

# ADVISORPRACTICE

## In Defence of Notes

PPNs are attractive alternatives for the risk-averse investor

### TRUE WEALTH

BY THANE STENNER



Over the past few months, Principal-Protected Notes (PPNs) have been the target of some

highly critical commentary in the press. Without going into too many details, the main thrust of the criticism seems to be that the drawbacks of PPNs – namely, their high fees and the lack of disclosure – made them unworthy investments. So much so, in fact, that “savvy investors” should avoid PPNs completely.

Now, I admit, PPNs are not a “perfect” investment. Then again, neither is any other that I’ve ever come across. Like every other investment, PPNs have their pros and cons and it’s up to us as professionals to determine whether they’re good for the client sitting across the table from us. Sure, we can zero in on particular features of an investment and discuss benefits and drawbacks in the abstract. But without a critical piece of information – the personal financial situation and risk tolerance of the client – it’s a little unfair to pass judgment on an entire asset class or structure.

Myself, I believe certain types

of PPNs are an excellent option for risk-averse, high-net-worth individuals. Because of their preferential tax treatment (returns are taxed as capital gains rather than interest if the PPN is sold prior to maturity), they are an attractive alternative to a traditional bond ladder or similar fixed-income strategy, particularly in a time of interest rate uncertainty. No, they’re not for everybody. But they are a valuable tool to keep in your financial toolbox.

With that in mind, allow me to present a defence of PPNs, addressing some of the points raised by the press:

**Accusation:** PPNs charge hefty fees, literally piling fee upon fee.

**Defence:** Not if you pick the right PPN structure.

Yes, some PPNs I’ve seen charge extremely high fees. And yes, I’ve seen notes where fees for the PPN are layered on top of fees for the underlying investment (a mutual fund, for example). But by no means does every PPN fall into this category. Index-based PPNs are often very reasonably priced, for example. And if you choose custom-built or private PPNs, with securities chosen for the individual investor, fees are in fact quite modest.

**Accusation:** The formulas for

determining PPN returns typically shortchange the investor.

**Defence:** PPNs are a compromise product.

PPNs are meant to be a hybrid product – a cross between a fixed-income investment and a basket of equities or indices. The investor has to give up something in return for a capital guarantee; there is no getting around this basic fact. PPNs will never provide full exposure to the returns of the underlying investment, but neither will they provide full exposure to the volatility or downside risk. For HNW investors whose primary financial goal has shifted from building their wealth to protecting their wealth, this is a worthwhile compromise.

Like every other investment, PPNs have their pros and cons, and it’s up to us as professionals to determine whether they’re good for the client sitting across the table from us.

**Accusation:** PPNs are opaque investments, with little or no regulation and oversight, and little disclosure.

**Defence:** It’s up to the advisor to perform due diligence and ask questions.

True, the do-it-yourselfer will probably be frustrated by the amount of homework they have to do with some PPNs. But professionals should have no problem understanding how PPNs make money for investors, and digesting the various statements and disclosures from the issuer. Make sure to explain these to your client in plain English when you recommend a particular PPN.

If you’re not satisfied with the information from the company, make some phone calls and ask questions. If the answers don’t leave you completely comfortable with a given PPN, choose another. In our practice, we are highly selective – out of the hundreds that come across our desks in any given year, we might recommend about 10. There’s simply no reason to settle for anything less than absolute quality.

**Accusation:** The principal guarantee is worthless anyway – no stock index is going to be down in 10 years.

**Defence:** Risk is in the stomach, not the brain.

We professionals know that it is very unlikely that any major stock market index will be lower in 10 years than it is today. So yes, you could say that the protection offered by PPNs is of little value. But at the end of the day, risk doesn’t reside in the head – it’s in the stomach. For most investors,

risk is a feeling, a deep sense of worry or anxiety that runs counter to both logic and financial history. As professionals, we have failed our clients if we don’t address this problem when we make portfolio recommendations. All the logic in the world won’t help if a client will jump out of his portfolio during a market downturn. If it takes a principal guarantee to ensure that some of our clients stay the course, then the guarantee has definite value. It will almost certainly result in a better portfolio over the long term. And isn’t that the whole point of what we’re doing for clients?

Not every portfolio will need a PPN. But that shouldn’t prevent you from having them in your toolbox. For many HNW clients, PPNs offer a compelling mix of performance and security. For those who already have “enough,” PPNs can be an excellent way to preserve and build wealth safely, without taking on more risk than they need. Keep that in mind the next time you read something to the contrary. **AER**

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