



Dr Wise's Column

Should You Invest in Structured Notes?

July 2005

I rarely talk about my family in this column, partly because there has not been a need to do so and partly so that I can maintain some privacy. However, I have decided to make an exception and disclose some of my family life in this column because of a recent incident involving an elderly family member.



Dr. Wise

I got married young and have many relatives. Married life is great and the weekly dinners with my in-laws and my side of the family are excellent occasions to learn what is going on in the world. My uncle by marriage, who is in his seventies and retired many years ago, enjoys joining us regularly for dinner. Most of his hard-earned Hong Kong dollars are in fixed deposits in several local and overseas banks. One of his old friends, Ah Chan, has been enthusiastically recommending various investment products to him, such as capital guaranteed funds and retail bonds. So far, my uncle has not shown any interest in Ah Chan's recommendations, but, with the persistently low interest rates for deposits, even this very principled and cautious investor is finally giving in.

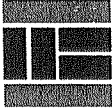
On a rainy Saturday night, I went for my weekly dinner with the relatives as usual. No sooner had I sat down than my uncle excitedly handed me a stack of brochures and said, "Wise, I have had a moment of enlightenment! The interest rates for fixed deposits have been so low, I think I will invest my money in some of those high-return-low-risk structured notes. Ah Chan told me that a new structured note will be launched next month. Although details are not available yet, it will be very similar to the structured notes launched recently. These are the brochures of the notes issued during the first half of this year. Ah Chan asked me to study them. He also said that investing in structured notes is less risky than investing directly in stocks. Why don't you buy some too?"

High return and low risk - do such attractive investment opportunities really exist in this world? I asked myself. Not wanting to dampen my uncle's enthusiasm, I pretended to study the brochures very carefully. To be honest, the brochures were really very attractive. It was not surprising that my uncle suddenly had all this interest in structured notes. In general, these are notes that are linked to baskets of stocks and they offer better interest rates than bank deposit rates. One particular note even boasted a potential total return of up to 40%.

After browsing through the brochures, I knew that that night's dinner might not be too pleasant as I would have to use all my resources to persuade my uncle to reconsider this important investment decision.

"Uncle, do you know what structured notes are?"

"Well, aren't they the same as high-yield notes? Like bonds, they regularly pay interests, but high-yield notes offer a higher interest rate."



“Uncle, structured notes are a bit like bonds, but their nature and inherent risks are different. Structured notes are products combining notes with financial derivatives, such as options. Their returns are linked to the performance of other financial instruments. The most common structured notes are equity-linked, either to a single stock or a basket of stocks. Another common type is the credit-linked note. The returns on credit-linked notes are determined by the credit performance of a single company or a group of companies. There are also some structured notes that are linked to stock indices, interest rates or exchange rates. The structured notes mentioned in these brochures are all equity-linked notes that are linked to baskets of stocks. The returns on these notes are determined by the performance of the stocks that they are linked to, which can be listed either locally or overseas. Depending on the performance of the stocks, a note may not pay any interest during its term; it may also not repay the principal amount at expiry. Instead, investors may be required to buy a specified number of the worst performing stock in the basket at a specified price that is higher than the going market price.

“Most importantly, the majority of structured notes are not principal-guaranteed, so it is possible for investors to receive an amount of cash or stocks that are worth less than the principal invested. Actually, these brochures all contain warnings about this.”

“Oh, I see. Well, actually I don’t plan to invest in any stocks in my old age. Even if I got rich, I wouldn’t have enough years left to enjoy the money! But do you think it is worthwhile investing in credit-linked notes?”

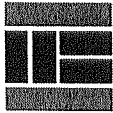
“Uncle, the amount of interest paid or principal repayment on credit-linked notes is affected by the credit events of the reference companies. The higher the number of credit events that have occurred, the lower the return. Some notes even spell out that no interest will be paid or that the notes might be terminated early if a credit event occurs. Issuers will define the “credit events” when they issue the credit-linked notes. Different notes will have different definitions, but, generally speaking, credit events include bankruptcy, restructuring of debts or demands to repay debts early of a single company or a group of reference companies.”

“This is all too complicated. I have no idea what you are talking about. At my age, it’s better just to play safe and stick to my bank deposits. By the way, I bumped into Ah Cheung’s son the other day. Seeing that I was so interested in structured notes, he immediately went and collected some brochures from the bank to study at home. Ah Cheung’s son is in his thirties, so buying structured notes should not be a problem for him, right?”

“It’s difficult to say. It really depends on his investment objectives, financial condition and risk tolerance. Changes in the investment environment are another important factor to consider. Structured notes are popular among investors mainly because of the prevailing low interest rate environment, which started one or two years ago.

“In fact, before structured notes became popular, many banks had already introduced a variety of structured deposits linked to equities and exchange rates. Although these are called “deposits”, the inherent risks are very similar to those of structured notes. A structured note is, by itself, not a problem, but, as you are in your seventies, this kind of investment may not suit you.

“If Ah Cheung’s son feels that these products are suitable for him, he should pay attention to the following:



“First, he has to understand that the returns on notes rely largely on the performance of the underlying stocks / companies / indices, etc. Next, he should look into the terms and conditions of the notes, especially the payoff methods and interest calculations. Other things that he should be aware of are the term of the note, the minimum investment amount, the interest rate fixing dates, the interest payment date and the settlement method at maturity.

“Equity- or credit-linked notes usually make reference to reputable companies or their stocks, but these companies are not the issuers of the notes. The responsibility to pay interest or repay principal to note-holders is the issuer’s responsibility, not that of the company to which the note is linked. Therefore, investors should carefully assess an issuer’s background, strength and financial status before making an investment.

“Investors should also consider whether they may need to use their money in the near future and whether there is an active secondary market for the structured notes before investing - just in case they need to liquidate their position or have access to money within a short period of time. Unless the notes are listed on the Stock Exchange of Hong Kong, investors will have to sell their notes on the over-the-counter market. The prices of structured notes in secondary markets are affected by a wide range of factors, including the performance of the underlying stocks / companies / indices, the market view of the credit quality of the reference company, interest rates, the market expectation for future interest rates and time-to-maturity, to name but a few. Also, secondary markets do not always exist and, if there is no secondary market, investors can only get their money back at maturity (and the amount they get back may be less than their principal) or if the issuer decides to redeem the note early.

“Some notes may give the issuer the right to redeem or terminate the note early. In the case of early redemption, issuers can redeem all or a part of the notes and, depending on the circumstances leading to the redemption, pay investors their principal plus accrued interest, or the market value of the notes; again, this may not be the full amount of the principal.”

“Wise, if Ah Cheung’s son wants to get more information about structured notes, where can he go?”

“A lot of general information can be found at the SFC’s InvestEd at www.InvestEd.hk, which includes some good articles on structured notes and equity-linked instruments. As for detailed information on individual notes, he can contact the issuer or distributors of the notes. In addition, he can visit the SFC’s website (www.sfc.hk) and download the offering documents and related marketing materials of unlisted structured notes authorised for registration by the SFC.”

“Let’s eat now!” demanded my mother-in-law, as she was the host.

That night’s dinner was enjoyable after all.

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