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Market Newsletters for Professionals

Reprint

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Bank of Montreal's upside booster notes offer substitute for long position in Euro Stoxx 50

CG Capital Markets: new boutique with long-standing team to tackle institutional market

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By Emma Trincal

New York, Nov. 9 – **CG Capital Markets LLC**, a broker-dealer, a market-maker and a wholesale distributer of structured products, sees great opportunities in the institutional market for the distribution of structured notes.

The firm has a new name, but the team consists of bond veterans who have been working together for years, chief executive officer Armand Pastine told Prospect News in an interview.

In July, CG Capital Markets successfully spun out from Capital Guardian, LLC, a North Carolina wealth management firm.

Spinoff

"We finished an intricate spinoff from the wealth management of Capital Guardian to its own entity. We became our own company," Pastine said.

"The entirety of our personnel, contracts, licenses, counterparties, compliance models, operations, all the components of the business has moved over."

Currently CG Capital has approximately 40 employees in numerous branch offices that include New York City, Red Bank, N.J., Charlotte, N.C,. and Boca Raton, Fla., where the executive suite of officers is located.

The CEO said he plans to expand.

"We have a targeted growth of 25% annually in both head count and revenue across the board," he said.

The firm is active in corporate bonds, municipal bonds, certificate of deposits and mortgage bonds, but the main focus has been and will continue to be structured products.

Institutional market

CG Capital Markets said that one of its niche markets for structured products is the institutional market, where the team has a long experience.

"We see growth potential on the institutional side," Pastine said.

"People don't realize how many institutions get into structured notes," said Joe Castelluccio, head of trading.

Institutional investors see a "great opportunity" in being able to buy debt referencing other asset classes, including equity, he said.

"Banks' trust departments, registered investment advisers, all QIBs ... use structured products," added Pastine.

The acronym QIB stands for "qualified institutional buyer." It designates any investor investing at least $100 million, according to the SEC.

"Virtually all of our clients are either institutional investors or downstream dealers or investment advisers. They are both knowledgeable and sophisticated about the structured product market," Pastine said.

He said he does not subscribe to the idea that institutional investors are too sophisticated to use structured notes as they can easily replicate the structure via options.

"People understand that there has to be a premium attributed to the source of a particular idea. A knowledgeable distribution network must be compensated for idea generation and innovativeness as well as market intelligence as to what's the most efficient structure at the time," he said.

"A lot of investors have the option of executing structures away. However, our clients usually want to continue to receive thoughtful advice and continued service,

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so we rarely come across a customer who tries to trade around us."

Team

The current team of structured products specialists – essentially Castelluccio and Steve Cocco – has been together 10 years, dating back to the early days at Maxim Group, where Pastine was the head of the fixed income group and Castelluccio the head of trading.

The team moved on to C&Co./Princeridge, which merged with JVB Financial in 2013. The brokers then joined Capital Guardian.

"The corpus of this team has worked together for over a decade ... Joe and I for over 20 years. We have a history together," Pastine said.

Castelluccio, a former U.S. Marine, spent the majority of his career at Prudential Securities, where he ran the corporate bond trading desk.

The friendship between Pastine and Castelluccio dates back to their days at Prudential Securities, where Pastine specialized in mortgage- and asset-based securities.

Pastine said the cohesion of the team is an asset.

"Our people have a lot of experience," he said.

A third of CG Capital Markets employees are principals, he noted.

"We want seasoned people on our trading desk with supervisory authority."

CG Capital Markets works with issuers to originate and distribute structured products, including the largest global issuers.

The broker-dealer clears through Pershing LLC.

Pastine defined his business relationships as a fine balance between cooperation and competition.

"In our view, everyone is, at some form or the other, a trading partner," he said.

"And what I mean by that is we look at our business as a series of one good relationship that is constantly growing one trade at a time.

"If a trading partner isn't approaching the business the same way, we tend to not do business with them, whether they compete with us, buy from or sell to us or even if they are an issuer.

"We always attempt to be as open and direct with all of our trading partners while still remembering that we are in this competitive environment."

Education

At CG Capital Markets, Castelluccio specializes in bonds linked to various indexes, baskets of equities, currencies and commodities.

"Structured products are one of the pillars of our operations," Pastine said.

"It's been a lead calling card for us with our counterparties, originators, customers, RIAs. ...

"We get the business done because we work with the same core group of people.

"Our knowledge allows us to customize products.

"We try to trade complex products and not make it complicated. That's Joe's formula.

"We allow clients to understand and digest the information."

Castelluccio said he tries to educate clients about the risks associated with the structures.

He recently put together a brochure that describes succinctly most structure types.

"I look at products as an investor," Castelluccio said.

"You put the equity component to pick up more yield. You also pick up more risk.

"Sometimes there are just too many moving parts. You have to help some people understand."

For Pastine, risk is not always clearly understood.

"The concept of relative value has escaped a lot of people. The risk-reward has to be assessed. People have mispriced risk," he said.

Market cycle

Structured product issuance has slowed since the summer, according to data compiled by Prospect News, as investors are turning skittish amid an expected Fed rate hike and a more than six-year-old bull market.

For some, structured note distribution may not be as easy as in previous years. Perhaps the timing may not be optimal.

But for Pastine, a market downturn would provide nothing short of an opportunity.

"Now is the greatest time to get into the structured products market," he said.

"When the market gets tough, a lot of the firms will not have the stomach to adapt to the change, but we've been there.

"If you've been buying equity-linked notes in the bull market, yes you've done well, but what you've really been doing is investing in equities converted in wrappers camouflaging in fixed income.

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"You've done well because the equity market was bullish.

"In the very challenging market we're in, we find solace in the fact that we have a core group of people who have been tested through many market cycles.

"A lot of guys on the Street have never gone through a high-interest-rate environment.

"We're looking forward to that."

Rate shop

Rates continue to be the specialty of the team.

"We do mostly fixed income, but we are also expanding our footprint into equity-, commodity- and currency-linked products," Pastine said.

"We're more active in the rates products. Our clients are fixed income primarily; they're looking for fixed-income alternatives."

The firm concentrates on plain-vanilla fixed-income notes such as Libor floating or step-up range notes.

"Most of our products have a view on rates. Those products are pricing out options, strategies to fit a customer's view on rates," said Castelluccio.

The term "structured product," which is widely used on Wall Street, may not be the most appropriate, he noted.

"I think the term 'constructed products' would be a better name.

"I like it because that's what we're actually doing. We're constructing products, not just structuring them. It's a positive terminology."

Battle for transparency

One of the challenges in the structured note business is liquidity, Castelluccio and Pastine said, although "the secondary market is more important in fixed income," Castelluccio noted.

"People on the distribution need to see structured products as a standalone asset class. And yet, structured products have not achieved the status of being an asset class on their own," Pastine said.

"We're fighting the good fight in pricing, transparency and underwriting the securities.

"There has been a constant battle for transparency and price discovery in the structured products space. Our team has participated at high levels in the debate regarding greater transparency for pricing securities in customer portfolios, but there's a lot of work that still needs to be done in getting the industry to create better standards and best practices for pricing.

"I look at this market. It reminds me of what [the] CMO market was in the early 1990s.

"The marketing, the sales practices had to be redefined. You couldn't sell it like CDs.

"The regulators are trying to do that now.

"But I don't think Wall Street firms do enough to educate their people, their customers and the regulator."

One of the keys to improving liquidity is to make pricing more "accurate and standardized" in customers' portfolios, he said.

"Until that happens, investors and market makers will be trading the product as a bilaterally negotiated instrument between a single buyer and a single seller.

"The single challenge is transparency associated with the pricing of securities.

"It's a major, major problem. It's not going away."