

News from globeandmail.com

Tuesday, March 21, 2006

Why you should protect yourself by avoiding PPNs

ROB CARRICK

And now for a crash course on protecting yourself from principal-protected notes.

Those supersafe PPNs -- you get your money back at worst -- are actually one of the nastiest investments to come along in years when you consider the lack of information about fees and other important matters.

Regulators have started examining PPN disclosure and sales practices, but it's a safe bet that gullible investors will buy a few billion more of these securities before any action is taken. In the meantime, do nothing without considering the following five reasons to avoid PPNs.

1. The way overblown guarantee. The appeal of PPNs is that you can invest in stocks, stock indexes, mutual funds, hedge funds and commodities with a bank-banked promise that you'll do no worse than getting your money back at the end of the five- or 10-year term. Since when have investors lowered their expectations to be satisfied with lame results like this?

First of all, you'd have lost the opportunity to make a reliable return through guaranteed investment certificates and government bonds, which yield in the area of 4 per cent right now for terms of one to five years. Second, breaking even is actually losing money in a real-world sense because of inflation.

Bank of Canada data show that the average annual rate of inflation over the past five years was 2.23 per cent. That's enough to have trimmed the buying power of \$5,000 down to \$4,466.82 over that period. Yes, you'll get your principal back with a PPN. But that doesn't mean you won't be poorer.

2. High fees that are haphazardly explained or just plain hidden. There are no standards saying what fee information PPN issuers have to disclose in their information statements, which means you have to dig through any crumbs you're given. Be on the lookout for sales commissions of more than 4 per cent, which is twice as much as any upfront commission you'd pay on a mutual fund these days.

If you pay an upfront sales charge with a mutual fund, you don't have to worry about any redemption fees. PPN issuers are bold enough to collect both, which means you should be aware of exit fees if you sell in the first couple of years after you buy.

Some PPNs charge management fees that eat into potential returns, while others will tell you they charge no such fees. That's nonsense -- PPNs are a black box of undisclosed fees that cumulatively dig deep into your potential returns.

3. Lack of clarity about returns. The aforementioned fees are essentially a hurdle over which the underlying investment of your PPN has to leap in order to make you any money. Don't expect to be told under what circumstances your PPN would produce a gain for you, though.

Instead, you get a lot of verbiage that leads you on about the earning potential of the indexes, stocks, funds or whatever that your PPN is based on. Sure, those investments sound appealing. The question is, how well would they need to perform to exceed the safe return of a GIC or bond? PPN issuers don't answer this question.

4. Lack of liquidity. One of the advantages that PPNs have over the index-linked GICs that banks have sold for years is that you can sell them prior to maturity on the open market. That's the theory, anyway.

In reality, there are pitfalls that call into question whether you can sell a PPN before maturity on decent terms. First off, some PPN issuers say they will maintain a weekly market, while others offer daily liquidity. Then there's the question of how big a gap there is between what sellers are asking and buyers are willing to pay. A large bid-ask spread cuts into your proceeds the same way as those redemption fees that PPNs also charge in some cases.

5. Overall sneakiness. Even investment advisers and analysts find PPNs unclear in the way they operate. "They are a nightmare to try to understand," independent fund analyst Dave Paterson wrote in an e-mail response to a column last week on PPNs. "If I am getting frustrated by it, I can only imagine what a typical adviser or client is going through."

Here's Michael Hill, an investment adviser with DeThomas Financial Corp. in Windsor, Ont., on PPNs: "Investors as well as advisers must be sure to fully read and then further question the information statement, because so much is missing, or not disclosed."

A general investing rule: Missing or undisclosed information is usually prejudicial. On that basis alone, investors should protect themselves against PPNs.

rcarrick@globeandmail.com

THE GLOBE AND MAIL