Perpetual Protected Investments Series 3 – Should I stay or should I go

Readers of our newsletter will be aware of our extensive features on Capital Protected Products in the last few issues. We have highlighted the differences between Bond + Call structures, CPPI/Threshold managed structures and Dynamic Hedging and have favoured the simplicity of Bond + Call type structures such as Man Investments OM-IP series, Commonwealth Capital Series and NAB Capital's Choice Series. If you need further clarification of the key differences, a read of our November 2008 Capital Protection Special or our Guide to Capital Protection should prove good reading.

We also featured the pitfalls of CPPI structures such as Perpetual's Protected Investment (PPI) Series and Macquarie's Fusion Funds in our June 2009 newsletter when we looked at why volatility was bad for CPPI/Threshold Management.

Sell Low – Buy High?

These 2 products in particular have been very successful in attracting new investments. The basic concept is that as the fund falls in value, the allocation to the shares is reduced by gradually moving into cash, and as the fund rises in value, the allocation to shares is gradually reintroduced. A simple idea in principle, but can be much more difficult in practice. The main issue is if your fund fell to a level that triggered a sale and danced up and down above and below the trigger point, the cost of selling and buying would eat up all of the gains.

As a result, trigger points to reinvest in shares are always at a higher level than the point you switched out of shares. ie sell low, buy high

Furthermore, what can be confusing for clients and advisers alike is that the trigger points are calculated based on the value of your new combined fund of cash and shares. So a trigger to sell when the fund falls to 80% then buy back in after it has risen to 85%, needs the underlying shares to rise by 6.25%, not 5% as is the common misconception.

As a result, investors who have seen a 20%-25% fall in the value of their managed fund can quite easily find themselves in the position of needing the underlying shares to rise by over 100% before they are fully reinvested in the share market.

Cash locked = meagre returns

What we have seen in the last 2 years is the ultimate stress test of CPPI/Threshold Management. With the share market falling by over 50%, many of the underlying shares have fallen to such a low level that the product has switched entirely to cash. Perpetual Protected Investments Series funds are a prime example *(35 out of 43 funds are 100% in cash).*

What many investors don't realise is that once you are 100% in cash, there is no going back, the investment is cash locked and will only ever return your original investment at maturity. In its simplest form, the funds are now sitting in a term deposit account and with the accrued interest, will grow to provide 100% of your original amount at maturity.

I think it would be unjust to have sung the sensationalist doom and gloom without pointing out the benefits of these products.

CPPI structures have allowed investors to access high flying investment funds with capital protection. Without the threshold managed/CPPI protection in place, these funds typically would not have been able to offer capital protection. More importantly, the capital protection has also allowed many investors to borrow 100% of their investment amount, allowing them to invest when they may not have had capital to invest or had capital tied up elsewhere.

It is also easy to get carried away pointing the finger now that many of these funds are only likely to return their original investment amount. Investors would do well to remind themselves that we have just been through one of the worst case scenarios in investment history. Investors finding themselves heavily cashed out or cash locked shouldn't feel too bad, a typical managed fund that fell by over 50% will have only seen a 20%-25% fall within a CPPI structure, providing the promised protection at a time most needed.

Investors are unlikely to benefit from a recovery in the markets

The issue now is how best to progress from here, many investors cash locked or heavily cashed out, are better off cashing-in their investment. Whether you feel that now is a good time to get back into the market or remain sitting in cash, our analysis of a typical CPPI/threshold managed structure shows that investors are unlikely to benefit greatly, if at all, from a recovery in the underlying managed fund.

The vast majority of investors would do well to consider cashing in these investments

We recently analysed Australia's largest investment offerings, Perpetual's PPI Series, Macquarie's Fusion Funds, Macquarie's Reflexion Funds and HFA's Octane Series and found that for the vast majority of investors, cashing in their investment is likely to yield a higher return*.

For most the problem is that with an encashment value 20% lower than the original investment amount cashing in now, would mean having to stump up the 20% to pay off the outstanding loan. Many are therefore forced to sit and pay interest of around 10% pa for an investment that will only return the loan amount on maturity.

Perpetual Protected Investments Series – Fund Participation Offer

Perpetual have recently written to all cash locked Series 3 investors offering a "Fund Participation Offer". In summary investors can regain exposure to the underlying investment at a cost of 15% of their original investment amount. The Offer is limited to 6 of the investment strategies available:

1. Ausbil Australian Emerging Leaders Fund
2. AXA Wholesale Global Equity Value Fund
3. Challenger Wholesale Australian Share Fund
4. Colonial First State Wholesale Global Resources Fund
5. Perpetual Wholesale Australian Fund

6. Vanguard Australian Shares Index Fund

My first thoughts were very positive, that an option has at last been provided for investors locked into product that is only ever going to provide mediocre cash returns and still having to pay interest on their investment loan.

However, on closer inspection, I felt this was a disappointment. The increased volatility in the markets is a real problem for CPPI structures (see June 09 – *"Increased volatility is bad news for CPPI / Threshold Management"*). Our view is that whilst volatility and uncertainty remains high, investors should limit the use of CPPI structures for funds that aim for absolute returns (such as Platinum International). ie a fund can produce excellent returns, but if it falls in value before rising, investors are only going to get a proportion of those gains as their sitting in cash. It is therefore disappointing to see that the Offer is yet another CPPI structure and would have been far more comfortable with a Bond + Call alternative for investors.

The Offer also limits clients to remaining in the fund they were previously invested in. Our thoughts are that the recent Global Financial Crisis was a true test of which funds were suited to this structure. To force clients to reinvest with a manager that has proven they are not a suitable for a CPPI managed structure seems odd. We would have much rather seen investors have the choice of using the more successful managers that were on Series 3 panel.

We also feel that the increase in the *Dynamic Management* fee from 0.70%pa (as is currently) to 0.95%pa for the Fund Participation Offer is understandable (smaller fund, same admin) but a bit cheeky.

Finally, the starting participation rate of less than 100%, currently estimated to be around 85%, is also disappointing and means that investors are still not fully participating in any gains in the underlying managed fund.

So what are your options?

Whether you want to regain exposure to share market investments or just sit in cash, our opinion is most investors should take action with PPI Series 3. Investors options are*:

Remain cash locked – From today's current fund value, remaining in cash (call options) is generally providing investors with a net return of 4%-5%pa* depending on your current fund value. However, with 5 year term deposit rates at close to 7%, investors are generally better off encashing and placing funds on deposit, this also has the added benefit of the government guarantee, providing greater returns and more security.

Fund Participation Offer to regain exposure to the managed fund – *Note: This offer is limited to 6 investment strategies*. We feel that a 15% cost of re-entry is high. Investors looking to exit altogether would only need to close to 20% to exit the fund altogether, why re-enter an investment fund that has struggled with the CPPI structure. However, for investors who wish to remain in the same investment fund and/or can't afford to pay more than the 15% this provides a real alternative to sitting cash locked.

Cash in your investment and re-invest with another provider – For many the problem has been the investment loan. Cashing in your investment then having to pay a further 20% (approx) can seem counter intuitive, but considering the alternative of paying a loan of around 10% pa for the next 5 and half years, this is generally a much better option.

Credit Suisse Launches Performance Plus Series to unlock cash locked products

Credit Suisse have just launched a true alternative for investors with their Performance Plus Series. Providing a capital guarantee of 121%, investors can borrow the full 121% and pay off their existing PPI fund. This then allows investors to once again participate in share market returns without having to find 20% to pay off their loan or 15% to regain exposure through the Fund Participation Offer.

Overall, there are a number of options for investors and in the vast majority of cases we suspect it would be beneficial to consider the alternatives to sitting in a cash locked fund.

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