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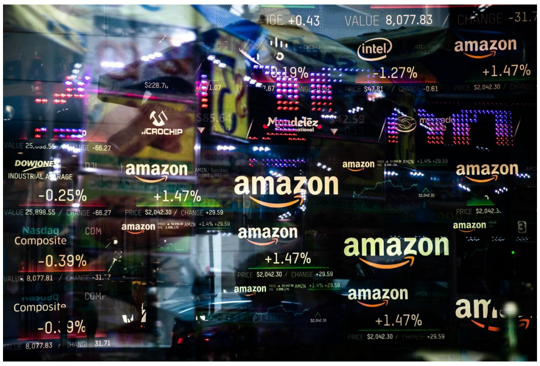
MARKETS

New Way to Play FANG Stocks Falls Short for Some Investors

'Auto-callable' notes tied to tech stocks are gaining in popularity but aren't always delivering large payouts



Offering documents for so-called 'auto-callable' notes say that buyers can earn fixed payouts of as much as 25% of the purchase price annually with less risk than buying tech shares outright. Yet returns have often been much lower. **PHOTO:** JEENAH MOON/BLOOMBERG NEWS

By Ben Eisen
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Investors looking to reap the gains of highflying technology stocks while avoiding the risk are finding they can't do both.

Citigroup Inc., C **-0.29%** ▼ UBS Group AG and Royal Bank of Canada are among the banks that have issued this year more than $1 billion worth of a type of structured notes linked to one or more of the four FANG stocks: Facebook Inc., FB **1.07%** ▲ Amazon.com Inc., AMZN **2.48%** ▲ Netflix Inc. and Google parent Alphabet Inc. GOOGL **1.27%** ▲ Issuance has more than doubled from a year earlier through mid-July, according to mtn-i, a London-based firm that tracks private debt markets.

The notes are often sold to mom-and-pop investors seeking higher-yielding alternatives to government debt, which is reliably safe. Offering documents say that buyers can earn fixed payouts of as much as 25% of the purchase price annually without taking on the risk of outright common-share ownership.

Yet many of these FANG-linked notes fail to produce returns anywhere near that stated range, according to an analysis of securities filings by The Wall Street Journal. Many times, the upfront fees banks collected were higher than the total returns earned by investors.

That is partly because the notes—dubbed "auto-callable" because a rise in the stock price contractually triggers their redemption—are often redeemed in less than a year, and sometimes in as little as a month. In many cases the auto-callable provision leads investors to earn scant returns and receive their money back long before the stated term of the investment.

When Citigroup sold $16.3 million of auto-callable notes tied to Amazon.com shares in mid-February, the firm advertised a 10% potential annual coupon for three years. Three months later, Amazon shares were up more than 20%—but the note was called, meaning that investors who purchased it received a total payout of 2.5%. The bank collected 3.5% in fees, according to calculations by Joe Halpern, a former structured-notes trader and chief executive at asset management firm Exceed Investments.

Citigroup declined to comment.

"These products give these great teaser yields, and I think people have been drawn to it," Mr. Halpern said. Then, many of "these things will be called after the first quarter."

In the first quarter of 2018, banks issued 275 FANG-linked auto-callable notes, totaling $499 million, according to mtn-i. By the end of August, 74% of them, or $326 million, had been redeemed, the Journal found, delivering fractions of the full-year coupons. They have paid 3.2% of their purchase price on average. Bank disclosures on these notes' estimated initial values indicate fees and other costs totaled an average of 3.4%, according to the Journal's analysis.

Among called notes linked to just one stock, the underlying shares rose an average of 18% between the time the notes were issued and the time they were redeemed.

The popularity of these types of structured notes attests to the powerful lure of technology stocks, which have risen sharply in recent years. In 2018, Netflix is up 82%, Amazon is up 66% and Alphabet is up 12%, compared with a 4.6% rise in the Dow Jones Industrial Average.

But the notes are unlike common shares, which offer purchasers unlimited potential gains as well as the risk of total loss. They are also unlike U.S. Treasurys, which pay out periodic "coupons" and entitle holders to full repayment at maturity.

Instead, the notes offer gains up to a certain, specified threshold and protect against only certain, specified equity losses. Typically, if the linked stock or basket of stocks trades below a designated barrier—say, 75% of its initial value—when the notes mature, investors can lose a share of their principal on par with losses on the stock or basket.

Banks set the schedule of the observation periods, which can be as frequent as monthly or as infrequent as annually. If the underlying stock has risen from its initial level as of that observation date, the bank automatically calls the notes.

Investors only get the full payment if the equities trade within a limited range, typically modestly below their initial level when the notes are issued. If the stock or basket falls below a given threshold on certain observation dates, the investor often doesn't collect.

If the underlying stock has risen from its initial level during these periodic reviews, the notes get called.

Tech stocks have pulled back in recent weeks, helping keep some notes—particularly those issued by Facebook—from getting called. Still, Amazon and Netflix are trading well above their levels from the first quarter, which means that notes tied to them are getting redeemed.

In March, UBS issued a $150,000 note tied to Netflix. It paid 20.58% annually as long as shares of Netflix weren't above the effective purchase price on monthly review dates. After one month, the stock was up 5.9%. The note was called, paying a coupon of 1.7% of the purchase price. The bank collected 2.7% in fees, Mr. Halpern found.

UBS declined to comment.

The notes can still outperform even when they get called early. UBS issued $110,000 worth of notes tied to shares of Facebook in mid-February. The stock began falling in March during an uproar over the company's handling of user data, but shares rebounded as the note hit its first potential redemption date. Investors received a coupon of 5.7%, even though the stock was up less than 1% over that period.

Banks typically piece together structured notes using a mix of their own debt and derivatives that reshape the returns of an underlying security, such as a stock. Other variations of structured notes, for example, can offer twice the returns of the linked asset or more.

The potential for volatility around shares of the big tech giants has kept away some buyers of structured notes. Jerry Verseput, who runs Veripax Wealth Management in Folsom, Calif., regularly buys auto-callable products tied to major indexes like the S&P 500, but says he stays away from most single-stock linked notes with that structure, even though they can offer higher yields.

“I have no idea what Facebook is going to be like in three years,” he said.

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