MEDIA MONITORS

Financial Standard
Monday 20/7/2009
Page: 16
Section: General News
Region: National Circulation: 10,257
Type: Magazines Business
Size: 2,524.76 sq.cms.
Frequency: Fortnightly

Capital protection products may be an easy choice for investors preparing for bad markets, but where do they fit in a portfolio over the long term? MICHAEL HOBBS investigates.

Protecting your retirement

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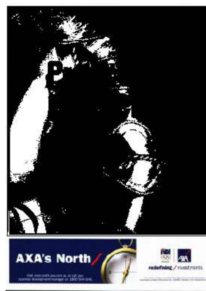

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In September last year, Bob Kolevski, a financial planner, met a prospective client, a man in his 50s, who was looking to invest half a million dollars. The man lost a lot of money because of the market correction and didn't want a repeat of that happening to his retirement savings.

Kolevski recommended a capital protection product. He advised that the client keep around $40,000 in cash for income and deposited roughly $466,000 into a capital protected fund. At the time, the S&P/ASX 200 index sat at around 4,500.

Today, that client's investment kept its value but had the financial planner recommended a pure index fund, his client would have lost $37,000.

"When he sits back and looks at the reports and the red line, which is the market, and the higher green line, which is his holding, he's very happy," said Kolevski, a partner at Barnes Dowell James.

"The client knows it may not be the absolute cheapest super fund, but he won't be the slightest bit worried. But he said it was chicken feed compared to what he lost in the last six months and in previous years."

This is not an isolated case. To provide some insight into how capital protection products have become mainstream, AXA North, one of the most popular capital protection products of its kind, has more than trebled its inflows from over $230 million in December 2008 to $750 million today.

Similarly, ING Australia's recently launched capital protection products had received "very very strong" interest from financial advisers, said Mark Pankhurst, the group's head of products and marketing, wealth management.

Suzanne Salter, head of structured products at Commonwealth Bank of Australia, said the last tranche of the bank's capital protection strategy gained $30 million in inflows and said she would be disappointed if the next round didn't top at least $25 million.

"It's like the airbag or the seatbelt in your car. You've got capital protection, so you've got a seat belt and an airbag and you hope that you never have to use it," said Duncan Schultz, director of financial planning firm, Focus Financial Wealth.

"But guess what? We had to use it because the global economy had a massive smash, and guess what? They all worked perfectly."

But some industry experts are already talking about the local economy climbing to recovery. The S&P/ASX 200 has now risen 1,000 points since its February low.

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At the same time, investors won't have forgotten the correction, which saw super and personal invested savings fall in value on an almost daily basis and by as much as 25 per cent last year.

With an Investment Trends report estimating $58 billion of cash sitting on the sidelines in investor pockets, capital protection products are being vaunted as the perfect way to re-enter the market.

The question is, where does a capital protection strategy fit over the long term and as the markets come out of the downturn?

Shopping for a shield

Capital protection products aim to do just that – protect your capital. The trick is how different providers do it. Salter said there are three ways to provide capital protection to investors: going long on a stock and having a put option, having a bond and an option or using a CPPI structure.

Each of these structures tries to package a risky asset with a non-risky asset t manage the risk and each product has it own tax structure.

The products that are available, includ ing the ING Protected Growth 2 and Pro tected AUS50, AXA North, the Common wealth Bank of Australia Capital Serie Compass and more recently, Linear Asse Management's Continuously Protecte Separately Managed Account (SMA) al use versions of this process.

The ING Protected Growth Fund 2 pro vides 85 per cent protection on the fun amount while the Protected AUS50 provide 80 per cent protection of the highest redemp tion unit price. Both funds have no lock-i periods and the protection rises as the mar ket rises, locking in at the high points.

The AXA North product has an invest ment guarantee option allowing investor protection against market downturns fo five to seven years. The fund uses "dynami hedging", a strategy that is slightly differ ent to the one used in an average capita protection product.

Advisers are willing to make trade-offs between the level of protection and the cost of protection – not every product needs 100 per cent guarantee.

Andrew Barnett, head of superannuation and retirement incomes at AXA Australia, said dynamic hedging comes from a tried and tested method used in the UK. It involves using the client's payment for protection, called the premium, to invest in assets that are negatively correlated to the invested funds. Shorting futures, interest rates swaps, currency forwards and property swaps are all used to hedge the firm's position.

The Commonwealth Bank of Australia's latest tranche provides access to two strategies that invest in Australian and Hong Kong markets and does include lock-in periods where investors cannot access their money for five and a half years.

The first strategy provides an index exposure to the ASX 200 and protects all investor capital until maturity with 70 per cent potential for capital growth over that term. The second strategy gives investors capital protection at 80 per cent and returns from the ASX 200 and the Hong Kong market.

Meanwhile, SMA provider Linear Asset Management allows investors to invest in Australian equities with capital protection on 80 per cent of the highest value of the portfolio. The protection uses a dynamic rebalancing and swap contract technique.

This is a major development because it means Linear is protecting investors against individually tailored bets in direct equities, whereas most capital protection products provide protection against their own investment strategies.

Protection in practice

J.P. Morgan's capital protection whitepaper said the products would suit investors, including retirees or those nearing retirement, who are seeking growth assets but are wary of the prospect of losing their capital.

"It's really around the wealth insurance side of it. Clients who are over 50 years old, pre-retirees and retirees, so individuals who've worked to establish a fairly good retirement savings and want to protect that," said Barnett.

The report also noted that the products could also be used by wealth accumulators – investors aged between 18 and 35 years of age that may have low balances – to gear into the share market without having to face margin calls – a strategy that Rick Di Christoforo, managing director at Matrix Planning Solution, endorsed.

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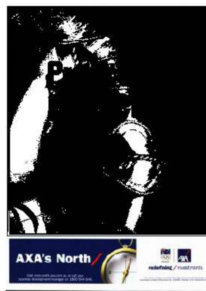

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"I think if you're an aggressive investor who is 39 years of age and has a long term outlook, I think zero is the amount of capital protection you need. I actually buy capital protection only when I want to access high levels of gearing," he said.

But Geoff Watkins, managing director at Path Independent, disagrees. He said investors should be wary of gearing and only allocate existing capital to these types of products.

"A lot of people are using the protection to get gearing without having to pay margin calls, but I think it makes more sense for people sitting in cash. The same people that want that comfort. It gives them some downside protection as long as they pick the right products," he said.

Financial planners also need to be aware that some products do not pay dividends.

"If it's being sold as an alternative to cash and you're not used to getting dividends it could be ok, but for a client that's used to having an active portfolio, it's kind of hard to get them out of shares and into some capital protection products because they lose the dividends," said Salter.

"It's may be a substitution for a secure asset and not a share portfolio and clients need to see it that way, but again, it depends on how it is structured."

In the end, Kolevski said for any client looking to deposit a significant amount of money on the market, capital protection is the right choice, regardless of age. However, what proportion of the sum is invested in a capital protection product depends on how much income or access the client needs.

"There's no hard and fast rule. It depends on what other investments the fund has and the level of income being generated by the other investments," he said.

But for Kolevski's client who walked into his office that day, there is one rule all advisers should live by: protect investor capital.

Back to the blacksmith

The rise of capital protection products in Australia can be traced back to how one of the country's largest banks, the Commonwealth Bank of Australia, first used it to access shares globally.

Seven years ago, the bank gave investors that extra assurance when investing in overseas markets by providing a "capital protection" over their global shares portfolio.

Over time, the products have become simpler.

"Now it's just straight growth, taking it from point A to point B. We've seen an increase in demand from the Australian market, local equities are now preferred over international equities whereas in the past, it was a lot more around the overseas markets," said Salter.

"Anything that's exotic has dropped off in terms of appetite. People are waiting for the dust to settle."

While plain vanilla type products appear to be popular, this hasn't stopped the bank from flagging the idea of creating products that provide access to hard commodities like gold and oil.

> **I think 10 years ago, fees may have been too high but there's been so much competition and innovation that the cost of these products is lower than it was.**

Getting access to assets outside equities could just be the tip of the iceberg. Barnett predicts more products will come to the market providing greater flexibility as Australians become comfortable with the concept of capital protection.

"If you look at these products over in the US, they evolved fairly rapidly. We've been on a bit of a learning curve over the past year, understanding where advisers like to use the product and there's certainly ways we could work the guarantee," he said.

Kolevski for one is hoping for additional gearing options to come out. "What is yet to be exploited is gearing which is a major opportunity – especially for accumulators," he said.

However, innovation can only go so far. Capital protection cannot be adopted to all asset classes because the protection strategies rely on listed, liquid markets in order to hedge positions and trade in and out of risky assets when markets rise and fall.

This means unlisted asset classes such as direct property, infrastructure and other illiquid assets cannot, for the most part, be capital protected.

But Mark Johnston, principal at Investment Trends, said regardless of what's already available, financial planners are still calling out for a broader range to choose from.

Their recent survey found 18 per cent wanted more capital protection products in listed property, 16 per cent sought more products for Australian equities and 13 per cent wanted protected access to international equities.

Johnston predicts that capital protection products will retain the term conditions like seven and 10 year stretches, but new products could allow shorter time frames, for example, five years.

He also said products would start to come to market that don't provide 100 per cent capital guarantee but are cheaper.

"Advisers are willing to make trade-offs between the level of protection and the cost of protection – not every product needs 100 per cent guarantee. Instead they're starting to look at 80 per cent guarantee at a lower cost," he said.

But according to David Jones-Prichard, vice president of equity derivatives and structured products at J.P. Morgan Chase Bank, said capital protection fees might not get much lower than they are now.

"When you're getting to around 1 per cent per year – we can't get much cheaper. For investors to sleep at night, paying 1.8 per cent is not a big ask," he said.

He argues that for the cost of a typical capital protection product, which he said is around 2 per cent, you could invest in a regular managed fund that provides no protection at roughly 1.5 per cent per annum or buy and sell an international share which costs much the same.

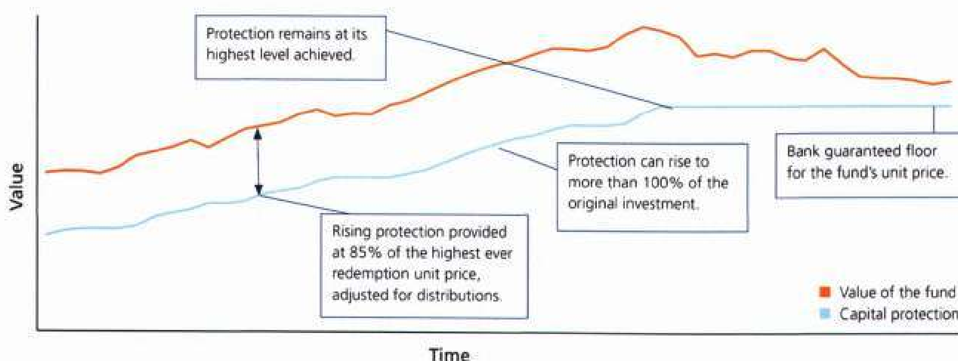
While innovation is being talked about, it could still be a way off. "These things have a reasonably long development time and I think what the financial crisis has done was put a lot of new projects on hold. New product development is really down across the industry," said Johnston.

The cost of a good night's sleep

A classic argument against using capital protection products is the fee associated with these products could eat into the overall return of the fund.

But the J.P. Morgan whitepaper found the fee structures that many capital pro-

Figure 1. How rising capital protection may work



Source: ING Investment Management
This graph is an illustration of how rising capital protection may work. It is not indicative of the funds' performance.

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tection products use are comparable to managed funds.

The report said while high fees were a deterrent to capital protection in the past, most products now provide a fee of 2 per cent or less per annum – this fee includes the management expenses and the cost of providing the protection.

"I think 10 years ago fees may have been too high but there's been so much competition and innovation that the cost of these products is lower than it was," said Jones-Prichard.

While some products may quote the product fee of around 2 per cent, it doesn't factor in the advice fee, which could be another 1 per cent on top.

This is an important point as, while some high net worth investors may invest in these products using their own expertise, the majority of investors would be investing on the back of financial planner advice.

I think if you're an aggressive investor who is 39 years of age and has a long-term outlook, I think zero is the amount of capital protection you need. I actually buy capital protection only when I want to access high levels of gearing.

Case in point is AXA North. Using the Protected Investment Guarantee over a seven-year term means a client would pay 90 basis points for the guarantee fee, 75 basis points for administration and asset management fee of 45 basis points.

If the investor uses a financial planner, then an AXA spokesperson said they usually charge one per cent, all up, the protection costs an investor just over 3 per cent in fees.

Chris Hipkin, managing director at Linear, said the firm's Continuously Protected SMA provides capital protected options at around 1.75 per cent – with the cost of the protection amounting to 100 basis points.

Despite this supposed drop in fees, Di Christoforo said the fees that some capital protection products charge are ridiculous and urged financial planners to do their homework.

"People pretend that it's for free and it's not, in some cases it's very expensive. Either the product providers cap the upside, which we're against, or they fee you to death. I'm more against the cap on the upside," he said.

He said if the cost of a capital protection product significantly limits the upside of a growth asset then it's not worth having.

Re-entering the fray

The latest Rainmaker Vantage Point said the Australian Securities Exchange has been buoyed by a strong rebound in large and small cap stocks and a better looking economy. While it does not chart a definitive path for the rest of the year, the signs are promising.

But this is beside the point, said Cam Cimino, general manager, licensee services and support at AXA. "We know that markets decrease and increase, what North does is it flattens those cycles so that at the end of the day, you'll have peace of mind," he said in a previous *Financial Standard* interview.

"Fundamentally, people don't want to worry about super, at all, so North allows them to do exactly that."

Put another way, the capital protection is meant to be an all-weather strategy. It evens out the ups and downs of the market cycles and ultimately, protects a person's accumulated retirement savings over time, not just over one period.

While product providers think capital protection strategies should be a part of every financial planners portfolio, Salter said the future of the product would depend on a financial planner's understanding of how to use the structures.

"Once people see the market go over 4,000 some people will say I don't need that for protection because people have short memories. The demand will vary – but it's something that's always going to be there," said Salter.

No doubt the impact of the GFC is one that will stay with the market for the better part of the next decade.

One thing is for sure, capital protection products are only going to become more mainstream, more flexible and more affordable in the years to come. The more pressing challenge is to ensure investors use it because they are in for the long haul. That is, it's their protection for time in the market and not because they are timing the market. ●

Choosing between capital protection and liquidity

Integrating capital protection strategies into superannuation could create liquidity issues for super funds, said Sam Sicilia, chief investment officer at HOST-PLUS.

Bruce Garratt, intermediary relationships director at AllianceBernstein Australia, predicted that capital protection strategies could become commonplace not just outside super but within super, but Sicilia, whose fund does not provide a capital protection option, said the strategies present liquidity issues.

"If the person comes along earlier than the roll-over date, which is the date specified to be protected to, and wants to take their money out or dies, it could present problems because the sum isn't protected along the way," he said.

He said if the majority of a super fund's members choose a capital protection option it could limit the fund's ability to diversify into other asset classes.

"If you offer a capital protection option, who wouldn't take it? But if everyone takes it then you can't afford to risk the other half of the bucket," he said.

However, one of the largest super funds in the country, AustralianSuper, does provide a capital protection option to members, although the term is used to refer to an option that is conservatively invested, not because there is a capital protection strategy on top of the underlying investment strategy. The option's strategic asset allocation has 70 per cent allocated to bonds and 30 per cent to cash. This option returned over 5 per cent during 2008.

More importantly, the capital protection feature does not necessarily limit the ability of a fund to diversify. Many providers offer the capital protection through various structures and can tailor those to suit a super fund's risk profile and portfolio make-up.

Regardless of what the impact of the feature could be on the running of the fund, demand could drive many funds to adjust their strategies. For example, Cam Cimino, general manager, licensee service and support at AXA, said capital protected investment options suit fund members who don't want to worry about the performance of their super in the intervening period before they retire.

"Fundamentally, people don't want to worry about super. At all," he said. ●

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