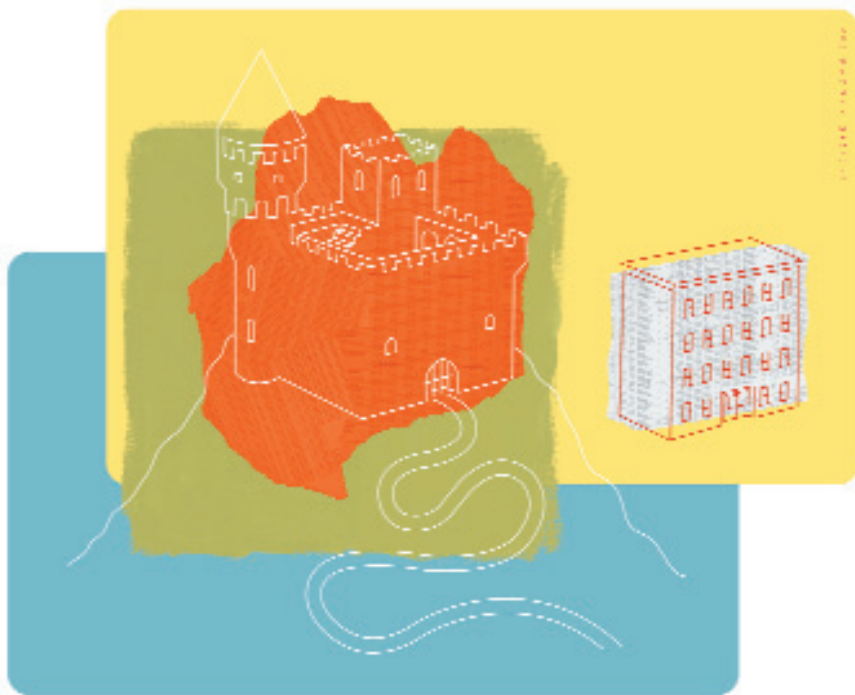


NOTED GUARANTEES

Principal-protected notes are gaining a following, but they are more complex than the average mutual fund. Advisors will need to do their homework.

By Dan Hallett



A painful bear market and waning investor interest prompted a number of product manufacturers to launch innovations that played into investors' most prevalent fear—loss of capital. At the same time, advisors began a buyers' strike on equity mutual funds. Plus, investor confidence had been battered

to the point where clients stopped buying the same old “you’re-in-for-the-long-term” line. Hedge funds, on the other hand, were prestigious and made money during the bear. This sparked the beginning of a proliferation of alternative-strategy structured notes.

The warm reception advisors gave to such products sparked a string of new notes linked to mutual funds. While these offerings bundle upside potential with a capital guarantee—a welcome feature during the bear—many structures and conditions exist. Add downright confusing fees in some cases and it becomes clear that each note must be carefully examined.

Guarantee Structures

Hedge fund or alternative-strategy linked notes typically invest about \$0.60 (out of every dollar) in an investment grade zero-coupon bond. The \$0.60 grows to about \$1 at maturity. The remaining \$0.40 is then invested in a hedge fund program.

Mutual fund linked notes are a bit more straightforward; their basic

structure often resembles that of the index-linked GIC. The guarantee is also financed using a zero-coupon bond, with the remaining amount (i.e., up to \$0.40) used to purchase a customized call option. This offers the note issuer—normally a bank—exposure to the mutual fund portfolio that determines its ultimate payment obligations.

In all cases, guarantees only apply if the notes are held to maturity. Otherwise, the proceeds of note redemptions will be a function of interest rates, the performance of the linked assets, liquidity restrictions and any applicable exit fees.

The guarantee structure is the easy part since pretty much everyone uses a bond of some sort. The trick to most of these instruments is how the upside is captured and what built-in trade-offs exist in return for the safety features.

Upside Structure and Trade-offs

Protection comes with a price, and it usually comes in the form of higher fees and/or limited upside potential. Otherwise, there is no incentive for the note issuers—national and international banks—to enter into such arrangements. Aside from higher costs, upside potential can be limited in many ways, including averaging formulas, performance ceilings and call provisions.

Early versions of linked notes—bank-issued index-linked GICs—typically limited upside via a stated participation rate or a ceiling on total returns. Current incarnations are more creative.

The CIBC Fulpay™ Mackenzie funds-linked deposit note uses an

averaging formula to determine the ultimate interest payment at maturity. The cumulative returns of five funds are averaged at quarterly intervals throughout the note's term. These averages are computed for each fund and then across

underlying fund returns are above the call price by the midpoint. The trade-off is that investors give up some upside potential but that is a minor risk given the extent of stock market gains (and current valuations) leading up to the

The **TRICK** to most guaranteed structures is how the upside is captured and what built-in trade-offs exist.

all funds to determine a variable interest payment—if any—to be paid to note holders at maturity. This averaging method results in a return that is unlikely to resemble that which is obtainable from a direct investment in the underlying funds. The only time the note is likely to outperform the underlying funds is if the funds lose money over the term or end with a significant decline.

On the surface, perhaps the fairest of the mutual fund linked-note structures is National Bank of Canada's CI Pro-Fit Note. It will pay (at maturity) interest equal to the performance of an equally weighted CI fund portfolio. Class I mutual fund units are used, with fees tacked on top resulting in a modest annual fee mark-up.

A twist (and a potential trade-off) allows National Bank to call the note halfway through the eight-year term at a price equal to an annualized return of 8% per annum. While interest rates and expected volatility influence the call decision, the note will be called if the

launch of this product.

Each mutual fund-linked note issuer enters into a long-term call option arrangement based on the performance of the respective underlying funds. The call option has a twofold function. First, it allows the note issuer to hedge its payment obligation under the note. Second, it facilitates the leverage required to “buy” \$1 of exposure with only \$0.30 to \$0.40.

Notes linked to alternative strategies get upside exposure a bit differently. While the BluMont Man Multi-Strategy Series 2 Note earmarks about 40% of net proceeds for hedge fund investments, the manager will borrow additional funds so that returns will be similar to dedicating all of the assets to its hedge funds. Hedge fund exposure can effectively reach 150% of the note's net asset value—or \$1.50 per \$1 of value. However, since only about \$0.40 is invested in hedge funds, the manager can borrow up to an additional \$1.10 to be invested in hedge funds. While

Continued on page 27

Continued from page 25

150% is a typical hedge fund leverage ratio, the hedge fund portion of this note actually has a maximum leverage ratio of 375% ($150/40 = 3.75$) so that the overall note structure can reach its maximum exposure.

Tricycle Asset Management's managed futures-linked notes do not rely on borrowed money. Rather, they rely on the leverage inherent in futures contracts to enhance exposure (thanks to the small margin requirements for futures contracts).

There are unique uncertainties to investing in alternative strategies that cannot be separated from the notes linked to such strategies. Many alternative strategy mandates are based on technical trading or other proprietary computer models. Since such models are likely the product of years of research, most managers are secretive about the factors they study to determine trade triggers. Hence, a significant risk in this area is a lack of transparency. When assessing a manager, it's impossible to objectively verify that a manager does what he says. It's not possible to look under the hood to see what's really going on before giving him money to manage. There is more subjectivity required, and a simple lack of hard facts makes the

decision that much more difficult.

It is also difficult to estimate what the returns of a hedge fund note will be. The usual caveat that past performance is no indicator of future performance applies, but in another sense. Most hedge funds in Canada don't have a very long record and as a result, it's hard to gauge how they would react under different market conditions. Often, a fund without a track record will use a proxy, such as back-testing. However, hindsight is always 20/20. There's no guarantee the manager would have reacted that way, knowing only what he knew then.

A broader proxy is a hedge fund index, which is subject to biases. Returns are often provided on a self-reporting basis and audited reports may not be available. In such a case, historical performance can be questionable. There's also selectivity bias (e.g., only managers with good records will want to provide performance to an index tracker), survivorship bias (e.g., old funds that blow up or perform poorly are folded) and valuation risk (e.g., valuation of illiquid holdings may understate downside risk and valuation policies may vary across funds). Survivorship bias alone has been found to overstate performance of hedge funds

by as much as 2.5% annually—though it affects mutual fund indexes, too.

Aside from data issues, there is the simple risk that past outperformers will not repeat. The body of academic research on managed futures, for instance, is not very supportive of the assertion that past outperformers will persist. Since there is little transparency of investment processes, historical performance is the key to many selection methods.

Fees

All structured notes first pay out 5% to 5.5% of total proceeds raised to compensate advisors or underwriters of the note issue. (The product sponsor sometimes pays this fee.) The remaining proceeds are then invested in each issuer's respective "note program." The fee similarities end there.

Mutual fund-linked notes will usually charge fairly modest direct fees, if any at all. The National Bank CI Profit Note, for instance, is linked to three CI funds, which, if bought directly in equal proportions, have a weighted average management expense ratio of 2.3%. The note charges all-inclusive fees of 2.6% annually. A more implicit cost is found in notes that use formulas to limit the ultimate interest payment

Continued on page 28

Continued from page 27

due at maturity.

Alternative-strategy notes, by contrast, generally have more complex fee structures. The BluMont note's fees are numerous and complicated. Borrowings to enhance exposure to the hedge fund program incur interest costs, payable to the guarantor. Management fees are also charged on the full amount of the borrowed funds. There are other fees applied to the hedge fund program and

the overall note net asset value. To my frustration, the language in the information statement is so vague it does not offer enough information to figure out the exact fees and net returns to note holders under different borrowing and return scenarios.

While fees on the Tricycle managed futures-linked notes are not low, the structure is much simpler and more transparent than with BluMont.

With all of the variations, general-

izations are difficult. However, mutual fund-linked notes tend to have larger embedded costs (which limit upside) while alternative strategy-linked notes have higher, more complex and less transparent fees.

Advisors should request an illustration from sponsoring firms showing "total fees" and "net investor return" variables for a variety of return scenarios. Linked notes are not bound by the standardized disclosure requirements of mutual fund prospectuses—they are a bank obligation, not a security.

Given all of these dizzying details, do linked notes deserve a place in client portfolios? The answer depends on two key questions: Does the return potential conform to the client's objectives? Will the notes have a sufficiently low correlation with the remainder of the portfolio?

Does the return potential conform to the client's objectives? Will the **NOTES** have a low correlation with the remainder of the portfolio?



Asset Allocation and Location

An asset allocation strategy should result from a clear statement of client return targets, risk tolerance, other constraints and the evaluation thereof. Within this context, it's relatively easy to quantify the downside risk exposure of the notes, provided the client intends to hold to maturity. However, from the standpoint of return targets, it is difficult to justify including linked notes as part of a portfolio.

As noted earlier, many mutual fund-linked notes are unlikely to generate a return that resembles underlying fund performance. Similar challenges exist with alternative strategy-linked notes which, if they state a return objective, generally target return levels of 7% to 9% annually. However, a generally complex pay-off structure makes the formation of a reasonable annual return

forecast extremely difficult.

Given these challenges, there is a good case to be made for excluding such instruments from many portfolios. Expecting linked notes to produce stock-like returns may not be justifiable since it is based solely on a potentially biased history. The guarantee, then, must be a key factor in opting for such instruments.

The attraction of a structured note should be that it has the potential to outperform GICs or a direct investment in government bonds. In this context, structured notes can be compared directly to such alternatives, though the challenge of expecting a reasonable return remains. Also, they should not be viewed as fixed income replacements, since structured notes are generally illiquid and generate no periodic cash flow. However, from a competing asset point of view, they may be compared to

fixed income alternatives.

Recall that adding an asset to a portfolio will generally add diversification benefits if it can enhance the portfolio's risk-adjusted performance. This will be the case so long as the added asset has a low positive (or high negative) correlation to the portfolio, and generates a positive return.

There is also an opportunity cost to using structured notes—namely the guaranteed return given up for not using GICs or government bonds. Such simple and safe investments already possess the diversification benefits created by low correlations. Hence, using structured notes may involve forgoing a guaranteed return.

If an advisor has decided that notes are attractive, the next decision is where to hold them. Asset location refers to

Continued on page 30

Continued from page 29

whether an asset is best held in a tax-deferred or taxable account. In short, if the notes are expected to result mainly in fully taxable interest income, they should be held inside tax-deferred accounts. Most mutual fund-linked notes appear to fall into this class. If more favourable tax treatment is expected (as is the case with managed futures-linked notes), they should be held in taxable accounts.

Some may hail such investments as the only way to access alternative assets. Further, advisors without a securities licence see structured notes as a major source of alternative product choices for their clients. To both lines of reasoning I would counter that something shouldn't be purchased or recommended simply because it is available. Less complex options, such as exchange-traded hedge funds and seg funds, should be examined prior to looking at these complex notes.

Structured notes have obvious appeal to investors still licking their wounds from the bear market. My personal test for whether or not to recommend an investment is by asking: Would I invest in it using my own money (or that of family members)? In the case of linked notes, my answer is "no." Generally speaking, I'd rather be exposed to the risk (and upside potential) of the underlying assets, rather than incur the explicit and implicit fees with such structured notes. **AE**

Dan Hallett, CFA, CFP, is president of Dan Hallett & Associates Inc., a company that provides managed money research to financial advisors. dba@danhallett.com