

# ADVISORPRACTICE

## The Wealth Defender

Use principal-protected notes to preserve client wealth and build your practice

### TRUE WEALTH

BY THANE STENNER



As institutions become increasingly aware of the unique needs of the high-net-worth population, they are issuing more and more specialized, equity-linked products – principal-protected notes (PPNs) and equity-linked notes (ELNs). And as HNW individuals become increasingly aware of the need to protect their capital, the demand for these products is increasing along with it. Clearly, this is a trend that anyone who works with the wealthy needs to be aware of.

PPNs and ELNs can be complicated. But the basic idea behind them is pretty simple: allow investors to participate in the potential for stock market gains, while limiting downside risk by protecting principal. In a typical note, performance is linked via derivatives to the performance of a basket of other investments and is paid out with principal on the note's maturity date.

Essentially, these notes represent a compromise between growth and security. A linked equity note allows

clients to build their wealth in a tax-efficient way without taking on undue risk. For clients who already have "enough," this is an extremely attractive proposition.

By recommending products that balance growth and security, you become a defender of the client's wealth and personal well-being. Your clients view you as a professional who's more concerned with ensuring their quality of life than promising extraordinary returns. In the long run, that's good for business.

Let's take a look at a few previously-issued notes, to show you how attractive these products can be. Understand that these examples are no longer available on the market, but similar products exist.

### REGIONAL WEIGHTING

One of the best note structures I've seen recently is the Global Equity Performance Weighted Securities Notes. Issued by a large U.S.-based investment bank, these notes track stock market performance in three geographic regions (North America, Europe and Asia). At the end of the seven-year term (or upon redemption), the top-performing region receives a 55% weighting in the note, the second-best region

receives a 35% weighting, and the third-best receives a 15% weighting. While this note does not have a principal guarantee, the regional weighting system takes the guesswork out of asset allocation.

### PRINCIPAL GUARANTEE

Index Optimizer Notes have a similar structure but with a 100% principal guarantee. Backed by one of the largest U.S. banks, this note's performance is calculated from a pool of eight stock, bond, and resource market indices. Each year, the return of the best performing index of the group is locked in and discarded from future calculations. The note has an upside limit of an 11.1% annual return, but with a 100% principal guarantee, clients will appreciate the protection.

### EXPOSURE TO UPSIDE

Offered by one of the largest mutual fund companies in the country and backed by one of the big five banks, bestLINK Protected Deposit Notes are tied to the performance of a five-star international small cap fund. The note offers an innovative leveraging formula to enhance returns: assets are allocated between the underlying fund and an investment in a national bond

portfolio.

The exact mechanics are a little complicated, but essentially, the greater the outperformance of the underlying fund, the more weighting it has in the note. With a 100% principal guarantee upon maturity (eight years), this note offers HNW clients excellent exposure to a high-reward sector while limiting downside risk.

The above examples are just three of literally dozens of PPNs and ELNs available. So what should you look for? Here are a few quick tips.

- ① Focus on quality. A PPN is only as good as the strength of its capital guarantee, which is why you should focus on who is underwriting the protection of the note. Your clients insist on absolute quality from you, and you should insist on it from the suppliers you work with.
- ② Find the "bright minds." Take a good look at the people behind the note. They should be the "bright minds" of the industry – managers or analysts with a track record of superior performance, and experience creating effective equity-linked products. Be cautious about any note that doesn't fit into this category.
- ③ Consider customized notes. If you can't find a note that suits the client's exact needs, consider having a customized note created for you. Such products typically require high investment minimums (\$5 million US or

more is common), but can fit well with a client's other holdings. In addition, clients like the idea of an exclusive portfolio created just for them.

- ④ Use backtested data and visuals. When presenting your recommendation to a client, make sure to use graphs, charts, or other visual aids during the discussion. Make these available as handouts that can remind clients why you're recommending a given note. Ultimately, these visuals will be the most persuasive part of your argument.

Both PPNs and ELNs are excellent choices for the HNW portfolio. Clients who have acquired significant wealth – enough to ensure they can attain their lifestyle goals with ease – are typically seeking capital protection more than capital growth. Something to keep in mind while building a successful HNW practice.

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## Looking For Logic

Are advisors consistent with their active vs. passive views?

### GUEST COLUMN

BY JOHN J. DE GOEY



A year and a half ago, I went around the country speaking at Advisor Forum and asking advisors if they believed they made consistent recommendations to their clients. Not surprisingly, there was near unanimity that advisors did precisely that.

My concern, as a person who wants financial advisors to think like and be thought of like doctors or lawyers, is with the professional recommendations that are made and the rationale behind them. Some may say I'm a zealot for passive investment vehicles. I disagree. I would say that I am a zealot for making recommendations based on evidence and consistency, which

leads me to a passive recommendation more often than not.

By now, a large number of advisors carry licences to sell both investment products and insurance products. Are their recommendations consistent both ways? Let's do a quick comparison. Suppose a client comes to you asking you to make two recommendations for a balanced portfolio: one in a non-registered cash account and another inside a universal life policy. What would you recommend?

My experience, in speaking with hundreds of advisors over more than a decade, is that many advisors use actively managed mutual funds or wrap accounts as the recommended solution for the open account, but asset class indexes as the UL solution. What gives?

If advisors are so consistent, wouldn't they recommend the

same approach irrespective of the product? I can't tell you how many times I've heard people in the business tell me "portfolio design is about having a specific process, not using a particular product." If this were true, why do virtually all advisors consistently recommend a passive product solution within an insurance context and an active solution in an investment context?

If the process is what is truly important, then it should lead to an unambiguous solution. What makes indexes so great in UL policies, but so horrible in investment accounts? Either the two approaches (active or passive) are equal in merit and therefore should be used interchangeably or one is conspicuously better than the other and should be used virtually exclusively. The best product should be used at the point of

implementation. Why have one approach for UL and another for open accounts?

If an advisor was truly indifferent wouldn't it be just as likely to see active investments within a UL policy and passive investments in the cash account?

Instead, most advisors prescribe a steady diet of actively managed cash account money and passively

### What makes indexes so great in UL policies, but so horrible in investment accounts?

managed UL money. Advisors who sanctimoniously insist they are totally focused on their clients' best interest deliver all this with a straight face. It's the self-righteous insistence that are unbiased professionals that bothers me.

My sense is that advisors are perfectly happy to recommend passive products if they can get a commission out of it, as seen on the life side of the business. Unfortunately, since index funds

and exchange-traded funds don't pay commissions and trailing commissions, those products don't make advisors' recommended lists on the money side.

In the past, advisors had little choice but to use indexes in a UL environment. Today, virtually all insurance companies offer active alternatives. Therefore, could all those advisors who simultaneously recommend passive UL product options and active investment account product options and insist they are being consistent and professional throughout, please write to me and explain your actions.

It seems to me we're at the point in the show where Ricky says to Lucy: "Luuucy, you've got some splainin' to do!"

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