An Introduction to Structured Notes

Structured notes are hybrid securities issued by financial institutions or other entities that consist of a debt obligation and an embedded derivative component tied to an underlying benchmark based on a single stock, equity index, ETF, commodity or currency. The hybrid nature of structured notes puts them in a category that has performance characteristics similar to both fixed income instruments and the underlying asset (equity, commodity, etc.) Although, structured notes are often too risky and complicated for individual investors they may be attractive to conservative investors otherwise hesitant to invest directly in equities, currencies or commodities. They typically have maturities from one to ten years.

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Structured notes feature a number of options: (i) **participate in market growth** or (ii) **enhance income**. If growth is a goal, they can be designed to help provide additional protection when the underlying market drops, or to produce additional gains when the market rises in the underlying securities. On the income side, structured notes may pay coupons that can increase or decrease depending on the performance of the underlying benchmark. In some cases, the coupon payment could be reduced or be zero. However, the note could be structured for potential large gains while limiting losses. Of course, there is always a trade-off between the amount of market exposure/growth and the amount of risk protection that each structured note offers.

Some structured notes are designed to return 100% of the invested principal at maturity, such as market-linked CDs that are insured by the FDIC to the applicable limit(s), or principal protected products that are backed by the issuer of the note. Others, however, are backed by the issuer, but exchange some or all of the principal protection features for higher potential returns. It is imperative that investors in structured notes understand the level of principal protection associated with them.

Other Considerations

Structured note products are not without some important considerations, that include the credit risk of the issuer, costs and fees, illiquidity, pricing complexity and the possibility of the note being automatically called early. As mentioned above, certain "retail notes" come with FDIC protection up to the applicable limits, but for those that are not insured by the FDIC, the investor assumes issuer credit risk.

Additionally, structured notes may carry higher costs and fees than other investments. Details about costs and fees can be found on the issuer's offering documents, and it is important for an investor to review such documents carefully with their financial advisor when considering complex investments such as structured notes. The term of a structured note investment is typically one to ten years, so they are considered long-term investments. Moreover, structured notes are considered to have limited liquidity with no guaranty of a secondary market. Structured notes are designed to be held to maturity. For sales prior to maturity, it is most common for the issuing investment bank to agree to buy the note back upon the investor's request, but the issuer has no legal obligation to repurchase the note. As such, investors are subject to market risk if they sell the note prior to maturity.

Structured notes can be difficult to value given their complexity and liquidity. Complex investments require sophisticated financial valuation models to price them accurately, and such models may not factor in each possible outcome or likelihood. The bid price for a structured note in the secondary market or from an issuer may differ from the model-based mark-to-market shown on an investor's statement.

Please see disclosure on page 2.

A Few Structured Notes Examples

Principal Protected Notes feature a full return of principal if held until maturity, similar to traditional fixed income instruments. By protecting the principal of the investment, such notes increase the potential for capital growth and/or income. If the underlier has a negative return at maturity, the product will return the full principal amount, subject to the credit risk of the issuer. As stated above, such products are intended to be held until maturity, so their value is unlikely to be reflected in the product until maturity as there is not a robust liquid secondary market. Market-Linked CDs feature additional FDIC protection up to the applicable limits.

Market-Linked Notes provide the potential for capital appreciation at maturity based on a participation rate, which is the degree to which investors can elect to participate in the potential growth of the underlier. A participation rate can exceed 100% (1.0x), but higher participation rates correspond to longer maturities or other tradeoffs. There also may be a cap on the product's maximum return regardless of the actual return of the underlier.

Customized Structured Notes can be designed to meet specific investor needs. In general, the range of potential payoff strategies results in a wide variety of off-the-shelf structured notes. Even so, for more specific strategies, many issuers are able to sell customized notes that are tailored to meet an investor's specific goals. Of course, customization comes with a higher degree of pricing complexity and lower liquidity than a standardized product.

Conclusion

Structured notes are financial products that can provide enhanced, multi-asset-type returns but carry some important considerations. They can be designed for growth or income strategies or both and have a wide variety of off-the-shelf options or can be custom built to meet an investor's goals. As with all investments, structured notes carry risk, and potential investors should speak with their financial advisors before making any investment decision.

Contact Us

Please contact our Structured Notes team or your HilltopSecurities representative to discuss any concerns or comments that you may have regarding the preceding information.

Fixed Income Capital Markets
Katie Buchgraber
214.859.6621

Structured Finance
Richard Konkel
214.953.4052

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Structured notes are complicated products that are subject to various risks including changes in interest rates, market valuations, low liquidity, default risk, and other factors.

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