

Structured Investments Solution Series  
Volume III:

# Reverse Exchangeables



Earn Higher Yields with Contingent  
Principal Protection

# Introduction

FOCUSING ON YOUR FINANCIAL GOALS can be challenging during periods of extreme market volatility. While your brain may tell you that staying the course is the smartest strategy, your stomach may lead you to make impulsive investment decisions. For many investors, finding the optimal balance between risk and reward—and having the fortitude to maintain that balance over the long haul—is no easy task.

In recent years, new Structured Investments have been introduced in the U.S. to help investors meet their objectives. Generally, Structured Investments can help you achieve three primary objectives: investment returns with little or no principal at risk, higher returns in a range-bound market with or without principal protection, as well as alternatives for generating higher yields in a low-return environment. They also provide you with an opportunity to access asset classes, such as commodities and foreign currencies, which in the past were primarily available to institutional investors.

You can use Structured Investments to achieve greater diversification, to gain or hedge exposure to certain asset classes, or to align your portfolio with a particular market or economic view. They provide asymmetrical returns, meaning that returns will be higher or lower than those derived from a direct investment in a particular asset. Structured Investments usually combine a debt security with an underlying asset, such as an equity, a basket of equities, a domestic or international index, a commodity, or some type of hybrid security.

These investments have long been popular in Europe and Asia and over the past several years, they have started to gain acceptance among U.S. investors. According to the Structured Products Association, nearly \$64 billion in new products were issued in 2006, up from \$48 billion in 2005<sup>1</sup>.

This report examines the role that Reverse Exchangeables can play in your portfolio, especially during periods when expectations for capital appreciation are range-bound. The report also discusses how Reverse Exchangeables can help you earn a higher yield with contingent principal protection.

1. [www.structuredproducts.org](http://www.structuredproducts.org)

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## Augmenting Returns in a Low-Return Environment

In three out of the four years between 2003 and 2006, stocks, as measured by the total return of the S&P 500® Index, logged double-digit gains. During such periods of relative economic strength, investing in stocks can be particularly rewarding. But what happens when the outlook for the economy and stocks in particular, becomes less certain? That's when stocks often move in a sideways direction, with no meaningful moves to the upside or to the downside. Under these conditions, investors have been limited to middling returns from their stock portfolios. Similarly, it's not uncommon for fixed-income investments to experience periods when returns are flat or in the low single digits.

If you believe that returns for stocks or bonds are likely to be range-bound over the short term, a Reverse Exchangeable can help you implement, or “monetize,” this view. Reverse Exchangeables enable you to earn potentially higher yields in a low-return environment, while providing contingent principal protection.

## Anatomy of a Reverse Exchangeable

A Reverse Exchangeable is a hybrid security that pays a fixed coupon and provides contingent protection for your investment principal. The specific terms and conditions of every Reverse Exchangeable vary, but they are typically linked to the performance of a particular stock, a basket of stocks or a stock market index. They are issued as registered

notes, mature within one year or less, and trade in \$1,000 increments. The coupon from a Reverse Exchangeable is taxed partially as interest on deposit and as put premium.

The primary appeal of a Reverse Exchangeable is its high coupon, which typically ranges between 10% and 20%. Under most conditions, this yield is higher than what you might attain from a traditional bond or money market investment. Unlike a direct investment in a stock or bond, however, your upside potential on a Reverse Exchangeable is limited to the coupon amount. If the underlying asset appreciates in value during the term of the note, you do not participate in those gains. Therefore, Reverse Exchangeables may be appropriate if you believe that the return on the underlying security will be lower than the coupon rate you can earn over the short term (one year or less).

The coupon on a Reverse Exchangeable is determined by the volatility of the underlying stock or basket of stocks, as well as the amount of contingent protection incorporated. The dividend yield of the underlying stock will also factor into the coupon rate—the higher the dividend, the higher the coupon rate. Once determined, the coupon rate remains fixed regardless of how the underlying asset performs. The frequency of interest payments varies and may occur periodically throughout the term of the note or may pay in full at maturity. In all cases, the frequency of interest payments is determined and disclosed at inception.

In addition to providing high coupon rates, Reverse Exchangeables feature a “contingent buffer.” This contingent buffer, which typically ranges between 20% and 30%, protects your principal in the event of a moderate decrease in the value of the underlying security.

This buffer disappears or gets “knocked out” if the security closes below the buffer level at any time during the life of the note. If that occurs, and the stock does not close above its initial level on the final observation date, you may receive physical settlement at maturity, that is, actual shares of the underlying security (assuming the underlying asset is a single stock) or the cash value of the actual shares. Reverse Exchangeables linked to a commodity or index offer cash settlement under these circumstances. You should be comfortable with the prospect of holding shares of the underlying asset before investing in a Reverse Exchangeable.

## Reverse Exchangeable Performance under Different Market Conditions

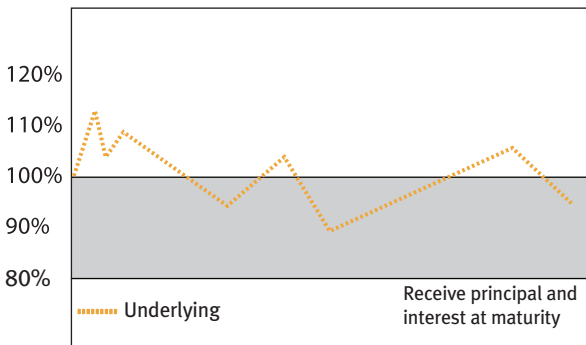
To understand how a Reverse Exchangeable might perform under varying market conditions, consider the following hypothetical example. David invests \$1,000 in a Reverse Exchangeable linked to ABC stock. The Reverse Exchangeable pays a coupon rate of 20% and features a 20% contingent buffer. ABC stock is trading at \$10 a share.

There are several possible outcomes that can occur when a Reverse Exchangeable matures (see figure 1). If the underlying stock never falls below the level of its contingent buffer (\$8), you receive 100% of your principal back, along with any accrued interest due. For example, if the lowest closing price of ABC stock was \$9.50, you would receive your entire principal back (\$1,000), along with 20% interest (\$200). Because the stock never breached the 20% contingent buffer by falling below \$8 a share, your principal remained protected.

The outcome would be the same if ABC stock breached the buffer, falling below \$8, but then closed above the initial level of \$10 a share on the final observation date.

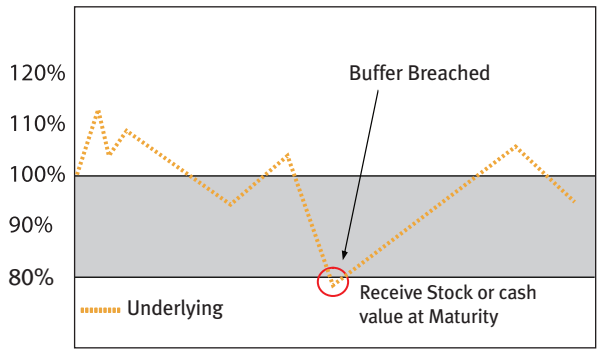
Now consider what would have happened if ABC stock had fallen below \$8 and remained there on the final observation date (see

Figure 1: Return: Reverse Exchangeable on ABC stock at \$10. Features 20% coupon and 20% contingent buffer.



Source: JPMorgan

**Figure 2: Return: Reverse Exchangeable on ABC stock at \$10. Features 20% coupon and 20% contingent buffer.**



Source: JPMorgan

figure 2). In this case, you would receive physical delivery of 100 shares of ABC stock at maturity or its equivalent in cash, along with any accrued interest. The number of shares you receive is determined by dividing the stock price at inception by the initial investment. For example, if ABC stock was trading at \$10 at inception and you invested \$1,000, you would receive 100 shares at maturity. If the Reverse Exchangeable settled in cash, the cash payment would reflect the decrease in the price of the underlying asset on the final observation date. While the overall value of ABC stock fell, the high coupon rate that you received helped to offset the decline in the value of your stock.

Due to its coupon rate and contingent buffer, a Reverse Exchangeable will always outperform its underlying asset in a declining market. However, the maximum return is the coupon rate. Therefore, you must be willing to forgo any appreciation in the value of the underlying security in exchange for the coupon rate. If you have a neutral to moderately bullish short-term outlook, are seeking a coupon rate that is higher than current yields, and are comfortable taking on some downside risk, you may want to consider a Reverse Exchangeable.

## IN BRIEF

# Reverse Exchangeables

### What benefits do they provide?

Reverse Exchangeables provide attractive coupon rates and contingent principal protection. They will always outperform the underlying security in a bear market, due to the coupon rates they pay. They typically mature in one year or less.

### What's the downside?

If the underlying asset appreciates in value, you do not participate in those gains. The notes provide only contingent principal protection and that protection disappears or “knocks-out” if the underlying security closes below the predetermined contingent buffer level. You may receive physical shares at maturity or equivalent cash value.

### Reverse Exchangeables may be right for you if you:

- Have a range-bound view of the markets.
- Are an income-oriented investor.
- Are comfortable taking on some downside risk.

## Are Reverse Exchangeables Right for You?

Structured Investments, including Reverse Exchangeables, can provide innovative ways to help you meet your investment goals. To determine whether a Reverse Exchangeable is appropriate for you, review the following questions with your advisor:

- What is my investment time horizon?
- Do I have a bullish, bearish, or neutral market outlook?

- Am I willing to risk losing a portion of my principal?
- Am I seeking higher coupon rates in a flat to moderately bullish market?

The answers to these questions should help you determine whether Reverse Exchangeables belong in your portfolio. At a minimum, taking the time to gain a better understanding of your financial goals and risk tolerance will be its own reward.

## Certain Risk Considerations

### *Reverse Exchangeables*

**An investment in a Reverse Exchangeable may result in a loss.** The notes do not guarantee any return of principal. Under certain circumstances, you will receive at maturity a predetermined number of shares of the applicable underlying stock. The market value of those shares will most likely be less than the principal amount invested and may be zero.

**Your return on a Reverse Exchangeable is limited to the principal amount plus accrued interest.**

For each \$1,000 principal amount note, your maximum return at maturity is \$1,000 plus any accrued and unpaid interest, regardless of any appreciation in the value of the applicable underlying stock, which may be significant. Accordingly, the return on a Reverse Exchangeable may be significantly less than the return on a direct investment in the applicable underlying stock.

**Your contingent buffer may terminate on any day during the term of the Reverse Exchangeable.**

If on any day during the term of the notes the closing price of the underlying stock declines below the contingent buffer, you will at maturity be fully exposed to any depreciation in that reference stock. You will be subject to this potential loss of principal unless at maturity the price of the applicable underlying stock subsequently recovers to an amount in excess of its initial level on the pricing date.

# Experience the JPMorgan Advantage

JPMorgan Structured Investments are designed to complement your overall investment strategy. New solutions are under constant development to provide you with additional opportunities to enhance your portfolios. Experience the unique benefits of JPMorgan Structured Investments, including:

- Innovative Structured Investments that span all of the major asset classes.
- One of the lower investment minimums in the industry.
- Direct access to Structured Investment specialists who can guide you and your advisor.
- A commitment to education demonstrated through teach-ins, conference calls, and educational materials.

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