



# Important Information about Structured Products

## Definition and Background

Structured products, as described by the Financial Industry Regulatory Authority (FINRA), are securities derived from, based on or linked to a single security, a basket of securities, an index, a commodity or group of commodities, a foreign currency or group of foreign currencies, changes to prevailing interest rates, a debt issuance, or other underlying or reference asset. Structured products generally do not represent ownership of any portfolio of assets but instead the product issuer's promise to pay, which is linked to the performance of the underlying or reference asset. They are a hybrid between two asset classes typically issued in the form of a corporate bond or a certificate of deposit but instead of having a pre-determined rate of interest, the return is linked to the performance of an underlying asset class. As this definition suggests, there are multiple types of structured products. These variations include certain products offering full protection of the principal invested while others may offer limited or no protection of principal.

Most structured products offer the potential to pay an interest or coupon rate above the prevailing market rate and are used as tools by high net worth investors for portfolio diversification. Structured products provide investors with highly targeted investments that are tied to a specific risk profile, return requirements and market expectations. Structured products can be in the form of certificates of deposit issued by a bank and protected by FDIC insurance (subject to applicable limits), which are often called "structured CDs", or in the form of a note or other debt security ("structured note"), which is not FDIC insured and may or may not otherwise offer any principal protection.

## How Structured Products Work

Similar to a zero coupon bond, often, no interest payments are made during the life of the security. In most cases, the investor bypasses traditional payments in exchange for participation in the underlying asset class of that particular issue. Any payments earned by the investor, such as through market performance or the return of principal, are determined by the specific terms of each individual deal and are made on the set maturity date. Some longer dated structures are designed with an annual income opportunity, which is the potential to earn periodic coupon payments based on the performance of the underlying reference asset. Moreover, many structured products are designed by combining two components, a zero coupon bond, providing for the principal return, and a call option on the underlying asset, allowing investors to participate in the potential appreciation of the reference asset.

## Underlying Asset Categories

**Indexes:** The performance of a selected index is used as a reference asset for some structured products. An index is a statistical measure of change in a securities market and the particular index selected varies by product and issuer. The S&P 500 and Dow Jones Industrial Average are two well-known examples, but narrower types of indices may be used, such as those relating to particular sectors, market capitalizations or regions.

**Equities:** A selected group or basket of equities whose weighted average is used as a reference asset for some structured products. The number of, and particular equities selected, may vary by product and issuer. A basket of 10-15 “blue chip” stocks are an example.

**Currencies:** A selected group or basket of currencies whose weighted average is used as a reference asset for some structured products. The number of and particular currencies selected vary by product and issuer, with changes in the value of the group or basket of foreign currencies measured against the U.S. Dollar. The Euro, UK Pound, Canadian Dollar, Russian Ruble, Brazilian Real, Chinese Renminbi and Japanese Yen are examples.

**Commodities:** A selected, basic good or group of goods whose value is used as a reference asset for some structured products. The type and number of commodities selected vary by product and issuer. Soft commodities (such as agricultural and livestock products), precious metals (such as gold, silver, copper and platinum) and energy (such as crude oil, heating oil, natural gas and gasoline) are examples.

**Interest Rates and Yields:** Bond indexes, yield curves, differences in prevailing interest rates on shorter and longer-term maturities, credit spreads, inflation rates and other interest rate or yield benchmarks are used as a reference asset for some structured products.

## Risks to Consider

As an investor, you must be fully aware of the associated risks and whether these securities fit within your investment parameters. Your investment objectives should be carefully considered and discussed with your Financial Advisor. Investors must understand the product’s features and be able to bear the risks associated with investing in them. Features of a particular product to consider when determining general suitability, dependent upon the type of structured products issued, include:

**Credit Risk:** Structured products are unsecured debt obligations of the issuer. As a result, they are subject to the risk of default by the issuer. The creditworthiness of the issuer will affect its ability to pay interest and repay principal. The financial condition and credit rating of the issuer are, therefore, important considerations. The credit rating, if any, pertains to the issuer and is not indicative of the market risk of the

structured product or underlying asset. If a structured product provides principal protection or a minimum return, any such guarantee rests on the credit quality of the issuer. Structured products issued by banks in the forms of CDs provide FDIC insurance with standard coverage limitations.

**Liquidity Risk:** Structured products are generally not listed on an exchange or otherwise actively traded. As a result, there may not be a secondary market for these products, making it difficult for investors to sell them prior to maturity. Investors who need to sell structured products prior to maturity are likely to receive less than the amount they invested. Therefore, structured products with longer maturities are subject to greater liquidity risk. The price that someone is willing to pay for structured products in a secondary sale will be influenced by market forces and other factors that are hard to predict. Sometimes, a broker-dealer affiliate of the issuer may make a market for the resale of structured products prior to maturity but the price it is willing to pay will be adversely affected by the commissions paid by the issuer on the initial sale of the structured products and the issuer's hedging costs. Some structured products have lock-up periods prohibiting their sale during such periods.

Persons who invest in structured products should have the financial means to hold them until maturity, as structured products are regarded as illiquid.

**Pricing Risk:** Structured products are difficult to price since their value is tied to an underlying asset or basket of assets and there typically is no established trading market for structured products from which to determine a price. Additionally, on the date of issuance, the issue price of a structured note is likely to be higher than the fair market value because of the issuer's costs for selling, structuring and hedging its exposure on the underlying asset. Issuers typically disclose the structured note's estimated value on the offering prospectus' cover page, allowing investors to gauge the difference between the issuer's estimated value of the note and the issuance price. After issuance, structured products do not provide daily pricing information, which makes value determinations more difficult.

**Income Risk:** Structured products may not pay interest (or may not pay interest in regular amounts or at regular intervals), so they are not appropriate for investors looking for current income. Because the return paid on structured products at maturity is tied to the performance of a basket of assets and will be variable, it is possible that the return may be zero or significantly less than what investors could have earned on an ordinary, interest-bearing debt security. The return on structured products, if any, is subject to market and other risks related to the underlying assets.

**Complexity and Derivatives Risk:** Structured products typically use leverage, options, futures, swaps and other derivatives, which involve special risks and additional complexity. Structured products can have complex features and the underlying asset can also be complex. Payoff calculations on structured products may include the use of a multiple applied to the performance of the underlying asset, caps, barriers or minimums on the potential return, and triggers or buffers designed to limit downside risk. Structured products can either make regular payments during their stated terms or make only a payment at maturity. It is important for investors to understand the features of a structured product and the underlying asset and its components.

**Pay-Out Structure Risk:** The underlying or referenced assets in structured products determine payoff structure and affect calculations regarding the product's performance. Complicated payoff structures make it difficult for investors to accurately assess the value, risk and potential for growth through the terms of a structured product. Some structured products impose limits, caps and barriers that affect their return potential by keeping loss and/or gain within a set price band. With barriers, a structured product may not offer any return if a barrier is broken or breached during the term of the structured product. Conversely, some structured products may not offer any return unless certain thresholds are achieved. Some structured products impose capped maximum return limits so, even if the underlying assets generate a return greater than the stated limit or cap, investors do not realize that excess return. Capped maximum limits offer no downside protection. However, capped buffers limit the maximum gain possible and offer downside protection until the downside threshold is surpassed, which then requires investors to cover any excess, negative return. Structured products also have participation rates that describe an investor's share in the return of the underlying assets. Participation rates below 100% mean that the investor will realize a return that is less than the return on the underlying assets.

**Market Risk:** The performance of the underlying asset on a structured product may cause investors to lose some, or all, of their principal. Depending on the nature of the underlying asset, the market risk of a structured note or other structured product that does not provide principal protection may include changes in equity or commodity prices, changes in interest rates or foreign exchange rates, or market volatility. Because the performance of a structured product is linked to the performance of an underlying asset, a structured product is subject to market risk associated with the underlying asset.

**Principal Risk:** Some structured products do not offer 100% principal protection. This means an investor may lose principal. These are commonly referred to as "structured notes." Some structured notes may provide partial principal protection or no protection at all. Loss of principal may result from the performance of the

underlying asset. Principal return is also subject to credit risk of the issuer. Some structured notes feature a buffer or trigger, which protects a specified portion of the downside risk. The amount of principal at risk is determined by the specific terms of each deal. Some structured notes may also require customers to hold the note to maturity in order to receive principal protection. Additionally, some structured products impose a buffer or trigger, which protects a specified portion of the downside risk.

**Volatility and Historical Performance of Underlying Asset:** Past performance of an underlying asset class is not indicative of the profit and loss potential on any particular structured product. The value of the underlying asset can experience significant periods of fluctuation and prolonged periods of underperformance.

**Different from Traditional Fixed Rate Bonds:** Structured notes and other structured products are different from traditional fixed income securities. They do not pay a fixed rate of interest, as the interest income is a function of the performance of the underlying asset, which can vary dramatically. The terms and features of structured products can be more complex than those of traditional fixed income securities. Some structured products do not make any payments until maturity.

**Costs and Fees:** Costs and fees associated with the purchase of a structured product vary.

**Tax Considerations:** Structured products may be considered “contingent payment debt instruments” for federal income tax purposes. This means that investors will have to pay taxes each year on imputed annual income based on a comparable yield shown in the final term sheet or prospectus supplement. In addition, any gain recognized upon the sale or exchange, or at maturity, of these products will generally be treated as ordinary income. This especially pertains to principal protected issues. Please consult your tax advisor for guidance.

Additional vulnerabilities may include loss of principal and the possibility that at maturity the investor will own the underlying asset at a depressed price. Interest rates and time remaining until maturity are all factors that may affect the value of the structured product. As with any investment selection, structured products should be purchased as a limited percentage of your portfolio and overall investable assets.

### **Categorization of Structured Products – Who Invests in Structured Products?**

The structured product market can encompass many variations and the appropriateness of each issue should be evaluated by its specific terms. Most issues can be categorized by one of the following headings.

**Principal Protection:** Principal protected structured products may be more appropriate for conservative investors seeking market exposure with principal preservation. These typically offer full principal protection at maturity with the potential for additional return based on the performance of an underlying asset or group of assets. Investors may forfeit some upside exposure to an underlying asset in exchange for principal protection. Return of principal may not be obtained if the investment is sold prior to maturity. Principal protection and payment at maturity are subject to the credit risk of the issuer. The creditworthiness of the issuer is an important factor to consider in investing in a principal protected note. Certain principal protected notes have differing levels of protection; some, for instance, do not offer 100% principal protection. Please note that principal protection applies only to nominal principal and does not offer inflation protection.

Some structured products are certificates of deposit of a bank, with the principal amount of the investment protected by FDIC insurance (up to applicable limits) in the case of a bank failure. Other structured products, such as structured notes, do not have FDIC insurance. Some structured notes and other structured products may offer partial principal protection or no principal protection. As a result, those products are more appropriate for investors who are willing and able to bear a potential loss on their investment.

**Enhanced Yield:** Enhanced yield structures may be appropriate for more risk tolerant investors seeking higher returns than comparable debt instruments. Payment at maturity on these short-term notes is determined by the performance of an underlying asset or group of assets and principal may be at risk. Investors generally forfeit partial or full principal protection at maturity in exchange for the potential to earn a higher participation. Investors can be exposed to downside risk and may lose part or all of their original investment. Additionally, with some structured products, investors may receive shares of stock or a payment at a value below the original principal amount at maturity. Coupon payments and payment at maturity is subject to the credit risk of the issuer.

**Access:** Structured products can provide investors with access to an asset or group of assets not readily available to private investors. These products can offer exposure to markets or strategies that may be inefficient or difficult for investors to obtain, such as foreign exchange rates or commodities. Since these products may not provide for full repayment of principal at maturity and are typically linked to sophisticated underlying assets, they may be more appropriate for moderate to aggressive investors.

**Leverage:** Structured products that utilize leverage may be generally more appropriate for aggressive investors wanting to capitalize on a particular market view. These short-term products provide partial or no principal protection but do offer the potential to receive leveraged returns on the value of the underlying asset. Some structures may offer additional leverage in exchange for capped or limited upside potential. Investors are exposed to downside risk of the underlying investment and may lose part or all of their original investment.

Structured products, principal protected or otherwise, may not be appropriate for all investors.

### Who Issues Structured Products?

Domestic and foreign banks along with corporations issue structured products. Certain structured products issued by banks may (but need not) be structured as certificates of deposit or other types of deposits and thus may be entitled to FDIC insurance protection subject to applicable limits.

### Complex Variations of Structured Products and Features

**Principal Protection (Full/Partial/No):** Structured products can have many different designs and features. The primary differences between structured products are their various forms of principal protection. Some structured products offer 100% principal protection so that even though the underlying asset suffers a loss over the period of the term of the investment, investors do not lose money. Despite offering 100% principal protection, structured products are subject to credit risk, which is the risk that the issuer may be in bankruptcy or default and thus not honor its obligation to repay principal. However, structured products with 100% principal protection can be certificates of deposit of a bank so that they are protected by FDIC insurance (up to applicable limits). Other structured products, including structured notes, may offer partial protection of principal or no protection at all against losses.

### Common Features of Structured Products

Beyond the direct linking of an underlying asset class as a dictate of return, some structured products include varying features and specifications that may impact performance, some of which are described below. Some structured products may have some or all of these features. For any complex variations that may be present with a particular offering, discuss the performance parameters with your Financial Advisor.

**Value Date:** Interest computations begin with the percentage change in the value of the underlying asset. It is the change between the “initial value date” and the “final value date” specified for the particular offering. The percentage change is the difference in the final value and the initial value divided by the initial value. The initial value date is usually

the date of issuance while the final value is typically calculated just prior to the maturity date to allow for the interest payable to maturity to be available on the maturity date. Some structured products may determine the return of an underlying asset and pay interest at regular intervals such as annually (known as “observation points”) rather than waiting until maturity to determine the change over the life of product.

**Participation Rates:** The participation rate (sometimes called a “gear”) dictates the extent to which an investor will participate in the underlying asset’s gain. This is applied to the percentage change in the underlying asset’s value. A rate of 100% would allow the investor a return equal to the percent change in value of the underlying assets. Certain products may offer participation rates of less or more than 100%. Those with participation rates of more than 100% may offer the potential for a return on the structured product that is greater than the return of the underlying asset, but may present the potential for a greater loss. Some structured products carry contingent protection, where no principal protection applies unless a pre-set contingency is met.

**Minimum or Maximum Interest Amount; Barriers:** In this case, the particular product will have a specified minimum and/or maximum interest, or cap, amount that may be paid at maturity. At maturity, if the interest calculated is less than the stated minimum, the interest amount paid to the investor will be the minimum interest amount. If the interest calculation results in a value greater than the maximum for the investment, only the maximum interest will be paid. If the value of the underlying asset decreases, a structured product with a minimum return (depending on how the minimum return is designed) may either mean that the investor will be returned his initial investment, or principal amount, at maturity or be exposed to the decline in the underlying asset. Barrier structures place parameters on the upside and downside performance of an underlying asset. A structured product with a barrier typically means that if the change in the value of the underlying asset (positive for an upper barrier and negative for a lower barrier) exceeds a certain percentage, the investor realizes limited or no return on his investment.

**Triggers and Buffers:** A trigger or buffer feature means that there is downside exposure (i.e. principal is at risk); however, the trigger or buffer is intended to absorb a defined percentage of the underlying asset’s decline so that the investor will not be exposed to the loss so long as it does not exceed the defined percentage. Beyond the trigger or buffer, the investor participates in the decline. There are different types of buffer features. In some cases, the initial buffer is always protected, so the investor cannot lose 100% of their principal, only the loss in excess of the buffer. This is known as a hard buffer. In other cases which may be known as a trigger buffer, there is full 1:1 downside exposure that is triggered once the buffer is passed. In this situation, an

investor bears all losses or declines in value. Structured products may also have upside buffers, in which the investor is not entitled to share in the gain unless the buffer is exceeded. Other buffers may provide that if the gain exceeds the buffer, the investor is not entitled to any gain.

**Callable Structures:** Certain structured products may have call features allowing them to be redeemed by the issuer prior to maturity. The call is at the option of the issuer only. The call features will be disclosed prior to issuance and are expressed as a percentage of the initial investment amount. The issuer would be most likely to call the investment when the value is greater than the call price. The value of the investment can be based on a variety of unpredictable factors including the current value of the underlying asset, time remaining to maturity, volatility and interest rates.

### To Learn More about Structured Products

Baird is fully committed to helping you understand a structured product investment. To learn more about structured products, please contact your Financial Advisor.

More information on structured products and their risks are available from the SEC and FINRA at the following URLs:

- SEC Investor Bulletin: Structured Notes – [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_structurednotes.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_structurednotes.html)
- Structured Notes with Principal Protection: Note the Terms of Your Investment - <https://www.sec.gov/investor/alerts/structurednotes.htm>; and <http://www.finra.org/investors/alerts/structured-notes-principal-protection-note-terms-your-investment>