

MARKET-LINKED CDs



AN OVERVIEW

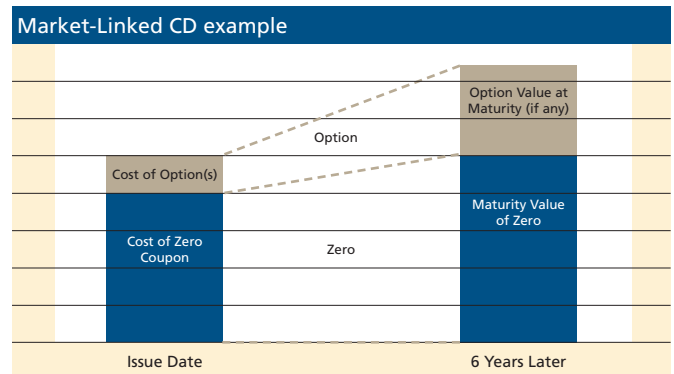
Market-Linked Certificates of Deposit (MLCDs) are structured products whose performance is largely based on one or more underlying securities or financial indexes. They are “structured” or designed to meet specific investor needs or objectives. These products are available in many formats and can be based on a wide variety of securities and market indexes with a plethora of features and certainly risks. MLCDs combine the long-term growth potential of equity or other markets with the safety and security of a traditional certificate of deposit. Purchasers are typically “buy and hold investors” seeking to participate in the appreciation of an underlying index(es) while retaining protection against market decline. Instead of paying a fixed rate of interest, MLCDs pay interest at maturity based on the appreciation of an individual or basket of securities or indexes. The MLCD’s principal is guaranteed by the issuing bank *if held to maturity*. Additionally, the original principal investment (not any underlying gain) is further insured by FDIC up to the current legal limits.

A BASIC EXAMPLE¹

A bank, rather than issuing a traditional brokered Certificate of Deposit (CD), issues a linked CD with a 6-year maturity. Instead of a set interest rate, the bank offers to pay, as interest, an amount equal to the appreciation of the S&P 500 index over that 6-year period. Assuming a \$1,000 investment, the bank promises to pay back the \$1,000 in six years as well as an amount equal to the increase in the S&P index. If the S&P index increases by 50% in that time period, the investor will receive an additional \$500 for each \$1,000 invested, \$1,500 in total. If the S&P index declines over the six years, the investor will receive the amount of the original investment at maturity, no matter how low the underlying index falls. (If liquidated prior to maturity, the investor may realize a loss, even if the underlying index is higher).

The bank may fund this issuance by buying a zero coupon bond as well as a call option on the S&P. The zero coupon investment, purchased at a discount, will accrete to par (\$1,000) at maturity assuring that the full principal amount will be available. Additionally, the bank may buy an option on the S&P index, structured so

that it will appreciate (or depreciate) at the same rate as the index itself. If the S&P 500 index doubles, the value of the option doubles.



The chart is a graphic illustration of how this might work, but there is no guarantee that the option component will have any value at maturity. This example is a good starting place to understanding Market-Linked CDs, but it is basic, and many of these issues have different underlying indexes and have more moving parts than illustrated by the example.

¹ This example is an illustration only, and is not based on a specific security.

FDIC INSURANCE

Certificates of Deposit (CDs) are FDIC insured, meaning that the principal investment amount (within legal limitations) is guaranteed by the Federal Deposit Insurance Corporation.² This guarantee does not cover the amount of interest earnings or any loss realized if the security is liquidated prior to maturity. In the example above, if the CD was held for the six years to maturity, subject to limitations, the FDIC insurance would cover the \$1,000 investment, but not the \$500 in earnings based on the index gain. FDIC insurance does not cover any decline in market value realized if the CD is sold prior to maturity.

ESTATE FEATURE

All MLCs offered by Janney include an estate feature, commonly referred to as a survivor's option or "death put." This provision allows, but does not require, an estate to "put" back a security to its issuer at a price of par, within certain limitations, in the event of the death of the beneficial owner of MLCs.

UNDERLYING INDEXES AND SECURITIES

Our example used the S&P 500 as the underlying index. In practice, the underlier may be an individual equity security, a basket of securities or indexes, a currency, a commodity or a combination of these securities, depending on the investment objectives being addressed. Some examples include:

- Basket of three equally weighted indexes such as the Dow Jones Industrial (U.S.), Hang-Seng (Hong Kong) and FTSE (London) to achieve exposure to equity markets representing major developed economies.
- Basket of three equally weighted indexes such as S&P 500, Dow Jones-UBS Commodity Index and J P Morgan Global Bond Index to achieve diversification across several major asset classes.
- Single commodity index or basket of commodity indexes.
- Currency—may be based on the performance of the U.S. Dollar (USD) versus another country's currency or a basket of currencies. It may be dollar bullish (positive return if USD rises against the other currency) or bearish (positive return if the other currency rises relative to USD).

² FDIC limits are currently \$250,000 per depositor per bank through December 2013. More information is available on FDIC website <http://www.fdic.gov/deposit/deposits/dis/index.html>

INTEREST CALCULATIONS —MANY VARIATIONS

As noted, the income generated on most Structured Products is based on the performance of the underlying security. Our example was simple—if the S&P increases by 50% the gain at maturity will be 50%. Not all calculations are that simple.

- Point to point—as noted the calculation method used in our example is simple—it's called point to point and requires a simple calculation. The starting point is the value of the underlying index(es) when the CD is issued, and the ending point is the value on a predetermined date just before maturity. If the index is 100 at the start and 200 at the end, the index gain is 100%.
- Averaging—many CDs use the averaging method. Rather than a point to point calculation the interest calculation method averages the index value on a series of "observation points" or dates. Assume for example that for a 6-year maturity, the index was 100 at the start and at maturity is 160. Under point to point methodology, the gain is 60%. However, if the index started at 100 and was then 110, 120, 130, 140, 150 and 160 respectively on each yearly observation date, the average of these six is 135, meaning the gain is 35%. Averaging has the potential to limit the gain—in our example to 35%. If the underlying index rises for four years, but then falls back to the initial value at maturity, an investor would benefit from the averaging method compared to point to point.
- Ceiling—another structuring approach is to have a ceiling on return—the investor receives a gain equal to the percentage gain of the underlying index subject to a 40% ceiling, for example, which may limit the potential upside performance of the CD.
- Participation rate—this can be another variable. Perhaps the investor will receive only 90% of the gain or as much as 125% of the gain.
- Minimum coupons are also frequently found. They may be expressed as a minimum over the life, 10% over six years, or a minimum annual coupon, 2.5% each year for example. The way this typically works is the investor will receive interest based on the appreciation of the index or the minimum coupon, whichever is higher.
- Some structured investments have a fixed coupon rate for one or more years and then the rate varies based on the underliers. A recent 5-year CD paid a 3.5% coupon in years one, two and three and then either zero or 6.40% in year four and five,

depending on whether the underlying index, in this case the S&P 500, closed higher or lower in each of those two years.

ALIGNMENT WITH INVESTMENT OBJECTIVES

Market-Linked CDs can be used to achieve a variety of investment objectives. Some examples:

- If an investor's asset allocation strategy calls for exposure to commodity markets, a commodity linked CD might be appropriate.
- A CD linked to a broad market index such as the S&P 500 can offer the upside potential of the markets with downside protection of the FDIC assuring return of principal for investors with a longer time horizon, matching the maturity length.
- Many of the available CDs offer diversification—across geographic markets or across different asset classes.

LIQUIDITY

MLCDs are not traded on any exchanges and are generally less liquid than many other securities, so they are best for investors with longer horizon investment strategies. *If sold before maturity, the value could be lower than the initial principal amount and an investor may realize a loss, even if the underlying indexes are higher.* There is no assurance that a bid will be available when an investor needs to sell.

TAX CONSIDERATIONS

Structured products may be subject to “phantom tax”. An original issue discount (OID) amount accumulates each year based on “comparable yields” for like maturity issues. Investors may be subject to tax payments even though no interest has been paid in a given year. For this reason, many investors use an IRA or other tax advantaged account to buy Structured Product Investments. Investors should contact their accountant, attorney or other tax advisor for information specific to their tax situation.

CALL RISK

MLCDs may have call features that allow the issuing bank to call or redeem MLCDs before their maturity. If called, the MLCDs will be redeemed at the call price and the investor may not realize the same return as he or she would have, had the Market-Linked CDs not been called or if they had been called at a later date. In addition, the investor may not be able to reinvest the proceeds in a similar instrument since interest rates and index levels may have changed since the MLCDs were initially purchased. It is important that investors understand that although MLCDs may be callable by the issuing institution, the investor does not have the right to put the MLCDs back to the issuing institution.

CONCLUSION

MLCDs may provide a variety of solutions for investors, but they can be complicated, and it is critical that any investor understand the features and risks before investing. A Janney Financial Consultant can help determine if a given product matches investment objectives and risk profile.

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