



House of the year, hedge funds

Merrill Lynch



Pierre Mendelsohn, Merrill Lynch

> Hedge fund returns are in the doldrums this year compared to their usual standards. But that has not stopped Merrill Lynch coming up with a host of new hedge fund-linked structured notes while also making the alternative asset class more accessible to non-institutional investors. Merrill Lynch has structured capital-protected hedge fund-linked notes for third-party distributors and also expanded its successful Guernsey-based fund platform. "While other houses have seen a pretty serious downturn in their hedge fund-linked business, we've actually done significantly more business this year than last," says Pierre Mendelsohn, London-based managing director within the Merrill Lynch Structured Solutions Group.

At the beginning of the year Merrill Lynch won a contract from a large European private bank to outsource the entire pricing and structuring effort involved in creating a hedge fund-linked structured note. The result was a novel principal-protected hedge fund note, which appeared on the market in February and March. "There is a genuine need for outsourcing, and genuine interest by outside partners in wanting to use our skills and expertise," Mendelsohn says.

The note is a five-year, fully principal-protected note with an underlying linked to the performance of a basket of seven hedge funds and funds of funds.

The structure uses leverage to give a maximum exposure of 200% to the underlying basket. Initially, however, exposure for the notes denominated in euros is set at 80%, while dollar-denominated investors get exposure between 90% and 100% (the level is set on the actual index level determination date). CPPI technology is used to guarantee the principal,

so a predetermined mechanism allocates the assets dynamically between cash and the underlying risky basket. If the basket performs well then more units are added to it, up to the maximum 200% exposure level. That means the product could actually outperform the underlying hedge fund basket. Of course, if the underlying basket performs poorly then exposure to the risky asset is reduced in favour of cash.

The note is just one of a number of innovative products produced by Merrill Lynch this year. Mendelsohn says Merrill Lynch's pricing is in line with competitors – but, more importantly, his group has the infrastructure in place to cover all the aspects of launching such a product. "Once the idea is in place we can very quickly create the product. We showed that we can actually deliver, and the feedback from clients is that no other house is as good as we are at delivering the full-value proposition," he says.

Merrill Lynch has also been working on its hedge fund infrastructure for distributing its own trademarked products, in the form of various wrappers, including bespoke funds. This has made hedge fund-linked products more accessible. "We have launched several structures recently that can be accessed directly by the private client market," Mendelsohn says.

For example, products can be delivered in the form of shares in a closed-end umbrella fund linked to the performance of underlying hedge funds or fund of funds, and they may or may not have principal protection. In July, for example, a six-year, non-principal-protected product was issued linked to the performance of four different funds of funds.

Merrill Lynch is clearly making the right moves to cash in on investor demand for alternatives exposure. But Merrill Lynch is not about to rest easy. "We have had a lot of success with non-standard transactions, but we look at this business very humbly, and we realise that it is extremely well covered by very serious competitors," Mendelsohn says.

Why Merrill Lynch won

Merrill Lynch has brought to market a host of new hedge fund-linked structured notes while also making the alternative asset class more accessible to non-institutional investors. Of particular interest is a five-year, fully principal-protected note with the underlying linked to the performance of a basket of seven hedge funds and funds of funds.