

## MANAGED INVESTMENTS

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### COORDINATOR'S MESSAGE

**By Scott McKenzie**

I'll never forget the Saturday morning when reading the Australian Financial Review I came across a large advertisement for the OM-IP funds (Man Investments) in which a return of 20% pa was indicated as likely but capital was guaranteed i.e. no capital loss, only upside possible. (The adverts are still about but the 20% is no longer featured to such an extent.) How could there be capital guarantee I wondered – and with such a high return. I got on to the then current President of AIA (Ray Bricknell) but heard no more.

Years later I found out how they do it. They use some of your money to purchase a bond that at the end of the guarantee period is worth the capital amount, and with the rest (say 30%), invest in highly speculative managed futures which have the capacity for huge returns.

These funds have been incredibly successful in Australia (for the limited risk involved).

Since then more products have evolved using different ways of providing capital protection.

In this edition of the Managed Investments bulletin Tony Rumble explains how the different mechanisms work to provide this capital protection. Well worth a look with the possibility of large share-market falls around us for the next few years.

*Scott McKenzie is a financial planner and Vice President of the AIA.*

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# CAPITAL PROTECTION – THE BIGGEST GAME IN TOWN

By Tony Rumble

## *Who needs capital protection?*

The biggest debate in financial services is whether or not capital protection is justified, or needed. The “justification” point relates to what the asset consultants (ie those that guide portfolio construction by wholesale fund managers) think is the best way to manage risk. The “need” point relates to what end investors think is important to their own portfolio. The debate plays out like this: most traditional asset consultants still think that a diversified portfolio held for a long enough period of time will provide its own set of checks and balances, giving the “optimal” mix of risk and return.

Asset consultants tell us that such a portfolio will experience a negative return only “once in a rolling seven year period”. (Thoughtful investors are quick to point out that the real world isn’t one of “rolling” investment returns)! On the other hand, research conducted for AMP Capital prior to the GFC indicated that capital protection was in the top 3 items sought by SMSF trustees; post the GFC the data is that over 60% of financial planners rated capital protection as the top item sought by their clients. Massive inflows to expensive capital protected products like AXA North (which now has over \$700m under its protection) tell us that investors are prepared to pay for protection. Let’s look at how capital protection is provided, what are its costs, and risks.

## *How does capital protection work?*

Since the Australian share market has now experienced two events of -50% performance in a decade, it’s not only investors that worry about capital protection. Protection costs have risen since the GFC, as product issuers’ costs of hedging rise. There are only 4 ways to provide capital protection:

1. “put” options – these are like insurance contracts, they allow investors to sell their assets at a preset price (eg the option “exercise” or “strike” price) within a predetermined time. Put options over single stocks may cost around 10% of the asset price per annum (less for assets that are diversified, like managed funds). Put options are expensive but they provide absolute certainty of outcome – barring default by the put seller (use an exchange traded put if you are worried about default risk), the put option will always pay you the set return if it is exercised;
2. “bond + call option” products – these have been around for a while. The hugely successful OM-IP products (now issued by MAN Investments) use bond + call option technology. Issuers of these products take a large portion of the client’s upfront investment and place it on deposit in a “zero coupon bond” or “ZCB.” A ZCB is like a normal bond but instead of paying interest, the interest is capitalized ie added to the capital value of the bond. By buying a ZCB for (say) \$70, the issuer knows that the ZCB will at some future point be worth \$100, because of the daily accruing interest which is being capitalized within the bond. The remaining (say) \$30 is then used to buy a call option which gives exposure to the underlying risky asset that the protected product is linked to. In the case of OM-IP the risky asset is a fund of hedge funds. These types of products are available over a wide range of asset classes, including ASX 200, international indices, commodities, hedge funds etc. We’ll come back to analysis of these products below;
3. “CPPI” or “Constant Proportion Portfolio Insurance” – these products were developed to overcome the main problem of “bond + call” products, which don’t work when interest rates are so low that the bond component eats up most of the up-front investment funds. (In low interest rate environments the upfront cost of the ZCB may be up to \$85 or more – leaving insufficient funds to buy any meaningful call option exposure). CPPI works like this:
  - a. Recognising that the risky asset may rise in value after the product is launched, instead of placing money into a ZCB on day one, the product issuer constantly

- monitors the price of the risky asset, allowing 100% of the overall investment funds to be allocated to the risky asset from day one;
- b. If the risky asset stays above its starting price, the CPPI product maintains 100% exposure to it, but if the asset starts to fall in price, the CPPI product may start to reduce its exposure to that asset;
  - c. This process references the prices of ZCB's on a daily basis, noticing that at any point during the life of the investment product, a ZCB can be purchased which will deliver 100% of the initial investment cost at the maturity date of the product;
  - d. The reference price of the ZCB is termed the "ZCB floor" and, as time goes by during the life of an investment, the "ZCB floor" rises. This is because the ZCB relies on accruing and capitalizing interest in order to provide \$100 at its maturity: as time passes, and the time to maturity falls, more and more is needed upfront to purchase the ZCB;
  - e. CPPI is infallible in providing capital protection, but if asset prices fall rapidly, the CPPI product will quickly sell out of the risky asset and place its funds into the ZCB. If all exposure to the risky asset is sold down and all funds are moved into the ZCB, the product enters into "cashlock" ie it no longer provides exposure to the risky asset.
4. "Stop loss" protection mechanisms are starting to flourish, especially in ASX listed instalment style products. These products provide a guarantee of capital and rely on selling down assets in a falling market, in order to provide cash to meet the guarantee. As you can imagine, stop loss style products normally guarantee somewhat less than 100% of the asset price (as a guarantee at 100% would mean any small market movements would trigger a massive sell down). Look for protection levels around 50% for stop loss style products.

### ***Rating capital protected products***

Unfortunately it is hard to rate or understand capital protected products. This sad state actually applies to most investment products – the problem is that typical research houses use a scorecard where 80% of a product rating relates to "people, systems and processes" rather than the hard merits of the investment itself. This means that inferior or risky products issued by fund managers that have been around for a while and have good systems, will end up with a high rating – think back to the high ratings that Basis Capital received, or to the "award winning" status that pedestrian managed funds like Colonial First State receive. You can access some broad information about capital protected products from the educational site [www.LPAOnline.com.au](http://www.LPAOnline.com.au), or you can read my weekly product reviews on the Eureka Report [www.eurekareport.com.au](http://www.eurekareport.com.au).

Here are some brief snapshots of typical capital protected products:

#### ***AXA North***

AXA North offers some attractive investment features. It does not use the "CPPI" protection method and so it remains fully exposed to the underlying investments for its full term – this means that as markets rise after falling, the investment returns can recover also (in CPPI products this often isn't possible, as they enter into "cashlock" after severe market downturns). AXA North can be invested in without the capital guarantee (in which case it is just an expensive administration platform) or the "Protected Investment Guarantee" (with a 5 or 7 year term) or the "Protected Growth Guarantee" (with a 10, 15 or 20 year term) can be selected. The "Protected Growth Guarantee" facility offers annual profit lock in, ie each year there is a gain above the invested amount, that gain will be locked in (even if the asset falls in value subsequently). See <http://axaaguarantee.com.au/>.

There is a choice of 40 different managed funds within the AXA North protected facilities. Many of these funds are "mainstream" and suffer from the travails of traditional active management. Investors need to keep a spread of funds across different asset classes and there is some flexibility to re balance or change allocations.

The capital guarantee does not cover the upfront or ongoing fees paid to financial advisers. And it's the potential for massive fees and charges across the entire AXA North product that will, in practice, make the facility unattractive for well informed investors:

- Contribution Fees of up to 4% can be charged and these are paid to the investor's financial planner;
- Annual administration fees are between 0.5% pa to 1.46% pa (including trail fees paid to financial planners);
- Managed fund management fees are between 0.22% pa to 2.74% pa depending on which funds are selected;
- Depending on which managed funds are selected, the AXA North Guarantee Fee is between 0.9% pa to 2.95% pa;
- Annual Adviser Fees of up to 2% pa can be charged.

Instead of succumbing to annual fees of up to 9.15% pa and hefty upfronts, investors could instead deposit the same amount into a cash account over the same time frame, with the balance invested in either the same managed funds or even better performing direct equities, giving themselves the prospect of significant outperformance with capital preservation even in volatile markets. No wonder AXA North was placed on review by Standard and Poor's earlier this year – which makes one wonder how it's possible for some of the other industry research houses to have given AXA North high ratings and "product of the year" awards.

### ***Macquarie Equity Lever***

Like the newer forms of ASX listed Instalments, Macquarie's Equity Lever provides leverage suitable for use by SMSF's, up to 50% LVR, with relatively low cost interest rates (currently 8.65% pa). The technology used involves the "limited recourse" loan that the SIS Act allows for, meaning that investors can choose whether to repay the loan or to walk away instead. Payment of the loan happens by way of the investor making payment of a "final instalment." If the investor walks away, Macquarie only has recourse to the specific assets that have been purchased with the Equity Lever facility. The investor's other assets aren't able to be accessed by the lender – and that is one of the significant and real benefits that the Macquarie product provides (in the same way as ASX listed Instalments). <http://personal.macquarie.com.au/lending/smsf/equity-lever.htm> .

Like the newer ASX listed Instalments, Equity Lever does not contain expensive, embedded "put" option protection. Instead, the issuer protects itself from the risk that they will be left holding potentially worthless securities by involving an "Instalment Acceleration Event" mechanism. Initial LVR's are set at around 50% and there is a maximum LVR of 65%. Equity Lever is available over a wide range of blue chip ASX shares. If share prices fall such that the **overall** facility LVR reaches 65%, this triggers an "Instalment Acceleration Event", which effectively acts like a margin call. So like the newer ASX listed instalments which include this feature, investors need to be aware that in falling markets they can be required to make cash payments to reduce the gearing levels below the maximum permitted. This is obviously a real risk in falling markets – as many margin loan investors experienced last year. Prudent gearing levels are a good weapon against this event occurring, as well as ensuring that suitable cash levels are maintained to cover the risk of an "Instalment Acceleration Event".

But unlike the newer ASX listed Instalments, the Macquarie Equity Lever works on a "whole of secured portfolio" approach. That is, if an investor doesn't pay in the event of an "Instalment Acceleration Event", Macquarie can choose which shares it will sell down to cover this quasi margin call. In practice this means that "good" shares may be forced into sale, to cover losses on weaker stocks. This is very similar to the problems experienced last year when margin lenders (and worst still, stock lending based loan providers) sold down quality stocks to cover losses on the rest of the client portfolio. Whilst it's clear the Macquarie Equity Lever product does not involve stock lending – and that the risk in the event of an "Instalment Acceleration Event" is very similar to that involved in normal margin lending – the Macquarie product does not provide the same level of risk minimization that single stock, ASX listed instalments provide.

Equity Lever has some great features, including good interest rates and automatic repatriation of dividends to reduce the size of the loan within the investment, but in a rapidly falling market it exposes investors to risks that can be avoided by using some of the newer forms of ASX listed Instalments.

### **CBA Capital Plus**

It's sad but true that much of the distress caused by buying shares using home equity or margin lending (a la Storm Financial) could easily have been avoided by using protected investments or protected loans. With memories of the GFC still very fresh, the majority of Australians are still sidelined from the sharemarket, and with little cash to spare, even the brave are often unable to find the funds to buy shares.

Enter CBA's innovative Capital Series investments, which has a new "Compass" series open for investment until mid June this year (<http://www.commbank.com.au/corporate/financial-markets/structured-investments/capital-series/default.aspx>). Compass is perhaps the cleanest and simplest capital protected investment currently available to Australian investors, and it comes with gearing facilities which offer attractive interest rates. CBA frequently issues new series of these products, with a variety of different underlying assets. Compass Strategy 1 provides a 5.5 year exposure to the ASX 200 with 100% capital protection, up to 100% investment finance, and potential for up to 3% coupons paid annually after 18 months. Strategy 2 provides 5.5 year exposure to a blend of the ASX 200 as well as the Hang Seng Index, with 80% capital protection, no coupon potential and up to 80% investment finance.

CBA Compass is for cash poor investors looking to get into the market, with the security of capital protection for the wary. But how well will it perform these tasks? Like with any investment, the devil is in the detail – and as anyone who has watched the failures of many forms of structured investment over the last 18 months will be aware, there is a lot of detail to contend with in these products.

Compass uses very simple risk management technology, with investors issued a "deferred purchase agreement" which is a security for Corporations Law purposes. Retail investors and SMSF's can buy DPA's. Under this DPA, the final value of Compass is delivered in the form of SPYDRS (ie ASX Index Funds), which investors can elect to sell and receive cash if they wish (why CBA charges brokerage of 0.55% on this sale is puzzling – that sale can be effected by CBA at wholesale rates of 0% and many DPA issuers now waive brokerage on the share sale facility). This DPA is risk managed by CBA which buys "zero coupon bonds" which will mature at the capital protected value, and invests the remainder of the product's proceeds in call options over the underlying assets (in this case, the ASX 200 and/or the Hang Seng Index).

This technology completely avoids the problems of "cashlock" which plague capital protected products using "CPPI" technology – so the investor's returns over the life of the product will cleanly track the performance of the indices. Because of the relative expense of these options, the capital growth in Strategy 1 (ASX 200) is capped at 170% and so investors may wish to exit early if this level is reached. Some break costs will be incurred. Overall, fees and CBA profit margin are reasonable.

The tax opinion in the PDS is clear but limited in key areas such as deductibility of interest for geared investors. ASIC should insist that tax opinions can't hide behind the usual statements that "investor's should take their own advice." It's not likely that investors can get full deductions for their interest costs on either Strategy 1 or 2, and they will not be able to claim deductions upfront either. CGT is payable at the maturity of Compass, which means typical investors will be forced to sell some of their proceeds to cover their tax bill.

### **Conclusion**

Traditional investment management assumes that markets behave with stability and predictability over the long term. There are lots of reasons to assume this is true but the creeping reality is that the massively integrated global markets, fuelled by massive amounts of money with sophisticated trading systems, is still a victim of the greed and fear embedded in the human psyche. Bubbles inevitably form and with rising geo political instability compounding uncertainty, it's inevitable that



markets will continue to be volatile. At the bottom of the GFC, the prices of all assets were 100% correlated – making a mockery of the idea (central to modern portfolio theory) that diversification is the primary source of protection against risk. Capital protection is rapidly becoming the biggest game in town – and rightly so. Just be careful in how you choose the protected product that is suitable for you.

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