Funds® FOCUS

Guide to Capital Protected Products

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Capital Protection - an introduction

Capital protection is an investment strategy that has gained popularity with the retail investor over the last few years. Combining protection with equity performance has provided investors with the impetus to remain invested when markets have fallen and take advantage of sharemarket recoveries.

With a growing number of products coming to market each year, understanding the differences can seem a daunting task but a basic understanding of the main protection structures used can be a relatively simple process since the vast majority of providers derive their products from three basic structures;

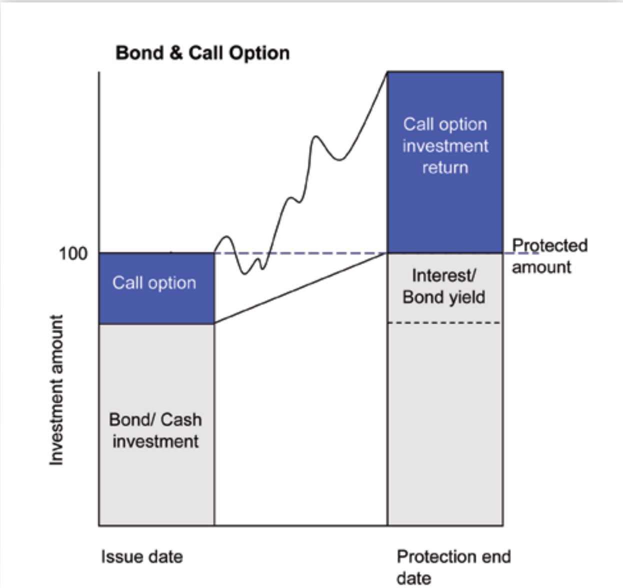
1. The Bond & Call structure which is made up of two parts;
   - The Bond - A safe asset such as a term deposit account or fixed interest bond which provides the protected amount at the end of the term and;
   - The Equity – An equity based investment such as a call option or futures contract which provides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

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.

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 deposit account or fixed interest bond to produce a fixed (protected) amount at the end of the term.
2. An equity based investment 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

Whether your bond costs 55c or 70c (for $1 invested) dictates the amount left over to purchase the Option which in turn dictates your level of exposure (participation) to the underlying investment.

Since the cost of The Bond and Option are dependent on market pricing on the day of issue (the start date), it is commonplace to see a range of participation quoted within the disclosure statement rather than a set participation rate. A range of 100%-150% is typical within this type of product, providing investors with returns equivalent to $1-$1.50 investment. The final level of participation just depends on the pricing of the Bond and Options on the day they are bought.

Why use Bond + Call Option Structures?

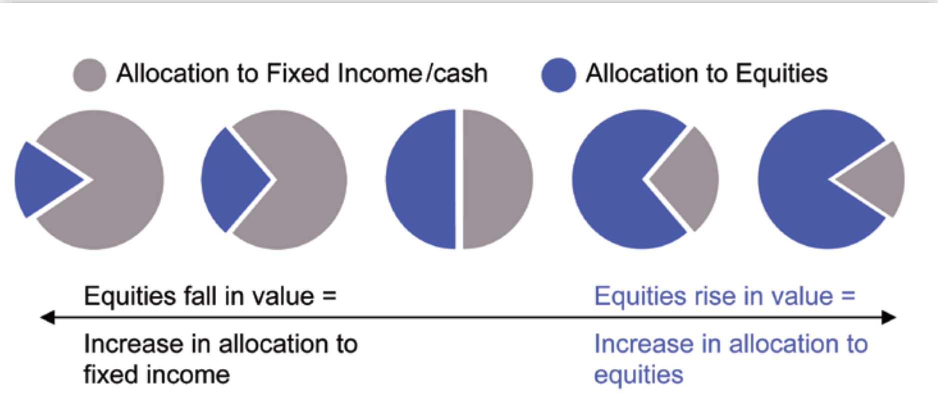
Bond + Call structures are tried and tested and have been around for a number of years and one of the main attractions is the simplicity of the product. There are however, limitations in what assets you can purchase options on. Investors are typically unable to gain exposure to a managed fund since the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

Funds Focus Guide to Capital Protection
A full list of our latest capital protected products are available online at fundsfocus.com.au/latestoffers

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

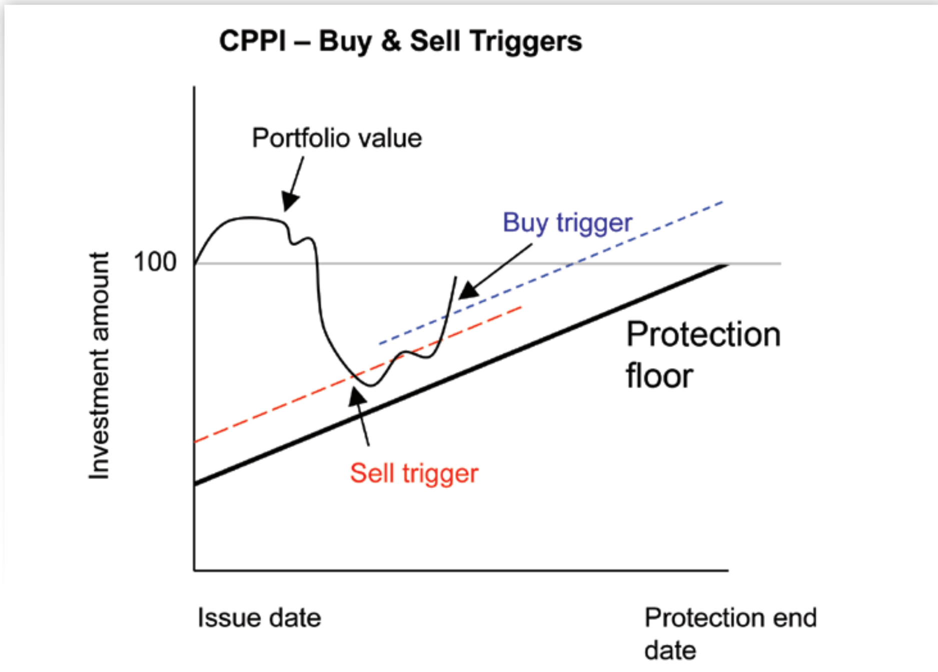


by increasing the allocation to term deposits (or equivalent), the fund ensures that it will have a certain value at maturity.

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') although some may require you to pay for a Put Option as insurance.

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 trigger point to buy and sell. 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 are buying back in at, and can be considered an implicit cost of having that protection in place.

> A lesser known feature of most CPPI structures is if the fund moves to 100% in cash, you remain locked into cash for the remainder of the term and will not participate in any share market recovery.

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.

In addition CPPI can also enable the provider to offer a rolling profit lock-in as the fund goes up in value.

Dynamic Hedging

A relatively new product to retail investors in Australia, Dynamic Hedging has already been offered to investors in the US for a number of years.

Considered an alternative to CPPI in protecting managed fund investments the protection provider ensures that your capital is protected in exchange for an annual percentage fee

Since you can't buy options on managed funds, the product provider typically offers managed funds that correlate closely to an index. This allows them to purchase derivatives in that index as a way of hedging (hence the name) the risk. 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 once it has recovered. Dynamic hedging allows investors to participate 100% in any rises since the the investor will never disinvest. However, the choice of investments is 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 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.

Put Option Insurance

One of the most often used protection mechanisms has been the use of Put Options. A textbook description is “the right to sell a share/stock at a predetermined price.” However, this is often confusing for the layperson and it is often far easier to comprehend a Put Option as insurance.

In the same way that an insurance policy provides a payout in the event of an insured loss, a Put Option provides a payout in the event that the investment ends up below the protected level.

Although Put Options have historically been the most commonly used forms of protection, the increase in volatility in recent years has increased the level of uncertainty, leading to a higher cost. As a result Put Options are less commonly used than they once were.

Why product providers use Put Options?

Put Options are often seen in products where the investor benefits from ownership of the underlying assets such as a parcel of shares. By allowing the investors to hold the underlying stock and pay a small “insurance premium”, the investor may benefit from tax benefits such as franking credits on dividends paid.

Put Option insurance is also often offered as a “bolt on” option alongside many CPPI structures to cover any potential shortfall that the CPPI manager may have as a result of not being able to sell at their anticipated trigger points.

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% partipation	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

Since Put Options act as an insurance contract, it is much easier to think of them as an additional protection option that you may see within many structures.

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 on investment opportunities when the market has fallen and stops us from cashing in at those low levels.

Most importantly Capital Protection ensures you keep hold of your hard earned money.

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