

Guide to Capital Protected Products

There are numerous products out there offering different levels of protection however they are generally derived from two basic structures;

1. Constant Proportion Portfolio Insurance (CPPI) which is an automated investment process that moves investors out of equities as the market falls and in to cash and back in to equities when it rises.
2. The Bond & Call structure which is made up of two parts;
 - The Bond - A safe asset such as a term cash account or fixed interest bond which provides the protected amount at the end of the term and an
 - The Equity – An equity based asset such as a call option or futures contract which provides the returns over and above the protected amount.

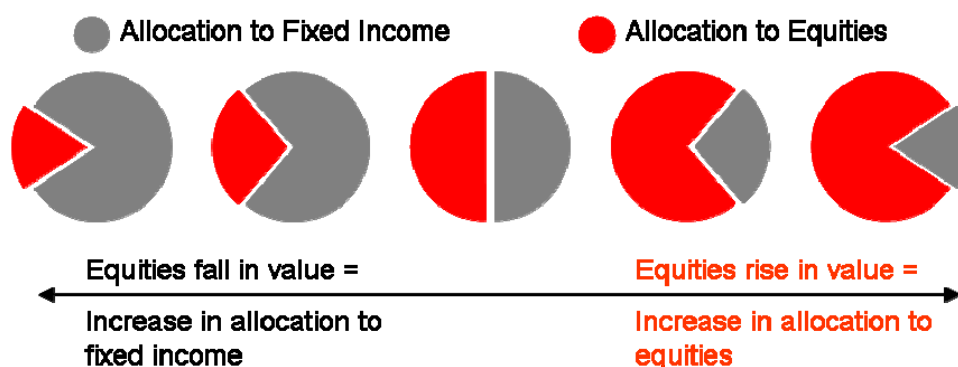
If you can understand these structures, you will understand 95% of the products currently being offered.

We should also mention Dynamic Hedging which operates as an insurance premium (e.g. 2% pa) whereby you pay the provider for your protection. This is a relatively new product to Australia but has operated for a number of years in the US. The term Dynamic Hedging relates to how the provider hedges the risk they are taking on. The risk lies with them so this is in effect an insurance premium.

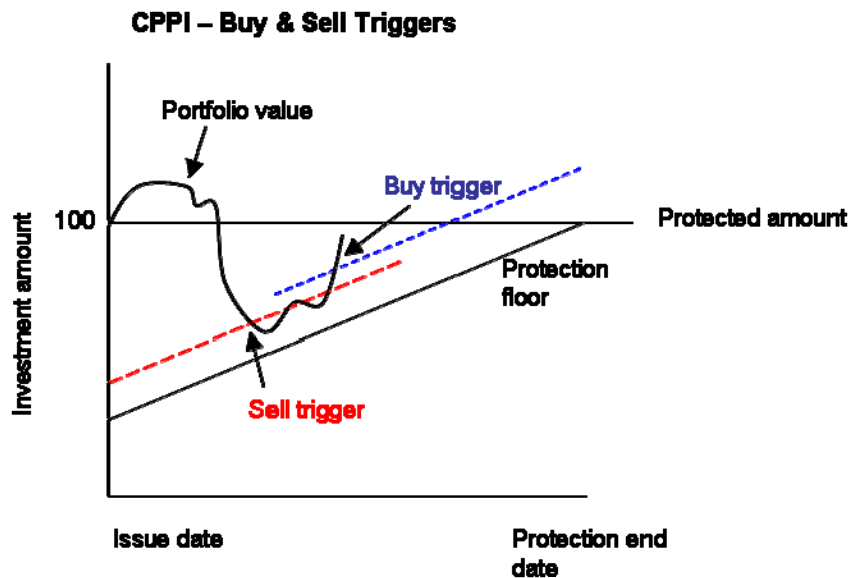
Constant Proportion Portfolio Insurance (CPPI)

Constant Proportion Portfolio Insurance (CPPI) is the name given to a trading strategy that automatically moves investors in and out of the sharemarket as it rises and falls. The basic concept is:

- If the market goes down, more money is switched into cash
- If the market goes up, more money is switched into equities



This can be an excellent way of mitigating the risks of investing and thus removes the need for making day to day investment decisions about when to cash in. By managing the investments in this way, the product can have in-built safety features to ensure that there is a minimum fund value at the end of the term. For example, by moving a fund entirely into a fixed term bank deposit (or equivalent), the fund ensures that it will have a certain value at the end of the term. For many funds, this is where your capital protection comes into play. This hypothetical level is known as the Protection Floor (also known as the Bond Floor). Most of the managers of CPPI also provide some sort of guarantee if they produce less than the minimum targeted return (the ‘Gap Risk’).



Trigger points

As you can imagine, and more particularly in recent times, volatility can cause a fund to buy and sell units as it skips above and below a buy and sell trigger point. As a result CPPI based products minimise transaction costs by placing a small buffer between buy and sell trigger points. This has the effect of selling at a lower level than you're buying back in at, but can be considered to be the cost of having that protection in place.

An anomaly of most CPPI structures is if the fund ever reaches the point of 100% in cash, you remain locked into cash for the remainder of the term.

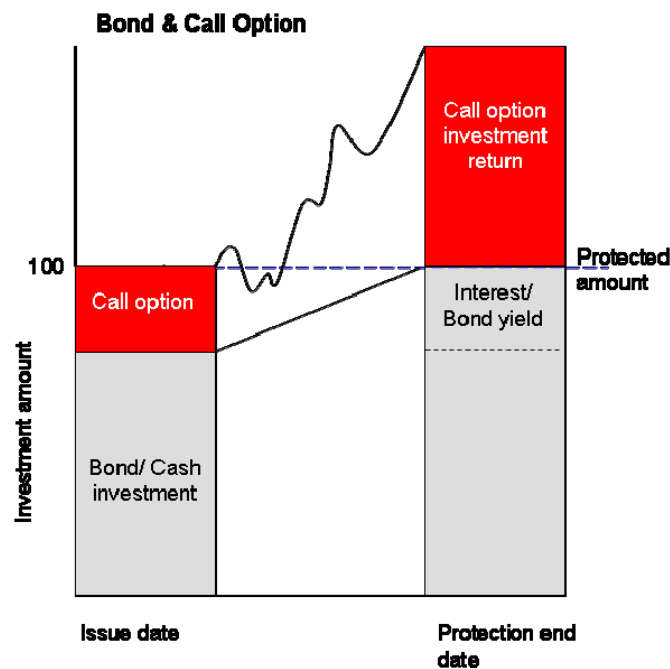
Why use CPPI structures?

CPPI enables product providers to offer protection on a wide range of underlying investments where a typical Bond + Call Option strategy would not be possible, such as investing in actively managed funds. Many investors like the idea of capital protection offered by Bond + Call structures but would prefer to link the performance to a fund manager rather than an index or individual stock. In addition, CPPI can also enable the provider to offer a rolling profit lock-in as the fund goes up in value that Bond + Call structures cannot.

The Bond + Call Option Structure

Bond + Call Options were one of the first type of products structured with the aim of providing capital protection. There are numerous variations on the Call Option element of this structure, but the basic structure remains the same. Essentially the investment is split into two parts:

1. A safe asset such as a term cash account or fixed interest bond to produce fixed amount at the end of the term.
2. An equity based asset such as a call option or futures which provides magnified returns to the investor.



Buying a safe asset, such as a bond, provides the capital guarantee and can typically cost between 55-70c for each dollar invested, the remainder can then be invested into call options to produce the returns that you would have had if you had invested a dollar straight in the underlying equities.

Participation in the underlying investments

Depending on whether your bond cost 55c or 70c dictates the amount left over to purchase the options and dictates your level of participation in the underlying investment. It is commonplace to see a range of participation quoted within a disclosure statement. A range of 100%-150%, ie the equivalent returns on investing a \$1-\$1.50 is typical within this type of product. Your final level of participation just depends on pricing on the day the Bond and Options are bought.

Why use Bond + Call Option Structures?

Bond + Call structures are a tried and tested and have been around for a number of years and one of the main attractions is the simplicity of the product. There are however, limitations in what assets you can purchase options on. Investors are typically unable to gain exposure to a managed fund since the performance could theoretically be manipulated by the manager for his own gain if he were to purchase options. Variations are therefore generally limited to index and individual stock or sector performances and quite often exclusive of dividends.

Dynamic Hedging

A relatively new product to the retail investor in Australia, this protection technique, generally used by institutions has been used extensively to investors in the US over the years. The protection provider ensures that your capital is protected in exchange for an annual percentage fee and is considered an alternative to CPPI for those looking to protect a managed fund investment.

Since you can't buy options on managed funds, the product provider typically offers a fund that correlate closely to an index. This allows them to use derivatives in that index as a way of hedging (hence the name). The provider is exposed to any shortfall.

Why product providers use Dynamic Hedging?

CPPI structures downfall has been that you sell as the market falls and buy back at a higher level when it rises. Dynamic hedging allows investors to participate 100% in any rises since the investor will never disinvest. However, the numbers of investments are likely to be more limited than under a CPPI structure since the provider will need to be able to correlate the performance to other indices/shares that can be used for their own hedging. It should also be noted that these products are likely to cost slightly more than CPPI but have additional benefits such as higher participation and the ability to switch protection on or off.

Which product and which protection mechanism?

For many, the rule of thumb as to which structure you opt for generally relates to what you want to invest into. Capital protection over managed funds generally has to use Dynamic Hedging or a CPPI type structure since you cannot buy options over a managed fund, whilst Bond + Call structures are generally linked to the performance of an index.

As with all investment products there are always variations but product comparisons typically fall into the following:

	CPPI	Bond + Call	Dynamic hedging
Performance based on	Managed Funds	Index	Managed funds
Level of participation in gains of underlying investment	Disinvestment with falls or volatility in the market = less than 100% participation	100-150%	100%
Cost of protection	Much of the cost is implicit. Lower participation rates typically mean this is lower than Bond + Call or Dynamic Hedging	Much of the cost is implicit. Higher participation rates typically mean this will be higher than CPPI	Explicit costing can make this look relatively expensive. Should cost somewhere between CPPI and Bond + Call
Investment loan interest rates	Lower participation rates reduces volatility and the cost of borrowing to invest	Higher participation increases volatility and the cost of borrowing	Should work out somewhere between CPPI and Bond + Call
Ability to turn on/off protection	No, in-built for term of product	No, in-built for term of product	Yes

Whichever way you choose to go, capital protection can be very useful to investors. It primarily removes the fear that causes us to miss out when the market has fallen, stops us from cashing up at the worst time and most importantly ensures you keep hold of your hard earned money.

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