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Unhappy with Low CD Rates? A Structured Note May Be the Answer

What are structured notes? How do they limit risk while allowing for gains? Considering their pros and cons, could a structured note be right for you? Find out how to tell.





By **KEVIN WEBB, CFP** | Kehoe Financial Advisors
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A question that commonly comes my way lately is, “How can I earn a higher return on my cash and CDs?” It’s a dilemma many find themselves in with the current market environment of low interest rates and a stock market near record highs. While low interest rates help borrowers, as highlighted by the surge in mortgage refinancing last year, it has strained savers who are earning next to nothing with their deposits.

The usual recommendations for a higher return than cash include using a CD ladder, shopping local credit unions for higher rates, seeking high-interest savings accounts with online banks, and turning to bonds, among others. All of these are usually viable solutions to squeeze out a little more return and may still be appropriate for some, depending on their goals.

But the problem this time around is that the extra yield does not go as far as it used to. Low interest rates have brought down the expectations on these investments, and the added return may still be less than desirable for some.

On the other end of the spectrum, dividend-paying stocks can be an option, especially for the long-term investor. But with markets near record highs, this level of risk may make some uncomfortable, as it opens yourself up to full market risk. As with all investments, it's a matter of risk versus reward.

One possible solution for the investor looking for higher return on their cash and CDs, without taking on the full market risk of the stock market, is the structured note.

How Structured Notes Work

A structured note is a type of debt security, issued by an investment bank, where the return is linked to the performance of another asset, such as the S&P 500. In this sense, it acts as a stock/bond hybrid and has characteristics of both. Benefits of a structured note include higher potential returns than CDs, participation in market upside while also limiting downside exposure, and customized parameters of the note to suit your risk level.

Some structured notes can have a “buffer,” which describes the downside protection. The buffer is a percentage of losses that the investment bank absorbs before any losses are seen by the investor. In return for offering a buffer, many structured notes also have a “cap,” which is the highest gain possible over the term of the note. While there are many different types of structured notes out there, the focus here will be on the most common type: the buffered note.

Buffered notes are notes designed to absorb losses on the downside and, in return, normally cap gains on the upside. The note is generally designed to return a single payment at maturity based on the return of the underlying asset, and usually no dividends or interest are paid in the interim.

Three Examples to Show What They Look Like

Example No. 1: At the time of this writing, early 2021, current offerings included a note that matures in six years, tied to the S&P 500 that has no cap and a 10.25% buffer. The value of the

note at maturity in the sixth year is determined by what the S&P 500 did in those six years. If the index is up 50%, then the buffered note is also up 50%. If the index is down, then the first 10.25% of losses are absorbed by the investment bank. If the index is down 8%, then your principal is returned to you for no loss. If it is down 25%, then the note will have decreased by 14.75%. These notes are generally considered buy and hold investments until they reach maturity.

Example No. 2: Another example of a current note happens to have a cap on the upside in return for a larger buffer. The tradeoff with buffered notes is a balance between upside potential and downside exposure. This note has a five-year maturity, a 32.5% cap and a 20% buffer, so the maximum upside is 32.5%. If the index is up 50%, the note increased by 32.5% in the five years. On the downside, if the S&P 500 is 25% lower in the fifth year, then the note would only be down 5%.

Example No. 3: While most buffered notes do not offer income during the term, some do. An example of this in a current two-year note is one with a 3.25% return per year for the term. For the higher return, the note does have some downside risk. In this instance, the downside risk is tied to the Russell 2000 index through a 10% buffer. As long as the index is not down more than 10% after the second year, the investor return is 6.5%, (3.25% per year for the two years). If the index was down 15%, the investor had a 5% loss in the note and a total return of 1.5% when factoring in the 6.5% of income received. When compared to current two-year CD rates that are struggling to get above 1%, you can see how a buffered note has higher return potential if some downside risk is acceptable.

These examples show how buffered notes can be customized to match your risk tolerance. You can choose to invest in one with a larger buffer and lower cap if you want to be more conservative or choose a lower buffer if you prefer more growth potential. Some even offer 100% downside protection. In this respect, structured notes may be a solution for investors who are looking for a potential higher return than what is being offered with CDs but also not wanting to be 100% exposed to the stock market.

Potential Disadvantages of Structured Notes

While the customizable payouts and exposures are the main benefit of structured notes, there are disadvantages that are important to consider before investing in them.

The main risk for a buffered note is that it is subject to the credit risk of the issuer. As with any other corporate bond, if the issuing bank goes out of business, the note could become worthless. This happened in 2008 to the note holders of Lehman Brothers. Therefore, it is important to invest only with reputable institutions with strong balance sheets.

Structured notes also have market risk. Losses are only protected up to the buffer so, in a bad market, the note can still incur considerable losses. In addition, in bull markets, gains may reach the cap resulting in no further growth above the cap.

Structured notes are designed to be held until maturity. There is not a strong secondary market to buy and sell them. Therefore, they do have liquidity risk if the funds are needed before the term is up. If you must sell the note before maturity, you may have to offer a discount to entice a buyer. Sometimes the issuing bank will offer to buy it back, but, again, usually at a discount.

Some structured notes have “call” features that allow the issuing bank to redeem your note before it matures, subject to certain conditions. In this instance, the issuer will pay you what they owe you to buy the note back.

With these risks, it is important to understand the features of the note before investing in it and to be prepared to hold it until maturity. Structured notes get a bad rap if advisers do not communicate the risks beforehand. Likewise, it is important to work with an adviser you trust, who is transparent on fees, and will shop around to find the note best suited for your goals and at the right price. When used wisely, structured notes can give a more predictable range of investment returns and may be an option for some who are dissatisfied with low interest rates and stock market volatility.

Kevin Webb is a financial adviser, insurance professional and Certified Financial Planner™ at Kehoe Financial Advisors in Springdale. He works with individuals and small businesses, offering comprehensive financial planning, including Social Security strategies, along with tax, retirement, investment and estate advice. Learn more by calling (513) 481-8555 or by visiting www.kehoe-financial.com