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## FINANCIAL FOCUS



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Your Accounting for a New Economy

# Understanding Principal-Protected Notes and CDs

Let's say you're beginning to think stocks are looking attractive again, but you're still wincing from the beating that equities took last year. What if someone told you that you might be able to earn returns similar to those of a stock index with an investment that protects your initial investment, regardless of what happens with the market?

The good news: investments that offer protection of principal and the potential for higher returns do exist. However, they require careful consideration before you invest to make sure you understand exactly what you're investing in, what the limitations of a specific investment are, and what could potentially go wrong.

### **Principal-protected notes and CDs**

Principal-protected notes (PPNs) are debt instruments that are typically created by an investment bank. They are one example of a type of investment known as structured products. As the name implies, a PPN is designed to return the initial investment, plus a return based on some other asset, index, or market data.

To do that, PPNs generally combine various types of investments. For example, a PPN might pair a zero-coupon bond to cover the principal with a derivative based on stock futures that determines your rate of return--if any--on that principal.

Principal-protected certificates of deposit (CDs) function much like PPNs, except that repayment of principal may be funded by a security that's covered by the same Federal Deposit Insurance Corporation (FDIC) insurance that governs other CDs.

In addition to the protection of principal, what makes PPNs so attractive to investors is that they frequently offer a coupon rate that's substantially higher than prevailing market rates. However, don't let that enticing figure be your sole consideration when evaluating a PPN.

For example, the creditworthiness of the issuer is key. A principal-protected note is essentially an unsecured debt owed by the investment bank that issued it (which may not be the financial institution from which you purchase it). If the issuer goes under, investors are treated just as other unsecured creditors are, as holders of Lehman Brothers PPNs learned to their sorrow when that company filed for bankruptcy.

### **Test-driving a hybrid: questions to ask**

What is the investment's term? Because there's no guarantee a principal-protected note or CD will be marketable if you try to sell it before its maturity date, it's best to invest in one that matches a predictable time horizon.

What underlying assets does it involve (i.e., options, futures, or other derivatives) and what risks do they involve? The derivative component of a principal-protected note or CD may be linked to interest rates, stock or bond indexes, an individual commodity or commodity index, or a currency or basket of currencies. Those investments and derivatives themselves involve risks that are quite different from those of a typical fixed-income security, and therefore may not be appropriate for all investors.

What interest rate does it pay? In general, the higher the interest rate, the more likely it is to be associated with volatile underlying assets, and the greater the uncertainty about your return--and indeed, whether your investment will earn anything at all.

Who issued it, and what underlies any guarantee of return or the safety of the principal? As mentioned previously, a PPN's guarantee is subject to the claims-paying ability of the issuer. If that institution is unable to repay its debt, the guarantee may be worthless.

Is there a limit on the return that a note offers? If your return is based on an index, find out if that return will be capped at a certain maximum if the index moves beyond a given level.

How is the derivative-based return calculated? For example, the return might be based on either the value of an index at maturity or on an average of prices over the term of the note.

Can the promised results be duplicated costeffectively in a different way? Costs can be difficult to compare. Weigh them against the convenience of investing in a single note or CD rather than in separate bonds and/or derivatives.