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Are ETNs Joining the list of Troubled Financial Products?

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By Ron DeLegge, Editor

SAN DIEGO (ETFguide.com) - While much of the public's attention has been focused on exotic financial instruments like credit default swaps (CDS), collateralized debt obligations (CDOs), and auction rate securities (ARS), the \$5 billion exchange-traded note (ETN) business has received little mainstream media attention.

But the stunning collapse of major financial institutions like Lehman Brothers Holdings (Other OTC: LEHMQ.PK) could change that by heightening the scrutiny of these little known financial products called ETNs.

ETN Basics

Exchange-traded notes (ETNs) are unsecured debt instruments that pay a return linked to the performance of an index, a currency or a commodity. In a similar arrangement to investing in bonds, ETN payments rely on the full credit and faith of the institution backing the product. Many ETNs have a long-term maturity date that can be anywhere from 20 to 30 years. (To learn more about ETNs, visit ETFguide.com's ETNEducationCenter)

The iPath Dow Jones-AIG Commodity Index Total Return ETN (NYSEArca: [DJP](#) - [News](#)), the iPath S&P GSCI Total Return Index ETN (NYSEArca: [GSP](#) - [News](#)), and the iPath S&P GSCI Crude Oil Total Return Index ETN (NYSEArca: [OIL](#) - [News](#)) are among the most popular notes.

Other ETNs track narrow and leveraged indexes.

Examples of this include, the PowerShares DB Gold Double Short ETN (NYSEArca: [DZZ](#) - [News](#)), the PowerShares DB Crude Oil Double Short ETN (NYSEArca: [DTO](#) - [News](#)), and the PowerShares DB Agriculture Double Short ETN (NYSEArca: [AGA](#) - [News](#)).

Investors blindly buying these notes may be thrilled by the thought of juicy returns, but less informed about the serious financial risks they carry.

The Sales Pitch

Having portfolio exposure to hard to reach asset classes like commodities, currencies, or other specialized investment strategies is the typical ETN sales pitch. Another benefit is zero tracking error, which basically means obtaining identical performance to the underlying index or security.

Under the current tax law, commodity and equity linked ETNs are taxed as prepaid contracts. This means investors incur tax consequences only upon the sale, redemption, or maturity of their note. However, this tax loophole is likely to disappear in the future.

In late 2007, the Internal Revenue Service issued an adverse tax ruling on currency linked ETNs. The rule stated that any financial instrument linked to a single currency regardless of whether the instrument is privately offered, publicly offered or traded on an exchange should be treated like debt for federal tax purposes. ETNs linked to commodity and stock baskets aren't likely escape IRS rules for much longer.

Beware of Credit Ratings

For investors relying on the safety of credit ratings, think again. The financial strength of institutions like American International Group (NYSE: [AIG](#) - [News](#)) and Lehman Brothers deteriorated so fast and unexpectedly, not even the hallowed credit rating agencies could keep up.

While major ETN sponsors like Barclays PLC (NYSE: [BCS](#) - [News](#)) and Deutsche Bank AG (NYSE: [DB](#) - [News](#)) appear to be financially sound, solid credit ratings are far from a guarantee things will remain the same.

After seven short months of being launched, Lehman ETNs never delivered on their promise and note holders are now waiting to get their money back along with the rest of the defunct company's creditors.

Conclusion

Purposeful investing should be quick to reduce financial risks, but ETNs don't do that. Along with market risk, ETN investors also bear credit risk. As the Lehman ETN blowup illustrates, if the company backing the products goes out of business, ETN investors are left in the lurch.

All of the asset categories that investors need to build a fully diversified portfolio are already being covered by index exchange-traded funds (ETFs) and mutual funds. You don't need exposure to the Japanese Yen or some other specialized investment strategy to be diversified. And you certainly don't need the additional risk of exotic financial products.

Keep it simple.

Stick with broadly diversified index mutual funds and ETFs.

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