replicate, the choose-your-path, best-of, worst-of pay-off or other exotic profiles that are too difficult to reverse engineer. I worry that some clients are buying things they don't understand.

Q: Tell me about these exotic structures?

A: We recently had a client tell us they wanted to buy a note that would profit if interest rates went up. The client sent us the [offering documents]. We review [them] and explain the payoff profile. They're not actually betting that interest rates are going up. Effectively, through this note, they are betting that interest rates are going up by more than what is already priced into the market.

It's like betting on a football game. You're not just betting the favorite is going to win. You're betting the favorite is going to cover the spread.

Q: How do you reverse engineer these notes?

A: The client will send us the [documents] and we come up with some combination of options, that may also include the purchase of an ETF, [that] when combined will provide the same payoff profile. The replicated structure will decrease the counterparty risk, do away with a bunch of fees, and give them the economics they want.

As recently as last week, we saw a bank-issued OTC buffered note that provided 15.7 percent maximum potential return. The day before, we executed a replicated note with the same downside payoff profile that provided a maximum potential return over 18 percent.

There are all sorts of tax considerations with both OTC notes and replicated notes. Sometimes using the replicated structure gives you a better tax result; sometimes the OTC note provides a better tax result.

Q: Do you think investors are being compensated for the counterparty risk they're taking, with structured notes?

A: It doesn't seem that way. It looks like there is both more counterparty risk and a lower possible return in the OTC notes.

Q: How much do you charge?

A: We charge an institutional brokerage commission when we work as a broker and a management fee when acting as a [registered investment adviser].

This interview has been edited for length.

AT A GLANCE

Age: 37

Experience: Most recently senior internal investment consultant at Phoenix Investment Partners

Education: University of Scranton, bachelor's in finance; CFA charter holder

Family: Wife Jen, son age 5, and 3-year-old twins, a boy and a girl

Hobbies: Playing golf