Dual path to capped returns

Investors in Merrill Lynch's Australian capital-at-risk product have the chance to construct their own product from a choice of two series, each with its own issue price and maximum return based on the performance of the S&P/ASX 200

Product description

This is a capital-at-risk investment with a maturity of one year and 11 months linked to the S&P/ASX 200 Index. Returns are capped at either 68% or 107% (in addition to capital), depending on which option is chosen. Capital is not protected at maturity, and if the final index is below the starting level, the investor will lose 100% of capital.

There are two options – series one and two – and each has a different issue price and maximum return. The product is a call spread between either 100% and 120%, or 100% and 130%, depending on which option is chosen. The maximum return available to the investor depends on the issue price of the call spread per notional amount, which is not 1:1 as is usual with structured products. The maximum returns are indicative and will be set on the issue date.

The notional exposure per unit of each investment is A$10. If one unit of series one is purchased for A$1.19, an investor effectively holds A$10.00 by notional of the call spread. The issue price for series one is A$1.19 and in pricing terms this is equivalent to the investor purchasing a unit for A$1 and holding a call spread between 100–120% with gearing of 840%. The maximum return is therefore 168% of the initial investment. The issue price for series two is A$1.45 and in pricing terms this is equivalent to the investor purchasing a unit for A$1 and holding a call spread between 100% and 130% with gearing of 690%. The maximum return is therefore 207% of the initial investment.

According to the product provider, most structured products offered in the Australian market are issued by US or European banks. For Australian investors to be covered by the national compensation scheme they must invest in a home bank.

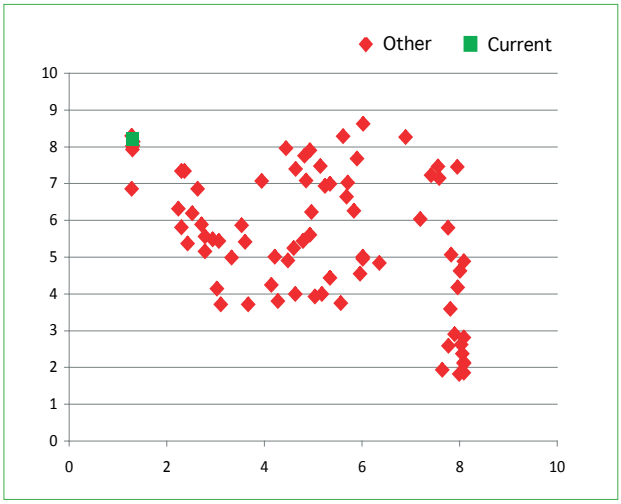
One of the features of this product is that it enables investors to construct their own product by using part of their A$100 capital to invest the necessary amount in a bond or equivalent guaranteed to pay A$100 at the same time as the product matures. The remainder of the

Issuer:	Merrill Lynch	**Currency of issue:**	Australian dollar
Country of issue:	Australia	**Product type:**	Scarps growth (capital at risk)

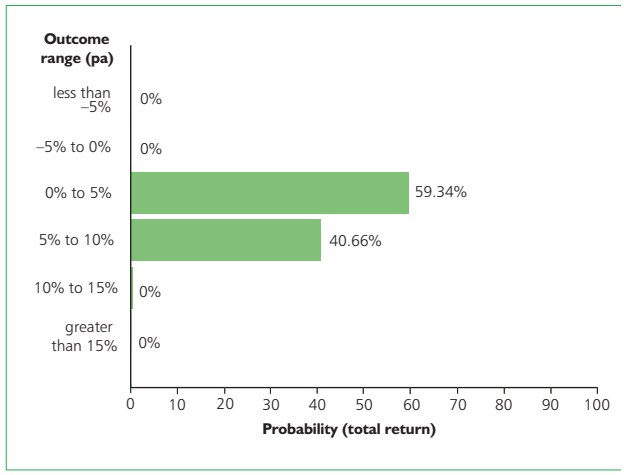
Points for:	1. Leveraged return based on the performance of the S&P/ASX 200 Index 2. Investors have the choice of investing in series 1 or series 2
Points against:	1. Capital not protected at maturity if the index finishes below its initial level, when the investor would lose 100% of capital 2. The index must finish 11.9% or 14.5% (depending which option is chosen) above its initial level before any returns on investment
Asset exposure period:	1.92 years (full term length 1.97 years)
Underlying asset:	S&P/ASX 200 Index
Final index level:	Monthly average over the final three months of investment
Credit rating of investments made (according to information from the product provider):	A (Standard and Poor's)
Investment limits:	Minimum 5,000 units

Offer period	Opens 12/02/2009	Transfers by n/a	Closes 23/04/2009
Key dates	Strike set 27/04/2009	Final reading 31/03/2012	Maturity/payout 14/04/2012

Score versus risk plot



Probability table of product return outcomes (based on simulated performances)



Performance statistics	Series 1	Series 2
Annualised volatility (product)	3.66%	4.31%
Annualised volatility (underlying)	31.91%	31.91%
Product Sharpe ratio	–0.53%	2.01%
Market Sharpe ratio	37.70%	37.70%
Equivalent initial portfolio	**Series 1**	**Series 2**
Underlying	10.62%	13.62%
Bond	86.81%	85.01%
Cash	2.57%	1.37%

Upside and downside measures	Series 1	Series 2
Upside measure	2.76%	3.13%
Downside measure	0.00%	0.00%
Upside measure beyond risk-free	1.68%	1.98%
Downside measure beyond risk-free	0.99%	1.08%
Initial sensitivities	**Series 1**	**Series 2**
Delta	0.11	0.14
Rho	–0.16	–0.16
Vega	0.00	0.00

Product assessment	Series 1	Series 2
Overall rating	6.66/10	6.76/10
Riskmap	1.30/10	1.30/10
Value rating	8.20/10	8.28/10
Simplicity rating	7.50/10	7.50/10
Return rating	4.70/10	4.88/10

investment, which would depend on the level of the risk-free rate at the time, would be a significantly reduced amount. When scoring this product we have done so on the basis of the above.

Compensation and creditworthiness of issuers is a growing issue and we have seen the introduction of measures to reduce related risk globally. In the UK there has been a rise in collateralised products, gilts and deposits and in the US there are more certificates of deposit. It would appear that this product is looking to offer investors a way of creating a fully protected part of their portfolio and growth linked to the performance of the S&P/ASX 200. The product itself is not guaranteed and would be subject to the risk associated with the issuer, Merrill.

Capital is not protected at maturity. If the final level is below the initial index level, the investor receives neither any returns nor his capital back. For the investor to receive 100% of capital at maturity, the index must finish at a minimum of 11.9% of its initial level if series one is chosen and 14.5% if series two is chosen.

If the index performs by more then the chosen cap level the investor receives no further returns and will get the maximum 68% or 107% return at maturity in addition to capital. Therefore this product would perform well in the case of moderate gains in the index, between 11.9–120% for series one and between 14.5–130% for series two.

Pricing and risk

This product consists of a call spread with strike at 100% and either 120% or 130% depending which option is chosen. This product is not meant to be a used as a standalone investment, so rather than structuring the product with a zero-coupon bond, the investor is left to choose whether to invest some capital in a bond or similar to mimic a standard structured product.

The scoring assumes that the investor only used a small percentage of capital to invest in this product while putting the remainder in a bond paying the risk-free rate and paying back 100% at maturity. Direct investment in this product would see the investor exposed to a loss of 100% of capital if the index finished below its starting level.