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RBC's autocallables on Aetna pay top premium if notes are called, but risk is high otherwise

By Emma Trincal

New York, Oct. 27 – **Royal Bank of Canada**'s autocallable notes linked to **Aetna Inc.** offer a rewarding call premium but sources said that it may be well deserved given the downside risk posed by the underlying stock, which is highly volatile.

Royal Bank of Canada priced $5.74 million of 0% autocallable optimization securities with contingent protection due Oct. 28, 2011 linked to the common stock of Aetna, according to a 424B2 filing with the Securities and Exchange Commission.

If Aetna stock closes at or above the initial share price on any of 12 monthly observation dates, the notes will be called automatically and investors will receive par of $10 plus an annualized call premium of 20.07%.

If the notes are not called, the payout at maturity will be par if the final share price is greater than or equal to 80% of the initial share price. Otherwise, investors will be fully exposed to the share price decline.

High volatility

"The 20% call premium is really good. But the underlying volatility of Aetna is amazing too," said a market participant.

The underlying volatility of the stock is 60.5%, according to Future Value Consultants, a research firm specializing in structured products.

"If you get called, that's great. You invest two or three months and you get out with a nice return. But if there's no call and you end up 30% down at maturity, that's not so great," he said.

"The 20% cushion is good. But you've got a stock that can easily move plus or minus 5% intraday. So it's really not a stretch to see it breaching the barrier."

If the securities have not been called, and the underlying stock closes below the 80% trigger price at maturity, investors will lose 1% of their principal for every 1% decrease in the price of the shares, according to the filing.

Cash versus shares

At maturity, investors are paid in cash, not in shares as is the case with reverse convertibles.

Eric Greschner, portfolio manager at Regatta Research & Money Management, said that he prefers structures that give a payout in stock shares rather than in cash, because he can run an analysis on the stock and decide to place a stop loss order on it.

"If the stock trades sideways, that's ok. But if it ends up breaching the barrier, it's more than trading noise. What we do is put a stop of 10% below the share price that we get. Let's say we lose 20% of principal at maturity. The most we can lose is now 30%. I prefer to own the shares, that way, I have an opportunity to make up for the loss in principal," he said.

Downside risk

Greschner said that autocallables in general represent "an extension of the reverse convertible issue" as both structures allow investors to be short volatility,

"A 20% protection is not so bad but you still have downside risk," he said.

"The first thing that we do is not to look at the coupon first. The first thing we do is to look at the barrier and the downside

Continued on page 2

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Continued from page 1

protection."

"A lot of the volatility represents a risk that people rarely factor in," he said, adding that the expected payout rises with the risk of breaching the barrier, a risk that becomes greater when the stock is more volatile.

"I'm leery to have my portfolio situated around those structures. You have to look at the market conditions first. And then, you need to take into account the fact that an individual stock is going to be much more volatile than an index. Even financial advisers realize it," he said.

Occasional relationship

UBS is one of the most active distributors and has joined forces with several other issuing banks in open architecture arrangements, according to SEC filings.

Over the past two months, Barclays, JP Morgan, Deutsche Bank and HSBC USA Inc. have all used UBS as their placement agent in a variety of deals, according to data compiled by *Prospect News*.

But the collaboration between UBS and Royal Bank of Canada has been less common.

Their previous joint deal occurred last month when UBS sold $8 million of Royal Bank of Canada's Return Optimization Securities due Oct. 21, 201tied to the **S&P 500 index**.

"I haven't seen UBS teaming up with RBC that much. I know they're loaded with Barclays' paper. I guess they need to diversify issuer's risk and RBC has a solid double-A rating," the market participant said.

UBS Financial Services Inc. and RBC Capital Markets Corp. are the underwriters of the latest deal. Fees were 1.25%.