

The Art of Engineering Financial Engineering

As with many other aspects of modern society, the realm of finance continues to grow ever more complex. Due to an explosion of financial nuance, decisions that were once within the grasp of the average person have become much less so. Years ago, obtaining a car required its purchase. Later, cars could be leased. Now, consumers who can't distinguish amongst a multitude of leasing options are at a distinct disadvantage.

In general, the huge array of financial options that exists today is the result of financial engineering. From teaser periods, to payment caps, to purchase options, to insurance riders, financial engineering is everywhere. The good news is that choices abound. The bad news is that it's easier to step in the mud.

Once a piece of financial engineering finds success, it often wiggles its way into a variety of venues. What determines financial engineering success? No definitive answer exists, but common sense dictates that the resulting financial option should have, at a minimum, some visceral appeal to the consuming public while being profitable to its sponsor. All else being equal, the more difficult a given piece of engineering is to analyze, the more profit potential it would seem to hold. That is, to the extent it's more difficult to know what a particular financing option is really worth, the easier it is to price it to the sponsor's favor.

Therefore, the holy grail of financial engineering is to create financial options that possess a high degree of inherent appeal while also being generally difficult to analyze. When those two attributes can be developed within the same piece of financial engineering, the industry has itself a winner.

A good portion of the financial engineering that we have today has focused on a variety of financial guarantees. Follow this column as we explore some common, but puzzling ones.

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