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What to Tell Your High-Net-Worth Clients about CDOs

By Colleen O'Connor Grant

Now is as good a time as any to spark up a conversation with your high-net-worth clients about the risks involved in adding structured finance products to a portfolio. Any advisor perusing recent financial news is familiar with the washout that two hedge funds run by Bear Stearns have reportedly taken, due to overexposure to subprime credits from vehicles called collateralized debt obligations (CDOs).

When it comes to retail investors, due to regulatory capital requirements, only high-net-worth individuals can invest in this asset class, which is considered a risky part of Wall Street. Structured products are sold by investment banks to, primarily, institutional investors and funds. However, just as the term “hedge fund” went mainstream in recent years, advisors with high-net-worth clients report that they have increasingly been asked about structured products, such as CDOs and mortgage-backed securities (MBS).

“It has become one of the hot things to say you’re invested in. And when something is en vogue there’s a psychological aspect to owning it,” says John Deyeso, CFP, Financial Filosophy, based in New York, Texas and California. Deyeso says he has fielded inquires about these securities, which do offer some logical benefits to retirement portfolios, from his clients. However, Deyeso warns structured products require a very detailed conversation with the client first and he offers these guidelines for advisors when speaking with their clients about structured products:

• Ask Where the Interest Is Coming From
An advisor should assess why the client is asking about CDOs or MBS in the first place. Discover if it was generated by a conversation the client engaged in during a cocktail party or from a recent article. Remember, these products are predominantly sold only to the institutional crowd so the first step is to find out what the motivation behind the interest really is.

• Be Specific About Risk Tolerance
Just because your high-net-worth client has the ability to absorb a loss on paper doesn’t mean he or she, like those Bear Stearns-led hedge funds, fully appreciate the weight of risk involved here. Yes, generally, clients with more money like to take more risk, but he or she may not understand that despite the name “structured” these securities specifically have the potential for extremely large price shifts. Ask your client, “If it looses value are you willing to ride it out?” and “Can you afford to ride it out over the long term?”

• These Products Are Considered Illiquid
Yes, there is a market for these securities but explaining exactly how it functions will help decode what you mean by “illiquid.” Unlike stocks or plain vanilla bonds like T-Bills, which are universally bought and sold, it’s a very small world of buyers and sellers for structured products. Point out that these securities are not listed on some ubiquitous Yahoo! Finance page and that phone calls to individual firms have to be exchanged to find price quotes. Keep in mind that clients who look to sell during downward or panicky times are not candidates for these securities regardless of their net worth

• Consider an Asset Manager
Rather than parking the money into a CDO tranche outright, seek out an asset manager with a specialization in structured finance. The right type of due diligence can make all the difference as these securities are constantly moving, internally, thanks to the hundreds of individual loans and bonds that are packed into one single vehicle. Ideally, the asset manger would seek to invest your client’s money in multiple places by breaking it up into different funds and looking towards different industries.

• Remain in Constant Communication
As the story of Bear Stearns’ subprime hedge fund meltdown progressed into its first week, Deyesco sent information to his clients. He reviewed their exposure levels, if any, and added his own prediction for the summer markets – expect to see higher-than-usual volatility this summer market as the subprime drama plays out. But it’s an excellent time to reach out to high net worth clients, who expect a high level of contact from their advisors, period.