



Protection for the wealthy

Principal-protected notes are a great way to protect your wealth

By Thane Stenner, CIM, FCSI – featured on fundlibrary.com July, 2003

One of the benefits of wealth is the ability to invest in instruments that are beyond the reach of the average investor. Take alternative investments, for example. For the most part, their high investment minimums and low liquidity make them the exclusive domain of the rich. But for those fortunate enough to have the money, alternative investments can be very beneficial, boosting portfolio returns and minimizing risk. In fact, they are one of the only asset classes that have performed well in the current market downturn. Call it one of the advantages of wealth.

Now you can add another investment product to the this list. Principal protected notes (PPNs for short) have been around in a variety of formats for some time. But the recent market downturn has led financial institutions to redesign them for use in the HNW portfolio. The idea behind these PPNs is simple: allow HNW investors to participate in stock market gains while limiting downside risk. Performance is linked to the performance of a basket of other investments – a portfolio of blue-chip stocks, a group of stock market indices, or a collection of actively-managed mutual funds. PPNs can be customized in a variety of ways, but in most cases, they provide investors with a full guarantee on principal if the note is held until maturity.

Hang on a second – why do millionaires need downside protection? If you have a lot of money, you can afford to take on more risk, right? That's not the way I see it. If you've acquired a significant amount of capital over the course of your life – enough to allow you to achieve your lifestyle goals with relative ease – then it makes sense to take steps to protect that capital. Or to put it another way, once you have “enough,” it stands to reason that your primary investment goal should be to make sure you *always* have “enough.” That's not to say that you don't want your capital to grow. But your primary goal should be security, not growth.

And that, in a nutshell, is why I'm such a fan of PPNs. Certainly, there are plenty of other investments that offer you more potential for growth. And yes, there are other investments that offer principal protection. But the balance of growth and security offered by PPNs is hard to beat. With a PPN, your portfolio has the opportunity to grow without undue risk to the capital that allows you to pursue a high quality of life. That's something most every HNW individual could benefit from.

PPNs are extremely flexible financial instruments. Because they can be issued as private placements, PPNs can be customized to suit the investment needs of a specific individual. A few examples will demonstrate what I mean.

PPN structure #1: The protected portfolio

In this structure, investors purchase a principal-protected note with a seven-year maturity. Performance is tied to a portfolio of fourteen big-name international stocks representing a variety of different industries. Every six months (as measured by the issue date), the performance of the top stock in the portfolio is

locked in and the stock is removed from the portfolio. Upon maturity, performance is calculated by taking the average of these locked-in returns, and is paid out along with principal. This structure offers a number of attractive benefits, primary among them is the ability to lock in the performance of a high-flying stock without worrying about whether it will crash back to earth close to maturity. Diversification is another obvious benefit: by holding stocks in a variety of industries, investors don't have to guess which industry will perform best in any one year. This can be particularly useful in times like these, when it's unclear which sector will lead the charge out of the market downturn.

PPN structure #2: income and principal protection

Growth is all well and good, but what if you don't want to wait a full seven years before you see a return on your investment? There's a PPN for you too. You can construct a seven-year PPN that pays annual interest based on the performance of three global equity indices: the FTSE 100 (which represents stock performance in the UK), the Dow Jones Euro STOXX (which represents Europe), and the Nikkei 225 (which represents Japan). The exact interest payments are calculated by using the greater of (a) nine percent plus the lowest average monthly return for the previous 12 months, or (b) zero percent. In other words, the worst investors can do in any one year is break even. As with other PPNs, principal is returned in full upon maturity of the note. The result is a fully guaranteed income product that offers potential for higher interest without the downside risk associated with junk bonds, income trusts, and similar investments.

PPN structure #3: deferred income

On the other hand, if income isn't an immediate concern, you can modify the above strategy. Instead of paying out annual interest, your PPN will pay "variable interest" upon maturity. In such a structure, gains would be calculated by taking the average of the compounded monthly returns of a basket of world equity market indices, with a predetermined number of top returns excluded. Again, principal would be fully protected if the note were held to maturity. Speaking of maturity, investors can customize their own maturity dates with this option: three, five, or seven-year notes are available. This would be a good strategy to pursue as the market looks to resume its growth phase.

Drawbacks of PPNs

Despite their obvious advantages, PPNs do have a few drawbacks. Number one is their high investment minimum – \$5-million is the entry level for the private placement notes I describe above. Number two is the relative lack of liquidity with these notes. Simply put, these are "locked-in" investments: once you buy, you may not be able to access your capital prior to maturity. True, issuing institutions have agreed to maintain an informal, over-the-counter secondary market for the notes. But there is no way for investors to know for sure that they will receive full value for their notes if they need to sell prior to the maturity date. For those who have income coming from other sources, this won't be much of a hassle. But for those who may need the capital prior to maturity, there are probably better investment options.

At the end of the day, PPNs are a hybrid investment. If you want absolute growth, then you're going to be disappointed with PPNs. On the other hand, if you want to lock in a given rate of return, again, you're going to be disappointed with PPNs. But if you're willing to compromise a little on either of these positions – if you want growth, but you're willing to trade some upside for some downside protection – then PPNs might be worth taking a closer look at.

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