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Pros and cons of protected loans: bank product

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LOANS to buy shares that come with protection from falls in share prices -- known as protected loans -- are being promoted heavily by some banks.

The threat of a sudden fall in share prices is one of the big anxieties weighing on investors' minds as they cautiously make a comeback to the market.

Last week, the Commonwealth Bank released a new protected loan product that it says will allow investors greater flexibility in tailoring their portfolio to build on their retirement wealth. The bank says new enhancements to its protected loan give investors greater control over their cashflows, allowing them to optimise the after-tax cost of the loan.

As an example, CBA says borrowers can choose to pay the protection premium up-front as part of the interest rate, as opposed to annually; and the gearing level that suits their risk-reward profile, compared with traditional protected loans that offer only a 100 per cent loan-to-value ratio.

CBA's head of structured investments Suzanne Salter says the protected loan provides a compelling opportunity for self-managed super fund investors who are looking to diversify, obtain greater control over their investment portfolio and build their wealth.

But for most investors with a long-term outlook, **Wren Investment Advisers director Andrew Quinn says protected loans are not necessary.**

"A lot of these protected loans are offered for a period of five, seven or eight years," he says. "And the odds of a share portfolio being behind your original investment after about five years are very small."

Quinn estimates that on a total return basis, the odds of being behind your original investment after five years are about 5per cent and after six years it is 10per cent on Australian shares.

Put bluntly, he thinks that in most cases protected loans are a waste of money.

"I find it hard to believe there is a case for them," Quinn says.

Protected loans are used by investors to fund the purchase of a parcel of shares for a set term -- usually more than 12 months -- with that investment protected against any loss.

They are most effective in a volatile sharemarket environment and commonly used if an investor has a bearish long-term outlook on the market.

The biggest advantage of having a protected loan is you can't lose your money because your downside is protected by a put option. The interest on the loans is normally prepaid so payment can be used as tax deduction.

On the negative side, the cost of that protection is usually very high, carrying an interest rate of 9 per cent to 16 per cent, depending on the level of protection and stocks, compared with fixed margin loan interest rates of about 7 per cent.

Leverage Equities general manager Eric Blewitt believes protected loans do have a place if investors are unsure about the sharemarket.

"With the sort of yields that some of the ASX 50 stocks, some of the blue chip stocks are throwing off, it does make the people who have been concerned, or perhaps going into the market after a period of absence ... but are still concerned about all of the downside given the recent history ... they can take advantage of the upside but

utilise some exchange traded options to package and protect either the full amount or even a portion of the initial outlay, Blewitt says. "It's not the biggest market in the world but it's certainly the growing one for people getting back into the market or in for the first time."

However, Blewitt also believes that the time for this type of protection has gone. He does not see the protected loans space as a growing market.

"If we get some more confidence over a sustained period a lot of people will just want to be in the market and see that protection as maybe a little bit expensive for the value it is returning for them," he says.

On the borrowing costs of a protected loan, based on figures from Wren Investment Advisers dating back to 1875, the long-term total return on the sharemarket is about 11.8 per cent.

"When you work on those numbers, if you believe that over any given period around 11.5 per cent or 12 per cent is probably what the total return you should be expecting," Quinn says.

If the interest rate on the protected loan is 9 per cent plus, "you need exceptionally good, better-than-average sharemarket performance to even break even".

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