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PPNs fall out of favour with investors and issuers

Bryan Borzykowski



(October 2008) When Desjardins Group announced Monday that it was closing its line of principal-protected notes (PPNs), it was just another nail in the coffin for the once-popular investment vehicle.

Over the last few years it seemed as if everyone was offering PPNs, but lately that hasn't been the case; Sun Life, for one, hasn't issued the product since December 2007. So, why has the market dried up?

"Part of it has to do with a concern in counterparty risk," says Dan Hallett, president of Dan Hallett & Associates. "Maybe it's about whether issuers can find a credit-worthy bank to back those up."

Hallett adds that it ultimately comes down to investor appetite. He says most people are looking for conservative investments right now, so a PPN is not their first choice.

It might seem odd that risk-averse investors are shunning PPNs, considering the product is supposed to protect capital at maturity, making it impossible to lose money, but in falling markets, the note can frustrate people.

The basic premise behind the popular constant proportion portfolio insurance (CPPI) PPN is that an investor's principal is protected as long as it's held to maturity, which is usually around five to seven years.

If the markets are strong, clients can get back more than their principal, but if markets tank and the value of the PPNs fall, the products are usually converted to bonds to ensure that investors get their capital back when the notes mature. Unfortunately, when this happens, that's all they will get; there won't be any additional returns, even if the market later improves.

Thanks to the crumbling stock market, both Sun Life and Desjardins have converted their PPNs into bonds. "Essentially, the client is now stuck with a fixed income allocation that's returning principal," says Jason Pereira, a financial consultant with Woodgate Financial Partners in Toronto. "A lot of people use these products to replace fixed income in their portfolio, which depending on how the portfolio was structured was not a horrible strategy. But, now it is."

Unfortunately, it's likely most investors are now holding these bond-like PPNs, as the investment product only launched about five years ago, after the tech bubble burst.

Back then, interest rates were low and people wanted to invest in something that offered more of an upside than a GIC. It seemed like a pretty good investment at the time, but many people forgot, ignored, or weren't told that their PPN was riskier than a GIC.

"It plays on investor psychology," says Hallett. "You have a guarantee that you don't have with stock investments, but if bonds are yielding around 4% and trading 80 cents on dollar today, that means they're seeing a 20% decline from par and probably a larger decline from peak."

"I understand why it became popular," he adds. "But I never really understood how you'd integrate that in a portfolio structure. I suppose you could use them as a proxy for stock exposure and I think if you use it that way, it may well pay off, but you can't go in today and get that money."

Thane Stenner, managing director with Stenner Investment Partners of GMP Private Client in

Vancouver, is a big proponent of PPNs, though not the CPPI type.

"The CPPI version seemed counterintuitive to us," he says. "When the underlying mutual fund or holding drops, it becomes unlevered, and that's when it doesn't make sense. You'd think when the underlying portfolio drops that you'd want to increase leverage."

Stenner's PPN of choice is the option-based version. This involves a zero-coupon bond and a call option package. Generally, 70% of the investor's principal goes toward the bond in order to protect the initial investment. The rest of the capital is used to make leveraged investments in an underlying asset.

According to investopedia.com, "interest rates prevailing at the time the PPN is created determine the cost of protection and, therefore, the funds available to purchase the call option package. As interest rates fall, the cost of protection will increase and funds available to purchase the call option will decrease. The opposite is true also: as interest rates rise, the cost of protection will decrease and funds available to purchase the call option will increase."

Stenner says the option-based PPNs, which have been around for about 16 years, have a price movement that's in line with a balanced portfolio. "But it doesn't move one-on-one with the markets," he explains. "You can have a note with global indices tied to it and if it's got two or three years to go, even though underlying indices would be down 50%, the underlying option PPN would be down half that because of the mechanics of the note."

Besides the structure, the big difference between the two types of PPNs is that the option-based one never gets converted into a bond. If the value falls, investors will still get their principal back at maturity, but because it doesn't have a "protection event"; it's still possible for a money-losing note to see gains as the market turns around.

"With option-based PPNs, assuming the markets recover, which is common after a bear market phase, it has the potential to get above par," says Stenner, who usually creates this kind of PPNs for his high net-worth clients.

One of the reasons companies have pushed the CPPI version, says Stenner, is that it's wrapped around a mutual fund, in most cases one of the financial institution's own offerings.

Now, with the markets down, these companies are frantically trying to preserve capital. "Certain organizations that are discontinuing this don't want to lever up their balance sheet anymore," explains Stenner. "It's a corporate decision. In this case it happens to be this type of PPN that's utilizing a fair amount of leverage."

Sun Life Financial says the reason they've stopped issuing PPNs is because their segregated fund products essentially do the same thing, but better. PPN issues also accounted for only \$57 million out of the company's \$17 billion in assets.

Rocco Taglioni, vice-president of individual wealth management at Sun Life Financial, says the PPNs they have issued, which are now in a protection event, are doing what they're supposed to be doing. "The fact that many PPNs are now in protection mode, where principal is protected as long as it's held to maturity, speaks to the power of principal protection."

But, clients might not see a protection event as pragmatically as Taglioni does. In fact, Pereira says people are going to be "pissed off" and advisors will get into trouble "because they pitch everything based on the upside."

Pereira says advisors need to manage clients' expectations, especially in a situation like this. "They have to understand that in the worst case scenario they're going to get their principal back. The worst case scenario is happening right now, and they might want to get mad about it, but they didn't appreciate the fact that this could happen, or they were sold on the fact that these were upside products."

"If they really wanted market participation they wouldn't go into this," he adds. "They'd go into a full equity portfolio."

With PPN issues stalling, the question is now, what will happen to this investment product once the market recovers?

"Everything goes in cycles, so they will come back," says Hallett. "To what extent they come back and in what flavour will really be dictated on the type of risk investors are prepared to take and how well those exposures will be hedged."

"There's still an unbelievably low interest rate environment and people are not happy getting single, low-digit returns for guaranteed money," Pereira explains. "Someone somewhere will engineer a product similar to this — or maybe it will be the exact same thing — that will migrate people over who wants principal protection and money."

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