Investor Watch
Principal-Protected Notes (PPNs)

What are PPNs?
A Principal Protected Note, or PPN, is an investment product that consists of two parts. One part is an investment that promises to return to you the original amount you invest in the PPN, usually after a six to ten year period. A third party, called the guarantor, guarantees the amount you will receive. The second part of the PPN is a market-based investment, usually linked to a market index, a fund, or another investment product that offers the potential – but not a guarantee – of a profit on your investment.

PPNs are marketed under various names such as "linked notes" or "return notes" with different terms and conditions. Sellers of PPNs attract investors by promising that they can have the principal amount of their investment guaranteed and still have the prospect of earning a rate of return above what might be provided by a GIC or other investment providing a fixed return.

What should I know about PPNs?
Before you buy a PPN, you should know that with some PPNs:

1. There is no guarantee that you will get back more money than you invested.
2. Your money is locked up for several years and, if you take your money out early, you can lose the guarantee on your principal and be charged a fee.
3. You might receive little or no profit on your investment, which would leave you worse off than if you had bought a GIC or other investment with a fixed rate of return.
4. The various fees associated with the PPN can make it harder for you to earn a profit on your investment, even if the underlying market investment performs well.

Understanding these facts can help you identify some of the risks of investing in PPNs. Knowing the risks of an investment before you buy it is one of the key elements to making an informed investment decision.

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How does this kind of PPN guarantee my principal?

Using the example of a $100 investment, the majority of your money, say $70, is used by the PPN manager to buy an investment that is guaranteed to be repaid, with interest, after a period of time (for example 10 years). A bank or insurance company will often provide the guarantee on the investment. By the end of the guarantee period, the $70 will have grown to $100 because of interest earned on it. This is how the PPN managers guarantee that they will repay you at least as much money as you originally invested.

What are the risks with this type of guarantee?

Once again, using the example of a $100 investment and a 10-year guarantee period:

1. If you take any of your money out before the 10-year guarantee period expires, you can lose the guarantee on your principal. The PPN managers will typically also charge you a fee for removing your money early.
2. The guarantee is only as good as the guarantor providing it and the security backing the guarantee. If the guarantor goes out of business or the security provided is inadequate, then the guarantee on your principal may be worthless. Even though PPNs are sometimes referred to as deposits, PPNs are often not insured by the Canada Deposit Insurance Corporation or the *Régie de l'assurance- dépôts du Québec*.

What can I do about these risks?

You need to assess if the value of the guarantee is appropriate for you. To help you do this you should at least understand the answers to these questions:

1. Can you afford to lock up your money until the end of the guarantee period?
2. How reliable is the guarantor providing the guarantee to the PPN managers and the investors?
3. Is the security backing the guarantee adequate?
4. Is the PPN insured by the Canadian Deposit Insurance Corporation or the *Régie de l'assurance- dépôts du Québec*?

With some PPNs, you might receive little or no profit on your investment.

How does a PPN make a profit for its investors?

Using the same example of a $100 investment and a 10-year guarantee period, the PPN manager will use $70 of your money to buy a guaranteed investment that provides at least $100 after 10 years. That leaves $30 (minus any sales commission) to generate the profit for your entire $100 investment. The PPN manager will attempt to invest the $30 in products that will generate a high enough return that is satisfactory to you when calculated as a return on your entire $100 investment.

What is the risk of this strategy?

Using the previous example, some PPN managers take a higher risk on your $30 to try to obtain the desired returns. Generally, a higher return is accompanied by a higher risk that you will not make a profit on your investment.

This may mean that, in the worst case scenario, you still get back your $100. However, you should consider the fact that you will have to wait 10 years to get your principal back with the possibility of no profit having been earned on your investment at all. This can have a negative impact on the growth of your retirement fund.

What can I do about this risk?

To understand the risks associated with a particular PPN you should at least know and understand the answers to these questions:

1. What are the risks associated with the investments in which the PPN manager will invest your $30?
2. Based on your investment goals and assets, how much risk are you comfortable taking with your investment?
3. Are the risks associated with the investments chosen by the PPN manager acceptable to you?

The various fees associated with PPNs can make it harder for you to earn a profit on your investment

What fees do PPNs charge?

PPN managers decide the amount and kind of fees to charge. Types of fees that some PPN managers charge are:

- selling commissions
- management fees
- performance fees
- structuring fees
- operating fees
- trailer fees
- early redemption fees
- swap arrangement fees

It is more important to understand how much of your money is used to pay fees than it is to understand what each fee means.

What is the risk of having these fees?

The payment of these fees can decrease the return on your investment. If the total fees on your investment are substantial, you risk making less on your investment than expected.

What can I do about this risk?

You need to decide whether you will receive a satisfactory return on your PPN investment after all of the fees are paid. To help you do this, you should at least know and understand the answers to these questions:

1. What is the total amount of PPN fees you will have to pay?
2. What rate of return can you expect from the PPN?
3. After taking into account the cost of the fees, is that rate of return satisfactory to you?

Helping you find answers to your questions

Is there someone who can help me answer all of these questions?

Yes. You can talk with a registered adviser. He or she can help you assess your financial needs and goals to determine if a particular PPN investment is right for you. A registered adviser can help you:

1. Assess whether the conditions of the guarantee are adequate for your investment needs. For example, does the guarantee require you to lock up your money for a period of time that does not suit your investment objectives? Can you afford the penalties if you withdraw your money before the guarantee period expires?
2. Review the credentials of the guarantor that is providing the guarantee of your principal to ensure that it is reliable.
3. Review the security backing the guarantee to ensure it is adequate.
4. Determine if the PPN is insured by the Canadian Deposit Insurance Corporation or the *Régie de l'assurance- dépôts du Québec.*
5. Identify the risks of the investment strategies of the PPN managers to see if they match your investing profile and risk tolerance.
6. Evaluate the estimated return on the PPN and assess whether it is realistic. If it is not realistic then establish a reasonable estimate.
7. Calculate the total amount of fees associated with a particular PPN investment and assess how that will affect your return on investment.

Your adviser may need to do research to identify the risks, to determine a realistic estimate of your return on investment, and to calculate the total fees. The investment strategy of the PPN manager and the PPN's fee structure may be very complicated. At present, there are few rules that dictate what PPN managers must tell investors about the investment.

If you are interested in the concept of PPNs, but wary of the risks, you can ask your registered adviser whether other investment strategies would be more suitable for you. For example, you can ask whether proper diversification using other investment products suits your investment profile and can achieve your investment goals on a less restrictive and less risky basis than the PPN you are considering.

Registered advisers have an obligation to ensure that they recommend only investments that are suitable for their clients. Providing your adviser with accurate information and asking the questions outlined in this investor watch can help your adviser fulfil his or her duty when considering if PPNs are an appropriate investment for you.