Range accrual notes

A range accrual note is a structured product where the coupon is linked to the performance of a reference index. The initial coupon is typically above market price, and is derived from a formula based on an underlying index. The most common index is LIBOR. However, it can also be based on constant maturity swap rate, equity, or inflation indices.

Features

Range accrual notes have similar features of traditional bonds, while offering higher coupons than plain vanilla bonds of similar terms and credit. This is achieved by embedding an option(s) into the bond where the investor sells certain rights to the issuer. The issuer pays for these rights by returning enhanced coupons to the investor. Interest and principal are guaranteed by the issuer which exposes the investor to default risk of the issuer. Therefore, secondary pricing will be sensitive to changes in the issuer’s credit rating. A variable coupon is paid regularly throughout the life of the note. In addition, regular interest is paid monthly, quarterly, semi-annually or yearly. Range accrual notes have a stated maturity just like a bond, and may have a call feature as well.

Maximized returns

A range accrual note offers the potential to earn higher returns based on the performance of the reference index. Returns will be maximized if the index stays within a predetermined range during the entire investment period. The coupon on the note will be 0% for any period during which the index sets outside of the given range. Otherwise, the coupon will be paid at the set level.

Range accrual note example

For example, an investor buys a range accrual note, with a target range defined as 0.00% to 5.50%. The investor is taking the view that the underlying index will stay within that range. Each coupon depends on the number of days in the coupon period that the index falls within the stated range.

Callable range accrual notes

Range accrual notes may have a call feature in which the issuer has the option to call the note at a specified date in the future, usually at par. Because this option has value to the issuer and exposes the investor to reinvestment risk, the investor is typically offered a higher potential return to compensate for this risk in the form of a high initial coupon. After the initial period, the coupons become dependent on the performance of the index within the range. If the note is called, the investor stops receiving the coupons and receives their principal back. These structures are attractive to investors because they will receive an above-market initial coupon as well as the potential for above-market coupons in the future if the index stays within the designated range.

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Royal Bank of Canada (Moody’s (Aa2))</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue type</td>
<td>Issuer callable daily range note</td>
</tr>
<tr>
<td>Issuer’s option</td>
<td>Callable by the issuer beginning January 2011 and every three months thereafter</td>
</tr>
<tr>
<td>Issue size</td>
<td>USD 10,000,000</td>
</tr>
<tr>
<td>Settlement date</td>
<td>14 Oct. 10</td>
</tr>
<tr>
<td>First call date</td>
<td>14 Jan. 11</td>
</tr>
<tr>
<td>Maturity date</td>
<td>14 Oct. 25</td>
</tr>
<tr>
<td>New issue price</td>
<td>$100.00</td>
</tr>
<tr>
<td>Reference index</td>
<td>3m USD Libor</td>
</tr>
<tr>
<td>Range</td>
<td>0.00% to 5.50%</td>
</tr>
</tbody>
</table>

*The example shown is for illustrative purposes only and does not reflect current or future market conditions.

- The issuer has the right to call the note beyond the first call date
- Unpredictability of actual maturity and, therefore, investment income received
- In order for this range accrual to generate a yield compared to a traditional fixed rate non callable note paying 4.00%, the Range Accrual would need to remain within the range 80% of the time in each coupon period.

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**Benefits of investing**

- **Attractive yields** — Range accrual notes are structured to offer a yield greater than that of the issuer’s corporate debt at comparable maturities.

- **Safety of principal** — Issuers promise to repay the original investment regardless of market performance, at maturity.

- **High credit quality** — Issuers include governments & agencies as well highly-rated investment grade (typically A, AA, and AAA) corporations and financial institutions.

- **Flexibility** — A variety of notes exist to fit a wide range of investor needs. In addition, subject to a minimum placement, notes can be tailored to fit an individual investment profile.

**Special Considerations**

- **Interest rate risk** — In a rising rate environment, the issuer will likely not call the note to lock-in low borrowing costs. Investors will remain long in a bond that has declined in price and returns a lower yield.

- **Call risk** — The final maturity of the bond is unknown due to the call feature. Fluctuations in market interest rates and volatility levels will determine whether or not the bond is called.

- **Reinvestment risk** — The probability of early maturity increases with falling rates. If the note is called, reinvestment of cash is difficult at the same yield as a matured note.

- **Default risk** — The risk that an issuer will be unable to pay the contractual interest or principal on their debt obligation. Each note represents an unsecured debt obligation of the issuer. When purchasing structured products, an investor has a legitimate and compelling need to look at the creditworthiness of the company issuing the notes.

- **Limited price appreciation** — Structured notes rarely trade much above par. In these cases, the note would likely be called by the issuer.

- **Liquidity** — While most issuers intend to make a market in the notes, it should be considered a “buy and hold” investment. Some notes are listed and trade on a major exchange. However, it is not possible to predict whether a secondary market will develop. Therefore, you may not be able to sell your notes. If you sell your notes prior to maturity, you may have to sell them at a substantial discount.

To find out more about range accrual notes, contact your RBC Wealth Management® financial advisor. We can help you find the right investments for your individual needs and long-term goals. When considering a range accrual note for your portfolio, request a prospectus or preliminary prospectus, which will contain more complete information including the terms and conditions of the note.