What is an Equity-Linked Note?

An Equity-Linked Note ("ELN") is an investment product issued by counterparties, including banks, broker-dealers or their affiliates. It's structured to offer a return linked to the underlying instruments within the ELN. These instruments are HIGHLY customizable – you can package a host of structures, reference indices/securities, and other features that allow for you to hold one note (the ELN), and at the maturity of the note receive the amount back that reflects the payoff of selected features in the note.

This is all to say that you have a structured product whose return is linked to the performance of its underlying reference equity or index.

ELN in an ETF wrapper

ELNs can provide an option structure otherwise not available in a '40 Act ETF. This includes leveraged spreads with other potential features. It simplifies those options structures into a simple debt instrument held in the fund and helps to increase distributable income from the options premiums.

Potential Risks

Counterparty risk – the risk that the note issuer defaults. While the notes we purchase are fully guaranteed by the issuer *and* prepaid, there is always the small risk the issuer fails to meet their obligation.

Market risk – influenced by the structure inside the note, including reference security (in our case, S&P 500), leverage multiplier, and other market factors including volatility.

Liquidity risk – while we intend to hold the ELNs until maturity, a forced liquidation in the fund holding the notes may have an adverse impact on fund NAV selling the ELNs back to the issuer at a discount.

Managing the Risks

To manage counterparty risk, we a) cap the exposure to any single issuer to 5% at one time, b) partner with reputable issuers with strong balance sheets, and c) write notes just one month to maturity.

To manage market risk, we stagger the periods in which we purchase each note and ladder the ELNs in the portfolio. This helps to smooth out distributions and market outcomes.

To manage liquidity risk, we purchase ELNs that have highly liquid reference indices like the S&P 500, keeping spreads tighter. Having a reference index that is transparent, liquid, and easily hedged is key.

Why use ELNs?

ELNs can be used in a variety of ways depending on their underlying structures and reference instruments. We believe with the proper risk management in place, ELNs can enhance income without adding style, credit, or duration risks that detract from long-term compounding and income generation.

Disclosures:

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