

Structured Investments in Action **Part I: Understanding Downside Protection**

A comparison of the different levels of protection available in today's structured investment marketplace and how they are used to manage risk.



Investors often look to the world of structured investments for ways to gain exposure to the markets while simultaneously maintaining a level of protection against market declines. Structured investments with full or partial principal protection can offer a risk-managed approach within a portfolio, providing peace of mind for investors that they should receive some or all of their principal at maturity regardless of the market's performance. However, an investor must hold the structured investment until maturity in order to receive the stated protection, and any promise of protection will always be subject to the issuer's creditworthiness and will depend on the specific terms of the offering.

What is a principal protected structured investment?

A structured investment with downside protection generally refers to an investment that combines a zero-coupon bond with a derivative component, where the payout is linked to an underlying asset such as an index (an "underlier"). The more risk an investor is willing to take on, the higher the upside potential will be and vice versa. Investments with full principal protection can be issued both in note form (as senior unsecured debt obligations of the issuing bank), or in certificate of deposit (CD) form (backed by FDIC insurance, up to statutory limits). Investments with partial principal protection are issued in note form, and are not available as certificates of deposit.

Mechanics matter!

Downside protection comes in several different forms, from 100% principal protection to protection that can actually "disappear" if the investment's underlier breaches a certain specified level. This variety across the risk-return spectrum is an appealing trait that the structured investment market is known for, offering a range of strategies for investors with varying risk appetites.

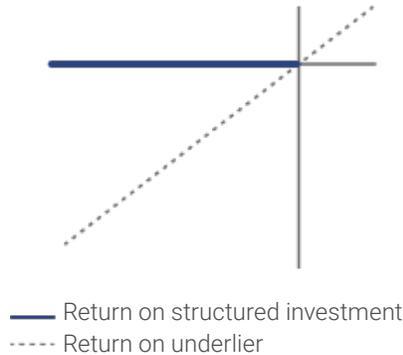
Because all downside protection is not created equal, when analyzing an investment, it's critical that investors understand just how much protection they have on the downside and what conditions must be met, if any, to achieve this protection.

Reminder: Because any form of principal protection on a structured investment is always subject to the credit risk of the issuer, investors must be comfortable with the issuer's creditworthiness. They must also be comfortable with holding the note until maturity in order to receive the offering's stated terms

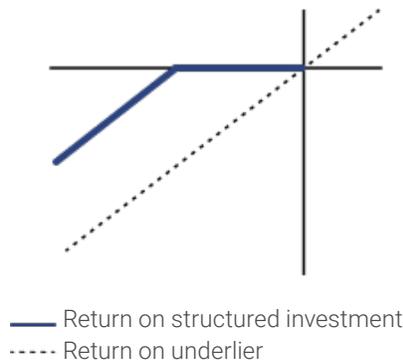
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Here are some of the common types of downside protection found in the structured investment market today, and how they compare.

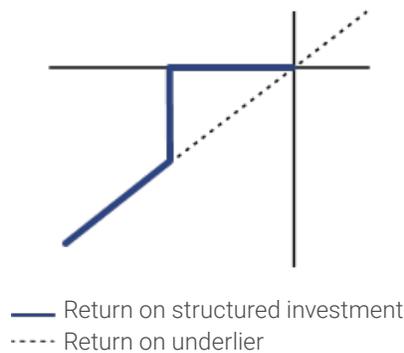
Full issuer protection: An investor’s principal investment will be returned at maturity.



Hard buffer: A type of protection that absorbs a fixed percentage of the underlier’s loss. Beyond the hard buffer, the investor faces losses that are one-to-one with the underlier.



Barrier: A type of protection that absorbs a fixed percentage of the underlier’s decline; however, if the underlier declines beyond a specified level, this protection disappears, and losses are one-for-one from the underlier’s initial level on the trade date. This type of protection may be observed continuously, daily, or at maturity.



The visuals included above are hypothetical examples. They do not reflect any specific structured investment, and are solely intended to help illustrate how different protection methods work.

Ready to compare?

Let's look at three hypothetical notes to underscore how these types of protection play out in negative market scenarios.

Underlier performance (at maturity)	-10%	-15%	-30%	
Return of principal (at maturity)*:				Max possible loss
Full protection	100%	100%	100%	0%
20% hard buffer	100%	100%	90%	80%
20% barrier**	100%	100%	70%	100%

*Subject to the creditworthiness of the issuer and at maturity only

**barrier observed at maturity

Putting it all together

Peace of mind with full principal protection

The table above highlights an attractive feature of structured notes with full principal protection: peace of mind that regardless of the performance of the underlier, investors will receive 100% of their initial investment back if they hold until maturity, subject to the credit risk of the issuer. One well-known trait of market linked CDs is that they offer not only full principal protection at maturity, but also FDIC insurance, subject to statutory limits. Keep in mind the return on a market linked note or CD is dependent on the performance of its underlier and may be less than a typical fixed interest rate bond, or even zero, at maturity should the underlier perform poorly.

A degree of dependable protection with hard buffers

As shown in the table above, hard buffers are considered more protective (i.e., less risky) than barriers since they provide protection regardless of the performance of the underlier. Even if the underlier declines to zero, an investor will receive the stated buffer protection amount (e.g., 20% in the table above), subject to the credit risk of the issuer, as always. Hard buffers can be a way to add a degree of risk management to an equity allocation, with the understanding that they generally come with a limit on upside participation in the underlier (either through a stated maximum return or a participation rate).

Conditional protection and greater upside with barriers

It is important to understand two key aspects about barriers.

First, and most importantly, barrier protection is conditional. It is conditional upon the underlier trading at or above a specified level (either at maturity, on a daily basis, or continuously, depending on the type of barrier). If this condition is not met—that is, if the underlier drops below the barrier level—the investor no longer has downside protection, but rather has full exposure to the underlier’s decline. Given the additional risk, notes with a barrier can offer more upside opportunities, so long as the investor is comfortable with the potential for exposure to the full downside risk of the underlier if the barrier is breached.

Second, barriers can be observed at different times such as:

- A barrier that is observed at maturity,
- A barrier that is observed throughout the term of the product on a daily basis at market close, or
- A barrier that is observed during the term of the product continuously, throughout each trading day.

Investors should understand which barrier observation type applies to their investment. Keep in mind that a continuously observed barrier usually allows for somewhat more upside versus the other two types, all else held equal, since there is greater risk of barrier breach.

A note on taxes

It is important to note that the tax treatment on structured investments can vary based on a variety of factors and may also be subject to change. Investors should always review the tax section of an investment’s offering materials and consult their tax advisor concerning any applicable tax consequences of owning structured investments that may apply to them.

Informed investing

When considering any structured investment, an investor should understand the type of protection it offers as well as its pay-out potential, by carefully reviewing the offering document. Structured investments are well known as risk-managed strategies, and the more familiar investors are with their various forms of protection, the more tools they will have in managing wealth.

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