Hitting a bum note

PPNs promise investing nirvana, but the reality can be quite different

›BY ARTHUR SALZER

IT'S DIFFICULT TO BELIEVE, but it is now 10 years since the Great Financial Crisis had its apex in early October 2008. At the time, I was managing $200 million in private-client assets, which consisted of public securities, but, more interestingly, I was co-managing a $400-million Principal Protected Note (PPN) issued by a Canadian bank that was linked to a mutual fund managed by the firm I worked at.

PPNs were then gaining prominence as an investment vehicle of choice for conservative investors, who in reality were savers unhappy with GIC rates. PPNs were pushed or recommended by bank sales staff and commissioned advisers as a strategy to "obtain growth, income and capital protection." The claim sounds like investing Nirvana — investors get to eat their cake and have it, too — but PPNs are a little bit more complicated than that.

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A Principal Protected Note is a structured finance product created by investment dealers that has two parts. The first part consists of the structure of a zero-coupon bond, which guarantees a rate of return as long as the note is held to maturity. The second part is an option with a payoff linked to an underlying asset or index. The payoff will vary based upon the performance of the linked asset, but it is not guaranteed.

For example, if the payoff is linked to an equity index, such as the Toronto Stock Exchange, and the index rises 30%, the investor will receive the full 30% gain. In effect, the principal protected securities promise to return an investor's principal, at the time of maturity, with the added gain from the index's performance if that index trades within a certain range. The risk is that should the issuer go bankrupt and default on all or most of its payments, including the repayment of investors' principal investment, the investor loses his or her principal. In reality, these products are essentially unsecured debt with their investors falling below the tier of secured creditors.

Let's revisit October 2008. Lehman Brothers Holdings Inc. had just been allowed to fail and the first iteration of the Troubled Asset Relief Program (TARP) did not pass the House of Representatives due to brilliantly played partisan politics by the Speaker during the bill's introduction. During the first week of October, the opening limit of the global stock markets was down each morning. I knew that by 2 p.m. we would receive the order from the bank to liquidate another $150 million or more in securities in order to meet the margin call that was occurring in regards to the PPN I was co-managing. The stress of each day was quenched with a couple of martinis in order to fall asleep. Each morning, I awoke to do it all over again. This happened for three days, then, like peace breaking out on a battlefield, the forced selling stopped.

Equity markets did not ultimately bottom until March 2009, but they recovered relatively quickly due to the unprecedented combination of 0% interest rates and quantitative easing or fiscal stimulus worth trillions of dollars. Was all this government intervention worth it? It's difficult to say, as these policies have distorted equity, credit and real estate markets globally for the past 10 years along with creating significant social and structural issues.

But the many investors who bought those PPNs with the expectation of earning a higher return for their savings experienced what is referred to as a "knock-out scenario" or "protection event," where the underlying asset, which the PPN is linked to, declines to such a level that the note becomes monetized. Depending on the issuer, investors would have received their initial investment back, but their loss of purchasing power after inflation was significant over the note's lifetime, which typically ranges from five to seven years. By the end of December 2008, 169 PPNs were monetized across 12 financial institutions in Canada.

The industry, of course, fared much better than investors, as the many banks, investment dealers and commission-driven advisers who created and recommended these products earned their significant management fees, operating fees, structuring fees and commissions. **FPM**

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