



SHERPA INSIGHT

Detterbeck Wealth Management, Inc.



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STRUCTURED NOTES

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One of our goals at DWM is to provide integrated solutions that seek to meet each client's personal financial needs, be it short-term or long-term goals. One of the newest ways we can do this is by employing structured investments.

Structured investments or notes are investments that are constructed to meet specific investor needs by incorporating special, non-standard features, including principal protection, leverage and exposure to a variety of underlying assets like bonds, stocks, currencies and commodities. Basically, one can now get direct exposure to various asset classes without being subject to their traditional volatility or return characteristics.

The **principal protection feature** - which provides investors with exposure to an asset or asset class with limited or no downside risk to the initial investment - is the one we would like to focus on. It is for investors who are concerned about principal/capital risk and who are willing to forgo some upside or yield in exchange for principal protection.

A great example of this is a **commodity-linked structured note**. We all know that commodities are one of the most volatile assets classes out there. Nonetheless, they offer a non-correlated complement to the rest of a traditional portfolio of stocks and bonds. By using a commodity-linked structured note, we can give the investor up-until-now-hard-to-get diversified commodity exposure without the scary downside risk. We recently coordinated a deal where the investor bought \$50,000 worth of a 100% principal-protected structured note where the underlying basket was made up of four commodity elements: copper (25%), zinc (25%), crude oil (20%), and the Goldman Sachs Commodity Agricultural Index - Excess Return (30%). The term is a 2 ³/₄ year note maturing in late 2009. So the way it works is that come late 2009, if the basket has appreciated at all, the investor will make money. If the basket is negative, the investor simply gets his \$50,000 back. In conclusion, the client got much needed exposure to a hard-to-get asset class with full downside protection. If his/her investment turns sour, he/she simply loses the opportunity cost of doing some other investment. Subject to the creditor's payment, he/she will be guaranteed his initial investment back.

And it doesn't just work with commodities. The other areas

we like to participate in are **global indices** and **foreign currency** structured notes. To be able to get global equity exposure (e.g. Dow Jones EURO STOXX 50 Index, Nikkei-225 Stock Average, S&P 500 Index) with a floor may be very tempting to some people. Furthermore, if you're a demographic believer and think the equity markets will be peaking in 2009/2010/2011, it's a great short-term protected way to play that.

As far as foreign currency exposure goes, structured notes give you a very direct way to play the dollar depreciating against several foreign currencies at once. Here is an example of a foreign currency note:

"BRIC" Currency-Linked Capital-Protected Note due April 2009

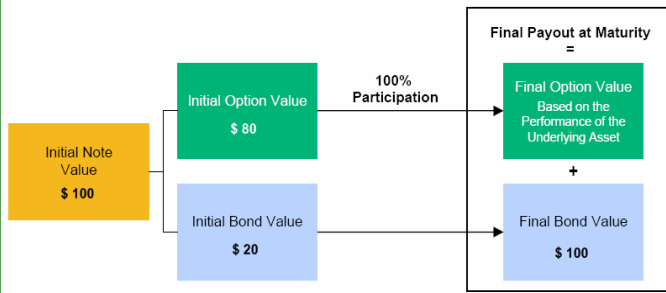
- Underlying basket: an equal-weighted basket that measures the combined performance of the exchange rates of four currencies (Brazilian Real, Russian Ruble, Indian Rupee, & Chinese Renminbi) relative to the US Dollar.
- 100% principal protected; 130% upside participation

Upside participation or "leverage" is usually an added bonus with the currency notes. What it means (using the above note as an example) is that come maturity, if the underlying basket of currencies is up 10%, the investor will get back 13% (10% * 130% participation rate). (Please note that typically there may be a "cap" or maximum return limit on your investment when leverage is in the mix.) If the basket was down, the investor would simply get their initial investment back.

You may be thinking that it almost sounds too good to be true. How can this be? It comes down to the structure. One way to achieve principal protection is simply by combining a zero coupon bond with an option. Recall that a call option is a derivative which gives the holder the right, but not the obligation to buy the underlying asset at an agreed strike price at any point during a fixed period of time or on a fixed date. In the diagram below, we see how a hypothetical initial note value of \$100 is split up into a zero coupon



bond that cost \$80 and a \$20 option (let's say on the Nikkei 225 equity index).



Note: All values are hypothetical.

The zero coupon bond will, by definition, mature at \$100, therefore we have our principal back on the zero coupon bond alone. However, if the Nikkei goes up, the \$20 option we bought will also go up. In summary, our final payout at maturity must equal the final bond value plus the final option value (based on the performance of the underlying asset, in this case, the Nikkei 225).


This is just one example of a structured investment. Hence, we come to the reason why they are called “structured” - because of the new ways that they often combine basic financial concepts. Structured investments give the investor new ways to pursue his/her specific investment objectives. They enable individual investors to balance risk and reward in ways that were most likely difficult to achieve effectively with traditional investments.

In conclusion, structured notes, in particular, principal-protected ones, can be designed to enhance the investor's portfolio. These notes can give you not only 100% or more upside participation, but also principal-protected exposure to areas like commodities, foreign currencies, and global equities. Of course, there are some considerations and risks to consider as well, including, but not limited to:

- Generally notes that have substantial principal protection are treated as contingent payment debt instruments under Tax Reg 1.1275-4 and hence taxable investors will generally have to recognize taxable income based on an assumed

yield even though they may not receive any payments thereon prior to maturity (“phantom income”). That being said, it may be appropriate to use these within a qualified account that enjoys tax-exempt or tax-deferred status.

- The guaranteed return of principal at maturity is subject to the credit risk of the issuer (e.g. Barclays, Lehman Brothers, Morgan Stanley, Bear Stearns, etc).
- Opportunity cost - if the underlying basket does not appreciate over its term, an investor will only receive the original issue price at maturity and not be compensated for the time of their investment. In other words, you could have made money elsewhere.
- Secondary trading may be limited. There may be little or no secondary market for these notes, hence if you buy one and need to liquidate you may not be able to or may be able to do so only at a significant discount to what you paid in at.


If this is the first time hearing of structured notes, I promise it won't be your last. In 2005, over \$12 Billion was raised in US Structured Product issuance. That number will be dwarfed in the years to come. If you or anyone you know may be interested in working structured notes into your portfolio, please give us a call. 

charles SCHWAB news:

We are pleased to announce that starting in April, you will have expanded access to:

- Cost basis information
- Market monitor indices
- More charts and tables
- Annual realized gain/loss report in an easier to read format

through www.SchwabAlliance.com and on your Schwab statements.

Please call us if you have any questions. 

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