SMART MONEY

Illustration Karl Hilzinger

UNLOCK YOUR CASH?

New products are offering to help people get out of capital guaranteed funds and get their money working again, writes **Chris Wright**.

In excess of $1 billion could be locked in investments sold to safety-conscious people who wanted to protect their capital from loss and so bought products that promise investment nirvana.

If you don't know what we mean by "cash-locked products", then you're one of the lucky ones.

These investments promised exposure to various different assets – a stock index, perhaps, or the price of commodities – with the guarantee that provided you held the product to maturity, you wouldn't lose money.

Macquarie Bank, Citigroup, CommSec and a host of other institutions created a multibillion-dollar market during the past decade by selling specially structured products to an enthusiastic investor base – including a quarter of all do-it-yourself superannuation funds.

Catchy names such as Fusion, Octane and Elixir were used to help sell this new investment.

"A lot of clients don't know, and their advisers don't realise, that all they're going to get out of a cash-locked product at the end is the money they put in at the beginning," says Sulieman Ravell, founder of Funds Focus, an advisory group focusing on DIY investors.

In a few years, they will get back the same amount they first put in, minus their interest bill.

The problem was that many of the capital guarantees involved a system in which, in certain circumstances, money invested would cease being exposed to the stockmarket (or other assets) and instead put into cash or a bond that makes no return to pay for the capital protection.

This happened widely during the financial crisis when stockmarkets around the world nosedived. And, having been put into cash, there is no way back: they will stay invested thus until the products mature. This is called being cash-locked.

It may take as long as seven years for such products to mature, though five is more typical. And in most cases, the investor in the product was encouraged, or very often required, to use a loan, on which they continue to pay interest today.

So here they are: paying interest on an investment that has them sitting in cash just so that, in a few years, they will get back the same amount they first put in, minus their interest bill, and having missed out on the stockmarket rebound in the meantime.

"A lot of people are cash-locked, paying interest rates on products that won't have any capital gain," says George Lucas of Instreet Investment, which structures products that are then sold by banks. These products did what they said they would in the circumstances, though it's

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SMART MONEY

Bitter pill

How to read these tables

This guide helps investors in capital protected products to determine whether it is best to stay in the products or take a loss and then invest capital elsewhere. Where possible, it estimates break costs for a variable rate investment loan. Investors with no loan are likely to be better off switching than illustrated. Investors with a fixed-rate loan are likely to be worse off than illustrated. Investors should request an individual illustration from their provider before cashing in their investment.

RED – Redemption is likely to be beneficial
AMBER – Redemption is likely to be beneficial, greater care needed
GREEN – Stay with product likely to be more beneficial

	How much of your capital is actually invested in markets*	Redeem or stay	Estimated gain/loss on early redemption	Potential overall gain/loss at maturity				Maturity date
				Remain in current fund	Switch to alternative investment	Switch to alternative term deposit (zero tax)	Switch to alternative term deposit (46.5% tax)	
• HFA Series								
Octane Fund (Series 1)†	0%	Stay	-26%	0%	-9%	-14%	-20%	Dec-12
Octane Asia	0%	Redeem	-24%	0%	8%	-1%	-12%	Jun-14
Octane 5 Fund	93%	Stay	-8%	60%	56%	40%	16%	Jul-16
• Perpetual Protected Investments Series 1								
Ausbil Australian Active Equity Fund	0%	Redeem	-11%	7%	23%	13%	1%	May-14
Colonial First State W'sale Global Resources	0%	Redeem	-10%	6%	24%	15%	3%	May-14
T. Rowe Price Global Equity Fund	0%	Redeem	-9%	7%	26%	16%	4%	May-14
• Perpetual Protected Investments Series 3								
Aberdeen Asian Opportunities Fund	100%	Stay	5%	60%	58%	44%	25%	May-15
DWS Global Equity Thematic Fund	52%	Redeem	-11%	23%	34%	22%	6%	May-15
Perennial Global Property Trust	0%	Redeem	-24%	0%	14%	4%	-10%	May-15
• Macquarie Fusion Funds *(Jun-09)*								
Vanguard Australian Shares Index Fund	100%	Stay	20%	76%	75%	60%	40%	Nov-14
Walter Scott Global Equity Fund	100%	Stay	3%	52%	50%	37%	21%	Nov-14
Winton Global Alpha Fund	100%	Stay	2%	50%	48%	36%	19%	Nov-14
(Nov-08)								
Ausbil Australian Emerging Leaders Fund	60%	Redeem	45%	97%	110%	93%	69%	Nov-14
DWS Global Equity Agribusiness Fund	100%	Stay	64%	140%	138%	118%	92%	Nov-14
Platinum Asia Fund	100%	Stay	47%	115%	113%	95%	71%	Nov-14
(Jun-08)								
Aberdeen Asian Opportunities Fund	78%	Stay	7%	36%	38%	29%	18%	Jun-13
Eley Griffiths Group Small Companies Fund	4%	Redeem	-12%	0%	13%	5%	-3%	Jun-13
Walter Scott Global Equity Fund	58%	Stay	-1%	22%	27%	19%	9%	Jun-13
• Macquarie Fusion Funds *(Nov-07)*								
Fidelity Australian Equities Fund	4%	Redeem	-12%	0%	13%	5%	-3%	Jun-13
Macquarie Asian Alpha Fund	47%	Redeem	-3%	18%	25%	17%	8%	Jun-13
Van Eyk Blueprint Australian Shares Fund	4%	Redeem	-15%	0%	9%	2%	-6%	Jun-13
• Macquarie Reflexion Trusts *(Jun-09)*								
BRIC and Emerging Markets Trust	78%	Stay	13%	78%	88%	69%	41%	Jun-16
(Jun-08)								
BRIC and Emerging Markets Trust	45%	Redeem	9%	48%	67%	52%	31%	Jun-15
China Trust	10%	Redeem	-6%	17%	43%	31%	12%	Jun-15
Commodity Trust	0%	Redeem	-8%	12%	41%	29%	10%	Jun-15
(Dec-07)								
Commodity Trust	0%	Redeem	-5%	16%	47%	34%	15%	Dec-14
Japan Focus Trust	0%	Redeem	-3%	18%	49%	36%	16%	Dec-14
Renewable Energy Trust	0%	Redeem	-6%	15%	45%	32%	13%	Dec-14
(Jun-07)								
BRIC and Emerging Markets Trust	26%	Redeem	3%	31%	52%	39%	21%	Jun-14
China Trust	12%	Redeem	-1%	21%	45%	33%	16%	Jun-14
Japan Focus Trust Variation	0%	Redeem	-23%	0%	14%	4%	-9%	Jun-14
(Nov-06)								
BRIC and Emerging Markets Trust	46%	Redeem	12%	43%	57%	44%	28%	Jun-14
(Jun-06)								
China Trust	37%	Redeem	4%	28%	41%	31%	18%	Jun-13
Emerging Markets Trust	0%	Redeem	-5%	9%	28%	19%	7%	Jun-13
(Jun-05)								
Asia Trust 2005 ($US)	0%	Redeem	-3%	8%	21%	13%	6%	Jun-12
China Trust 2005 ($US)	100%	Stay	53%	90%	90%	78%	66%	Jun-12

Each individual's circumstances and tax status should be seriously considered before cashing in or transferring to an alternative investment product. This table should not in any way be construed as providing securities advice or an endorsement or recommendation.

Assumptions

• Equity growth rate = 9%pa • CPPI product cash growth rate = 4.1% (overall average). • 'Switch to term deposit' rates assumed as market leading rates. • Fusion & HFA break costs have assumed a $100,000 investment. • CPPI maturity values shown assume equity participation does not increase for remainder of term. • Loan interest rate on alternative investment assumed to be equal to current rate. If new rate is lower then transfer is likely to be more beneficial and if new rate is higher then transfer will be less beneficial than illustrated. • †Redemptions are currently suspended on this fund. • *Amount invested can decrease to pay for capital protection.

SOURCE: WWW.FUNDSFOCUS.COM.AU

UNLOCK

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unclear if investors properly comprehended the complex sales documents used to spruik these difficult-to-grasp products.

"The important thing to note is the products did exactly what they were designed to do," says Peter van der Westhuyzen, executive director at Macquarie Bank. "I totally understand that being completely invested in cash with two or three years to go is not an ideal position to be in, but that was one of the possible outcomes if the market fell – and it did fall."

RBS reckons there's about $500 million being held in cash-locked products out there. It's hard to tell – everything's unlisted so it can't be found in stockmarket data – but when one considers the dozens of constant proportion portfolio insurance (CPPI)-backed investment series sold in recent years, it seems a fair estimate.

Ravell estimates that much more, or $1.5 billion, is sitting in cash-locked CPPI products (see "Back to the drawing board" on page 42) and another $2.5 billion in other products that could earn a better return invested elsewhere.

Note, though, that not all capital-protected products are performing badly and some people will do well by remaining invested in them.

There are a few options for the unlucky ones stuck in a dud capital-protected product, but some involve taking a loss with the aim of eking out a return from an alternative asset that might be as simple as a term deposit.

Alternatively, some banks have spied an opportunity and launched products to get people out of their cash-locked investments and start them working afresh in other products. One such is RBS.

"There's no silver bullet for that situation," the head of public distribution for Asia-Pacific, Aaron Stambulich, says, "but we can give people a chance to get some potential for growth."

RBS built a product called the Restrike Deferred Purchase Agreements by which investors can bail out of cash-locked products, surrendering their capital guarantee, and use what's left of their money (probably about 80 per cent in this environment) to regain market exposure in an RBS product underpinned by a new capital guarantee from National Australia Bank, without having to provide any additional cash. "It's too early to say if it will perform, but it will give an opportunity to get some profit going forward," Stambulich says.

These don't work by using your existing investment as collateral; instead, they encourage you to cash out of an existing moribund product – which you can generally do, at a loss, at quarterly redemption windows – and put your money into a new product.

Other banks have tried this approach with limited success, for perhaps obvious reasons. "They're not the most popular things in the world," Lucas says. "One reason is that you open old wounds ... if you're going back to the client and reminding them of the pain they're going through, just to get them to go into another product ..."

Nevertheless, Lucas has structured such a product for Merrill Lynch customers, using an existing product to swap clients into a new Bank of America note to regain exposure to the market, in return for an upfront payment.

Van der Westhuyzen says Macquarie offered some "variation options" for investors in its Fusion

YOUR CASH?

Photo Andrew Quilty

BUYER BEWARE

Structured products took a hit in July when the Australian Securities and Investments Commission launched a stern review of 64 capital protected, structured and derivatives products.

Among other things it warned that the differences between products meant the idea of a guarantee could mean different things without a strict definition – they often had substantial break costs, and despite being more expensive than simpler investments, they did not necessarily bring better returns. It found shortcomings in areas including foreign exchange, warrants and futures contracts, and issued a warning about disclosure of funds investing in other funds in tax-haven jurisdictions.

ASIC also noted more than a quarter of self-managed super funds were invested in capital-guaranteed investment products and warned these investors of hidden risks.

"A lot of people may invest in these products more now because of the financial crisis and feel that there is comfort because they are guaranteed, but we don't want them to feel false comfort," ASIC commissioner Greg Medcraft told the *Weekend AFR* in July.

and Reflexion series – both of which have in many cases been cash-locked – "to help them gain new exposure to equity markets, and this was well received". But, he adds: "The bottom line is there is no free lunch in repaying shortfalls and there will be the usual set of cost-benefit trade-offs."

Macquarie did not offer a similar variation this year, sensing lack of demand. Another group that has offered so-called rescue products is Perpetual.

Stambulich thinks RBS has an easier ride having not launched the unsuccessful products in the first place. "Every bank that sold the problem products has tried to do restructure trades," he says. "The issue they found was that when they went back to their client base after putting them into something that turned into a nightmare, there was a lot of pushback. 'I sold you this rubbish, here's another piece of rubbish'. We've been a little more successful because we didn't sell any of this before."

Yet some are suspicious both of the RBS product and "rescue" products generally. "The problem with these Restrike-style products is that by the time investors have repaid the shortfall on the loan against the cash-locked product to close it out, then paid the fees and charges on the new product, there's so little going into the underlying risky asset that the prospect of the investor getting anything for their time and energy is remote," says Tony Rumble, founder of Alpha Structured Investments, which also develops structured products.

"I'm not only questioning the structure of the product, but the need for it," he adds. "I don't think a lot of investors are running around demanding relief from cash-locked products."

> **Being completely invested in cash with two or three years to go is not an ideal position.**
> Peter van der Westhuyzen

But the time to do this was a year ago, he says, when the equity market was rebounding and it was worthwhile for cash-locked investors to pull out of those investments to put their money to work. "There are better things to do with your money right now."

Stambulich doesn't disagree about the timing. "If you bought one of these CPPI products that became bonds after the GFC and had five or six years to go on the loan, the best time to get out was 18 months ago when the Reserve Bank was aggressively reducing interest rates," he says.

At that time, people could abandon their products and get back 90¢ in the dollar. But the fact is, they didn't, and as interest rates have risen, the amount investors can get back has fallen to about 80¢. The RBS proposition today is that "we will get you out of this thing worth 80¢ that will never be more than a dollar and give you exposure to upside with NAB in the middle providing capital guarantees".

RBS doesn't buy the product: the investor sells it back to the issuer they bought it from. Consequently, in theory, the investor could do anything with that money: there's nothing magical about the RBS Restrike, nor does it pretend to be the only option. "We're saying: here's another option. You can crystallise your losses; you can keep paying interest and get your money back; here's another option," Stambulich says.

RBS and other new products represent a shift away from products that tie investors to a long-term loan to make the investment. Increasingly, investors get to walk away if they choose.

Macquarie's Flexi 100 Trust series – its latest incarnation opens to investment in November – is an example of this: it has a 5½-year term, with capital protection applying if it is held to maturity, but if it looks like a dud earlier on, investors can abandon it on a quarterly basis without being committed to making further investments.

"Whereas if you remember three years ago, generally you invested for a full five-year term and if you wanted to exit you couldn't," Van der Westhuyzen says. This might not sound much of a concession – if you walk away, you lose everything you put in – but it's the same principle that investors have been comfortable with in instalment warrants for years.

"Everything tends to be non-recourse loans with walk-away features in them now," confirms Lucas. "Where a product is capital protected with a loan, you can now break away without any penalty, which was a big pain in the other products."

Stambulich says: "In all the years I worked in Australia [he is now based in Hong Kong] I never heard a complaint about a client buying an instalment warrant over BHP. If the stock halves, they can walk away from the debt: they haven't put a house on the line and they're not going to get divorced." Applying those principles to structured products means a product where "you buy it because you like it but every year you have the option to go on or not".

"That has really resonated because people think: that's better than me being locked into a financing arrangement for five years where if the asset doesn't perform, I'm stuck with it."

Illustration Karl Hilzinger

When it pays to get out

Bailing out of a cash-locked product can sometimes make sense, writes **Chris Wright**.

Investors in cash-locked products face a choice: stick with them, continuing to pay interest on a loan just to get your money back when the product reaches maturity; or bail out at the next redemption window, accepting a loss and doing something else with the money.

But the decision will vary depending on the product and your circumstances, and in particular whether you took a loan to enter the product in the first place, in which case you don't actually have that money, just a debt.

"Your typical client in a cash-locked product right now might have $100,000 invested with three or four years to go," explains Sulieman Ravell, founder of Funds Focus, an advisory group focusing on DIY investors. "That's worth about $80,000 today, because all they're sitting on is a bond right now, which over time will grow to give you back the original $100,000."

That's how capital protection is typically created. "If the client wants to cash that in, they've got to physically come up with $20,000 to repay the loan."

This is the premise of so-called rescue products that will bail people out of these products: they will lend you $100,000, and you might spend $20,000 to pay off the loan shortfall in your original product and put the rest into a new capital guaranteed product.

Ravell says the rescue products are "a viable alternative for investors", but he is also cautious. "Some advisers are seeing it as a way of getting money out of [a cash-locked product] and into something that can get them more exposure, but are not necessarily doing analysis on what's worthwhile."

On some products, particularly those with fixed loans, the break fees can be very high and make it

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WHEN IT PAYS TO GET OUT

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prohibitive to transfer out. A variable rate loan, on the other hand, may have a break cost of only $250.

"My cynical side says some people are just doing it as a way of providing the perception they're doing something, without necessarily doing proper analysis about whether it's worth doing it."

Ravell says that product manufacturers have varied in the opportunities they have given cash-locked investors to get out of their products and into something more useful.

He says Macquarie was "the best and most proactive in offering a solution to investors – limited, but better than nothing"; he could see some merit in the approach HFA took, offering investors a call option over the ASX 200; but was not impressed by an offer from Perpetual which effectively charged investors 15 per cent to get back into the same product that had already become cash-locked once.

Ravell, whose background is in the UK financial planning industry, where regulation of structured products is more onerous, has discovered widespread misunderstandings in Australia.

Some investors don't even realise that their investment is cash-locked.

He recalls one adviser saying he expected his client to get his money back "plus a little bit more to cover the interest", when in fact the terms of the product clearly said that, once cash-locked, they would only get their money back no matter how well the underlying product performed in the meantime.

Some investors don't even realise they're cash-locked.

His company's website, www.fundsfocus.com.au/tools/, offers a calculator to help work out the effective return of a cash-locked product to figure out if you're better bailing out.

Back to the drawing board

After taking a battering in the financial crisis, capital protected products have returned, some with important protections built in, writes **Chris Wright**.

Capital protected products seem to be back with much the same zest they ever had, but there are some differences in their appearance.

"A lot has changed in the last two years, without a doubt," says Peter van der Westhuyzen, executive director of Macquarie's specialist investments business. "The overarching principle we use now in developing products is to focus where possible on long-term investment and short-term flexibility."

One is the ability to walk away from an investment. Another trend is that the method of providing the capital guarantee has changed somewhat.

In the run-up to the financial crisis a model called CPPI (which stands for constant proportion portfolio insurance), also known as dynamic or threshold management, became popular. These involve keeping a balance between risky assets and a riskless asset, typically a zero-coupon bond, with more of your money shifted towards the riskless asset if things turn bad.

It's through this structure that many products have become "cash-locked": stuck with all their money in the riskless asset until maturity, with nothing at all exposed to what they originally hoped to invest in.

"The vast majority of CPPI investments taken out prior to 2009 will be cash locked," says Sulieman Ravell, founder of Funds Focus, an advisory group focusing on DIY investors.

CPPI is less popular now, and the earlier methods of a zero coupon bond plus a call option are back in vogue. "Nobody is really doing CPPI products any more," says George Lucas, of Instreet Investment.

"Everything has gone back to plain vanilla structures."

Additionally, he says that products tend to be shorter dated: where seven years was common before the financial crisis, the average is about three years.

Another is that, where at one time people would buy structured products that gave them exposure to all sorts of weird and wonderful things, "people are more selective on the underlying investment now," Van der Westhuyzen says.

"A lot of questions are being asked about that investment, which is a good thing: if they don't understand what they are investing in, they won't invest at all. There is a massive drive for simplicity and transparency."

Lucas adds: "We have a product linked to Asian stocks, to South Korea, Hong Kong, Taiwan and Singapore. It gets good flows but these days it's nothing like what goes into products around the ASX 200. Everyone is going back to what they know."

In terms of the industry, there are fewer products from some of the international banks, such as JPMorgan, Credit Suisse, Goldman Sachs JBWere and Merrill Lynch (since absorbed into Bank of America), but more from others, such as Royal Bank of Scotland (whose team here is fundamentally the old ABN Amro business).

There are, though, some products that combine apparent capital protection with some real risks. These operate by selling a put option, in order to increase the yield of the product, and carry capital protection, provided the market doesn't fall too far – perhaps 40 per cent – but if it does, that protection doesn't apply.

These have been sold by Citibank (devised by Tony Rumble's team at Alpha Structured Investment), among others.

Some are troubled by them, since one hardly has to look too far back to see that the market has just fallen 40 per cent.

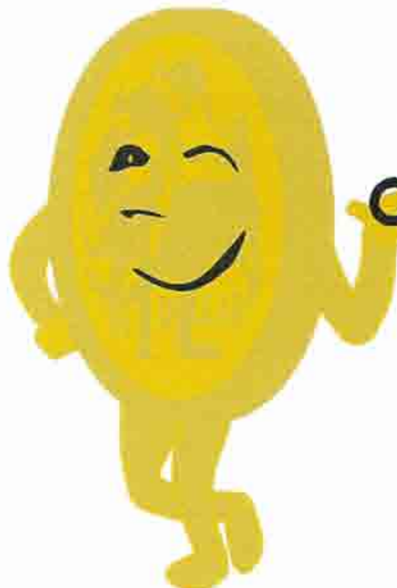
In addition, new areas of protection have emerged. An example is income protection, which features in retirement income products such as ING's MoneyForLife. This provides investors guaranteed income for life – something quite different from a capital guarantee.

It works by identifying a protected income base, calculated from the capital invested at retirement, then it promises to pay 5 per cent of that each year for life, regardless of whether the individual outlives their original amount of income.

The vast majority of CPPI investments taken out prior to 2009 will be cash locked.

Sulieman Ravell, Funds Focus founder

A LOOK AT WHAT'S UNDER THE BONNET



The Alpha RESULTS Series 7, structured by Tony Rumble's Alpha Structured Investments and sold and marketed by Citigroup, is an example of the sort of structured product being sold to investors today.

This sale ended on September 17, but with seven series already completed, another is expected to follow swiftly. This product shows a lot of the characteristics of products developed since the global financial crisis. It has an 18-month term, much less than the five to seven years that had become commonplace before the financial crisis.

It promises daily liquidity, again in contrast to previous products that might allow you to get out only once a quarter, and even then might sometimes stop you doing so.

It also has a straightforward underlying investment – that is, it's exposed to a handful of blue-chip shares like AMP, Wesfarmers and Rio Tinto, rather than some exotic foreign stock exchange or odd commodity.

What it does have in common with previous products, though, is offering something that at first glance seems too good to be true: "high levels of enhanced income of up to 16.5 per cent per annum, paid monthly, irrespective of the performance of the shares in the investment portfolio, and with conditional capital protection".

In fact, that's the conservative version, called the Income Strategy: another approach, the Growth Strategy, offers "the prospect of preset minimum growth of up to 20.5 per cent plus any upside and conditional capital protection".

How can this be? Behind the scenes, the backers of this deal are selling put options on the stocks. Because markets are very volatile, those put options are quite lucrative for sellers.

But actually, the performance of the puts is not really your concern as an investor, it's just how the bank is making its own money from your investment.

The key things for the investor, ultimately, are that Citigroup itself doesn't go under, and that the conditional capital protection isn't breached. So what does that mean?

What's the "conditional" bit? In most cases, this means that at the end of the term, you get paid at least your investment (in BHP Billiton shares or in cash, or you can be rolled into a similar product).

However, it's subject to something called a barrier level, which is 60 per cent of the initial price.

If the lowest performer within the reference asset (the portfolio of blue chips) falls below that barrier level – in other words, falls 40 per cent or more – then the capital protection no longer applies.

If that happens, then instead of getting your money back, you get the performance of that lowest-priced share. In theory, that could be nothing, although that would require a major blue chip to go under. It's highly unlikely, but then again it was

It is much harder to sell a structured product to financial planners now.
Paul Moran, Paul Moran Financial Planning

Photo Jessica Shapiro

The guarantee in this case is provided by ING Life Limited – a separate statutory fund set up under APRA oversight, specifically to provide the guarantee, with its own capital backing.

More of this is expected. "Income guarantees form the largest part of this market in the US," says George Lytas, head of product development at ING.

Total fees on the product, including investment management, a platform fee and the cost of the guarantee, vary between about 2 per cent and 2.5 per cent, depending on which of three underlying funds is selected.

Does it make any more sense to buy structured products than it previously did? Many planners are unconvinced. "It is much harder to sell a structured product to financial planners now," says Paul Moran of Paul Moran Financial Planning.

"Many planners and advisers have recommended structured products in the past and they haven't lived up to their promise, which has created a lot of tension with clients. Advisers are very sceptical now."

highly unlikely that the market would fall 50 per cent, and it did exactly that less than two years ago.

Correspondingly, some financial planners are queasy about selling these as capital protected at all.

"I like them, but I wouldn't push them as a capital protected offer," says Sulieman Ravell at Funds Focus. "It has a role as part of a broader portfolio and it's an attractive diversifier, but it's completely different to all the other capital protected products around. I wouldn't like to see people putting a big chunk of their portfolio in there."

The product disclosure statement says there may a financial adviser fee of up to 2.2 per cent and an arranger fee of up to 1.65 per cent.

Chris Wright

Inflation or deflation, correct timing is vital

BARRIE DUNSTAN
SMART INVESTOR

At this time of the year many investors are preoccupied with trading news, annual reports and dividend cheques from their companies, so it may only be natural to become wrapped up temporarily in micro matters. But smart investors know the dangers of ignoring big picture items.

Consider the many factors worrying sharemarket investors: our economy's reliance on China, uncertainty about whether the world faces inflation or deflation, and the price surge in commodities, especially gold.

When investors look at these factors individually, there is no consensus view in the investment world.

Some of this reflects sharp divisions – the Asian/emerging part of the world more bullish and watching for inflation, the western/developed economies more bearish and preoccupied with fears of deflation.

Australia is firmly in the first category, which means our concerns are more about the glass brimming over rather than that it is being drained dry. Consider what the Reserve Bank of Australia calls the biggest minerals and energy boom since the 19th century and Treasury's briefing to the incoming government that the economic outlook is positive, if challenging.

But if local smart investors fret a little about whether the China economic miracle can continue, at least they should be comforted by the fact that they are starting from a position of growth, rather than waiting and hoping for a recovery in the drooping economies in the United States and Europe.

Similarly, while many people around the world are worrying about the inflationary effects of rising commodity prices, at least Australia is in the happy position of receiving revenue from the prices boom – with a handy multiplier in the case of rural products from the breaking of the drought.

Of course there have been plenty of people keen to speculate in gold, with market prices rising above $US1300 an ounce. But many people forget that the exciting rise in the gold price to $1300/oz is happening in $US – and the greenback is a currency which is depreciating in value, certainly in terms of harder currencies like the Australian dollar

This means any appreciation in the $A versus the $US automatically reduces the extent of any gain in the gold price for Australian investors when the gain is translated from $US to $A. If gold rises from $US1000 to $1300 an oz and the exchange rate of the $A appreciates from US90¢ to US96¢, this will reduce the percentage gain in the gold price from 30 per cent in US dollar terms to about 22 per cent in Australian dollars.

Morgan Stanley's Gerard Minack warns of 'the great whipsaw'. Photo Tamara Voninski

Almost every investment that succeeds as fears of deflation rise would fall if inflation were the result.

Still people are selling the idea of gold as an ideal investment to cope with the likely risks from both deflation and inflation. And Morgan Stanley strategist Gerard Minack, who has long warned about the dangers of both inflation and deflation, this week told clients that he personally owned gold.

He warned that policymakers in developed markets were clearly worried about the dangers of deflation – and their lack of options in monetary or fiscal policy to cope with the threat.

Big fiscal splurges – Ben Bernanke's so-called "helicopter drops" of money – would trigger inflation concerns.

Almost every investment that succeeds as fears of deflation rise would fall if inflation were the end result, resulting in what Minack calls "the great whipsaw". As with all investment decisions, this means investors need to get their timing right to survive. He says that the spread between the 10-year and 30-year bond yields in the US suggest there are rising fears about inflation – though in the long term.

Another big-picture factor in sharemarkets is the equity risk premium [ERP] – a theoretical measure of the returns share investors get above the risk-free benchmark of a government bond. Over the long term, this figure moves around dramatically but the "normal" ERP is thought to be about 4 per cent.

Canadian pension fund and investment guru Keith Ambachtsheer, who studies long-term investment patterns, has identified seven distinct investment eras since the early 1900s. They have produced alternating periods of pessimism and optimism, lasting between 10 and 20 years, marked by mostly negative readings for the premium shares earn about bonds – that is, a negative equity risk premium.

Typically, in a "down", pessimistic period, US dividend yields rise by between 50 and 100 per cent, while in the optimistic or "up" periods, dividend yields would at least halve. In the 20-year boom from 1980, yields in the US fell from 6 per cent to only 1 per cent. In the same period, the ERP worked out at about plus 9 per cent.

This two-decade period of optimism ended with the popping of the dot.com boom in 2000. Ten years later – in what Ambachtsheer calls the "double-bubble blues" – the equity risk premium to date has turned into a nasty minus 6 per cent while dividend yields have doubled from 1 to 2 per cent.

But that's merely history. The key is what the future ERP is likely to be. Ambachtsheer gamely estimates an earnings yield of 6 per cent which, after 2 per cent implied inflation, suggests an ERP of around the average 4 per cent – what he calls "a rare point of equilibrium between expectations and requirements" of long-term investors like pension funds.

Now, before investors celebrate that modest likely future return from shares, Ambachtsheer warns that there are a few caveats on his numbers – that earnings are, indeed, "normal"; that companies keep returning about two-thirds of earnings to shareholders; that real GDP growth averages 2 per cent (in line with corporate earnings) and that investors keep a rational balance between optimism and pessimism in future.

His long-term, theoretical numbers do, however, provide some relief to the largely negative overall returns from equities in recent years. But a return of 6.5 per cent from a portfolio split 60/40 between shares and bonds, reduced to a "real" return of 4 per cent after a 2 per cent inflation rate, is hardly reason to break out the bubbly.

What it does is re-emphasise how vital it is for smart investors to make sure they get their decisions on big items like inflation or deflation correct – especially if they want to amass enough savings in the long term to fund their retirement.