

Income Generation with Equity-Linked Notes



Trust must be earned

- **Investors considering opportunities** for capital appreciation and income generation may wish to consider adding equity-linked notes (ELNs) to their portfolios.
- **By providing regular coupon payments and offering flexibility** relating to the underlying shares, we believe ELNs can be attractive to a range of investors.
- **Learn more about the potential opportunities and risks** involved with investing in ELNs.

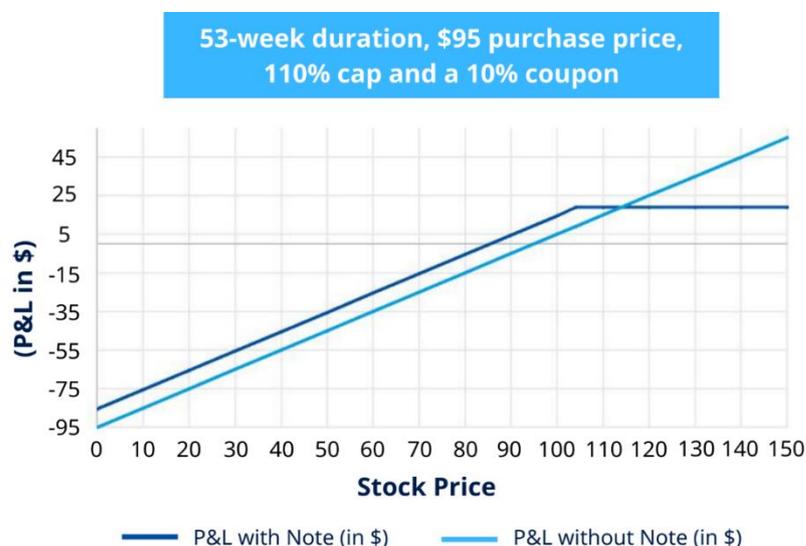
An equity-linked note (ELN) is a structured investment product that pays a coupon similar to a bond, but whose return is also tied to the performance of an underlying equity investment. An ELN has a cap that limits the upside return of the underlying security to a predetermined amount. (The cap, the coupon and the duration of the ELN are negotiated with the issuing bank and determined at the inception of the note.) This idea is similar to a covered call strategy, in which an investor takes a long position in a security but seeks to create income by selling a call option (an option with the right to buy a security at a specific price and time frame) that limits the upside capital appreciation potential of the underlying security. However, unlike an option, an ELN cannot be terminated by the issuer. Therefore, although the upside potential may be limited by the cap, the ELN can provide its owner the benefit of attractive coupon payments.

ELNs issued in the US are customized structured notes generally written under the Securities and Exchange Commission's US medium-term note program. They are not derivatives, but are considered senior unsecured debt. They are issued by major investment banks and are traded over-the-counter (OTC). Due to the short-term nature of the notes (generally three to 12 months) they are not rated. This results in some savings for the investor, who avoids expenses that would otherwise be incurred in the ratings process.

Example of an equity-linked note

The example below depicts the fictional stock of XYZ Company, which, at the initiation of the note, has a purchase price of \$95. If an ELN is written with a 110% cap, the upside limit on appreciation would be capped at \$104.5. The investor will also collect a 10% coupon during the period determined at contract initiation (in this example, the period is 53 weeks.) The note retains the full downside risk associated with the underlying equity.

Exhibit 1: Equity-linked note profit/loss potential for fictional XYZ Stock purchased at \$95



Source: Pioneer Investments. This hypothetical example is provided for illustrative purposes only.

What are the potential benefits of equity-linked notes in a portfolio?

We believe ELNs can help investors pursue attractive income as well as capital appreciation potential. Other potential benefits can include:

- An effective way to help diversify¹ a portfolio within a well-diversified portfolio of global stocks.
- The potential for custom maturity dates outside of listed calendar expiration dates.
- The note contract ensures coupon/units do not change during the life of the note, even if dividend is cut.
- The potential for reduced interest rate risk (due to short durations) usually associated with higher-yielding securities.

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What are the risks of equity-linked notes?

There are two primary risks associated with ELNs: (1) The default risk of the issuing bank; (2) The full downside risk associated with the underlying security. While these risks cannot be completely avoided, they can be reduced. The risk of one issuer defaulting can be reduced by having a portfolio of notes issued by a diversified¹ group of banks, especially those with higher credit ratings. Investors can also use tools such as equity futures to hedge the associated equity risk and help mitigate the risk of market losses.

How are equity-linked notes structured?

Selecting the underlying security is an important part of the process; investment managers can either structure notes on a basket of securities or on individual securities. Ideally, the investment manager will create notes based on equities of companies with strong fundamentals such as attractive valuations, low variation of earnings, high returns on invested capital and higher yield potential.

The process of negotiating the ELN involves seeking quotes for annualized coupons from each counterparty through a blind auction. The investment manager generally selects the broker that offers the most attractive yield potential for the chosen duration, which is usually 53 weeks.

How do investment managers seek to reduce risk?

Due to the downside risk and the return cap, investment managers may choose to avoid stocks with high price volatility. In an effort to reduce the downside risk of the underlying security, investment managers aim to select stocks they believe represent attractive values through rigorous research across industry sectors. From an overall risk perspective, investors can also utilize tools such as selling index futures to hedge the equity risk associated with the chosen positions.

¹Diversification does not assure a profit or protect against a loss.

Definitions

- **Derivative:** A security that derives its value from an underlying asset or benchmark.
- **Equity-linked note:** An investment product that combines a fixed income investment with additional returns tied to the performance of equities.
- **Call option:** A financial contract that gives the option buyer the right, but not the obligation, to buy a stock, bond, commodity, or other asset or instrument.
- **Coupon:** A coupon or coupon payment is the annual interest rate paid on a bond, expressed as a percentage of the face value and paid from issue date until maturity.
- **Covered call:** An investment strategy in which an investor holds a long stock position and sells call options on that same stock on a share-for-share basis in an attempt to generate income.
- **Yield:** The earnings generated and realized on an investment over a particular period of time.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **Hedge:** An investment used to reduce the risk of adverse price movements in an asset.
- **Futures:** Derivative financial contracts that obligate the parties to transact an asset at a predetermined future date and price.
- **Option:** A contract which gives the buyer (the owner or holder of the option) the right, but not the obligation, to buy or sell an underlying asset or instrument at a specified strike price prior to or on a specified date.
- **Senior unsecured debt:** Debt that is not backed by a specific asset and that has priority over other debts in case of bankruptcy.

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