THE WALL STREET JOURNAL.
WSJ.com

WEALTH ADVISER | September 11, 2013, 9:14 a.m. ET

Protecting Deferred Comp with Credit Default Swap

By KIMBERLY WEISUL

This client had been a senior executive at a Fortune 50 company. During that time, he'd socked $15 million into a nonqualified deferred compensation plan.

Now, early in his retirement, he was concerned that the plan was not guaranteed. He was essentially an unsecured creditor of the corporation, and if the company went under, his retirement savings would, too.

Bill Loftus

Upon the recommendation of a friend, the man went to see Bill Loftus, a partner with LLBH Private Wealth Management in Westport, Conn., a registered investment adviser that manages $1.2 billion for about 125 clients.

In this case, he saw that 80% of the client's net worth was in his deferred compensation plan. "All [the client's] friends at the company are telling him not to worry about it, but he can't sleep at night," says Mr. Loftus.

Mr. Loftus began considering ways to protect his client's deferred compensation. He could treat the company's stock as a proxy for its health and use a collar or a pre-paid forward contract to defend against a major price decline. But both ideas had the same flaw--the client didn't actually own the copy stock needed to enact those strategies.

Also in Wealth Adviser:

Moving Up in Floating Rate Bonds

Living Well a Feature on Advisers' Websites

Visit the Wealth Adviser page

And the stock price wasn't the issue. It was the company's creditworthiness. That gave the adviser an idea: Credit risk is exactly what a credit default swap is designed to protect against. The client could buy a credit default swap against the company's bonds. Then, if the company went bankrupt or defaulted on the bonds, the payment from the swap would cover the value of the client's deferred compensation.

"Credit default swaps kind of have a bad name, but here's one that has a really elegant application," says Mr. Loftus. "If something happens and the company goes bankrupt, we're covered."

It took Mr. Loftus more than three months, along with assistance from an attorney who is a member of the International Swaps and Derivatives Association, to buy the credit default swap--mostly because they're designed to be bought and sold by institutions, not individuals. "The [issuing] desks have got to face an institution. That's the rule," says Mr. Loftus.

The adviser opened an account with the U.S. division of a global bank, which purchased a credit default swap on behalf of Mr. Loftus from one of its overseas divisions. That swap acted as an insurance policy against a bond issued by the client's former employer, which would mature in 2015.

The swap cost about $80,000 in the first year, but if the company defaults on that bond, the client will receive $15 million. If the company's credit rating drops significantly, the price of the swap will increase and the client could cash out at a profit. But the adviser says that's not the point: "We don't want to make money on the swap."

If the bond that Mr. Loftus has insured reaches maturity, the contract for the swap will expire and he and the client will decide whether to repeat the transaction by purchasing another swap on a bond with a later maturity. But since the retirement plan pays out over 10 years, there will be less deferred compensation to protect over time and the cost of doing so will drop.

Although many of the client's co-workers scoffed at his concerns, the company's once pristine credit-rating recently took a substantial hit. Now, those colleagues are more envious than dubious of his conservative strategy, while the client has become "one of our staunchest supporters," says Mr. Loftus, referring several of his colleagues.

And he adds that the client sleeps just fine at night.