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Structured Products

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What are structured products?

The term "structured products" is used to describe a broad assortment of financial instruments that generally combine derivatives with either securities or other derivatives to create what is essentially a prepackaged investment strategy in a single product. Generally, a structured product offers a way to gain exposure to a given type of asset without actually owning that asset.

Most structured products are debt instruments issued by investment banks or other large financial institutions. Like ordinary bonds, they have a fixed maturity date. Structured products as an asset class originally were used as a way to tailor a financial instrument's risk/reward profile to an individual institutional investor's specific need that couldn't be met with existing investment vehicles. However, structured products also have been developed that are geared to individual investors. A structured product may be registered with the SEC, listed on a national securities exchange, and traded in the secondary markets as a stock or bond would be (in such a case, it may be known as an exchange-traded note or ETN).

Structured products are not the same as structured investment vehicles (SIVs), which typically function as a sort of credit arbitrage fund, borrowing money by issuing short-term commercial paper and buying bonds (often asset-backed securities) with the proceeds.

How do structured products work?

It depends on the type. Generally, a structured product typically includes an income component--for example, a zero-coupon bond--and a derivative component linked to a different type of asset, using options, futures, swaps or other derivatives to try to achieve its desired return or investment goal. Generally, the debt component of a structured product provides for periodic payments of interest, while the derivative component determines the amount paid at maturity; however, it can also be the other way around. Structured products are often designed to try to protect an investor's principal while enhancing return or hedging risk with the derivatives component.

The derivative component in a structured product might be based on interest rates; a specific equity or bond; a basket of securities; a stock or bond index or indexes; an individual commodity or basket of commodities; a commodities index; an individual currency or basket of currencies; or the creditworthiness of a security or basket of securities. As a result, the returns of a structured product are highly sensitive to changes in the value of the underlying asset(s), index(es), interest rate(s), or cash flows.

Caution: As with any debt, any guarantees a structured product offers depend on the financial solvency of the institution issuing that debt. For example, Lehman Brothers offered notes with "100 percent principal protection." However, that protection represented unsecured debt based only on Lehman Brothers' solvency. After the firm went bankrupt, those notes traded in many cases for far less than the amount invested, and their holders were on the same footing as other creditors to which Lehman owed money.

The general terms of a structured product are established before it is issued and do not change over the investment's life. In some cases, a structured product may have a credit rating from one or more of the various ratings agencies that evaluate other debt instruments.

Tip: Remember that credit ratings typically are based on the creditworthiness of the issuer and its ability to meet its obligations under the terms of the product. The credit rating does not reflect any potential market risk associated with the product itself.

Examples of structured products

The following are examples of structured products (some of which may overlap with one another):

Principal-protected notes

A principal-protected note is designed to return the principal invested when the note matures, plus (or minus) a return based on the value of whatever underlying assets the note is linked to. However, investors need to understand that the principal protection applies only at maturity, not if the note is sold before that date. Also, a note may pay its entire return at maturity rather than make periodic payments of interest.

Caution: Some PPNs offer partial or contingent principal protection, which is limited or comes into play only under certain circumstances. Make sure you understand what type of principal protection a note offers and under what circumstances.

Example(s): XYZ Bank issues a principal-protected note that has a face value of \$10,000. The note includes a zero-coupon bond and an option on an exchange-traded fund that mimics the Nasdaq Composite Index, which is at 1,400 when the note is issued. At maturity, the zero-coupon bond is redeemed to cover the repayment of principal. The call option will be exercised if the Nasdaq's value is high enough to justify doing so, and the note will pay out that return. If not, the option will expire worthless, and you receive nothing beyond the repayment of principal. (This is a hypothetical example and is not intended to reflect the performance of any specific investment.)

Market-linked notes and CDs

These are notes and CDs whose return is linked to that of a specific company stock (an equity-linked note or CD), market index (an index-linked note or CD), or other derivative. For example, an inflation-linked note or CD's return is based on the rate of inflation. A commodity-linked note or CD is linked to the performance of one or more commodities; a currency-linked note or CD is based on the performance of one or more currencies. A credit-linked note or CD's return is linked to an embedded credit default swap covering a given credit risk.

Example(s): ABC Bank offers a \$10,000 market-linked note that offers to pay the greater of a 5 percent total return after three years, or one-half of the S&P 500's return over that time as calculated on a quarterly basis (with a cap of 7 percent). If the S&P is up by 10 percent for the quarter, the interest due at maturity would be increased by 5 percent. If it is up by 18 percent, the increase would be limited to 7 percent. If the S&P experiences a 7 percent loss for the quarter, the interest due might be reduced by 7 percent. (This is a hypothetical example and is not intended to reflect the performance of any specific investment.)

A market-linked note may or may not have the principal protection discussed above. A market-linked CD also may have FDIC insurance that guarantees investors will get their principal back when the CD matures. However, the FDIC guarantee does not apply to a CD sold before maturity; if the market to which a CD is linked declines sharply, you could still suffer a loss of principal if you tried to sell before maturity. Also, CDs with FDIC insurance often offer a lower rate of return than similar products without it. Market-linked CDs are subject to the same dollar limits on the amount of FDIC insurance as other CDs.

Reverse convertibles

A reverse convertible represents unsecured corporate debt that gives the issuer the right (but not the obligation) to repay investors' principal at maturity in shares of a company's stock (typically not that of the issuer). Repayment in stock typically occurs if the designated stock's price is lower at maturity than it was when the reverse convertible was issued, or if it falls below a specified level during the term of the convertible.

For the issuer, a reverse convertible serves a purpose much like that of a put option. By allowing the issuer to repay the lender with stock if the price of that stock falls below a certain level, a reverse convertible gives the issuer the potential to reduce its cost for that debt. Because the investor's return depends on the value of the stock to which it is linked, and because of the uncertainty involved, coupon rates on reverse convertibles are

typically relatively high.

Caution: If the company's stock price drops below the level specified by the terms of the reverse convertible, at maturity investors may receive shares of stock that are worth much less than the value of the original investment.

Example(s): Bill purchases a \$10,000 one-year reverse convertible linked to the stock price of ABC Corp., which is at \$40 a share when the convertible is issued. The convertible's coupon rate is 20 percent. If ABC's price when the convertible matures is \$40 or higher at maturity, Bill will receive \$12,000 (his \$10,000 principal plus 20 percent interest). However, if ABC's price falls to \$20 by the time the convertible matures, the convertible's terms allow the issuer to pay Bill the \$2,000 owed in interest plus \$5,000 worth of stock (the \$10,000 principal divided by the \$40 original stock price = 250 shares currently worth \$20 each = \$5,000). Instead of the \$12,000 Bill had anticipated at maturity, he receives \$7,000. (This is a hypothetical example and is not intended to reflect the performance of any specific investment).

Return-enhanced notes

Some notes use options and/or leverage to try to enhance the note's return. However, gains may be subject to a cap. Also, a return-enhanced note may provide no protection against a decline in the value of the underlying asset or index on which the derivative component is based, meaning you could lose principal if the market to which a note is linked declines.

Example(s): ABC Bank issues a return-enhanced three-year note that offers double the return of the S&P 500. However, the note does not offer principal protection, and sets a limit of 17 percent on the potential return from the index derivative. If the S&P's return over the three years is 6 percent, the investor would receive both principal and a 12 percent return at maturity. If the S&P returned 10 percent, the investor would still receive the principal, but the excess return would be limited to 17 percent instead of 20 percent. And if the S&P suffers a loss of 2 percent, the investor would receive the principal minus the negative 2 percent return. (This is a hypothetical example and is not intended to reflect the performance of any specific investment.)

How can structured products be used?

- To provide income, as with other debt instruments.
- As an alternative to investing directly in a particular asset class.
- As a convenient way to adopt a complex investing strategy while investing in a single financial instrument. A structured product can streamline the process of investing in multiple asset classes, and may be more efficient than investing in its various components individually.
- To provide some exposure to the potential rewards from the asset class to which returns are linked, and in some cases, the potential for at least some downside protection.

Advantages

- For institutional investors, a structured product can provide a customized solution to an investing need. A product can be structured so that its maturity and underlying assets are tailored specifically to fit into an overall portfolio.
- Depending on the underlying assets, guarantees offered, and method of structuring payment, a structured product may offer an interest or coupon rate that is substantially higher than the prevailing market rate for other debt instruments. However, it's important to have a complete understanding of the specific conditions that govern payment of both interest and principal for a specific structured product, as they can affect both overall return and the amount an investor receives at maturity.

- A structured product can be a convenient way to get at least partial exposure to the potential returns of one or more asset classes without actually owning them. (However, you also need to understand the potential risks involved with those asset classes, and the extent to which payment of your principal and interest could suffer from them.)

Tradeoffs

- Because of its highly specialized nature, a structured product may be thinly traded, and there is no guarantee a structured product will be marketable if you try to sell it before its maturity date. Also, even for a principal-protected product, that principal protection applies only at maturity; if you sell it before then, you could have a loss of principal or be unable to fully realize the projected return on the investment. As a result, structured products are generally most suitable for investors with a time horizon that matches the individual investment's maturity date, rather than an investor who needs a high degree of liquidity.
- Any guarantee associated with a structured product--for example, the principal protection of a principal-protected note--is generally subject to the financial solvency of the issuer, as with any debt instrument. However, in some cases, such as some structured CDs, the product may come with FDIC insurance that guarantees the return of principal at maturity (though the FDIC coverage does not guarantee return of your principal if you try to sell a structured CD before maturity).
- Because structured products in general are not standardized, they can be challenging to understand and compare with other products--even other structured products. Some may be relatively simple; others can be quite complex. The risks involved depend not only on the financial solvency of the issuer, but on the specific financial instruments on which a given structured product is based. For example, the risks involved with a derivative based on an equity index will be different from the risks involved with a structured product's income component; they may also be different from a similar derivative that is not part of a structured product.
- Because there is no standardized method for pricing structured products, their fees may be challenging to understand. For example, in some cases, fees may be embedded in the pricing of the options associated with a given product. Also, a highly customized structured product may have higher fees associated with that customization.
- Returns from a structured product may not match that of the underlying asset. Don't assume that because you've invested in a particular asset previously that a structured product behaves in the same way. Also, there may be a limit on the upside potential return from the underlying asset, especially if a product also provides principal protection or the interest rate is substantially above the market rate.
- A specific structured product may require investors to commit a minimum investment for a specific term. Again, consider whether your time horizon is appropriate for a given product before investing.

Evaluating a structured product

There are many questions to consider when deciding whether to invest in a structured product. Some have to do with the investment itself, such as:

- What is the term of this product?
- What underlying assets does it involve? Does it include options, futures, or other derivatives?
- What types of risk are associated with those underlying assets?
- What interest rate does it pay? In general, the higher the interest rate offered by a structured product, the more likely it is to be associated with highly volatile underlying assets, and the greater the potential risk to principal.

- Does this product offer principal protection at maturity?
- What underlies any guarantee of return or safety of principal?
- Who issues the structured product, and what is their credit status?
- Is there a cap on the return that a structured product offers? If the product offers returns based on an index, will that return be limited if the index moves beyond a certain level?
- Can the results promised by this product be duplicated cost-effectively in a different way?

Other factors to consider involve your liquid net worth, tax status, risk profile, age, and investment experience, as well as how the structured product would fit into your existing portfolio.

Caution: Information about a structured product's characteristics and risks are included in its prospectus; you should obtain and read a copy before investing so you can carefully consider all significant factors.

Tax issues related to structured products

- Even though a structured product's returns may be linked to equity returns, those payments do not necessarily qualify for preferential tax treatment. Depending on the structure, they may be taxed as interest, not at the (generally more favorable) rate for capital gains or qualified dividends.
- In some cases, you may have to report the interest on your structured product as original issue discount (OID) taxable interest in the current year's tax return, even if the interest payment is not actually made until maturity. Be sure to understand how a structured product will be taxed before purchasing.

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