Equity index-linked notes are hybrid investment vehicles—neither a true stock, nor a true bond, but designed to capture certain investment characteristics of each. They are a form of what has been termed “structured products,” which typically are issued by investment banking firms.

In a structured product, the payoff typically is based on the price appreciation of an underlying stock index or other speculative asset. Many structured products are marketed as providing some upside potential of the underlying asset, while limiting downside losses.

Equity index-linked notes are structured products that are linked to an equity index, such as the S&P 500 or the NASDAQ 100. The product is typically designed so that investors receive a principal payment at the date of maturity, usually a small interest payment (sometimes less than 1% per year), as well as variable returns based on the change in value of the underlying index.

Typically, any increase in the index is paid out at maturity. However, some index-linked notes are structured to contain periodic coupon payments. Some firms even offer “bear” indexed notes, which gain when the underlying index drops.

> How It Works

To create this kind of product, the issuer may use derivatives, or portfolio management techniques (“dynamic hedging”) that simulate call or put option hedging strategies. This involves actively managing a portfolio of Treasury bills and the underlying asset. With a dynamically managed product, as the underlying asset price falls, the manager must sell the asset and move into Treasuries, and as the asset price rises the manager must sell Treasuries and move the asset.

> Terms of the Issue

The terms of each issue vary widely.

In general, index-linked notes are similar to bonds in that investors typically receive a repayment of principal at the date of the issue’s maturity. A typical index-linked note will have a maturity of one to 10 years and an initial principal amount of $1,000, with a minimum initial investment of $5,000. However, maturity length and minimum purchase amounts may vary by issuer and type of account.

The notes are structured in a variety of ways. For some, the payment at maturity includes the principal amount invested, a small interest payment and a gain (if any) from the growth of the reference index times a note-specific participation rate.

For example, assume an investor has a note that is linked to the S&P 500 with a 10-year maturity and an 80% participation rate. If, over the 10-year span, the S&P 500 gains 50%, the investor gains 40% on his investment (80% of the S&P's 50% return), or $1.40 for every dollar initially invested plus interest, if any.

Many notes promise a full repayment of principal (“principal-protected” notes), or at least partial principal protection; some, however, offer none (“unprotected” notes). As an example, if an S&P 500-linked note is principal-protected, the investor receives the full principal amount even if the S&P 500 declines or remains unchanged over the life of the investment. If the S&P-linked note is unprotected and the S&P falls 5% over the investment period, the unprotected note will lose 5% of its initial invested capital at maturity.

Some issuers will give investors a variable return multiple that is greater than the actual reference index increase, but is capped. For example, if a two-year note promises to pay three times the reference index return but is capped at an 18% return, and the S&P returns 5% over the life of the investment, the investor earns 15% (three times the S&P 500’s 5% return) plus the principal amount and any interest. However, if the S&P earns 25% over the two-year period, the investor gets only 18%.

> How to Trade

Equity index-linked notes are typically sold by broker/dealers, who charge a fee to purchase the notes. Fees vary by firm but tend to range between 2% and 3%.

Investors have options regarding selling and holding these notes. You can hold it until maturity and receive the principal amount along with any interest payments and variable returns earned during the holding period. The note can also be sold in the secondary market prior to
maturity, although there are significant liquidity concerns. Selling in the secondary market also means, like a bond, it may sell at a premium or a discount to par value.

**TYPE OF INVESTOR**

Principal-protected notes are designed for investors who want to protect their investment while still having some potential to gain from increases in the reference index. Unprotected notes are much riskier.

Equity index-linked notes are also more suitable for longer-term investors, as there is no guarantee of a buyer or selling price for the note in the secondary market.

**Pros**

**Limited Downside Risk**

Investors of principal-protected notes are guaranteed their initial investment of principal at maturity, or at least most of it, depending on the terms of the issue, regardless of the performance of the reference index.

**Possible Higher Returns Versus Bonds**

Compared to traditional fixed-income investments, equity index-linked notes have the potential to grow when the market grows.

**Cons**

**Limited Upside**

The cost of “principal protection” and/or limited losses is not free; typically, the notes do not provide the full appreciation of the underlying index. In addition, the payoff is typically based on price appreciation, and investors therefore forgo dividends.

**Illiquid**

Although they can be traded, these securities are highly specialized and therefore not as liquid as stocks or mutual funds since a buyer must be present and willing to buy your specific issue. This may mean that the product cannot be sold quickly, and it can lead to a higher bid/ask spread.

**Complexity**

Each issuing firm creates its own rules and terms for each issue, so they are difficult to analyze and compare with other offerings. Many issues also feature complex formulas and calculations for the rates of return.

**High Costs**

Purchase fees are high. In addition, typical management costs for the products—transaction costs and profit margins—are built into the price of the issue and are not explicitly evident.

**TAX IMPLICATIONS**

Income earned on an increased value of the reference index is considered interest because the notes are debt obligations. This means that an investor is generally taxed for each year the note is held on an amount of interest income based on a “comparable yield” even if no interest is received until maturity. Gain or loss on the sale of an index-linked note prior to maturity will be taxed as a capital gain or loss. Investing in these securities through a retirement account exempts investors from capital gain taxes.

**ADDITIONAL RESOURCES**

American Stock Exchange

**www.amex.com**

Hundreds of these products are listed, along with the issuer, under “structured products” at the Amex Web site.

AAII Journal


Provides a detailed description of how these products are managed and how they may or may not fit into an investor’s portfolio.

~By Cara Scatizzi

AAII Associate Financial Analyst