Investment Training Module
Topic: Structured Notes

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Disclaimer

This presentation is for informational purposes only. It does not constitute nor imply investment advice in any way. Investing involves risk, including the risk of losing principle. An investor should consider their own investment objectives and risk tolerance before choosing any investment product.

What Is A Structured Note?

- Structured Notes are offered by the major banks
- Notes are similar to bonds
  - You give the bank your money for a while; bank promises a certain return or interest rate
  - In the event of bankruptcy, Senior Note holders are paid back before bond holders
- Simple Notes pay a simple interest rate over a period of time
  - Example: Treasury Notes, Mortgage Notes, etc
- No rule requires Notes to pay simple interest
  - Structured Notes simply "structure" the return to be more complex and (hopefully) attractive to investors

Structured Notes are like any other notes (e.g. mortgage notes, Treasury notes) except that the return is more complex

Why Do Banks Sell Structured Notes?

- Banks need constant liquidity (new infusions of cash)
- To get you to part with your capital, they need to offer an attractive return incentive

- Banks do not attempt to make money by selling Notes
  - If they did, they would be in competition with their clients
  - Banks simply want access to capital to use for “banking stuff”
  - Taking a small loss is OK, and is considered the Cost-Of-Capital (just like selling a bond)
- Total market for Structured Notes is in the $40B - $50B range each year

Banks need your capital, which they raise by selling bonds, borrowing from other banks, and selling Notes

Structured Notes Get Lots Of Bad Press

"...everyone should stay away from these structured notes or any sort of financial transaction that cannot be fully understood." - Internet post

"Wall Street is a marketing and sales machine. They've developed a real stinker of a product..." - Forbes

"It gets worse...structured notes are exposed to the credit risk of issuers." - Bloomberg

"Some of these products offer only partial protection, so you could lose principal even if the issuer does not go bankrupt. – SEC.gov

- Verseput's theories on why there's so much bad press
  1. Complaints are really about the *marketing* of SN's
  2. Many advisors are not allowed to use them, and must explain to clients why
  3. People are lazy and refuse to be educated

Not all Structured Notes are a match to every portfolio, and there are some I wouldn't touch, but that doesn't make them all bad

Addressing the Risks

(Warning: what you are about to see may contain sarcasm)

- "Structured Notes are exposed to credit risk"
  - Yes, like every bond ever issued
- "Structured Notes have limited liquidity"
  - Yes, they are bought and sold just like individual bonds
- "Your principle may be subject to loss"
  - Yes, like every stock ever issued
- "Structured Notes contain commissions and other costs"
  - As opposed to all the "free" investments? Ultimate return is based on the conditions of the Note, independent of initial costs.
- "Structured Notes are too complex to understand"
  - Then hopefully your TV remote only has an ON/OFF button and CHANNEL select (VOLUME would be too complex)
- "Structured Notes may not be appropriate for all portfolios"
  - Neither is Facebook stock, but that doesn't mean all stocks are inappropriate for all portfolios

The job of any investor or advisor is to manage risk. Structured Notes simply offer more options and flexibility to do that.

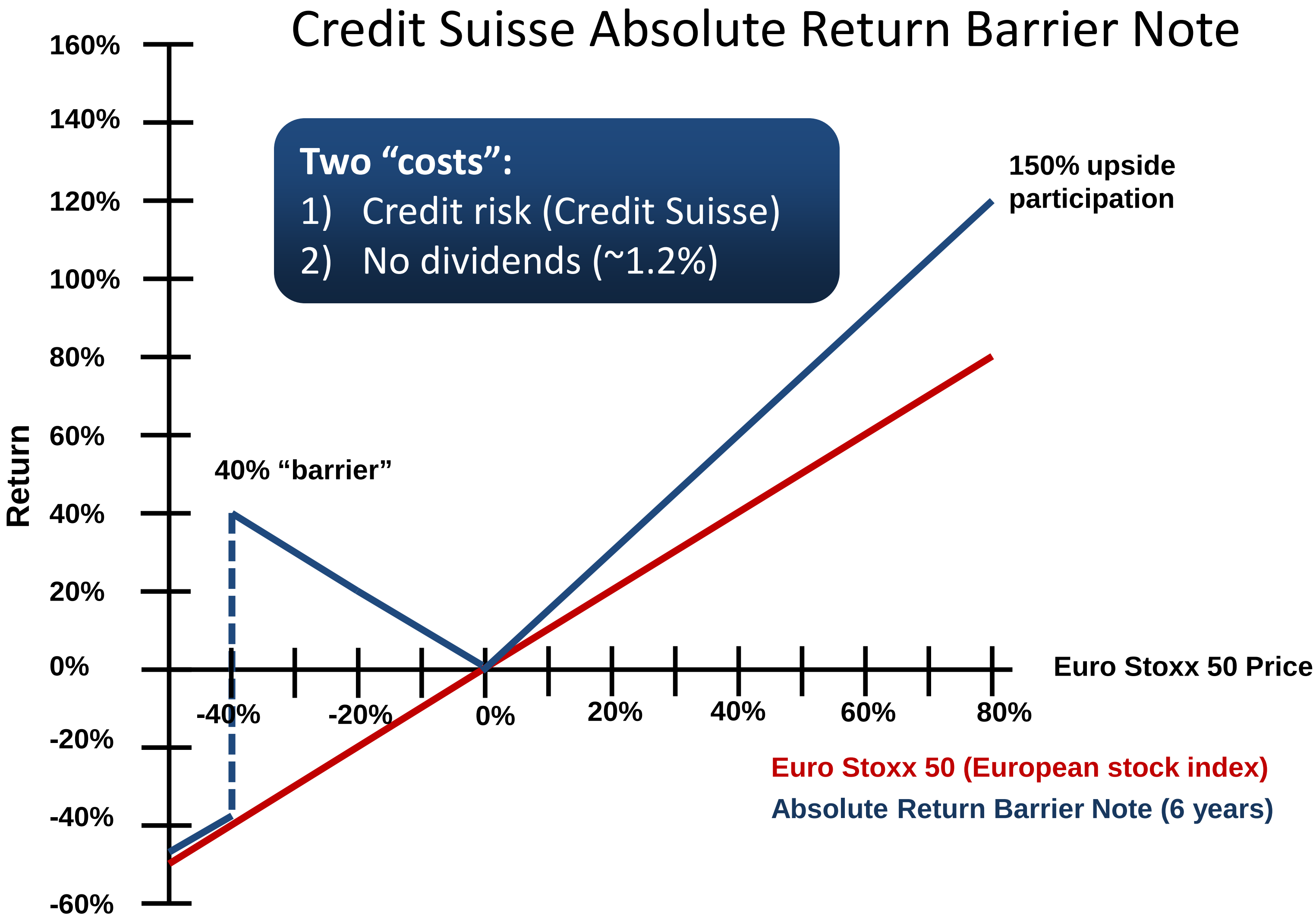
Show Me Some Notes (examples only)

- Barrier Notes
  - Higher yield, but daily interest is contingent on the S&P500 (or other Index) staying above a certain level (e.g. 60% of current price)

- Steepener Notes
  - Yield is calculated from the "steepness" of the yield curve
  - Example: 4 X (30y rates – 2y rates) ; 10% cap
- Step-Up Notes
  - Fixed yield, but yield jumps higher every few years
- Absolute Return Barrier Notes
  - Return based on an underlying stock index (e.g. S&P 500, EuroSTOXX 50, etc)
  - Upside participation typically higher than 100% (110% - 150%+)
  - Downside return is the inverse of the index (index loses -20%, Note gains +20%)
  - Downside protection subject to a "barrier" (25% - 45% depending on the Note)

Structured Notes come in almost an unlimited variety, and banks will customize them for large advisory practices

Absolute Return Barrier Note Example



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Structured Notes Summary

- Purpose is to offer a more attractive set of conditions so investors will loan the bank their money
- Variables to play with (with examples):
  - Duration: 2 years – 30 years
  - Interest Rate Contingency: Index > 50%; non-inverted yield curve; etc
  - Interest Rate Calculation: Multiple of Index return; yield curve steepness
  - Fixed Rate: Structured Notes will often have a fixed return for the first 1-4 years
- Most Notes are purchased by institutions or through advisors
  - Typically takes >$1M commitment for a bank to issue a custom Note
  - An advisor can use the combined purchasing power of entire client base

Structured Notes are simply investment products that contain risk and return tradeoffs, but are often overlooked

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