

# Important Information about Structured Products

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## Definition and Background

Structured products, as described by the Financial Industry Regulatory Authority (FINRA), are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency. They are a hybrid between two asset classes typically issued in the form of a corporate bond or a certificate of deposit but instead of having a pre-determined rate of interest, the return is linked to the performance of an underlying asset class. As this definition suggests, there are multiple types of structured products. These variations include certain products offering full protection of the principal invested while others may offer limited or no protection of principal.

Most structured products offer the potential to pay an interest or coupon rate above the prevailing market rate and are used as tools by high net worth investors for portfolio diversification. Structured product sales began in the 1980s. These investment vehicles arose from the needs of companies seeking options for debt issuance. Here, companies are able to transfer risk, for a fee. Structured products provide investors with highly targeted investments that are tied to a specific risk profile, return requirements and market expectations.

## How Structured Products Work

Similar to a zero coupon bond, often, no interest payments are made during the life of the security. In most cases, the investor bypasses traditional payments in exchange for participation in the underlying asset class of that particular issue. Any payments earned by the investor, such as through market performance or the return of principal, are determined by the specific terms of each individual deal and are made on the set maturity date. Moreover, many structured products are designed by combining 2 components, a zero coupon bond, providing for the principal return, and a call option on the underlying asset, allowing investors to participate in the potential appreciation of the reference asset.

## Underlying Asset Categories

**Index:** The performance of a selected index is used as a reference asset for some structured products. An index is a statistical measure of change in a securities market and the particular index selected varies by product and issuer. The S&P 500 and Dow Jones Industrial Average are two well known examples, but narrower types of indices may be used, such as those relating to particular sectors or regions.

**Currency:** A selected group or basket of currencies whose weighted average is used as a reference asset for some structured products. The number of and particular currencies selected vary by product and issuer. The Euro and Yen are examples.

**Commodity:** A selected, basic good or group of goods whose value is used as a reference asset for some structured products. The type and number of commodities selected vary by product and issuer. Grains, gold, oil and natural gas are examples.

**Interest Rates and Yields:** Bond indices, yield curves, differences in prevailing interest rates on shorter and longer-term maturities, credit spreads, inflation rates and other interest rate or yield benchmarks are used as a reference asset for some structured products.

## Risks to Consider

As an investor, you must be fully aware of the associated risks and whether these securities fit within your investment parameters. Your investment objectives should be carefully considered and discussed with your Financial Advisor. Investors must understand the product's features and be able to bear the risks associated with investing in them. Features of a particular product, dependent upon the type of structured products issued, to consider when determining its general suitability include:

**Credit Risk:** Structured products are unsecured debt obligations of the issuer. As a result, they are subject to the risk of default by the issuer. The creditworthiness of the issuer will affect its ability to pay interest and repay principal. The financial condition and credit rating of the issuer are, therefore, important considerations. The credit rating, if any, pertains to the issuer and is not indicative of the market risk of the structured product or underlying asset. If a structured issue provides principal protection or a minimum return, any such guarantee rests on the credit quality of the issuer. Those issued by banks in the forms of CDs may also provide FDIC insurance with standard coverage limitations.

**Liquidity Risk:** Structured products are generally not listed on an exchange or may be thinly traded. As a result, there may be a limited secondary market for these products, making it difficult for investors to sell them prior to maturity. Investors who need to sell structured products prior to maturity are likely to receive less than the amount they invested. Therefore, structured products with longer maturities are subject to greater liquidity risk. The price that someone is willing to pay for structured products in a secondary sale will be influenced by market forces and other factors that are hard to predict. Sometimes, a broker-dealer affiliate of the issuer may make a market for the resale of structured products prior to maturity but the price it is willing to pay will be adversely affected by the commissions paid by the issuer on the initial sale of the structured products and the issuer's hedging costs. Some structured products have lock-up periods prohibiting their sale during such periods. Persons who invest in structured products should have the financial means to hold them until maturity.

**Pricing Risk:** Structured products are difficult to price since their value is tied to an underlying asset or basket of assets and there typically is no established trading market for structured products from which to determine a price.

**Income Risk:** Structured products may not pay interest (or may not pay interest in regular amounts or at regular intervals), so they are not appropriate for investors looking for current income. Because the return paid on structured products at maturity is tied to the performance of a basket of assets and will be variable, it is possible that the return may be zero or significantly less than what investors could have earned on an ordinary, interest-bearing debt security. The return on structured products, if any, is subject to market and other risks related to the underlying assets.

**Complexity and Derivatives Risk:** Structured products typically use leverage, options, futures, swaps and other derivatives, which involve special risks and additional complexity.

**Pay-Out Structure Risk:** Some structured products impose limits, caps and barriers that affect their return potential. With barriers, a structured product may not offer any return if a barrier is broken or breached during the term of the structured product. Conversely, some

structured products may not offer any return unless certain thresholds are achieved. Some structured products impose maximum return limits so even if the underlying assets generate a return greater than the stated limit or cap investors do not realize that excess return. Structured products also have participation rates that describe an investor's share in the return of the underlying assets. Participation rates below 100% mean that the investor will realize a return that is less than the return on the underlying assets.

**Volatility and Historical Performance of Underlying Asset(s):** Past performance of an underlying asset class is not indicative of the profit and loss potential on any particular structured product. The value of the underlying assets can experience significant periods of fluctuation and prolonged periods of underperformance.

**Costs and Fees:** Costs and fees associated with the purchase of a structured product vary.

**Tax Considerations:** Structured products may be considered "contingent payment debt instruments" for federal income tax purposes. This means that investors will have to pay taxes each year on imputed annual income based on a comparable yield shown in the final term sheet or prospectus supplement. In addition, any gain recognized upon the sale or exchange, or at maturity, of these products will generally be treated as ordinary income. This especially pertains to principal protected issues. Please consult your tax advisor for guidance.

Additional vulnerabilities may include loss of principal and the possibility that at maturity the investor will own the underlying asset at a depressed price. Interest rates and time remaining until maturity are all factors that may affect the value of the structured product. As with any investment selection, structured products should be purchased as a limited percentage of your portfolio and overall investable assets.

### **Categorization of Structured Products – Who Invests in Structured Products?**

The structured product market can encompass many variations and the appropriateness of each issue should be evaluated by its specific terms. Most issues can be categorized by one of the following headings.

**Principal Protection:** Principal protected structured products may be more appropriate for conservative investors seeking market exposure with principal preservation. These typically offer full principal protection at maturity with the potential for additional return based on the performance of an underlying asset or group of assets. Investors may forfeit some upside exposure to an underlying asset in exchange for principal protection. Return of principal may not be obtained if the investment is sold prior to maturity. Principal protection and payment at maturity are subject to the credit risk of the issuer. The creditworthiness of the issuer is an important factor to consider in investing in a principal protected note. Certain principal protected notes have differing levels of protection; some, for instance, do not offer 100% principal protection. Please note that principal protection applies only to nominal principal and does not offer inflation protection.

**Enhanced Yield:** Enhanced yield structures may be appropriate for more risk tolerant investors seeking higher returns than comparable debt instruments. Payment at maturity on these short-term notes is determined by the performance of an underlying asset or group of

assets and principal may be at risk. Investors generally forfeit partial or full principal protection at maturity in exchange for the potential to earn a higher participation. Investors can be exposed to downside risk and may lose part or all of their original investment. Additionally, investors may receive shares of stock at a value below the original principal amount at maturity. Coupon payments and payment at maturity is subject to the credit risk of the issuer.

**Access:** Structured products can provide investors with access to an asset or group of assets not readily available to private investors. These products can offer exposure to markets or strategies that may be inefficient or difficult for investors to obtain, such as foreign exchange rates or commodities. Since these products may not provide for full repayment of principal at maturity and are typically linked to sophisticated underlying assets, they may be more appropriate for moderate to aggressive investors.

**Leverage:** Structured products that utilize leverage may be generally more appropriate for aggressive investors wanting to capitalize on a particular market view. These short-term products provide partial or no principal protection but do offer the potential to receive leveraged returns on the value of the underlying asset. Some structures may offer additional leverage in exchange for capped or limited upside potential. Investors are exposed to downside risk of the underlying investment and may lose part or all of their original investment.

Structured products, principal protected or otherwise, may not be appropriate for all investors.

### **Complex Variations of Structured Products**

Beyond the direct linking of an underlying asset class as a dictate of return, some structured products include varying features and specifications that may impact performance. Barrier structures, for example, place parameters on the upside and downside performance of an underlying asset. During the noted observation period, which may be a day, a set period of time or for the life of the contract, if the value of the underlying asset exceeds an upper barrier or falls below a lower barrier as specified by the issuer, an investor may be exempt from any gains or losses on the investment.

For any complex variations that may be present with a particular offering, discuss the performance parameters with your Financial Advisor.

### **Principal Protected Structured Products**

Many investors, especially those more risk-averse, would like to participate in the potential profits of a particular asset class, while at the same time limit their exposure to a market downturn. Principal protected structured investments can allow investors to achieve both objectives. Instead of paying a fixed rate of interest, a principal protected structured product can provide a return at maturity based on the appreciation of an underlying asset or basket of assets, such as a U.S. or international equity market index, one or more commodities or various other financial benchmarks. While the interest the investor will receive is uncertain, and could be zero, the return of the initial investment amount at maturity is assured, subject to the credit quality of the issuer, regardless of the performance of the underlying asset(s).

## The Basic Structure of Principal Protection

Interest on principal protected structured products is calculated based on a formula which may include some or all of the factors discussed below.

**Value Date:** Interest computations begin with the percentage change in the value of the underlying asset. It is the change between the “initial value date” and the “final value date” specified for the particular offering. The percentage change is the difference in the final value and the initial value divided by the initial value. The initial value date is usually the date of issuance while the final value is typically calculated just prior to the maturity date to allow for the interest payable at maturity to be available on the maturity date.

**Participation Rates:** The participation rate dictates the extent to which an investor will participate in the underlying asset’s gain. This is applied to the percentage change in the underlying asset’s value. A rate of 100% would allow the investor a return equal to the percent change in value of the underlying assets. Certain products may offer participation rates of less or more than 100%.

**Minimum or Maximum Interest Amount; Barriers:** In this case, the particular product will have a specified minimum and/or maximum interest, or cap, amount that may be paid at maturity. At maturity, if the interest calculated is less than the stated minimum, the interest amount paid to the investor will be the minimum interest amount. If the interest calculation results in a value greater than the maximum for the investment, only the maximum interest will be paid. If the value of the underlying asset decreases, the investor’s initial investment, or principal amount, must be returned in full at maturity. A structured product with a barrier typically means that if the change in the value of the underlying asset (positive for an upper barrier and negative for a lower barrier) exceeds a certain percentage, the investor realizes a limited or no return on his investment.

**Callable Structures:** Certain products may have call features allowing them to be redeemed by the issuer prior to maturity. The call is at the option of the issuer only. The call features will be disclosed prior to issuance and are expressed as a percentage of the initial investment amount. The issuer would be most likely to call the investment when the value is greater than the call price. The value of the investment can be based on a variety of unpredictable factors including the current value of the underlying asset, time remaining to maturity, volatility and interest rates.

## Who Issues Principal Protected Structured Products?

Domestic and foreign banks along with corporations issue principal protected structured products. Certain structured products issued by banks may (but need not) be structured as certificates of deposit or other types of deposits and thus may be entitled to FDIC insurance protection subject to applicable limits.



## **To Learn More about Structured Products**

Baird is fully committed to helping you understand a structured product investment.

To learn more about structured products, please contact your Financial Advisor or review the Structured Products Association (“SPA” website at [www.structuredproducts.org](http://www.structuredproducts.org) or a structured investments informational website at [www.structuredinvestments.com](http://www.structuredinvestments.com).