



Investing with Style: Hybrid Notes

Designed for performance ~ tailored for stability

Things I have learned listening to Robin
by Henry Pole, Guest Writer

More Often Than Not, articles on finance relish in the complexity of their subject. Many writers bury their point behind walls of jargon and pretext, making the subject itself all but indecipherable. Often this is because writers struggle to make these topics engaging or relatable - it can be some pretty dense stuff. However, it's my belief that this lack of clarity is intentional more often than not. By concealing important information amidst specialist language, finance writers reinforce the idea that it requires a specialist to make sense of it.

Both of my parents have PhDs in Chemistry. My mother studied Physical Chemistry, my father Organic Chemistry. Growing up, I was steeped in specialist language.

If you think financial jargon or legalese is hard to understand, scientist-speak will put you straight to sleep. There is a considerable gap between expert knowledge and lay knowledge in this regard.

High School Science class does little to prepare you for drawn out conversations on mass spectrometry. My parents don't enjoy making their work confusing or concealing their meaning behind layers of jargon. They're simply not good at explaining these things in a way most people will understand. There is too much information, too many caveats, too much to address before they feel their topic has been adequately addressed. This is a professional responsibility, but it's also a huge obstacle towards understanding. As a writer, I deal in meaning, not in jargon.

Robin has asked that I put that unique ability to work on Hybrid Notes, a subject that defies easy explanation. To put it simply, they are an asset that combines elements of the stock market with qualities of bonds. A fusion of two different types of investment. However, to leave it at that would do you a disservice. Hybrids are a great investment strategy for those who know how to use them. With a high yield and built in safety mechanisms, the results are very exciting, but explaining how they work is about as interesting as drying paint.

Growing up with scientists has taught me many valuable things, chief among them is the ability to take dull information and make it interesting while preserving the substance.

insights

*An investment bulletin prepared by
Robin Kingsmill and*

The Kingsmill
Wealth Management Team

BMO / Nesbitt Burns

Robin Kingsmill
B.Sc., CIM®
Sr. Investment Advisor
Sr. Portfolio Manager
905 89 5212

Susan Taptelis
B.A., CIM®, QAFP®
Sr. Investment
Associate
905 897 5227

Teresa Wilejto
Client Service
Associate
905 897 1204

BMO Nesbitt Burns Private Wealth
360 Oakville Place Drive 2nd Floor
Oakville, Ontario. L6H 6K8

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Wealth Management Team

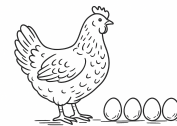
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Hybrid Notes: Where Bonds meet Equity:

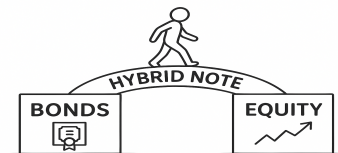
To understand how Hybrid Notes work, it helps to first grasp the distinct roles that bonds and equities play in the broader financial ecosystem. Both asset classes have benefits to investors, and there's no downside to diversifying your portfolio with bonds and equity. However, they do serve different functions. Stocks and equity are great for building wealth over time. Bonds, on the other hand, take a long time to mature, but they pay out along the way.

You could think about bonds like owning a chicken. Eventually, that chicken will be ready to eat. But, in the meantime, it lays eggs - small, regular contributions to your diet. You're not going to get a whole feast out of these eggs, but they're consistent, reliable and nourishing. That's the nature of a bond: you'll eventually enjoy a full meal, but you also get something to snack on while you wait.



Conversely, equity is more like a cask of wine. You select the grapes, the barrel, the conditions. But, once the barrel is sealed, it's out of your hands. The maturation process is influenced by countless variables: humidity, temperature, time and a little luck. You won't know how it tastes until it's ready to pour. With any luck, you could produce a stunning vintage with a high valuation, or you could end up with vinegar.

We can think of this parallel as the two different approaches to investing. Like stocks, the wine may produce higher value, but it has more risk associated with it. Like a chicken laying eggs, bonds will produce regular income, but that income is limited.



Hybrids present a middle way. They are engineered products that use equity to maximise cashflow while retaining the regular interest payments of bonds.

Downside Protection:

The most unique feature of a Hybrid Note is the downside protection. Most notes have either 20%, 25% or 30% downside protection, meaning that you are shielded from drops in the market up to that level. As long as the underlying asset stays above the barrier level, the Note will make regular interest payments.

However, it is possible to go outside of the barrier, in which case the interest payments will be paused.

If the value of the asset is outside of the boundary by the time the contract is closed, you will receive the value of the underlying asset.

The higher the downside protection is, the more expensive the Notes are to make. As a result, the interest payments are lower. So a Note with 30% protection has less risk, but it also has smaller payments than a Note with 25% protection. Either way, you get more security than you ever would if you owned the shares outright.

Investing without risk is an unattainable goal. Yet Hybrids offer investors a way to mitigate risk while still seeing favourable returns.

Upsides and Downsides:

The traditional philosophy of investing doesn't always work with Notes. When buying shares, you typically look for assets that offer good growth. With a Note, stability is more important. A Note can be affected if the underlying asset goes too high or too low. When it drops below the barrier level, the Note stops paying interest. If it surpasses the upside cap, the contract is closed out early. Your principal investment will be returned to you in full. But, if the asset remains in its boundary, you will get the benefit of regular interest and the return of your principal investment when the contract matures.

Upsides Caps

As we discussed before, every Hybrid Note has an upside cap - usually 5% above the initial level. If the value of the underlying asset exceeds this upside cap, the Note is autocalled.

When this happens, the note is closed out early. The issuer hands you back your principal investment and any interest you've already received. They shake your hand and say goodbye.

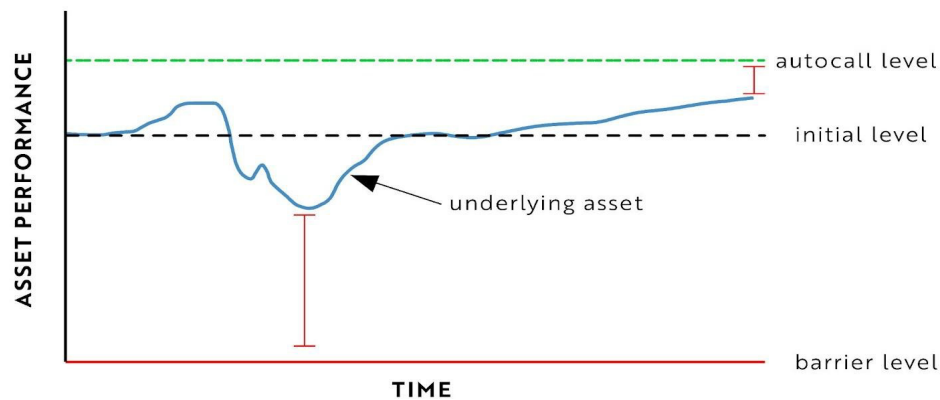
You walk away with whatever you put in plus interest.

All investment involves risk - even bonds. What makes Notes so appealing is their structured nature. Notes are tightly contracted however they also have added protections from exposure.

How do Hybrids Work?

A Hybrid Note is directly linked to a stock or an index. We call this the *underlying asset*.

Importantly, you don't actually own the shares. You own a product whose rate of return is based on the performance of the underlying asset. If you were to invest traditionally, you would hold the shares of a company. When the value of that company increases, so does the value of your holdings. With a Hybrid, you're assuming that the underlying asset stays within a certain boundary.



The chart pictured above is designed to indicate the important features of Hybrid Notes. The blue line represents the underlying asset - the stock or index that the Note is tied to.

The black dotted line is the 'initial level'. This represents the price of the underlying asset on the day the Note is issued. The variables built into the Note's contract are all based on this initial level.

The green line is the 'autocall level' or the 'upside cap'. Every Note has a predetermined autocall level - usually about 5% above the initial level. If the underlying asset's value exceeds this autocall level, the contract is concluded and the Note is closed out early.

The red line at the bottom of the chart is the 'barrier level' or 'downside buffer'. This is also determined by the initial level and represents the amount of downside protection you get.

While the Note is tied to an underlying asset, it behaves very differently than owning shares in the market. The Note doesn't gain value if the asset performs well, however it has measures to protect you from drops in the market.

What is my Conclusion?

Earlier, we compared bonds to chickens laying eggs and equity to the wine market. One provides small but consistent payments. The other can give a great return on investment, but is directed by external factors. While we've been working on this article, the idea of the chicken and the wine has proved to be a good litmus test for what an investor values. Some people prioritize long term returns while others focus on assets that provide revenue. Both approaches can be used effectively. Perhaps you're looking for a return on investment and don't have years to wait. Or maybe you're looking for consistent income and feel that bonds don't provide enough sustenance. If that's the case, then Hybrids may be for you.

When you think about it in the abstract, risk doesn't sound so bad. Everything has risk to it. Markets fall, affecting stock prices. Bonds can be devalued by rising interest rates. Even a piece of fine art may be affected by shifting critical winds. But when it's your money, risk isn't hypothetical. It's very real.

These complex assets provide healthy yields, have built-in safety features and come with a contract, meaning that you will always know the parameters of your investment. All of this combined make Hybrid Notes an exceptional item for investors.

You should know:

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