
The Sure Thing vs. The Gamble

By Editor Test *Wed, Jun 9, 2010*

There may be a certain futility to creating supposedly win-win products for a market that thrives by generating losers and winners.

“The one investor who always loses money is the man who wants a piece of paper that represents both a sure thing and a gamble.”

Martin Mayer, the financial journalist (and my first cousin, once removed) used those words years ago to describe the participating preferred or income bond, which supposedly offered bond-like safety and stock-like potential.

As he wrote in *Wall Street: Men and Money* (Harper & Row, 1955), the first of his books about The Street, the banks, the Fed and other institutions, such securities were custom-built for the “sucker trade.” He didn’t think much of them.

When I study the complex income products that insurers and fund companies are cooking up for soon-to-retire Baby Boomers, Mr. Mayer’s description of income bonds often comes to mind.

Many of us—and I include myself in the retirement income industry—are trying to build, sell or analyze products that purport to offer bond-like protection and stock-like potential.

The more I see of these products, the more they give me pause. I wonder not just about their ultimate value to the consumer, but also about their safety for the manufacturers. Even the principles that underlie them—which in their extreme forms seem to resemble the principles by which alchemists once tried to convert lead to gold—strike me as incongruously speculative, considering that they are purported to be risk-reduction tools.

The products in question include almost anything that uses derivatives to keep risk temporarily at bay, in the way that music keeps risk temporarily at bay in a game of musical chairs.

Index annuities and variable annuities with lifetime income guarantees belong to this category. So do structured products that pay an absolute return unless the market vastly over- or underperforms, in which case the investor gets bupkes.

These products work great in the lab, and they keep financial engineers busy. But no one can promise or predict how they will perform. Every customer liquidates his product at a different point in financial history and ends up with different results.

A product that is both a sure thing and a gamble obviously has broad appeal. Everyone loves one-stop shopping. We now have drugs that control both triglycerides and cholesterol. We have “crossover” automobiles that blend comfort, practicality and excitement.

So it makes perfect sense that the financial services industry, forced to compete for the fragile resources of a feckless, flattered but financially unsophisticated (on average) cohort of Boomers, would concoct products that eliminate the need for tough choices.

Yet, at some point, the cost of the glue (i.e., derivatives) needed to overcome the tensions inside these products, plus the cost of feeding everyone at the table (manufacturers, distributors, corporate shareholders, employees, asset managers and, last of all, consumers) has to extinguish the value of the products in all but the most benign future scenarios.

In their complex versatility, many of today's retirement products challenge the most basic and natural of laws: Keep It Simple Stupid (KISS). The more simplicity, the less room for stupidity. While bond funds and equity funds are not invulnerable to the uncertainty of the future, their risks seem relatively easy to gauge.

The issue goes beyond the virtue of simplicity over complexity and transparency over opacity. It involves the futility of creating win-win products for a market that thrives by generating losers and winners.

Still, it is the abiding nature of financial manufacturers to build products, and they must in turn dress up those products and move them. And for dressing, hope and optimism have always served well.

As my cousin also wrote in his first book, "It is notorious on Wall Street that a man selling stock in a gold mine may actually find some gold once the stock has been sold. It isn't an everyday occurrence, but it isn't impossible, either."

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