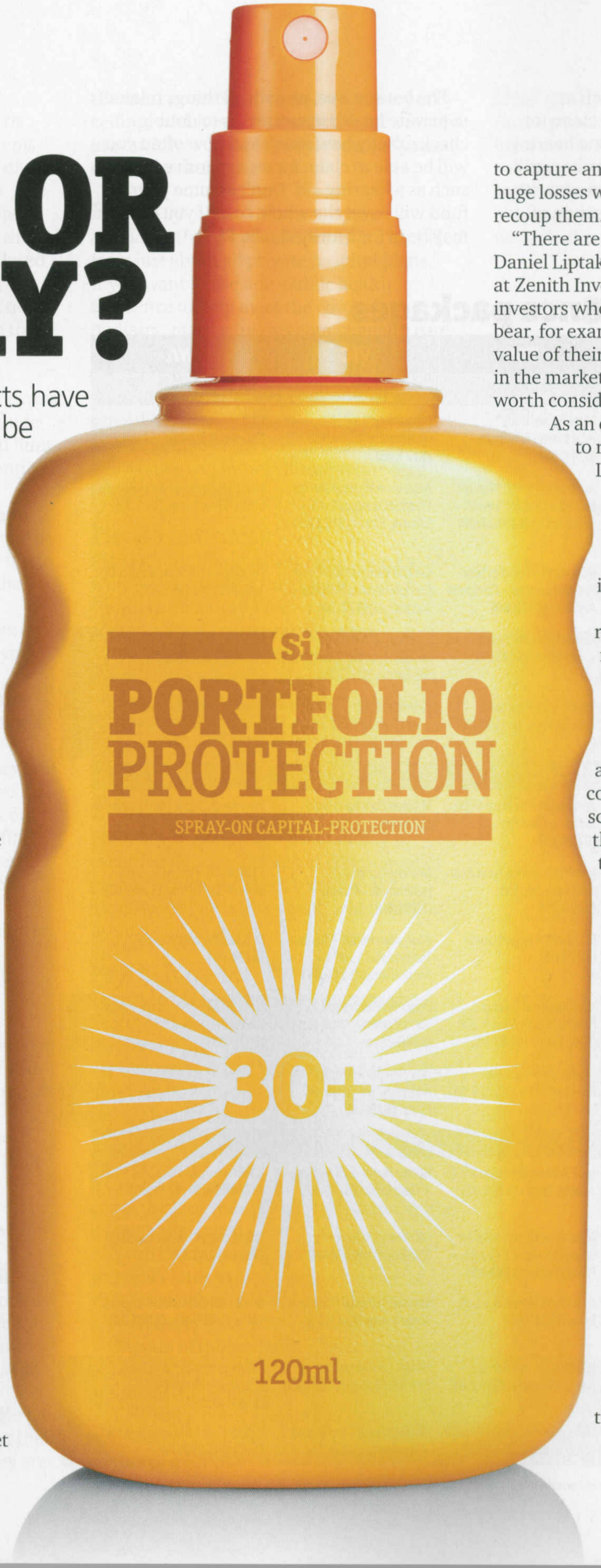
SAFE OR SORRY?

Capital-protected products have their time and place, but be aware that they come with their own risks and at a price, writes Debra Cleveland.



Fancy investing in local or international stocks with no risk of losing your money? Or being able to increase your exposure thanks to a loan from which you can walk away if the value of your asset falls? If the answer is yes, get your specs out because you'll need to wade through a lot of small print.

A plethora of offerings promise the world in terms of capital guarantees, locked-in gains or 100 per cent loans to buy shares on which you receive full dividends.

Investors caught in "cash-locked" instruments over the past few years will already know there's no such thing as a free lunch. But a host of new structured vehicles and variations on the theme are springing up, trying to woo people back into the market. You'll also have noticed a host of prepaid instalment products fighting for your attention before the end of the tax year.

As with anything, there's a time and a place for these products. For some buyers, a capital-guaranteed vehicle offers a way to invest knowing they won't lose the original sum they put in.

For others, with shorter time horizons, it means being in the market to capture any gains without having to face huge losses with limited years in which to recoup them.

"There are extra transaction costs," says Daniel Liptak, head of alternative research at Zenith Investment Partners. "But for investors who don't know whether they can bear, for example, a 50 per cent drop in the value of their investment or an extra 20 years in the market to make a recovery, they're worth considering."

As an example of how long it can take to recoup sharemarket losses, Liptak says the All Ordinaries Index is likely to take until 2014 to recover to pre-2007 levels. If there are further market corrections (even small ones), it could be 2020 or even later.

"If you've got 10 years before retirement [and limited time to recoup losses], it's worth considering these types of products," he says.

But there are plenty of naysayers, too. For a start, they argue, there's the opportunity cost. If, in the worst-case scenario, you're left at the end of the investment (typically in five to seven years) with just your original capital, you've not kept up with inflation and you've fallen behind what your cash could have done instead – such as earning interest in an account.

Financial adviser Paul Moran isn't a fan. The principal of Paul Moran Financial Planning says the biggest danger – especially if you're borrowing to go into these products – is the cost exceeding the expected return.

"Then there's no point in doing it," Moran says. "For example, if it's costing you 12 per cent [in interest] then you really need to get 15 per cent [assuming inflation of 3 per cent] just to break even in real terms."

The other problem, which he says is often overlooked, is third-party risk.

"If the product is using

options or a swap-type derivative, you're relying on counterparties to come up with the money. If it was a Lehman Brothers or AIG, you couldn't be sure they'd get the money when you needed it."

He believes older style bond-and-call products are safer because they use government bonds.

Since risk is inherent in investing in the sharemarket, manipulation comes at a cost. Moran says a better way to lower your exposure to risk is to place a portion of your funds in safer assets, such as government bonds.

To help guide you through the maze of choices, we've divided capital-protected products into four categories. These aren't strict divisions because some of these instruments would fit into more than one category, but the groupings do allow a simple overview.

You need to understand the underlying investment and you need to look at the bells and whistles and what you're paying for them.

The bottom line, suggests Westpac Institutional Bank's head of structured equity investments, Cathy Kovacs, is that you need to know the issuer of the product you are purchasing and be aware of what counterparty risk you're taking on; you need to understand the underlying investment and you need to look at the bells and whistles and what you're paying for them. "If we look at past experience, people came unstuck through the global financial crisis because they didn't know what they'd bought," she says.

And that's not surprising, says the head of ratings for income and alternative products at research house Lonsec, Michael Elsworth. "In this space, there's so much marketing spin, and product information is written in a way that confuses people." ▶

▸ CASE STUDY

JUST A LITTLE PROTECTION

CONSTRUCTION CONTRACT manager David Peda, 32, initially invested in capital-protected products thinking they were safe investments but now says he wouldn't rush back into them.

"To get only your original money back after seven years [in the worst-case scenario] is a pretty poor result," he says.

Luckily, the bond-and-call products David has with Man OM-IP are ahead, but he hasn't been as fortunate with a few other investments, which have become cash-locked. He borrowed to get into them and is paying interest of about 7 per cent.

The capital-protected products are only a relatively small proportion (25 per cent) of his portfolio. The rest is in managed funds and direct shares.

To save on fees, David bought into his managed funds and protected products through discount broker www.fundsfocus.com.au, which rebates most of the entry and trailing commissions.

He's saved about $5000 in entry fees.

David is becoming more interested in property but says if he did want to increase his exposure to the sharemarket, he'd be more likely to buy blue-chip shares.

Bond-and-call structure

The deal: Worst case – if markets plunge, say – you'll still get your money back at the end of the investment term, which is usually between five and nine years. If markets rise, you'll benefit from the increase.
Product options: Man OM-IP Global, HSBC 100+ Series Asian Equity (Growth) Investment, HSBC 100+ Series Asian Equity (Income) Investment, Westpac Maximiser CBA Capital Series. These are "closed-end" products; new investors have to wait for the next "tranche" if they miss the deadline. Some banks offer loans over them.
How it works: Part of the investment (up to about 70 per cent) is put into a zero-coupon bond (with National Australia Bank in the case of Man OM-IP) that will develop to produce your original investment amount at the end of the term. The rest is used to give you exposure to a growth asset. "You still get your money back but you get the money plus growth," Westpac's Kovacs says. "It's a really good one to get people out of term deposits because their money's secured, plus they get growth. Otherwise, their money may be secure in a term deposit and they're draining income but they're getting no capital growth. It's a good way to dip your toe in the water and still be protected."
Minimum investment: From $5000 (for Man OM-IP Global); $20,000 for the HSBC 100+ Series, with increments of $1000 thereafter.
Whom it may suit: Lonsec rates the Man OM-IP product as "highly recommended" and says it suits those looking for exposure to international absolute return/hedge fund strategies and people seeking medium- to long-term capital growth who don't need income distributions. The HSBC 100+ Series is rated "recommended" by Lonsec and given it has a growth/income choice, would suit those looking for income but who are not reliant on capital growth, or vice versa.
Fees: On the HSBC products, Lonsec lists a flat adviser fee of 3 per cent. There are no ongoing charges; instead, HSBC says it aims to profit from the difference between the amount it receives from the assets and the total that is payable to investors.

The Man OM-IP instrument lists a raft of fees, including establishment costs of 1.5 per cent, management charges of 2 per cent, outperformance payments of 0.75 per cent to 20 per cent and a guarantee fee of 0.25 per cent. However, Lonsec does note that although the charges are at the high end, they've been worth it while the product has performed well. If performance fell, the added costs would have a greater impact.

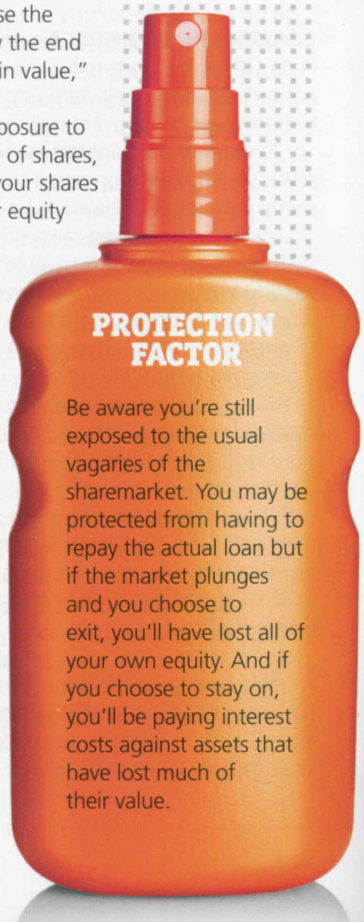
Protected loan over shares

The deal: You borrow to buy shares and the loan is then protected via a put option (which covers the value of a share or your portfolio against falls by locking in a sell price). If the value of the underlying shares plunges and you want out, you can walk away from the loan. You get full franking credits and dividends whether your portfolio is partly or fully geared.
Product options: Westpac Self-funding Instalments; CBA Protected Loan; Citi Instalments; Westpac Protected Equity Loan.
How it works: Explaining a 100 per cent loan, Westpac's Kovacs says the amount borrowed is protected with a put option, and the investor pays interest plus option costs. These costs depend on the riskiness of the underlying asset, as well as how long the protection is in place. Expenses (interest plus put costs) are tax deductible up to the capital-protected borrowing rate – now 8.8 per cent [the home loan indicator rate plus 1 percentage point]. Lonsec's Elsworth says it's worth including instalment products in this category.

"You can choose your level of gearing, with a more conservative style being about 50 per cent, where it's essentially a loan over stocks," he says. "You can select from a menu of shares, usually the top 50. It's very much like a margin loan, without facing the prospect of a margin call [if markets fall].

"The idea behind self-funded instalments is they're very much 'set and forget' because the dividends cover interest payments and by the end of it hopefully the shares have increased in value," Elsworth says.

What you're protected from here is exposure to the loan. Say you bought $10,000 worth of shares, having borrowed $5000. If the value of your shares fell to $2000, you'd have wiped out your equity but would not be on the hook for the $5000 loan, Elsworth says.
Minimum investment: $2000 for cash applications on Westpac Self-funding Instalments; $25,000 for a CBA Protected Loan; $2000 per instalment series on Citi Instalments.
Whom it may suit: Those able to make the interest payments without relying on income from these shares, self-managed superannuation funds wanting to gear and those seeking greater leverage to the sharemarket without having to face a margin call.
Fees: They vary by product but there can be adviser fees of 2 per cent, trailing fees of 1 per cent a year and establishment fees of 1.1 per cent. The protection cost depends on your level of borrowing and the volatility of the shares you intend to buy.



Protected loan over funds

The deal: You borrow to invest in managed funds and your capital is protected via something called continuous portfolio protection insurance, or "threshold management".

If the value of the funds falls by a pre-designated amount, funds are sold and the proceeds put into bonds to ensure the capital is returned at maturity, Westpac's Kovacs says.

Product options: Macquarie Fusion Funds, Perpetual Protected Investments, HFA Octane Series.

How it works: You borrow 100 per cent and choose the underlying investments from the funds on offer.

"If those funds start to go backwards," Kovacs explains, "the issuer is watching them and if they fall by a certain per cent then they start selling out of the fund and putting the money in cash so they can give you your initial money back.

"There are pros and cons, like selling into a falling market with a stop-loss mechanism. But if you're sitting in cash that's not being reinvested, you've still got to pay interest."

What this meant for thousands of safety-conscious investors during the 2007-08 sharemarket crash who had purchased these instruments was that their total investment was converted to cash as the market fell and fell and fell. So they're now "cash-locked": they can't get their money out until the products reach maturity. Often the required term is seven years.

"There has been a trend away from these because – particularly in 2008 – a lot of them became cash-locked," Lonsec's Elsworth says.

"It's important to say that they did do what they said they would do. But for investors, it meant that instead of their money being invested in the fund it was invested in cash with very little prospect of being invested in anything else."

So not only are these people now paying interest of about 9 per cent on funds that are earning only about 6 per cent, they've also missed out on any of the sharemarket's subsequent increases in value.

Minimum investment: $50,000 for the Macquarie Fusion Fund.

Whom it may suit: People wanting to borrow into managed funds without taking out a margin loan, although the bad experience of cash-locked investors has put off potential new entrants.

Fees: Management fees at a rate of 1.025 per cent, plus protection charges of 1 per cent a year.

Swap-based structures

The deal: You take out a loan for 100 per cent of the investment amount, with various pay-offs depending on the investment alternative that you choose. Wealth Focus' Ravell likens these swap-based products to bond-and-call structures, in that what they deliver is very similar – although in this case, collateralised swap obligations are used instead of bonds.

"The capital protection is provided by the limited-recourse loan, which allows investors to walk away without making further payments [if markets fall dramatically]," Lonsec's Elsworth says.

"If the underlying investment markets increased steadily, then investors would likely keep paying the interest payments, in order to capture the upside of these markets."

Product options: Macquarie Flexi 100 Trust.

How it works: You have the opportunity, on a quarterly basis, to walk away from the loan if the assets decline in value and you want out. Until recently, returns were capped, but in May, Macquarie announced it was no longer imposing caps on the Australian and US equity funds. Interest on the loan is largely tax-deductible.

Minimum investment: $25,000.

Whom it may suit: Consumers seeking medium-term leveraged exposure to Australian equities, US equities, Asian equities, emerging-market equities and/or commodity markets, Lonsec's Elsworth says. Also, those who seek fixed distributions over certain investment terms.

Fees: 2.2 per cent adviser fee, 2 per cent loan establishment charge, annual management expense of 0.5125 per cent.