Prepare for the future with confidence

It is possible to invest your hard-earned cash and keep your peace of mind, writes **Sally Patten**.

As investors emerge from the debris of the global financial crisis, many are wary about placing further bets on the sharemarket and are more interested in preserving their capital.

A chart supplied to Portfolio by UBS says it all – even long-term holders of equities are not being paid for the extra risk investors are taking.

The chart shows that in the past 20 years, investors would have been better off putting their money into a basket of bonds rather than shares, and the All Ordinaries Index outperformed the UBS Composite Bond Index for only about three years.

Capital preservation is particularly important for retirees and savers approaching retirement, as they have less time to make up any losses.

Luckily there are ways to protect hard-earned savings. This week, Portfolio looks at how.

Cash

One of the simplest ways of protecting capital is by leaving money in cash.

Holding cash at the moment may seem counter-intuitive, given the low cash rate, but banks are prepared to pay handsomely for customer deposits because they are considered a stable source of funds.

Australian banks rely heavily on wholesale markets to fund their loan books but the financial crisis showed just how fickle these markets can be, and banks have realised the value of having a large, solid, deposit base. As a result, they are offering high rates to attract customers' cash.

"Term deposits are offering wonderful returns for the risk you are taking," says Michael Furey, head of research, advice solutions for Suncorp.

"Rates are excellent compared to government [cash] rates."

Official rates were kept at 3.75 per cent two weeks ago but 12-month term deposits are paying more than 6 per cent.

Meanwhile, St George Bank, owned by Westpac Banking Corporation, is paying 8 per cent for a five-year term deposit, reports RateCity, and some online accounts are paying as much as 5.6 per cent.

John Dani, manager of advice strategies at ipac Securities, recommends savers split their portfolio between different maturities so they can withdraw at least part of their nest egg quickly

> **Over the long term investors would be better off with products that are linked to inflation.**
> ipac's John Dani

if the need arises.

Savers, Dani advises, should divide their money into three maturity baskets: short term; one-to-two years; and three-to-five years.

That said, Furey warns that over time, cash will be eroded by inflation. "Cash is a better product in the short term," he says.

Over the long term, he says, investors would be better off with products that are linked to inflation.

Fixed income

For investors who are looking for slightly higher rates of return but still want peace of mind, high-quality fixed-income products are a good bet.

Bonds generally offer a higher rate of interest than cash because the investor takes on the risk that the borrower will repay the principal.

In the case of governments, semi-government organisations and blue-chip companies, however, the probability that the principal will be repaid in full is high.

In the case of second- and third-tier companies, there is a greater probability that a borrower will default, so investors need to be wary of the types of bonds they invest in.

It is difficult for individual investors to invest in bonds directly, so they usually buy units in bond funds which invest in a large number of different issues.

Andrew Bowring, senior adviser at planning firm Henderson Maxwell, likes fixed-income funds run by UBS and Perpetual.

Among funds that invest primarily in high-quality or investment-grade bonds, Aberdeen's High Grade Bond Fund was the best performer last year, posting gains of 25 per cent, reports asset consultancy Mercer.

Other top performers were Colonial First State's Global Corporate Debt Enhanced Fund, which returned 19 per cent, and Aviva Investors High Yield Fund, which posted a gain of 14.4 per cent.

Stop-loss mechanisms

As one market expert puts it: "The first discipline that any investor or trader should master is to always limit your losses."

One way investors can protect their portfolio is to use a stop-loss mechanism. A stop-loss order can be arranged through full service or online brokers such as Commsec or E*Trade, and can limit an investor's potential losses.

With such an order, a broker will automatically sell the shares if they fall below a pre-determined price, say, 10 per cent below the price the investor paid for the stock.

But a broker from Commsec warns that such orders cannot be guaranteed.

"Investors need to understand that, like all orders, stop-loss orders are taken on a 'best endeavours' basis," the broker warns.

"This means that while we are committed to doing our very best for our customers, a stop-loss order execution cannot be guaranteed.

Continued next page

Preserving your capital

PHOTO: PETER BRAIG
SOURCE: DATASTREAM

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From previous page

"An order might be subject to our vetting procedures before it is placed, for example, to identify inappropriate trading. Also, if the price drops rapidly through the trigger and limits prices, your stop-loss limit order may not be executed."

Capital-guaranteed products

There are several investment products that offer capital guarantees although, in some cases, they come with some hefty price tags because the products are often equity linked.

The upside for investors is they can benefit from capital growth if markets rise. However, providing protection against falls in equity markets is costly, given their volatility.

Most products have similar features, says Sulieman Ravell, managing director of discount broker Wealth Focus, although the mechanism that provides the guarantee can differ.

A product may guarantee the return of all, or a percentage, of an investor's capital on a fixed date; the time horizon of the product is typically between five and seven years; and the return is linked to an index or a managed fund, usually equities-based.

Protected investments should ensure there's enough to last. Photo: WARREN HACKSHALL

Axa Asia Pacific's North product offers maturities of five, seven, 10 and 20 years. Customers can use their superannuation, pension or other funds to invest in one of 49 funds approved by Axa, including Australian and global equities, fixed interest, listed property and cash.

Investment terms of five and seven years provide a capital guarantee, while investors draws down on their principal during that period.

In a worst-case scenario, an investor would leave the product, retaining all of the principal after withdrawals but not have experienced any capital growth.

Critics, however, argue that the cost of protection, which is about 3 per cent a year, means the investor will only get a return equivalent to a moderate balanced fund and will still suffer the eroding effects of inflation.

BlackRock, Man Investments Australia, Commonwealth Bank of Australia and Credit Suisse also offer capital-guaranteed products.

ING Australia offers capital-guaranteed products with no fixed term.

The ING Protected Growth Fund No. 2 is 85 per cent protected, while the ING Protected Aus 50 Fund is 80 per cent protected where the underlying investment is the S&P/ASX 50.

Capital-protected loans

Bowring suggests choosing protected loans as a means of preserving an investor's capital.

Capital-protected loans allow savers to borrow up to 100 per cent of the value of a share portfolio with protection against any losses if the shares fall in value.

If the shares are worth less than the loan when it matures, an investor can give the shares back to the lender as full repayment of the loan and walk away having only lost the interest costs.

"The guarantee means that you won't owe any more than the amount you have borrowed even if the value of the portfolio falls," Bowring says.

On the other hand, if the value rises, the investor keeps the difference between the loan and the portfolio value as well as any dividends received during the loan period.

The loans include a put option or some other form of hedging that protects the lender against losses on shares.

Loans can generally be taken out against a single stock or a portfolio of shares.

The cost of the protection is included in the headline interest rate charged by investment loans so while a standard margin loan might charge an annual interest rate of about 8.5 per cent, a capital-protected loan might charge between 17 per cent and 22 per cent, depending on the risk of the underlying portfolio and the term and type of loan.

The Australian Taxation Office

Money-back guarantee

Comparison of capital guaranteed products

Investment name	Minimum initial investment	Investment term	Income	Level of protection guarantee	Level of participation in underlying investment fund	Able to borrow to invest	Closing date	Fund choice	Lonsec Rating
Axa North (Investment Guarantee)	$20,000	5 or 7 years	Distributions reinvested until end of term	100%	100%	No	Ongoing	49	Recommended
Axa North (Growth Guarantee)	$20,000	10, 15 or 20 years	Distributions reinvested until end of term	100% (plus enhanced early encashment)	100%	No	Ongoing	49	Recommended
BlackRock - Capital Protected Top 20	$50,000	7 years	Can receive dividends (no need to leave until maturity)	100%	(CPPI) Starts at 80%, drops if fund falls in value	Yes	01/03/2010	1	Recommended
Commonwealth Bank - Capital Series OzAsia - Strategy 1	$10,000	5.5 years	5% pa after 18 mths	100%	100% (capped at 70% rise in 20 of ASX's largest shares)	100% (not for SMSFs)	19/03/2010	20 of the ASX's largest shares	S&P rating - sound
Commonwealth Bank - Capital Series OzAsia - Strategy 2	$10,000	5.5 years	3% pa after 18 months (if targets met)	100%	100% (capped at 100% rise in ASX 200)	100% (not for SMSFs)	19/03/2010	S&P/ASX 200 Index	S&P rating - sound
Commonwealth Bank - Capital Series OzAsia - Strategy 3	$10,000	5.5 years	No	100%	100% (capped at 100% rise in portfolio of Asian indices)	100% (not for SMSFs)	19/03/2010	HSCEI Index (33.3% weighting) TAIEX Index (33.3% weighting) KOSPI 200 Index 33.3% weighting)	S&P rating - sound
Credit Suisse - Performance Plus Series	$20,000	Will be either 3.5 or 4 years (TBA)	50% of growth over 5% is distributed as income each year	100%	The volatility overlay increases and reduces participation between 25% and 150% as volatility falls and rises	100%	Anticipated June 2010	A basket of Asian indices or S&P 500 Index	
Credit Suisse - Performance Plus Series (cash lock solution)	$20,000	5 years	50% of growth over 5% is distributed as income each year. Plus 3% pa	100%	The volatility overlay increases and reduces participation between 25% and 150% as volatility falls and rises	115%	Anticipated June 2010	S&P/ASX 200 Index	S&P rating - sound
INstreet - Reliance Funds	$5,000	Open ended	No	75% of price from start of quarter	(CPPI) Starts at 100%, drops if fund falls in value. BlackRock fund can increase allocation to 125% if fund rises.	No	Ongoing	2 funds available - Blackrock Global Allocation Fund and Schroders Commodity Fund	Highly recommended Blackrock & recommended Schroders
Macquarie - Deposit plus Access 200	$10,000	5 years	Yes (from 90% in term deposit)	100%	100% of rise between hurdle and cap	No	05/02/2010	S&P/ASX 200 Index (10% weighting) Macquarie term deposit (90% weighting)	
Man Investments Australia - OM-IP Eclipse 2010	$5,000	10 years	No	100% and rising as fund value increases	150% (100% participation in AHL and 50% to Man Investment portfolio)	100% available through NAB Capital	26/03/2010	1 fund made up of 100% exposure to AHL Diversified Program plus 50% to Man Investment portfolio	Highly recommended
Macquarie-Winton Global Opportunities Trust 2	$20,000	5.5 years	25% of growth distributed each year (capped at 7.5% pa)	100%	33%-150% depending on investment returns and volatility	100%	26/03/2010	1 fund - Winton Advised Account	Recommended

SOURCE: WEALTH FOCU

confidence

allows tax deductions on interest payments, although these are not as generous as they once were.

While interest repayments on standard margin loans are fully tax deductible, the deduction allowed on interest payments for protected loans is capped.

Interest charged above the cap is considered to be the cost of the protection, which means that the tax deduction allowed on capital protected investment loans is lower in many cases than that allowed on a standard margin loan.

Banks that offer protected loans include Macquarie Group – the Macquarie Geared Equities Investment allows investors to select their own portfolios from more than 80 securities listed on the ASX, or use a portfolio pre-selected by the bank – and Citigroup, whose Investment Protected Loan lets investors choose different levels of protection for their portfolio: 100 per cent, 90 per cent or 80 per cent.

Major Australian banks such as Westpac, Commonwealth Bank, and Australia and New Zealand Banking Group, also offer such products.

Protected loans are also commonly taken out against capital-protected products.

Annuities

Many people think annuities are only bought by retirees, but this is incorrect. An annuity is simply a product that will provide a regular income stream during a pre-determined time frame.

Some annuities offer this guarantee over the period of the investor's life. Others offer steady income streams for a set number of years.

The biggest annuity provider, Challenger, recently modernised its annuity-style offerings with its Challenger Guaranteed Income Fund.

It is a managed fund, available on investment platforms, that invests in annuities and derivatives provided by Challenger.

The fund pays a set monthly income and is meant to be held until maturity, with penalties for early withdrawal. It is available over terms of three, five and seven years, after which time the investor's capital is returned.

Depending on the maturity, the returns on offer range between 6.24 per cent and 7.28 per cent a year.

Inflation-linked annuities

Challenger also offers inflation-linked annuities that will ensure investors' cash is not eaten by rises in consumer prices.

Its Guaranteed Income Plan, rather than being a unitised managed fund, allows investors to invest directly into a product that is issued by Challenger Life.

The fund can be indexed to inflation so investors are receiving a real rate of interest, says Richard Howes, chief executive of Challenger Life.

Investors are assured a 4 per cent real rate of return, says Howes, and: "That is obviously a very attractive rate of return."

Lifetime annuities

Lifetime annuities have their place, too, although Australians have not embraced them as other markets have.

Such products offer the attractive feature of taking away longevity risk, providing a guaranteed income for as long as a retiree lives.

The downside is that if the retiree dies early, his or her money remains with the life company.

By contrast, allocated pensions do not offer any protection against people living longer than they might expect and hence not having enough money to last their lifetime.

The only provider of lifetime annuities in Australia is Commonwealth Bank's CommInsure, ING Australia, and the wealth management arm of ANZ.

ING has launched a hybrid between a lifetime variable annuity and an allocated pension. MoneyForLife is "a super account-based pension with a lifetime guarantee of income", says David Kan, ING's executive director of retirement and investment solutions.

The product gives investors full access to their capital with their beneficiaries receiving the balance when the investor dies.

A big part of good returns is not getting bad returns, not getting into . . . the stuff your neighbour made a lot of money from last year.
Pinnacle Investment Management's Ian Macoun

ING is encouraging investors to consider the product 10 years before they retire, so they can lock in the guaranteed amount.

From the age of 65, retirees can draw down a maximum of 5 per cent of their guaranteed balance each year.

The guarantee costs between 1.24 per cent and 1.47 per cent, on top of which investors must pay advice, administration and investment fees.

Put options

Put options are akin to buying insurance for your portfolio, but there are two downsides. The first is the paperwork involved. The second is the fact that options expire, so investors need to keep taking out fresh policies.

Patience

"Nothing beats patience," Bowring says . "If you can wait, as long as your portfolio is good quality, it should work for you."

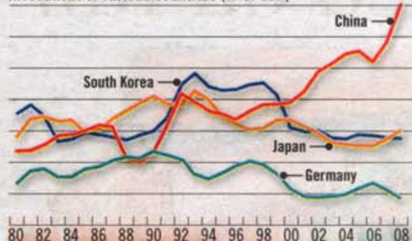
A well diversified, high-quality portfolio should limit the damage caused by falls in financial markets, assuming the investor understands that investing is a long-term game.

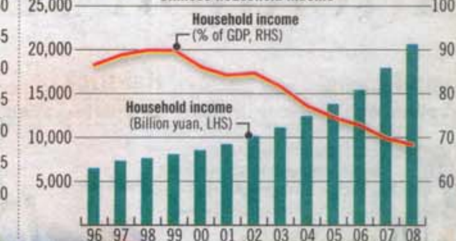
As Ian Macoun, managing director of Pinnacle Investment Management, says: "A big part of good returns is not getting bad returns, not getting into the hot stuff and the stuff that your neighbour made a lot of money from last year that you go into because you are jealous.

"Good investing is about having a balanced portfolio, a good chunk of Aussie equities, a good chunk of global equities, some emerging markets, small caps, bonds and cash."

The last word comes from Furey, who says: "The only free lunch in investing is diversification."

Looking before you leap





SOURCE: IMF, PIVOT

Don't count on China for growth, say contrarians

Long view
Philip Baker

Australia's link to China has rightly been touted as a major reason why the economy has been able to withstand the global financial crisis so well.

Investors have been able to bask in the glory of China and the riches it is able to bestow, comfortable in the knowledge that even experts at Treasury are upbeat that the resources boom will last for years.

But what if it doesn't? What if China disappoints?

Contrarian investor James Chanos, who built a multibillion-dollar fortune foreseeing the collapse of Enron, has suggested that China's investment bubble might lead to a Dubai-style implosion. A host of experts disagree, but it's worth taking a look, given that China is crucial to long-term investing.

There are three key areas highlighted by the bears.

First, China's expansion is unprecedented. While a lot of investors think the country's development phase is in its infancy, and therefore has years to run, spending is larger than anything seen before, implying it can't keep growing at such a rate.

The second area of concern is policy actions announced last year that can't be repeated. The current level of growth is all linked to the massive stimulus package, and so government lending and spending is tipped to fall away in 2010.

Finally, the bears say there are signs China's massive industrialisation and structural changes are almost complete. If true, then long-term investment needs are grossly overestimated.

Digging a little deeper into each of these concerns, China's capital spending is larger than the great spending periods in Germany and Japan after World War II or South Korea in the 1980s and 1990s. Investment contribution to China's gross domestic product is around 50 per cent and for the past 12 years has been higher than 30 per cent.

Brisbane wouldn't be counted as a city in China as it is too spread out.

James Chanos has suggested China's investment bubble might lead to a Dubai-style implosion.
Photo: BLOOMBERG

Singapore and Thailand are the only other countries to experience that sort of spending spree and then only for a nine-year stint.

History says that pace can't be kept up, while there are also signs that the investment China is making is not as efficient as it once was.

The other problem is credit. Since the beginning of the decade domestic credit in China has expanded around 50 per cent more than GDP. In the past that sort of growth has led to sharp and brief credit crises in Brazil, Russia and India. If loans continue to grow at the current 35 per cent rate, credit to GDP ratio will be close to 200 per cent.

The bears say that all of this implies credit in China is not going to be able to grow for much longer without risking a major crisis.

Also, China was a real winner between 2003 and 2008 thanks to the global credit explosion that led to a tenfold growth in its exports.

But that inflow of money is dwindling as the global credit crisis unfolds. Another worry for the bears is that China is running out of easy ways to boost growth through investment.

Pivot Capital Management says China is already a country with plenty of manufacturing capacity and a well-developed infrastructure. As a result, any further expansion won't have the same impact on growth as in the past.

Pivot is also a non-believer when it comes to the theory that urbanisation will drive growth for the next few decades. It says reports of China's urbanisation rate are a myth. In fact, at 45 per cent, it is low compared with the rates of developed countries of about 70 per cent to 80 per cent.

It says more of China is urban than investors think. It all depends on your definition. For example, Brisbane wouldn't be counted as a city in China as it is too spread out. In China, to be classified as a city you need population density to be more than 1500 a square kilometre. That implies a lot of villages and townships are in fact urban already. With a very low level of people living in urban centres of less than 500,000, the overall level of China's urbanisation could be understated by 20 per cent, implying that instead of 350 million people needing to be urbanised, the number is closer to 100 million.

Bullish investors often say private consumption will automatically take over from investment as the main driver of growth. Private consumption accounts for a third of China's GDP, but would have to grow at an average real rate of up to 30 per cent for the next two years to ensure that GDP hits the magical 10 per cent. No doubt there are more bulls on China than bears, but that doesn't mean long-term investors shouldn't be prepared for a surprise.

■ *From today, AFR senior markets commentator and associate editor Philip Baker takes over the Portfolio Long View column.*