

LOCK-UP OPTIONS

The capital protected investment sector has emerged from the financial crisis alive but transformed.

David Chaplin writes.

When Sulieman Ravell, who heads online DIY advice business Funds Focus, arrived in Australia in 2007, he was a little puzzled to see such a high demand for capital-protected products.

"I came to Australia [from Britain] in 2007 and launched the business just as the [Global Financial Crisis] hit, and I thought, 'why would people want capital protection when the market has fallen so much?'" he says.

That was probably the worst time to get capital protection. They should've wanted it before when the markets were high.

He says while, rationally, it might not make much sense to pay for a feature that is unlikely to be activated, from a behavioural finance perspective, capital protection does have a value.

The addition of capital protection, Ravell says, encourages timid investors to at least have some exposure to growth assets, albeit at what can be a substantial expense.

"With anything that has an additional bell or whistle attached there is always a cost," he says. "If the market has fallen so much are you ever likely to need that protection? Probably not – so why are you paying for it?"

The answer is, if you didn't have it you'd probably still be sitting on the sidelines, worrying about is now the best time to get into the market?"

Ravell says more market savvy investors normally eschew capital protection, except for perhaps a small part of their portfolios, but for many of the more cautious DIY types, who form a large part of Funds Focus client base, the strategy is useful and demand is picking up.

He says falling interest rates in the wake of the GFC also spurred conservative investors to seek higher returns than term deposits could offer while also limiting their risk.

"People were saying 'I'm sick of term deposits, I might as well put it into a capital-protected product and get more than 5 per cent returns,'" Ravell says.

However, it's crucial that investors understand risks (and costs) entailed in the various capital-protection mechanisms used by providers. Essentially, he says, capital protection is structured in one of three ways:

- ☒ Constant proportion portfolio insurance (CPPI) – an automated investment process that moves investors out of equities as the

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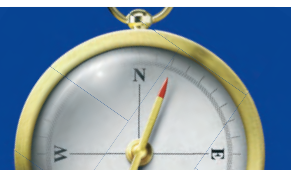


MICHEL O'SULLIVAN

Suliman Ravell,
Funds Focus: For
cautious DIY types,
the strategy is useful
and demand is rising.

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MICHELE MOSSOP, JIM RICE



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market falls and into cash, and back into equities when it rises.

- ☒ Bond and call structure – where an equity-based asset such as a call option or futures contract provides the returns over and above the protected amount.
- ☒ Dynamic hedging – where investors pay an explicit fee for the protection, similar to an insurance policy, leaving the provider to carry the risk and hedge it out. (This is the strategy AXA North employs.) Ravell says each protection strategy has

pros and cons (see panel, below) but the mood has shifted against CPPI after a number of products became cash-locked during the financial crisis.

CPPI structures are generally used to give investors capital protection on open-ended managed funds, rather than indices that suit the bond and call approach. But because CPPI products must sell underlying equities and allocate more to cash as markets fall, the GFC crash left many investors stuck in what became expensive cash funds that were not due to mature for many years.

Ravell says if investors had geared into such products – many borrowed 100 per cent of their investment – they could be left paying interest of 8 per cent to 9 per cent, with nothing to show at the end of the product term.

Peter Horsfield, a Sydney-based adviser who operates under the Patron Financial Advice dealer licence, says many investors were caught unawares by the cash-lock. “Some clients sold out early and took the capital loss,” he says, but later made the loss by deploying the money elsewhere.

Protection strategies pros and cons

	CPPI	Bond and 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 per cent participation	100-150 per cent	100 per cent
Cost of protection	Much of the cost is implicit. Lower participation rates typically mean this is lower than bond and 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 and 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 and call
Ability to turn on/off protection	No, in-built for term of product	No, in-built for term of product	Yes

SOURCE: WWW.FUNDSFOCUS.COM.AU

Peter Horsfield, far left, Patron Financial Advice. Adam Weale, left, Next Financial. David Jones-Prichard, right, JPMorgan Australia: Advisers are at the coalface, they know what investors want.



JIM RICE

Unlike Ravell's clients who are typically ungeared and wanting pure capital protection, Horsfield says his client base tends to be interested in leveraged capital-protection products. He fronts a website, capitalprotected.com.au, that serves as a lead-generation vehicle for the financial planning business. "The website is about giving people information about capital protection from an independent view, rather than just from the product provider," he says.

Horsfield says potential clients can access the website to learn the basics about capital protection before contacting the firm to establish whether it may suit them. For example, if individuals are on a lower marginal tax rate, pre-paying interest on capital-protected products won't make sense.

"But from a wealth-creation perspective, it may suit their risk profile [to gear into capital protected products]," he says.

"[If they are] we'll work through cash flow, worst-case scenarios, probable outcomes

and then they can make a call based on that."

Horsfield says capital protection normally appeals to two types of clients: those in their 20s or 30s with good cash flow but few assets and retirees or near-retirees who want to maintain exposure to growth assets but don't want to put their hard-earned retirement savings at risk.

Youthful gear

For those in the first group, the wealth accumulators who make up the bulk of Horsfield's

Protection appeals to those in their 20s and 30s and retirees or near-retirees.

client base, fully leveraged capital protected investments might be the only way they can gear into the market.

"[Geared capital protection] can suit younger people who have a good job but no assets – they don't have \$50,000 to put down against a margin loan," he says.

"And rates on a capital-protected product can be just as good as a margin loan."

While his practice sticks mainly to Australian and international equity capital-protected products, Horsfield says the group performs thorough due diligence.

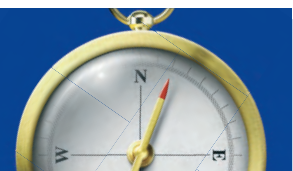
"We lift the bonnet on capital-protected products to see the moving parts to form our own view that we put to clients," he says.

The business is also working with issuers to design its own capital-protected products. One on the drawing board includes an 8.9 per cent interest rate and three-year maturity. "We have relationships with different providers and can shop around for price."

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Geoff Watkins, left, Path Independent. Andrew Barnett, Axa: If you retire today, you've probably got 20 years to live, so you need wide exposure.

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Adam Weale, director of distributions for the Wilson HTM-owned Next Financial, says you get what you pay for with capital protection.

Weale, who works with dealer groups to create structured products, says any capital-protection mechanism needs to be robust. "CPPI was sold as cheap but we now know it was cheap for a reason – it was the issuer getting protection, not the investor," he says.

Weale says Next generally constructs capital-protected products around quality liquid underlying assets, such as the S&P/ASX 20, using instalment warrants with put options.

"Put options are probably the most expensive way to get protection, but it's the most robust," he says.

"If you're paying only 1 per cent per annum, you'd have to question the level of protection you're getting."

But JPMorgan Australia's head of structured products, David Jones-Prichard, says a rash of new issuers has introduced fierce competition in the capital-protected market.

He says there is pricing tension in each of the building blocks that comprise capital-protected products.

"Over the past five years the cost [of protection] has come down," Jones-Prichard says.

He also says there's been improvement in

product design, including to CPPI structures that avoid cash lockouts.

JPMorgan plays in both the wholesale and retail markets, often building capital-protected products in association with advisory firms.

"Financial advisers are at the coalface. They know what investors want," Jones-Prichard says.

Off-the-shelf answers

Geoff Watkins, head of research firm Path Independent (which also supplies structured product research to Adviser Edge), says there are a number of niche dealer groups that work with institutions to create capital-protected products.

However, most advisers access the capital-protected market via the off-the-shelf products being pumped out by the 10 or so major providers, which include the Macquarie Group, Man (famous for its OM-IP range), JPMorgan and most of the major retail banks.

Watkins says advisers have to be very careful about what products they choose, and there is also an element of timing.

"If it's the right time of life for clients and the right strategy, capital protection can make sense," he says.

"Doing it all the time is too expensive."

Comparing capital-protected products is also a tricky business, Watkins says, and most issues have to be analysed on their own merits across a range of metrics.

"You need to look at break-even points," he says. "If the product is too opaque, it won't score well. But most are straightforward these days, and advisers who take the time can understand how they work."

George Lucas, head of one of the new breed of structured product shops Instreet Investment, says the industry has learnt some valuable lessons over the GFC years.

Lucas says capital-protected products are now simpler, more transparent and more flexible than before the crisis.

He says maturity lengths have come back significantly, with many now offering two- to three-year terms compared with the seven-plus years common a few years ago.

Lucas also says new technology has allowed manufacturers to design innovative features into capital-protected products, such as pre-payment of loan interest.

Like all those who spoke to *Asset*, Lucas says the capital-protected market is on the up, an experience also matched in other parts of the world (see *Next generation products*, page 13), but it's not quite boom times yet. "There's nowhere near as much interest in



JESSICA SHAPIRO

capital-protected products as in 2007, but there's more than last year," he says.

Lucas says the market is also evolving into two dominant styles: the structured-loan approach practised by most players, and the open-ended protected funds epitomised by the Axa North range.

Since AXA North's launch in late in 2007, its two product ranges – Protected Investment and Protected Growth – have proved to be a runaway success, garnering \$1.4 billion.

AXA head of structured solutions Andrew Barnett says the North products have captured 8 per cent to 9 per cent of total flows across retail platforms.

"Which, in effect, is 8 to 9 per cent of the retail market," he says.

The North range clearly uncovered huge pent-up demand for capital protection in the super and pension markets. And while the product has been labelled as expensive, Barnett says North merely made the fees inherent in capital protection explicit.

He says replicating the North protection strategies using over-the-counter options, "the simplest comparison", could result in investors paying up to 22 per cent in annual interest costs on a five-year guarantee versus the 2 per cent to 4 per cent fee on the AXA products.

The flexibility of the North range, which allows investors to switch the guarantee on and off any time they want, also hit the mark.

Late last year, ING also joined the capital-protection fray with its MoneyForLife product that took the concept even further, offering retirees guaranteed income for life.

It's a market that AXA North, too, is also

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for clients, capital
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about to attack with its new Protected Income guarantee.

Barnett says the retirement product will use the same dynamic hedging process as the North range with the addition of an insurance contract, with AXA's life company, to hedge out longevity risk.

The product "is, in effect, an allocated pension that provides a deferred lifetime annuity which starts if and when pension assets are exhausted".

JPMorgan's Jones-Prichard says the post-retirement market for capital protection will be a big growth area with few solutions to longevity risk on offer.

"JPMorgan offers these products offshore and we're thinking about bringing some to Australia," he says.

"If you retire at 65 today, you've probably got at least another 20 years to live, so you will need exposure to growth, income and capital protection after retirement.

"People don't often think about that." ☒

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