



February 01, 2008



Capital guaranteed: the fine print

By James Frost

PORTFOLIO POINT: Investors are sure of getting their capital back, but risk having inflation eating away at the promised returns.

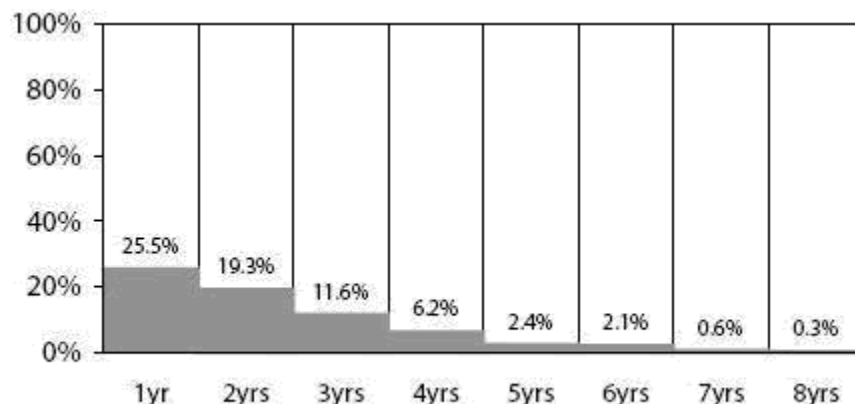
Capital guaranteed products are seducing investors looking to reduce their exposure to the wild gyrations of the sharemarket. But in many cases, the protection offered is little more than sleight of hand that ultimately puts you at a disadvantage.

The first aspect to consider is the protection itself. Most capital guaranteed products are only guaranteed at maturity, which is typically six years or more. If you assume a modest rate of inflation, say 2%, then by the time you cash out your capital will already be worth 12% less than when you invested it.

What some investors don't take into account is that the sharemarket produces a constant level of return over the long term. In fact over a period of six years, the risks of a balanced share portfolio being in the red are extremely small.

Andrew Quinn, an adviser and director of Wren Investment Advisers, says: "It's really just an advertising gimmick. I've run models that show that the risk of a share portfolio being in the red after six years, not including dividends, is 2.1%. Based on those same models, after eight years the risk falls to 0.3% or one in more than 300."

◀ Australian shares (risk of capital loss per holding period)



* Based on historical data from 1980

The managing director of Dixon & Associates, Alan Dixon, agrees. "In too many cases people chase capital guarantees because they are scared about the investment world and don't understand what they are doing," he says. "They would have less tolerance for risk but also no real awareness of the concept (of risk and return)."

Still, there's no shortage of products being slapped with a capital guaranteed sticker and placed on

the market. Man Financial launched its popular OM-IP series of capital protected “alternative” investments in 1997 and today has more than \$6 billion under management.

Since then the “market wizards” at Australia’s top-tier investment banks have muscled in on the act. No self-respecting peddler of structured financial products would dream of being without a full suite of complicated capital guaranteed financial instruments ready to dazzle risk-averse SMSF fund operators.

But if investors knew how this was achieved, they might think twice. Alan Dixon explains: “In some of these products, for every dollar you invest maybe 60¢ goes into a zero coupon bond that will be worth \$1 in seven years’ time and the remainder is put in the equivalent of a hedge fund. You are buying two different instruments. If you had to write two cheques for each component you would realise pretty quickly what’s going on.”

But it was the ALPS series of products from Macquarie Bank that first started throwing up red flags. By now many investors would be familiar with the story that we covered on October 24 (See [MacBank’s mountain retreat](#)) and December 7 (See [Knockouts floor MacBank fund](#)). The ALPS series of products from Macquarie were based on a basket of 80 stocks from Australian or US sharemarkets. The capital guaranteed products were on a six-year basis; that is, investors were promised that whatever happened they would get their money back in six years time. The headline rate of return promised 12% or more, but every time one of the stocks traded below 55% of its purchase price it could be “knocked out” and the yield was reduced by one-seventh.

As we foreshadowed on December 7 (link), medical devices manufacturer Boston Scientific and coffee franchise Starbucks were “knocked out” of ALPS 5. This means that the product will not deliver investors any more distributions. Ever. Investors must wait until 2013 to get their capital back.

But this wasn’t the only ALPS product to turn sour. Macquarie’s ALPS 6 was the latest vehicle to reduce payments – from 11.57% to 7.71% – as the stockmarket rout continued over January. But two more stocks teeter within 10% of the strike price and if they fell the yield would fall to less than 4%.

.....

The first four ALPS products aren’t out of the woods yet either. Based on baskets of Australian stocks they haven’t suffered quite as much although they each have suffered between two and four “knockout” events and hold several stocks that are dangerously close to the strike price.

ALPS wasn’t even the first capital guaranteed product from Macquarie to turn sour. Macquarie’s Atlas series was similar. Atlas 1, 2, 3, and 5 were based on baskets of Australian stocks but the stocks in Atlas 4 were selected from a group of Asian markets. Less than 18 months after the investment was launched payments were suspended. Like the unfortunate investors in ALPS 5, they will have to wait until 2013 for their capital to be returned.

Many of those caught out by these developments are those that can least afford it. Martin McGrath, a director of the financial planning firm AIM Investment Management, says: “These products are often for people over 60 or 70 who want a nice little income stream but don’t want any risk.”

Other products available from Macquarie offer substantially better protection. For instance, Macquarie’s MQ Term Plus product also offers a capital guarantee but the interest rate is fixed at between 7.15% and 7.45%. Upside is produced by the ASX 200 outperforming that rate, producing “bonus payments” capped at a total of 10%.

But importantly your downside is limited to the rate fixed at the time of making the investment.

Structured investments and capital guaranteed products appeared to have flourished for one reason and one reason only: to make the big financials more money by capitalising on skittish markets and nervous investors. The fees are generally higher, and by selling you two products dressed up as one they are clipping your ticket twice.

With more volatility expected on the horizon it’s going to be a difficult period for risk-averse investors. But buying these products may put you at an even bigger disadvantage than a turbulent equity market.

Martin McGrath says: “Sure you probably get your money back after seven years but consider what you could of produced in the market over the same period. It’s not about timing the market, it’s about your time in the market.”

Copyright© 2008 Eureka Report Pty. Ltd. All rights reserved.

For the use of the above named subscriber only

ABN 84 111 063 686 AFSL 285 078

Level 7, 22 William St. Melbourne. Victoria. 3000 Phone: 03 8624 3000 Free Call: 1800 458 656 Fax: 03 9614
2205

<http://www.eurekareport.com.au>