

Reverse Convertible Notes

A new choice in alternative investments for those seeking enhanced income during short maturities

What They Are

Stagnant markets, shrinking yields and moderate equity returns have forced many investors to ask, “Where’s the income?” With yields that can currently range from 7% to 20%, Reverse Convertible Notes (RCNs) regularly outpace traditional returns, even those of high-yield bonds. No wonder they’re gaining favor among income-hungry investors.

With relatively short maturities, usually 3 to 12 months, Reverse Convertible Notes are coupon-bearing investments whose payout at maturity is determined by the performance of an underlying stock, basket of stocks or index. Traditionally, RCNs are linked to a well-known stock such as Apple, Inc. or Valero Energy Corp., with the coupon payment reflecting the general volatility of the underlying asset. The more volatile the underlying security’s performance, the more risk the investor typically

incurs, and therefore the higher the coupon payment received for the Note. In addition to a stated coupon payment, which is typically paid monthly or quarterly, at maturity RCN investors receive either 100% of their original investment or a number of shares of the underlying security. In exchange for the enhanced income feature, investors do risk loss of principal and should be comfortable with the risk of receiving physical shares of the underlying asset at a depressed price at maturity.

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Key Terms

Reference Share: The individual or underlying stock (or index or basket of equities) to which the performance of the Reverse Convertible Note is linked.

Trade Date: The date in which the Reverse Convertible Note is priced for initial sale to the public.

Initial Share Price: The closing price of the reference share on the day the note is listed for initial sale.

Physical Delivery Amount: The number of reference shares delivered at maturity to the investor.

Valuations Date: The final pricing date, typically four business days before the maturity date.

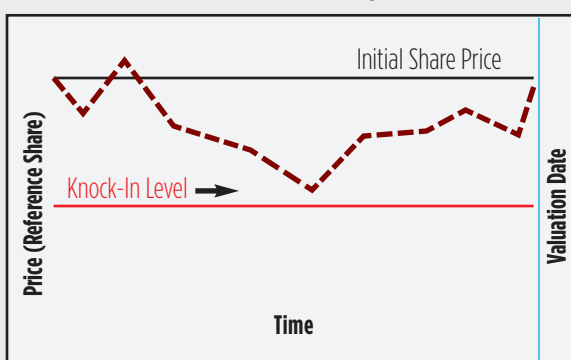
Knock-in Level or Barrier Price: A predetermined closing price that can trigger the possibility of an investor receiving shares of stock (reference shares) at maturity as opposed to their original investment, generally (70%-80%) of the price of the stock on the trade date.

Reverse Convertible Note Return Scenarios

Investor Receives Return of Principal at Maturity if:

- The market value of the Reference Share never closed below the Knock-in Level during the term of the Note (typically 70-80% of the initial reference price).
(See Fig.1)

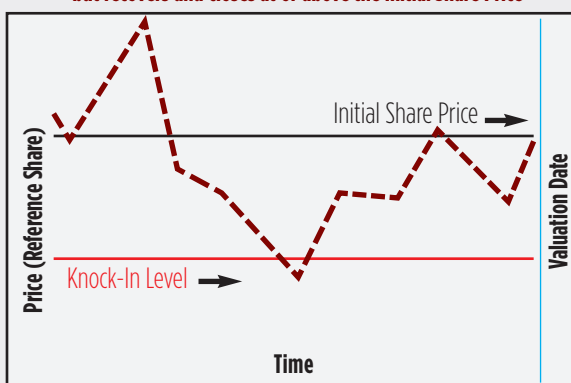
Reference Share does not close below the specified Knock-in Level



(Fig.1)

- The market value of the Reference Share closed below the Knock-in Level during the term of the Note, but the Reference Share closed at or above the Initial Share Price on the Valuation Date.
(See Fig.2)

Reference Share closes below the specified Knock-in Level, but recovers and closes at or above the Initial Share Price

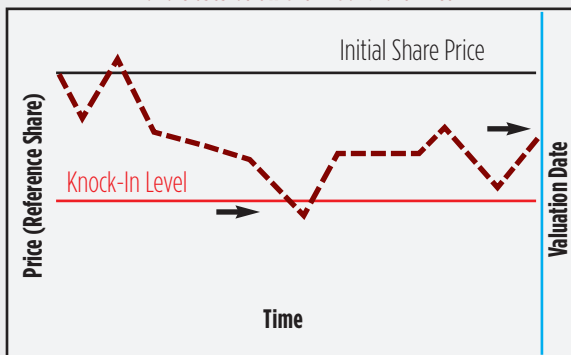


(Fig.2)

Investor Receives Physical Delivery of the Reference Share at Maturity if:

- The market value of the Reference Share closed below the Knock-in Level during the term of the Note, and the Reference Share closed below the Initial Share Price on the Valuation Date. Note that in this scenario the investor will receive less than the principal amount invested.
(See Fig.3)

Reference Share closes below the specified Knock-in Level and closes below the Initial Share Price



(Fig.3)

A Brief History

While they are a relatively new phenomenon for American retail investors, RCNs and other structured products have a history in Europe as well as among U.S. institutional clients. Reverse Convertible Notes are

regularly issued by some of the world's leading financial institutions such as ABN AMRO Bank NV, Banc Nationale Paribas (BNP), Barclays Bank PLC, Credit Suisse, JP Morgan, and Societe Generale. In 2006,

more than \$64 billion in structured products were issued — up 33% from \$48 billion in 2005, according to the New York-based trade group The Structured Products Association (SPA) (www.structuredproducts.org).

Who Should Consider RCNs?

“Reverse Convertible Notes have become an important component in creating a balanced asset allocation strategy combining potentially high coupon payments with relatively short maturities,” says Matt Lloyd, Chief Investment Strategist at Advisors Asset Management (AAM)(www.AAMsecurities.com). AAM is a division of Fixed Income Securities (FIS) (www.fisbonds.com) of Monument, CO, a registered investment advisor, distributor and pioneering educator of Reverse Convertible Notes in the United States. Although investors may receive stock at maturity, RCNs typically offer some downside protection, meaning the price of the underlying security must fall below a certain point before the

investor's principal is at risk.

Reverse Convertible Notes are an attractive investment for more risk-averse investors seeking relatively high returns as compared to traditional debt securities. Additionally, RCNs can serve as a diversification tool to help manage portfolio risk while generating relatively high returns in a flat to moderately positive market environment. The potential for comparatively robust coupon payments may also help to hedge portfolio risk by offsetting possible declines in the underlying investment present in the investor's portfolio. Both commission and fee-based discretionary WRAP accounts can utilize these types of investments.

More retail financial advisors are discovering RCNs. “Reverse

Convertible Notes can provide tremendous diversification and spread risk,” says Paul Puleo, of advisory firm Messing, Puleo and Associates in Boca Raton, FL. “They enable us to add another asset class to a portfolio.”

John Ceurvorst of Financial Investment Research & Management in Iowa City, IA, has allocated as much as 15% of some portfolios to Reverse Convertible Notes. “For clients who need cash flow, these may be used in place of some equities and high-yield bonds,” he says. “Depending on the terms of the individual issue a Reverse Convertible Note can be less risky than buying a stock. The high-net-worth client is usually open to new ideas and is experienced enough to understand the product and what it can do.”

Customized Notes

Reverse Convertible Notes are customizable. For a minimum investment amount, advisors can work with an issuing firm such as ABN AMRO Bank NV or Barclays Bank PLC, to create individual requests that meet particular portfolio needs. Dean Evans of EHG Financial Planning Services in Irvine, CA, recommends Reverse Convertible Notes to high-net-worth clients, generally allocating about 5% of a portfolio to them. “The number-one reason to use a Reverse Convertible Note is for its income,” Evans says. “We track the historic prices of the underlying stock with clients,” he says. “We point out that during a 12-month period a junk bond can experience a lot of

fluctuation and its value may drop considerably.” Despite the historical price fluctuations of the underlying asset, it is important to remember that past performance does not guarantee future results.

In cases where clients are very comfortable with a certain stock, Evans has worked with Advisors Asset Management (AAM) to provide custom Reverse Convertible Notes. “If an advisor has an opportunity, usually at a client’s request, we have the ability to create a custom issue and bring it to market relatively quickly,” says AAM’s Lloyd. “Advisors really appreciate the ability to customize investments that specifically meet client objectives.”

While an RCN investment can

be as low as \$1,000, due to the fee structure, it’s usually not recommended to start with less than \$10,000. Generally, Reverse Convertible Notes are backed by the issuing firm, and the coupon payments, as well as payment at maturity, are the responsibility of the issuer. As a result, individual RCNs carry the rating of the issuer. Although there is usually a secondary market for these investments, the issuer does not guarantee that an active trading market will develop whereby the investor can sell a position. However, due to their relatively short maturities, RCNs are designed as buy-and-hold investments and investors may experience a loss of principal if sold prior to maturity.

Reverse Convertible Note Checklist

A Reverse Convertible Note is a multifaceted investment that can provide:

- Comparatively high coupon payments
- Short-term maturities
- Asset allocation
- A possible hedge to a current portfolio holding
- An additional level of portfolio diversification

How to Learn More

Reverse Convertible Notes are just beginning to make their mark on the American investment landscape. Advisors aiming to stay ahead of the curve and provide their clients with the latest solutions and services should note that each issue is unique and that the investor should understand the risks associated with these Notes prior to investing. RCNs are sold only by prospectus. Financial professionals seeking additional information, educational tools or other literature, please visit www.AAMsecurities.com or call 800-537-3632.