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► FEBRUARY 2007

A Note about Notes

Evaluating Structured Products

By: Adam P. Newell, CFP

The world of investments and investment products is a constantly changing and evolving one. Financial instruments have been created to satisfy almost every conceivable risk, return and cash flow objective, for both the large institutions and the smaller private investor. However, not all investments are suitable for every type of investor, no matter how 'customized' these investments may appear. One such financial instrument is the Structured Note.

Advantages	Disadvantages
Low Investment Minimums	Illiquid – Small Secondary Mrkt
Instant Diversification	Not Actively Traded
Professional Management	Not Actively Priced
Low Credit Risk	Complex Terms & Payoffs
Customized	High Fees
Use of Leverage	Use of Leverage

Structured Notes, in some shape or form, have been a part of the investible universe for many years. However, certain aspects of today's market and economic climate have led to the increased creation and solicitation of structured notes to both public and private investors. For example, this current period of low interest rates can make for unacceptable and unattractive returns for many fixed income investments. An investment that can potentially offer higher returns for the same, or less, amount of risk should appeal to many investors.

Furthermore, outside the financial arena, the field of behavioral finance is also playing into the increased popularity of structured notes. For example, as any behavioral finance supporter would agree, investors feel a higher amount of pain from losing money than the amount of joy they get from making it. An investment that can offers an opportunity to make money while limiting (in some cases eliminating) the chance of an investor losing their initial investment should also appeal to many investors.

Structured Notes were in part created to combat the issues mentioned in the above paragraphs. However, a structured note is not like the typical stock or bond, mutual fund or ETF, but rather a complex combination of stock or bond indexes, leverage, and derivatives such as options, zero-coupon bonds or interest rate floaters, just to name a few. Careful consideration and evaluation should always be given to the details underlying a structured note.

The value of a basic derivative is dependent on the performance of the underlying security (i.e. stock, bond, index, etc). Structured notes are hybrids, incorporating features of common debt (interest payments, for example) with those of equities and basic derivatives. Structured notes usually have a term and are meant to be held until maturity at which time the principal, plus/minus any accrued gains or losses, is paid.

A structured note's redemption value at maturity is affected by the derivatives embedded in the note in conjunction with the performance of the underlying security, which is typically an index. It is the identification, analysis, and pricing of these derivatives that gives structured notes their level of complexity.

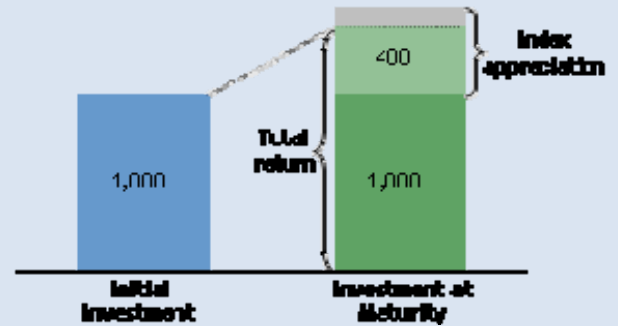
While structured notes can be created using an almost infinite variety of combinations of bonds, options and other derivatives, there are two basic forms of notes which offer substantially different payout potential: Principal Protected Notes and Return Enhanced Notes.

Principal Protected Notes are designed to offer investors equity-like return potential tied to the performance of a specified index, without the accompanying downside risk. These notes generally offer a return at maturity linked to an underlying stock index such as the S&P 500. However, these types of notes typically have a cap on the return (such as 80% of the return of the index) which limits the upside potential as a trade-off for the protection of principal.

Scenario 1 – 80% Cap on Gains w/ 100% Principal Protection

The index is up 50% at maturity

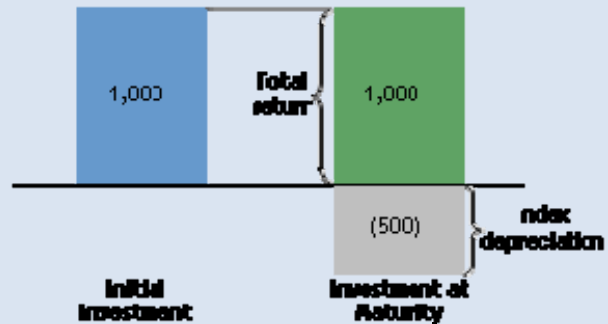
At maturity, the investor will receive their \$1,000 principal back, plus 80% of the index appreciation, equal to 40% (= 80% x 50%).



Scenario 2 – 80% Cap on Gains w/ 100% Principal Protection

The index is down 50% at maturity

At maturity, because the index has declined, the investor will receive only their \$1,000 principal back.



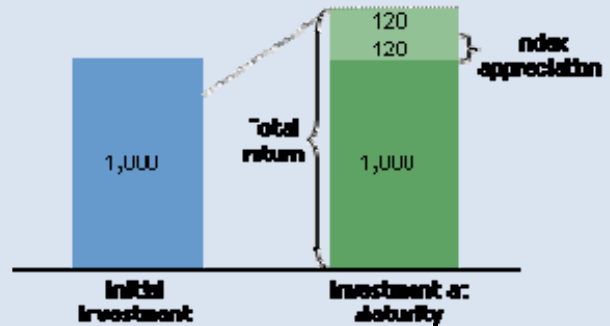
*Source: JP Morgan

The second type of structured note is the Return Enhanced Note. These notes use leverage, or borrowing, to offer 2X or 3X the upside of a specific index in exchange for the investor giving up **any** protection of principal.

Scenario 1: 2X Upside of Index, No Downside Protection

The index is up 12% at maturity

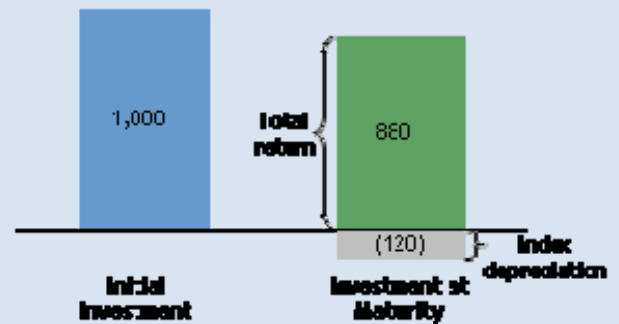
At maturity, the investor will receive their \$1,000 principal back, plus double (2X) the 12% index return.



Scenario 2: 2X Upside of Index, No Downside Protection

The index is down 12% at maturity

At maturity, the investor will lose 1% of their investment for each 1% decline in the index.



*Source: JP Morgan

Advantages

Structured notes do have several positive characteristics that can make them attractive and advantageous for investors. Many structured products have low investment minimums - as low as \$1,000. Investors may also feel comfortable with the low credit risk of these investments, as issuing firms typically have triple-A credit ratings. In addition, structured notes can allow investors instant diversification, access to professional management and leverage, and the ability to select a customized product tailored to their investment time horizon and investment goals.

Disadvantages

Although investors may feel comfortable with the positive attributes these products can provide, there are still many potential negatives that investors should be aware of. First, in contrast to mutual funds and stocks, structured notes are not traded and priced on a continuous basis. Therefore, there is currently a limited secondary market for trading outstanding notes, resulting in very low liquidity for investors wanting to sell out prior to maturity. Furthermore, notes can confuse investors with complex return payoff calculations and lack of transparency. Finally, depending on how the notes are structured, total fees to the investor can be extremely high, reaching 6% or more in some cases.

Structured products have become more popular with investors and more profitable for the institutions selling them. Structured products should be evaluated carefully, and are generally more appropriate for sophisticated investors due to their complex use of derivatives. However, as these products and the disclosures improve over time, structured notes can provide a meaningful benefit to an investment portfolio for investors with a specific financial objective.