

June 27, 2007

ECONOMIC INDICATORS

CANADA

| | Dec. 2006 | May 2007 | |
|--------------------|--------------|--------------------|---|
| GDP ⁽¹⁾ | 2.7 | 2.0 ⁽²⁾ | ↘ |
| CPI ⁽¹⁾ | 1.6 | 2.2 | ↗ |
| Unemployment | 6.1 | 6.1 | - |

UNITED STATES

| | Dec. 2006 | May 2007 | |
|--------------------|--------------|--------------------|---|
| GDP ⁽¹⁾ | 3.3 | 1.9 ⁽²⁾ | ↘ |
| CPI ⁽¹⁾ | 3.2 | 2.7 | ↘ |
| Unemployment | 4.5 | 4.5 | - |

(1) Year-over-year % variation

(2) March 2007

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

EQUITY INDICES

| % Change | 2007 in local currency | 2007 in C\$ | |
|-------------------|------------------------------|-------------------|---|
| S&P/TSX | 8.4 | 8.4 | ↗ |
| S&P500 | 5.9 | -2.8 | ↘ |
| NASDAQ | 7.2 | -1.7 | ↘ |
| NIKKEI | 5.6 | -6.8 | ↘ |
| S&P 350 Europe | 7.5 | 0.8 | ↗ |

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PACKAGING IS NOT EVERYTHING

Principal-protected notes (PPNs) are very popular investment vehicles. According to the Globe and Mail, their issue total is about \$14 billion. The very first PPN we recall was launched in 1993 by the National Bank of Canada under the French name "Securibourse", referring to its combination of safety and stock market upside. Not surprisingly, this PPN was launched at a time when Treasury Bill rates reached a multi-decade low of 3%. Clearly, risk-averse investors were looking for an alternative to the wimpy interest rate offered by certificates of deposit.

PPNs are a synthetic combination of three elements. First, there is a zero-coupon bond. This type of bond pays all the interest at maturity, so it sells at a discount. For example, a 5-year federal government zero-coupon costs about 80 cents per dollar of face value, for a 4.6% yield. With such a bond, the principal is 100% guaranteed at maturity. This leaves 20 cents on the dollar to buy the second component: a call option on a stock index. A call option provides the investor with the right to buy the index at a fixed price, at a certain maturity date. If the index level is above this fixed price at the maturity date, the holder of the option will pocket the difference. If the index level is below this fixed price at the maturity date, the call option expires worthless. This is what happens when investors end up with just their capital and zero return. This leaves us with the last but not the least component of PPNs: the issuer's profit on the transaction.

When I attended MBA classes (ages ago), one of the first things I reviewed was the put-call parity concept. This concept says that by combining options to buy and options to sell the same index, you can create a riskless portfolio. Put and call options are always priced so that a riskless combination will deliver nothing more than the market's risk-free interest rate. Otherwise, speculators will quickly arbitrage this situation to make a profit. And believe me, they will. The consequence of the put-call parity is straightforward: options are correctly priced in line with one another and with their underlying index. There is no magic: options, even when bought at institutional prices, are not a cheap way to participate in the stock market. Period.

PPNs are very similar to another investment vehicle: a balanced portfolio made of stocks and bonds. Just like PPNs, a balanced portfolio protects capital through the weight allocated to high-grade bonds. It also benefits from the stock market's upside. But the balanced portfolio also has several advantages over PPNs. Management fees are fairly transparent, whereas they can be difficult to identify for PPNs. A balanced portfolio benefits from dividend return, a feature rarely seen in PPNs. Lastly, part of a balanced portfolio return comes from capital gains which benefit from an advantageous tax rate, while most PPNs generate ordinary income with no tax advantage whatsoever.

We understand that many investors perceive PPNs as a safer way to participate to the upside of the stock market than balanced portfolios, but they really are not. In our view, PPNs are equivalent to balanced portfolios with less transparency about fees and less tax efficiency. They may look good, but packaging is not everything.

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