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The *Steady Pulse*

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ETN's-Proceed with Caution

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In today's world of ever evolving investment products, Exchange Traded Notes (ETNs) followed their much-hyped cousins, Exchange Traded Funds (ETFs), into the marketplace. They are heralded as an efficient and inexpensive way to gain exposure to certain investment strategies. Structurally, ETNs are senior, unsecured, unsubordinated debt securities issued by an underwriting bank. Similar to other debt securities, ETNs have a maturity date and are backed only by the credit of the issuer.

While an ETN does track an index, the return is not based on the underlying asset. Remember that these securities are a note with the issuer guaranteeing the holder a return that is an exact replica of the underlying index, minus expenses and fees. This means an investment with virtually zero tracking error and low fees! Sounds like the perfect fit for a portfolio, especially for a tax-exempt entity like a foundation, endowment or hospital. Easy decision, right? Not so fast, my friends. Instead of investing in actual portfolio securities, you are relying on the issuing bank's promise to pay these returns. This is called counterparty risk. Counterparty risk is the risk that one party to a transaction does not live up to its contractual obligation. While it may seem obvious that this is an important factor to consider, it is often overlooked or viewed as a "one in a million" risk and quickly dismissed.

The "credit crunch" and ensuing turmoil in the capital markets, especially the impact on large investment and money center banks in both the U.S. and abroad has shined a spotlight on counterparty risk. Several of these top institutions have been shaken to their foundations by the sub-prime and mortgage securities mess and are in a desperate search for capital. Multi-billion dollar write-downs have become common and stock prices of some of the world's largest banks have plummeted. Recent history has provided us with a very real example of counterparty risk.

You are probably familiar with the story of Bear Stearns. Over the course of one week, Bear Stearns went from a highly respected, cash-rich investment bank to a near bankrupt company being sold to J.P. Morgan Chase for a fraction of the company's former value. How does this relate to ETNs? Bear Stearns was the underwriting bank for the BearLinx Alerian Select Index MLP ETN which means the investment was supported solely by the creditworthiness of Bear Stearns. As events were unfolding, serious questions arose about liquidity and the stability of the Net Asset Value (NAV) of this investment vehicle. If Bear went bankrupt, would investors be able to get the full value of their investment back? Could the market handle mass liquidations that might follow this news? Investors were facing the very real possibility of receiving much less than NAV for sales in the open market. Becoming a general creditor in bankruptcy court was not a pleasant thought for those who thought they were buying an "index" fund. Luckily, the Federal Reserve and J.P. Morgan Chase rode to the rescue and bailed them out. If this happens again, will the next firm be so fortunate?

A secondary consideration is liquidity. This is important no matter who the sponsoring institution is. It is important to understand the daily trading volume. If an institution needs to sell part or all of a position, is there enough daily volume to absorb the trade without affecting the price? Would it be better to trade it all at once or in blocks to minimize price impact? Will the issuing institution redeem the shares directly versus placing a market order? All are considerations when considering the use of an ETN.

The key takeaway is to remember that there is risk in ETN investing that extends beyond the asset class being covered. Take the time to perform proper due diligence on the issuing institution, its credit rating, financial stability and outlook before committing to any strategy. This is just as important as other due diligence you might perform on your portfolio. Thus research will provide a level of comfort as well as an understanding of your options when it comes time to liquidate. ETNs can be a good fit in a portfolio, but proceed with caution.

Inflows