



## STRUCTURED NOTES: INVESTMENT TOOLS WITH A PURPOSE

Structured Notes (SNs) are flexible vehicles that offer investors the ability to customize the risk and return profiles of a given investment to reflect a specific investment view, or specific investment needs. They offer access to a wide range of underlying markets and investment strategies in an operationally and, in some cases, a tax-efficient manner. In certain circumstances, structured notes can be created to suit investor demands with flexibility that cannot be found in a mutual fund or an exchange traded fund.

That said, SNs vary in terms of complexity and risk. Before making an investment in any SN, it is important that investors understand the specific features of the SN and ensure it is consistent with their investment objectives, risk factors and liquidity needs.

### CHARACTERISTICS OF STRUCTURED NOTES

SNs are typically senior unsecured debt obligations of a financial institution. SNs issued by Canadian Schedule 1 chartered banks rank equally with their deposit obligations; however, unlike Guaranteed Investment Certificates (GICs), SNs are not covered by CDIC insurance.

SNs allow for customization of a wide range of investment attributes,

including maturity, currency exposure and underlying assets (equities, commodities, interest rates, currencies). Notes can be structured to adjust the risk-return profile of an investment by altering the trade-offs between principal protection, price appreciation potential and income. For example, an investor may give up some of the upside on an equity index in order to receive a measure of principal protection, or a higher yield. In many cases, a structured note can be created to meet an investment need that is not readily met with the existing universe of traditional investments such as bonds, mutual funds and ETFs.

SNs may convey certain tax advantages. For example, certain vehicles may be structured such that capital gains may not be triggered on the rebalancing of

the underlying portfolio. In addition, SNs may be designed to make Return of Capital (ROC) payments, which defer tax on the distribution until maturity or disposition of the note.

Unlike alternative products such as mutual funds and Exchange Traded Funds (ETFs), SNs typically have a stated maturity date.

SNs typically pay a formulaic amount at maturity, which is based on the change in price of an underlying asset over the term of the SN. At maturity, SNs issued in Canada are generally cash settled (i.e. the payout is in the form of cash versus physical delivery of the underlying asset). SNs can also be designed to pay fixed or variable payments over the life of the note.



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## TYPES OF STRUCTURED NOTES AND THEIR BENEFITS

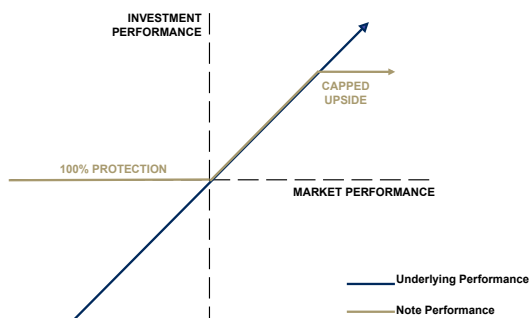
### PRINCIPAL PROTECTED NOTES (PPNs)

PPNs are the most traditional form of SNs and have been available for many years. They can be viewed as alternatives to fixed-income investments and offer potential returns in excess of GIC rates (or other regular debt securities of the same term). Payment of principal is fully guaranteed by the issuer at maturity. In addition, the investor participates in changes in the price of the underlying asset, which can occur either:

- In the form of variable coupon payments over the life of the note; or
- In the form of a return payable at maturity

Here is an example of a typical PPN. As the diagram below shows, at maturity, the investor participates fully in positive changes in the price of the underlying asset (in this case, up to a certain maximum amount). If the price of the underlying asset at maturity is less than the price on the issue date, the investor is fully principal-protected.

Payoff Profile of a Principal Protected Note at Maturity



It is important to note that principal is guaranteed only at maturity. Depending on the performance of the underlying asset, the price of the note in secondary market can fall below the issue price.

### NON-PRINCIPAL PROTECTED NOTES (NPPNs)

NPPNs are designed as alternatives to traditional equity investments where full principal is not guaranteed at maturity. Their benefit lies in their ability to customize risk and return trade-offs to suit investors' needs. They may also offer tax efficiencies. Broadly, they can be grouped in two categories: long-equity NPPNs and options-based NPPNs.

#### LONG-EQUITY NPPNs

Long-equity NPPNs can be viewed as an alternative to a conventional mutual fund or ETF.

One of the key differentiators is tax efficiency: where funds and ETFs pass on realized capital gains to their holders over the term, similar gains may be triggered in a note structure only at maturity or disposition of the note. This makes notes particularly appealing for portfolio strategies where the turnover of the underlying holdings is high, as is the case with many popular quantitative investment strategies. Depending upon the structure, income may also be paid out in the form of Return of Capital, which defers tax payments on the distribution until the note matures or is sold.

Long-equity NPPNs represent a "one-ticket" solution since the issuer executes all trades related to portfolio rebalancing at no additional transaction cost beyond the fees stated in the note.

#### OPTIONS-BASED NPPNs

As implied by their name, options-based NPPNs utilize option-based strategies in order to modify the trade-off between the risk and the return of an investment. For example, they can be customized to provide various combinations of the following benefits:

- Enhanced participation in price changes of the underlying asset(s)
- Enhanced yield over what is available in cash equity and bond markets
- Principal protection where the investor is looking for some level of capital protection

The cost of these enhancements is funded by other features of the note, such as capping the upside price appreciation potential beyond a certain point. Note that dividend payments are not received on options-based NPPNs. Their value, however, is reflected in the economics of the note. As a result, performance of an options-based NPPN is normally stated on a price-return basis and not a total return basis.

Some examples of options-based NPPNs include but are not limited to the following:

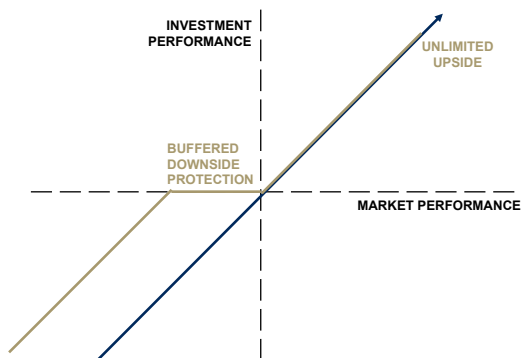
- **Buffered NPPN.** A buffered note allows investors to partially protect their principal at maturity while gaining more upside participation in the performance of the underlying investment than in a fully principal protected note.

This strategy protects investors' principal against a drop of a given percentage in the underlying asset at maturity; however, the investor still participates in any negative returns on the underlying asset below the stated percentage (or buffer). For example, if a note provides protection

against the first 20% decline in the underlying asset at maturity, and if the underlying's return at maturity is -35%, the effective return of the note is -15%. The upside return on the note may be capped or uncapped depending on the structure of the note.

- **Application:** An investor who purchases a buffered NPPN generally has a positive outlook on an underlying asset, however, desires a measure of protection against negative returns.

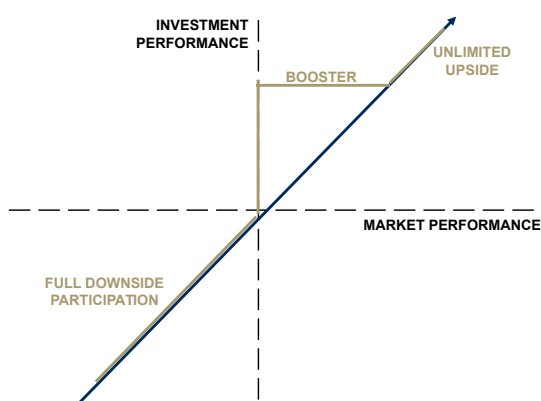
**A Buffered NPPN**



- **Booster NPPN.** A booster note allows investors to earn enhanced returns on an underlying asset that is expected to provide muted returns over a certain time period. It provides exposure to the underlying such that, at maturity, the investor receives a “boosted” return for any return in the underlying below a specified amount. Booster notes can be capped or uncapped. Unless buffered protection is built into the note to protect against negative performance, investors are fully exposed to downside risk on the underlying asset.

- **Application:** An investor who purchases a Booster NPPN is generally seeking superior price appreciation amid expectations of muted or modest returns.

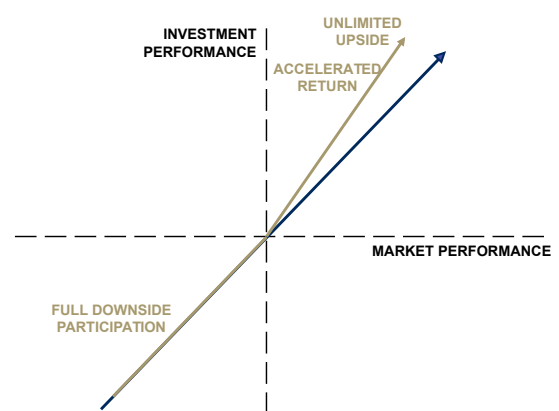
**A Booster NPPN**



- **Accelerator NPPN.** An accelerator note enables investors to receive an accelerated price return for any positive performance in the underlying asset. The upside on these notes can be capped or uncapped depending on the term, underlying and return multiple built into the note. Investors' exposure on the downside is the same as owning the underlying outright.

- **Application:** An investor who purchases an accelerator note is generally someone who holds a bullish view of an underlying asset and wants to outperform that underlying asset.

**An Accelerated NPPN**



## LIMITATIONS AND RISKS OF STRUCTURED NOTES

Just as most investments do, SNs have several limitations and risks of which investors should be aware. The following are some examples of limitations and risks. Investors should refer to the applicable offering documents for a complete summary of limitations and risks:

- **SN investors are unsecured debt holders of the issuing bank and are, thereby, exposed to counterparty credit risk.** Investors should be aware of the credit rating of the issuer and should assess the ability of the issuer to pay its obligation as it comes due. Currently, the most prominent issuers of SNs in Canada are the six Schedule 1 chartered banks. In the past, global banks and investment banks have issued SNs in the Canadian market.
- **Returns are viewed on a price basis.** Typically, in the case of a principal protected note or an options-based non principal protected note, the return is price-return not total-return. As such, dividends on the underlying assets are not received by investors but their value is reflected in the economics of the note.

- **Liquidity for SNs depends on the issuer's willingness to make a secondary market.** SNs are generally not listed for trading on an exchange. However, most issuers in the Canadian market make an active secondary market to repurchase the SNs that they issue. Selling early however, may not always lead to a positive return (generally associated with options based notes, as discussed in more detail below). Also, certain SNs may be subject to early trading charges. Refer to offering documents for the applicable early trading charge schedule (if any).
- **Early in the term of the SN, an investor may not see the note value increase or decrease to the same extent of the underlying asset.** The secondary market price of PPNs and options-based NPPNs is affected by a combination of several market factors which include the price of the underlying asset, interest rates, volatility, dividend yields, time to maturity and correlation (if there is more than one underlying asset). Therefore, the secondary market price of a PPN or options-based NPPN can be above or below the initial purchase price of the note. The secondary market price may be less than the implied return to date for the underlying asset or the maturity return as defined by the payoff formula. With the passage of time, the price of the underlying asset and the secondary market price of a PPN or an options-based NPPN will increasingly reflect the maturity payoff formula of the SN. The secondary market price of a long-equity NPPN is generally only affected by changes in the price of the underlying assets, that the strategy tracks, and the accruing management fees.

## IN SUMMARY

Structured notes can be useful tools in an investment portfolio, provided they are consistent with the investor's investment objectives, risk tolerance and liquidity needs. Used effectively, structured notes can help investors increase diversification within their portfolios. SNs vary in terms of complexity; however, generally speaking, the best SNs are simple and transparent. Before making an investment, investors should pay particular attention to the principal at risk (if any), the method for calculating the coupon payments amounts (if any) and the payoff amount at maturity, associated fees and the creditworthiness of the issuer.

The terms and conditions applicable to a SN, including a full discussion of any associated risk factors, are set out in its offering documents. Investors should read the applicable offering documents carefully before investing and should discuss the suitability of an investment in the SN with their Investment Advisor before making an investment decision.

*Speak to us today to learn more about whether structured notes are a suitable addition to your portfolio.*

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An investment in principal protected notes may not be suitable for all investors. The full principal amount invested is guaranteed to be repaid at maturity only for principal protected notes that are held to maturity. Any payment on principal protected notes above the principal amount invested depends on the performance of the underlying assets. Investors should read the applicable Information Statement for an issue of Notes carefully before investing and should discuss the suitability of an investment in the Notes with their investment advisor before making an investment decision. To obtain a copy of the Information Statement, please contact your advisor or visit the website at [www.rbcnotes.com](http://www.rbcnotes.com). The offering and sale of Notes may be prohibited or restricted by laws in certain jurisdictions. Notes may only be purchased where they may be lawfully offered for sale and only through individuals qualified to sell them. The Notes are not insured deposits under the Canada Deposit Insurance Corporation Act (Canada).

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PSN (10/2014)