YES and YEP Should be a Nope

From this weekend's WSJ:

Clients of UBS Lost Millions

Investment strategy was sold as low-risk

By Gretchen Morgenson

A complex investment strategy pitched as low-risk by stockbrokers at UBS Group AG has triggered a backlash from clients of its securities unit.

The strategy, called Yield Enhancement Strategy, or YES, has generated at least $60 million in losses for clients and more than two dozen customer complaints, according to a lawyer for the investors.

The strategy involved the use of several option trades and borrowing, according to marketing materials, and faltered when volatility in the stock and bond markets intensified last year. In just one month late last year, the strategy had losses exceeding 13%, a customer-account statement indicates.

The UBS team overseeing YES had $5 billion to $6 billion in assets under management, arbitration records show.

A UBS spokesman said the benefits and risks of the strategy were clearly disclosed to investors.

"Clients who participated in the strategy acknowledged in writing that significant market movements could result in losses and that they should not participate in the strategy unless they were prepared for the potential of large losses," he said in a statement. The spokesman added that only a small percentage of customers who invested in the program have filed arbitration claims over it.

UBS marketing materials state the program seeks to limit exposure to extreme market moves.

Two UBS portfolio managers oversaw the YES Group and began promoting the strategy to other sales representatives across the firm in 2015, arbitration records show. ...

The strategy's losses highlight the risks in financial bets during periods of heightened volatility in the markets. The YES strategy typically involved putting on four different options trades—relating to an underlying stock index, such as the S&P 500—at different strike prices but with the same expiration date. The strike price can be the point at which the owner of a "call" option can buy or the owner of a "put" option can sell the underlying security.

The sale of short-term, "out-of-the-money" puts and calls on an index—a situation when the underlying price of the index isn't at or better than the option's strike price—was coupled with the purchase of short-term below-market puts and above-market calls on the index to mitigate risk, UBS marketing materials show.

When the S&P 500 was relatively stable, for example, the options generated a positive return, but when the index gyrated, losses resulted. Because the strategy made use of borrowed funds—as much as $5 were borrowed and invested for every dollar put in by the client—investors had to either put up additional money or have their positions sold at a loss when the trades went against them.

Sherrie Pellini, who supports three children and a mother and has little investment experience, put $3 million into the YES program in March 2017. She has filed an arbitration case against UBS contending that her broker didn't advise her of the risks in the investment. She says she lost $750,000.

Ms. Pellini, 60 years old, and several other UBS clients said their brokers told them the investment strategy had a lengthy and solid record. Ms. Pellini said her broker, Robert Perlman, told her the strategy had a 17-year history of no losses. "He said: 'If the world came to an end tomorrow, you'd be the only one with any money left,'" Ms. Pellini recalled.

Asked about this exchange, UBS declined to make Mr. Perlman available for a comment.

When selling the enhancement strategy, UBS brokers focused on the firm's wealthy clients. The firm's spokesman confirmed that it offered the program to clients whose net worth was at least $5 million, not an unusual threshold for complex or highly leveraged investments.

Ms. Pellini was charged 1.75% to invest, according to Jacob Zamansky, a securities lawyer in New York representing Ms. Pellini and other UBS customers. Fees exceeding 1% for wealthy investors are generally considered steep.

The UBS spokesman declined to disclose the commissions the program generated for the firm's brokers.

Over the past decade, regulators have cited UBS for securities-law violations at least nine times, Securities and Exchange Commission filings show. Many matters involved individual investors who had been harmed when they bought specialized and complex UBS products. In all cases, UBS settled with regulators, neither admitting nor denying the allegations. ...

Structured Notes: The Exploitation of Retail Investors

By Larry Swedroe August 22nd, 2019

…Wall Street's product machine is continuously pumping out fairy tales. Their product innovations can also be called "fanciful tales of legendary deeds." The only difference is that they are intended for adults. Like the Evil Queen's apple, they have shiny features designed to entice naïve investors. And despite the many fanciful tales available, almost all of them have one thing in common: despite their seeming appeal, they have attributes that make them more attractive to the seller than the buyer. Typically, these products fall into the category of what are referred to as "structured products."

Structured products are packages of synthetic investment instruments specifically designed to appeal to needs that investors perceive are not being met by available securities. They are often packaged as asset allocation tools that can be used to reduce portfolio risk. Structured products usually consist of a note and a derivative—the product derives its economic value by reference to the price of another asset, typically a bond, commodity, currency or equity. That derivative is often an option (a put or a call). The note pays the interest at a set rate and schedule, and the derivative establishes payment at maturity.

Because of the derivative component, structured products are often promoted to investors as debt securities. Depending on the structured product, full protection of the principal invested is sometimes offered. In other cases, only limited protection may be offered, or even no protection at all.

Since the 2008 drop in interest rates to historic lows, investors have been engaged in a search for yield. This is especially true for those who use a cash flow approach (instead of a total return approach, which I recommend) to spending. For years, regulators have cautioned that the complex products may be hard for a retail investor to evaluate and could be misleadingly marketed as conservative fixed-income investments. For example, in 2016 the SEC charged UBS Financial Services for unsuitable sales of $548 million of reverse convertibles to 8,700 inexperienced investors.

Despite such warnings, the 2018 Greenwich Associates survey of structured products reported that after a decline in the previous year, the volume of structured products distributed to U.S. retail and high-net-worth individuals in 2018 increased to just over $48 billion (annualized). Among the biggest suppliers of product were HSBC, J.P. Morgan, Barclays, Goldman Sachs, Credit Suisse and Morgan Stanley. And this is not just a U.S. phenomenon. In some countries (such as Germany and Switzerland) about 6 percent of all financial assets are held in structured products.

Unfortunately, these products are “popular” for the same reasons many financial products are popular—either they carry large commissions for the sellers, or they so greatly favor the issuers that they push the products on unsophisticated investors who cannot fathom the complexity (but are assured by the salespeople and the advertising that these are good and often safe products).

Fortunately, there’s a substantial amount of research on structured products. We know that sophisticated issuers create them because they lower their costs of capital and generate profits. Thus, whenever an individual investor buys a complex instrument from Wall Street, you can be certain they are being exploited. The reason is simple: If the issuer could raise capital more cheaply with a straightforward and simple debt instrument, they would do so. Thus, the question isn’t whether an investor is being taken advantage of, but only how badly. I’ll review the evidence from the academic research on these products.

The Evidence

Petra Vokata contributed to the literature on structured notes with her June 2018 study “Engineering Lemons.”

She began by noting,

“Since 2008, banks have engineered and sold over $100 billion of yield enhancement products (YEPs) to U.S. households. These products offer attractive yields—12% per annum on average—and represent the largest and fastest-growing category of retail structured notes. YEPs package high-coupon bonds with short positions in put options and embed a fee that is largely undisclosed and cannot be estimated without applying option pricing techniques.”

She added that YEPs “represent the largest category in terms of the number of products of retail structured notes offered in the U.S. Their issuance volume accounts for more than 40 percent of the volume of structured notes registered with the SEC.” These products are distributed to the public through affiliated broker-dealers as well as through unaffiliated broker-dealers, private banks and registered investment advisers. Banks market the products under different names, such as reverse convertible notes, income securities, yield optimization notes, equity-linked securities and reverse exchangeable securities.

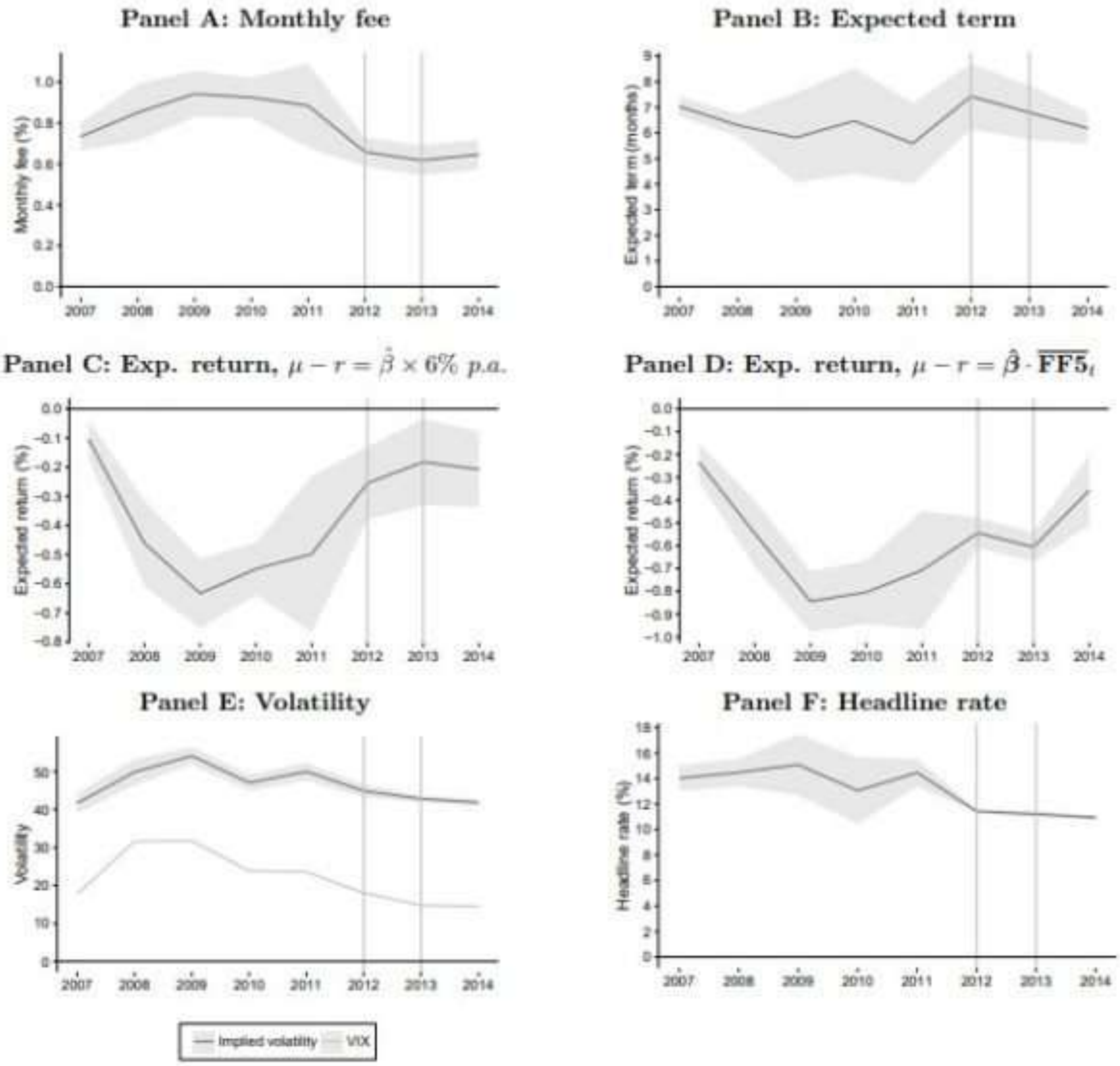

Figure 3: Fees, expected returns, and product characteristics around mandatory value disclosure

The figure shows the evolution of monthly fees (Panel A), expected term (Panel B), monthly expected returns (Panel C and D), volatility (Panel E), and headline rate (Panel F). The figures display averages of the variables over products issued in a given year and 95-percent confidence intervals based on standard errors clustered at the issuer level. Monthly fees are estimated using the pricing model described in Section 4 and are not adjusted for the credit risk of the issuer. To estimate the expected returns, I assume the expected excess return on the underlying equals $\mu - r = \hat{\beta} \times 6\%$ *p.a.* (Panel C) or the product of the factor loadings and their respective mean factor values from the Fama and French (2015) five-factor model: $\mu - r = \hat{\boldsymbol{\beta}} \cdot \overline{\mathbf{FF5}}_t$ (Panel D). Panel E shows the average implied volatility over the options of a product at issuance and the average monthly VIX index. The sample consists of 20,659 yield enhancement products issued between January 2007 and December 2014. The first vertical line depicts the year when the SEC announced the requirement to disclose the issuer estimated fair value. The second vertical line indicates the year when the mandatory disclosure was implemented.

Vokata's study covered the U.S. market for YEP products over the period January 2006 through September 2015. Her sample included more than 21,000 products. The following is a summary of her findings:

- Investors pay 7 percent in annual fees and subsequently lose 7 percent per year relative to risk-adjusted benchmark returns.

- The average realized returns over the decade are negative, and the losses are not restricted to the financial crisis of 2007-08.
- The bottom third of the products with the shortest maturity—and therefore the shortest time to recoup their fees—earn negative average returns in eight of the 10 sample years.
- YEP fees are large enough, and the product betas low enough, that even the expected returns of YEPs are negative.
- In some cases, embedded fees were well into double digits.
- YEP fees are several times larger than fees charged by a typical mutual fund and about twice as large as fees charged by hedge funds, private equity funds and venture capital funds.
- Fees remained large even after the SEC mandated disclosure of product values.
- The underlying securities are typically highly volatile stocks, with high idiosyncratic volatility, selected systematically to support high headline rates and moderate downside protection. Their average beta is over 1.5—a value common for the top beta decile of U.S. stocks.
- Investors in YEPs lost money on average. The volume-weighted average return is −4.6 percent over the holding period, or −0.7 percent monthly. More than a quarter of the products paid back less than the invested capital.
- The vast majority of the products are not listed on an exchange, are traded only over the counter, and are highly illiquid. In most cases, the only buyer of the notes before maturity is the issuing bank. The issuer, however, is not required to repurchase the notes or to quote their daily prices.
- The notes constitute a senior unsecured debt of the issuer and are therefore subject to its credit risk.
- Their tax treatment is complex, often uncertain, and the products do not appear to offer any tax benefits.

Sadly, but not surprisingly, Vokata reported that "YEPs are targeted at non-accredited retail investors. Evidence from regulatory investigations shows that some investors do not understand the terms of the products (U.S. Securities and Exchange Commission, 2011) and that some broker-dealers are aggressively marketing the products to elderly, non-English speaking investors, and to investors with conservative investment objectives, modest income or wealth, and little investing experience." She found: "Conflicted payments—kickbacks and commissions to the brokers recommending the products—account for nearly half of all YEP fees." This finding was consistent with that of Mark Egan, author of the study "Brokers vs. Retail Investors: Conflicting Interests and Dominated Products." Egan showed that brokers' incentives can explain the popularity of relatively inferior YEPs and that their buyers are not sophisticated enough to find "the best deal" in the market. Perhaps most disturbing of all is that Vokata noted the evidence that "brokers targeting YEP sales to elderly investors—for whom YEPs are less likely to be suitable—is consistent with broker efforts to exploit investors' cognitive limitations." This provides further support for the popular saying "When you deal with a broker, the one likely to be broker is you." Perhaps it's also why Woody Allen defined a broker as "someone who invests other people's money until it is all gone." That's why stockbrokers changed their titles to "financial advisors." But painting stripes on a horse doesn't make it a zebra.(1) Vokata concluded: "The most plausible interpretation of my results is that banks issue YEPs to cater to yield-seeking investors who do not understand their high fees and poor performance."

In my view, YEPs are products meant to be sold, never bought, because, by definition, they are bad products. Their issuance should be banned, or at least limited to institutional investors who have the resources to evaluate the offerings. Of course, that would likely drive demand to zero! In recognition of the problem, FINRA introduced rule 2111, broker-dealers can only sell products that are suitable for a customer based on the customer's investment profile. FINRA encourages broker-dealers to consider the recommendation of a YEP suitable only if they have a reasonable basis to believe that the investor is capable of evaluating its risks based on knowledge and experience. Clearly, there are virtually no retail investors capable of analyzing the true risks and costs of these complex products (or there would be no sales). In fact, as Vokata noted, regulators in Belgium and Portugal have issued moratoriums on selling complex structured retail products.

Regulations Required

In their University of Chicago working paper, "An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets," Eric Posner and E. Glen Weyl proposed that "when firms invent new financial products, they be forbidden to sell them until they receive approval from a new government agency designed along the lines of the FDA, which screens pharmaceutical innovations." While the FDA can often take years to approve a product, the review of financial innovations should be much cheaper and faster because it should involve readily available public data and well-known mathematical calculations.

Investments in derivatives and other innovations can be as dangerous to your financial health as taking a bad medicine can be to your physical health. Naïve individuals need to be protected from exploitive financial firms who seek not to help investors but to plunder them, treating them like Muppets. Greg Smith, a former executive director at Goldman Sachs, in a New York Times editorial, "Why I Am Leaving Goldman Sachs," claimed five different managing directors referred to their own clients as Muppets. Smith also said the firm's culture had changed during his nearly 12 years at the company, from one that looked out for clients to one that seemed focused on liberating them from their money.

If the fiduciary standard of care was applied to the selling of financial products, it's likely that virtually all structured notes would disappear. And if a person selling the product can't demonstrate that its purchase is in the buyer's best interest, why should that sale be allowed? This standard should be applied to all products, but especially the category of structured products such as equity-linked CDs and equity-indexed annuities, which were created by sophisticated financial institutions to sell to naïve investors. Their complexity allows the creators to embed fees that are exploitative at best and immoral at worst….

It's clear that retail investors have no clue as to the underlying nature of the risks and true costs of these products. Given that Vokata conservatively estimated that U.S. retail investors lost more than $1.5 billion over the period studied, it's time the SEC caught up with regulators in Belgium and Portugal and outlawed structured products. What are they waiting for? You can be virtually certain that no financial advisor who is held to a fiduciary standard, as are all registered investment advisors, would ever recommend any of these products. Unfortunately, the same cannot be said for those who work for broker-dealers or other non-fiduciaries. Forewarned is forearmed…

Further Evidence

The 2011 study "Why Do Investors Buy Structured Products?" by Thorsten Hens and Marc Rieger concluded that, for investors, any utility gains from structured products are typically much smaller than their fees.

If you're wondering just how much smaller the benefits are, Brian Henderson and Neil Pearson, authors of the study "The Dark Side of Financial Innovation: A Case Study of the Pricing of a Retail Financial Product," published in the May 2011 issue of the Journal of Financial Economics, found that the offering prices of 64 issues of a popular retail structured equity product were, on average, almost 8 percent greater than estimates of the products' fair market values obtained using option pricing methods. As you might guess, given the 8 percent shortfall, they found that the mean expected return estimate on the structured products was slightly below zero. The authors concluded that the issuing firms either shroud some aspects of their innovative securities or introduce complexity to exploit uninformed investors.

Geng Deng, Ilan Guedj, Joshua Mallett and Craig McCann, authors of the July 2010 study "The Anatomy of Principal Protected Absolute Return Barrier Notes," examined the evidence on a popular product called principal-protected absolute return barrier notes (ARBNs). ARBNs are structured products that guarantee to return the face value of the note at maturity and pay interest if the underlying security's price doesn't vary excessively. The principal protection feature guarantees the full payback of the note's face value at maturity as long as the investor holds the note to maturity and the issuer does not default on the note….

Not surprisingly, the conclusion was that the ARBNs' fair price was approximately 4.5 percent below the actual issue price—investors were paying $1 for something that was just 95.5 cents. Given that, generally speaking, ARBNs are short-term investments, with maturities typically ranging from 6 months to 3 years and most between 12 and 18 months, 4.5 percent is a hefty premium to pay.

The study also found that the yields on ARBNs were lower than the corresponding corporate yields. Many were even lower than the risk-free rate! The authors also cited a similar study that found that Lehman Brothers' structured products generally had implied yields below the one-year London Interbank Offered Rate! This indicates that Lehman used structured products to finance its operations at submarket rates, even when the company's credit quality had decreased sharply in 2007 and 2008.

As further evidence, Carole Bernard, Phelim Boyle and William Gornall, authors of the study "Locally-Capped Investment Products and the Retail Investor," published in the Summer 2011 issue of the Journal of Derivatives, found that the contracts were on average overpriced relative to their fair values by about 6.5 percent…

The Summer 2015 edition of the Journal of Investing contains a study, "Ex Post Structured-Product Returns: Index Methodology and Analysis," that contributes to the literature on structured notes….

The results clearly show that structured products have dramatically underperformed alternative allocations to stocks and bonds because of overvaluing the products. The authors also showed that the excess returns of the structured product indexes exhibit a stronger linear relationship with the S&P 500 than to the bond index. Yet they are often sold as alternatives to bonds. The results also indicate that structured products are not a unique asset class. The authors concluded: "Ex-post analysis of structured product returns shows that a simple portfolio of stocks and bonds are better investments than structured products." They added: "Results of our index analysis should cause investors and their advisers to avoid structured products."

Check out Pat Cleary's article https://alphaarchitect.com/2015/04/16/top-10-bank-lobbyist-rebuttals-to-fiduciary-standard/ on the lobbying against a Fiduciary Standard by bank lobbyists. Either you're a fiduciary who only acts in the client's best interests, or you're not.

About the Author: Larry Swedroe

As Director of Research for Buckingham and The BAM ALLIANCE, Larry Swedroe spends his time, talent and energy educating investors on the benefits of evidence-based investing with enthusiasm few can match. Larry was among the first authors to publish a book that explained the science of investing in layman's terms, "The Only Guide to a Winning Investment Strategy You'll Ever Need." He has since authored seven more books: "What Wall Street Doesn't Want You to Know" (2001), "Rational Investing in Irrational Times" (2002), "The Successful Investor Today" (2003), "Wise Investing Made Simple" (2007), "Wise Investing Made Simpler" (2010), "The Quest for Alpha" (2011) and "Think, Act, and Invest Like Warren Buffett" (2012).He has also co-authored seven books about investing. His latest work, "Your Complete Guide to Factor-Based Investing: The Way Smart Money Invests Today," was co-authored with Andrew Berkin and published in October 2016….

Our Thoughts:

If it sounds too good to be true, it likely is. YESs, YEPs, ABRNs, Annuities, and other structured products all claim to protect your principal while providing a respectable return. While in theory these products aren’t a bad idea, the amount of fees that accompany them are devastating. As mentioned above, these products are meant to be sold, never bought. Their main purpose unfortunately is to enrich the advisor as the expense of the client. Avoid them at all cost.