

EDUCATION UPDATE

# Using Structured Products in Your Asset Allocation Strategy

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In this volatile market environment, it can be difficult to identify any investment that you can trust with any certainty to protect your principal. However, there are certain investment vehicles that have the ability to provide a certain degree of downside protection—specifically the market-linked CD and the market-linked note, also known as structured products. Market-linked CDs are Federal Deposit Insurance Corporation (FDIC) insured up to \$100,000 in coverage per depositor, subject to FDIC rules and decisions, while market-linked notes are not FDIC insured but have Securities Investment Protection Corporation (SIPC) protection. These types of investment vehicle offer the reassurance of downside investment protection along with exposure to potential upside opportunities. When used appropriately, such investment vehicles offer many benefits. Since there is no such thing as a free lunch, however, investors should also be aware of their limitations.

In this week's update, we will look at strategies for using market-linked notes and market-linked CDs in a well-diversified investment portfolio.

## How Do Market-Linked Notes and CDs Work?

Structured products may be thought of as hybrids. They can provide you with exposure to a number of asset classes and offer you similar comfort of a zero-coupon bond—a bond that is sold at a discount to its face value and redeemed at face value—with very little investment risk. Each is based on an underlying risk index that helps to determine the value of the note. Structured products are commonly designed around investments in commodities, international equities and domestic equity asset classes, though many other structures can be available. Since the structure of each note is unique, it is important to understand its qualities and limitations before you make your investment.

### Qualities:

- Depending on the structure of the note, this investment can offer you as much as 100% protection of your principal.
- If the downside protection offered on the note is less than 100%, it is designed to buffer, or reduce, investor losses on the downside—an appealing trait in the current market

environment and one which makes traditionally more risky types of investments, such as commodities, more accessible to more risk-averse investors.

- If the structure of a specific note includes the use of leverage, the note has the potential to provide investors with greater gains than they would have enjoyed had they invested in the asset class underlying the note.
- If the upside is less than 100% of what you would have received if you had invested directly in the underlying asset, this is typically in compensation for greater downside protection.

### **Limitations:**

- *Liquidity.* Structured products require tying up capital, sometimes over a significant amount of time. This means that you will pay a penalty for early withdrawal even if the market has gone up. The result is that you cannot easily cash out of these types of investment to meet unforeseen needs or to rebalance your portfolio.
- *Cash Flow.* Stocks pay dividends and bonds pay interest. Structured products commonly don't pay anything during their term. Moreover, depending on the terms of the note structure, it is possible that you may have to pay taxes (see below) on imputed income, driving the cash flow negative during the period over which you are required to be invested.
- *Tax Consequences.* The favorable tax treatment accorded dividends and capital gains doesn't apply to the safest structured products. The investor has to accept some downside risk; otherwise, the return is taxed at ordinary rates so that even if the structured product should outperform the underlying investment, the after-tax return could still be less. Further, tax payments may be accelerated so that the investor pays tax on imputed interest income during each year of the term, even though the income isn't received until maturity.

### **How Do Such Investments Fit Within an Asset Allocation Strategy?**

We recommend you think of structured products first as an allocation to the underlying risk index that is used to calculate the return of the note. What does that mean? Basically, if you buy a market-linked note that is designed around the return of the S&P 500 Index, the benchmark index for domestic large-cap stocks, this note should count towards your large-cap domestic equity allocation.

Structured products can be a great way to reduce portfolio volatility, or at least protect against the downside kind, which is the one investors worry about.

To protect yourself from potential limitations and to take advantage of the benefits offered by market-linked notes and CDs, here are some general rules of thumb that you should consider when using these products in your portfolio:

- Keep structured products to less than 50% of any asset class allocation to allow for portfolio rebalancing, using the more liquid portion of the allocation.

- Diversify structured note exposure to different asset groups within a portfolio.
- Maintain adequate cash flow/liquidity to satisfy lifestyle needs and surprises.
- Ladder—or stagger—structured note maturities to provide reinvestment opportunities.
- Pay attention to tax efficiency across your portfolio, both in your more liquid asset allocation and in the location of your structured products.
- Utilize downside risk protection to enhance risk management and diversification of your overall asset allocation strategy.

## Summary

Like any specialized investment vehicle, structured products can be an appropriate way to implement an asset allocation strategy. They offer upside exposure to asset classes at a reduced level of risk. If you are skittish about the markets, they can provide you with the confidence to invest in asset classes that seem high risk. Structured products are a powerful tool to implement a well designed, globally diversified asset allocation strategy. However, they should not be considered as a total replacement for investing in securities that can be sold at any time, pay interest or dividends or help reduce an investor's tax bill. We recommend that you use them judiciously in a way that is appropriate for your specific circumstances, while keeping all of your portfolio goals in mind.

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You cannot invest directly in an index.

Asset allocation does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

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