Manufacturing managing director Stephen O'Connell: The ease of mind from capital protection is magnificent.

JESSICA SHAPIRO

SAFETY FIRST

Capital-protected products are being raced out to meet the demand for reduced risk. But investors should be aware that this peace of mind comes at a cost, **Chris Wright** reports.

Stephen O'Connell, like most of us, lost a lot in the past year and a half, both through his stocks and his funds. "If I were looking at retirement today, I'd be ready to slit my wrists after what I've lost," he says. At age 50, the textile manufacturing managing director didn't want to be in that position of uncertainty again – so he went for some capital protection.

He opted for two Axa products, one a capital-guaranteed super fund and the other in equities, and was happy to take the seven-year lock-in that comes with these offerings.

"I can now say I know my worst-case scenario in seven years," he says. "The ease of mind is magnificent."

He's not alone. Benjamin Kohn is a regular user of capital-protected investments. Three times now he's bought into Macquarie's Fusion Funds range, which exposes investors to a host of managed funds. He's also used Macquarie Geared Equities Investment and taken out a margin loan to make capital-protected investments. All told, they account for about 20 per cent of his portfolio.

Products like these involve borrowing money for your investment, with a guarantee that you won't be on the hook for that loan if the markets turn against you.

"I prefer to be able to preserve my cash to buy property, invest in my business or put it into super," explains Kohn, who runs a boutique financial advisory group called Link Financial Services in Caulfield, Victoria.

"And with respect to the shares, it gives me a higher exposure to the market with capital protection in place. I know I won't have any margin calls, and the collateral is 100 per cent protected."

He also knows the interest he pays on the products generally is tax deductible.

So, how's he done? He made a lot of money out of the geared equities product and made money on one of the three Fusion investments. Two others didn't work out, but at least it won't cost him more money.

This is the theory of capital protection: it's a safety net if your investment turns sour.

Nothing is for free, of course, and the trade-off is usually either a bigger fee, a lock-in period that requires you to keep your money invested for several years, a cap on your gains, or (if the product involves a loan) a steep interest rate. But for some, those are worthwhile trade-offs.

It's not all about tax

In recent years, capital-protected products have been driven not by conservatism but tax.

You can get a tax exemption when you borrow to invest (although the terms of that exemption may be about to change – more on that later), therefore, many products have been developed where typically you borrow the whole investment cost in advance, with a guarantee that if the investment does go wrong, you'll at least be covered for the value of that loan.

As much as these products are about protection, they're also a method of gearing into the market – gaining a big exposure to an investment without a correspondingly big (or sometimes any) initial cash commitment.

The wilder events of the past 18 months have brought about a change, though. Many in the market report that investors are returning to the basics, looking for security, rather than gearing. At JPMorgan, a longstanding provider of structured products with capital protection, David Jones-Prichard notes "a slight shift in the types of investors who are looking for capital-protected products".

"In the bull market years, 2004 to 2007, it was investors looking to enhance returns based on the gearing they could get," he says. "Now it's more real investors with cash to invest who want to dip their toes back into the water. They like the value of equities but are using that cash to invest through a capital-protected product because they've either been burnt already or seen other people get burnt in the last 18 months and are more conservative. They want to sleep at night."

George Lucas is managing director of Instreet Investment, a group that builds products for the financial adviser community. "There are two ways of using capital protection," he says. "The first one is as a tax-effective investment at the end of the financial year, where people borrow money to buy a product. The other is using capital-protected products in self-managed super funds or portfolios as a normal part of the asset allocation. That part of the market is growing, while using it as a geared vehicle for tax effectiveness is diminishing."

Instreet has products that work well for self-managed super funds, and this represents another shift in capital protection: funds for near-retirees who want protection in super.

In November 2007, Axa launched its North product, modelled on an offering it has been selling in the United States for years, with some success. The innovation is that it provides capital protection within a super fund.

Axa's head of structured solutions, Andrew Barnett, says the dynamics are different in a product like this, compared with some of the gearing-driven capital protection offerings popular in recent years. "The investor psychology, in terms of the purchase, has a lot more to do with wealth insurance. We see a number of superannuants who are approaching retirement, are 50 to 65 years old, and have accumulated a fairly large asset for retirement. They want to make sure it's not impaired by anything that happens in the markets."

Lucas also notes that an older investor base has an impact on how funds are structured and sold. "Self-managed super funds tend to be for older people – because of the amount of money you need to justify opening one – or people in their pension phase, who are very capital conscious and about to retire in the next five years," he says. "They don't want to see huge drawdowns in their capital. Advisers tend to use the gearing products for a completely different group, 30- to 40-year-olds, as a way of accumulating wealth."

Another shift is in the way these products work. In recent years, most capital-protected products have been sold for a six- to eight-week period, generally around the end of the tax year, and then closed to new money and locked away. You then have to wait for a fixed term, usually between three and seven years, before the capital protection kicks in and you can take out your money.

Both Instreet Investment and Axa, though, have tried to move towards methods of continuous capital protection.

Providers of the traditional gearing-linked products say rumours of their demise are exaggerated. Macquarie's Peter van der Westhuyzen says demand "has been stronger than ever".

The volatility of the past 18 months has focused investor attention on the value of capital protection, he says. He argues that the protected lending products from Macquarie and others do two things: allow investors back into the market with protection against falls, and "give the biggest possible exposure to a rebound", since investors are borrowing money, rather than just using their own capital.

"The number of users of protected lending has increased year-on-year quite significantly – about 21 per cent in terms of number of clients," he says, although industry-wide the protected loan book has stayed pretty steady in terms of overall volume, at about $2.7 billion.

Macquarie recently launched its Equity Lever product, which allows investors to buy any of the top 100 ASX-listed shares and leverage up to 50 per cent, with an 8.65 per cent variable interest rate. He calls it "a very clean and very simple way of getting leverage into blue-chip Australian shares", which fits another pattern in the industry: greater simplicity where possible.

Capital protection is finding popularity because people have been burnt and are more conservative. They want to sleep at night.

Scenarios

To give an example of how a capital-protected product works under different scenarios, let's take a look at JPMorgan's offering: the ASX 20 Growth series. This product involves a loan. You put in $9000, of which $1500 goes to interest; you also get a $22,500 loan. There are two separate assets and your investment is split between them. The proportion varies depending on what's happening in the markets.

One asset is a basket of shares in 20 of Australia's biggest companies; the other is a swap agreement that protects the value of the loan. This means you'll never be on the hook for that loan but that your original $9000 isn't protected.

Depending on market volatility, you'll have between 20 and 200 per cent of your money committed to those Australian stocks. The 20 per cent minimum ensures you never end up cash-locked – what it's called when everything you have in your investment goes towards capital protection and nothing towards the shares you wanted to invest in.

It's a five-year product and you get to lock in half your returns at the end of the third and fourth years.

Aegis research shows that with flat or 25 per cent market returns, you'd be better off in the JPMorgan product, coming out with 0.4 per cent and 31.7 per cent a year, respectively. In both cases, this is better than buying direct.

At 10 per cent growth a year in the stocks, you'd have a 4.7 per cent return, and for 20 per cent growth, a 20.7 per cent return – in both cases, worse than if you'd gone in yourself.

Finally, Aegis calculates that the basket needs to grow by at least 2.8 per cent a year to preserve your initial capital once you consider fees and loan interest, as well as dividends and tax deductibility.

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The dark side

It should be said that not everyone is a fan of the idea of capital protection. The reputation of these products hasn't been helped by a couple of events in the past 18 months.

Many products provide protection by dividing the funds between the asset you wanted to invest in (shares, say) and something safe and dull like a zero-coupon bond. In many cases, when markets become volatile, more and more of the investment is transferred to the bond, until in extreme circumstances the whole lot ends up there. That means you're stuck for five years or so waiting to get your money back, knowing you no longer have any exposure to the shares you bought the product for in the first place.

While that's exactly what these products are supposed to do in a market crash, it can be annoying for the people who are in them, and many products did end up cash-locked like this during the recent volatility.

Worse, there have been instances – most notably involving UBS and its protected loan into a product from Rubicon – in which the bank providing the guarantee claimed it no longer applied because the underlying asset (Rubicon's fund in this case) had been wound up and no longer existed.

"People are a bit more cautious about capital-protected products than they have been in the past," says Paul Moran of Paul Moran Financial Planning in Melbourne. "They are asking manufacturers to justify more and more why does a product need protection and what is the cost of that protection?"

Planners tend to be suspicious about the very idea of capital protection. "Every asset class, broadly, should have some kind of risk and return characteristics, and the return you get should be on the basis of the risk you're prepared to take," Moran says. "Often, these are sold on the basis you can get the expected return without taking the expected risk. I have trouble with that concept."

So does Darren Johns, a certified financial planner at Align Financial on Sydney's northern beaches. "There's an inherent relationship between risk and return," he says. "The biggest antidote to risk is time – provided you've got time on your side, in theory you've eroded all risk. These products try to strip out the risk but after fees they can't deliver the returns investors might expect from taking market risk."

Johns also feels this is just the wrong time to be seeking capital protection anyway – the right time was before the market crash, when there were gains to be protected, not now when those gains are long gone.

"Right now the expected return from the market, whether it's the All Ords or global shares, is much better than it was 12 or 24 months ago," Johns says.

It's also important to understand how capital-protected lending works. In these products, the manufacturer makes its money on the interest on the loan, which can be pretty steep and well into double-digit percentages (see "Scenarios", page 40).

The capital guarantee covers your initial loan but you still have to pay interest on that borrowing for its duration, so it's not true to say you'll get all your money back – you'll get your money minus the interest costs, although there is the tax benefit to consider. You want to be sure that the return from your investment will be greater than the interest you're paying, after considering the tax.

Protected lending products have another headache to deal with, too. In the May 2008 federal budget, changes were proposed to the level of interest deductibility on protected loans. Historically, the benchmark for deciding deductibility is the personal unsecured lending rate. The budget proposed that it be changed to the housing loans benchmark rate.

That's a big deal: as of June this year the unsecured personal loan rate is about 13.5 per cent, while on housing loans it's 5.75 per cent.

"The impact of that has been reasonably significant on the capital-protected lending industry," van der Westhuyzen says. "We don't see investors using capital-protected loans as purely a tax investment, but the tax consideration is clearly a component."

That said, this hasn't become law and federal Treasury has indicated it's prepared to listen to industry before implementing the change, so providers are hopeful they can keep things as they are. It's fair to say that if the change does come in, it will badly dent the attraction of protected lending. **Si**

UNDER THE BONNET

The ins and outs of capital-protected products: main traits and how they work.

Capital-protected products often feature some or all of these attributes:

- A fixed term – commonly three, five or seven years – upon which capital protection applies.
- A loan, often compulsory, that is taken out to make the investment; the interest on this loan is where the bank makes its money.
- Those loans carry a tax exemption (however, see main story for how this might change).
- They're typically on sale for a short period around tax time.

However, a new breed of products looks a bit different:

- They're continuously on sale.
- They offer continuous protection, rather than protection over a fixed term.
- There's a move towards better liquidity, meaning you can get money in and out if you want to.
- They can be used in a super fund.

Capital protection is usually gained in one of two ways:

- Some of the money goes into a safe asset, such as a zero-coupon bond, and that asset provides you with capital if your main investment (shares, for example) goes wrong.
- Alternatively, derivatives are used. Often your investment is split between the asset you wanted to invest in and the mechanism that provides the guarantee. In many products, the balance between the two shifts according to what's happening in the markets.