

Demystifying Principal Protected Investment Products

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The new millennium is proving to be a difficult investment environment for many. Old economy stocks were suffering earlier this year due to the market's love affair with all things telecom, media and technology related but over the last few months even these sectors have fallen out of favour.

The dilemma for private clients is that if they are not in the market they miss out on appreciation opportunities but investing in the market during such a volatile period could result in significant losses. It is understandable against this backdrop that investors thoughts turn to wealth preservation.

One potentially attractive solution for private clients is principal protected or capital guaranteed products. These products can combine the security of a term deposit plus the opportunity to earn attractive returns linked to equity, bond, foreign exchange or commodity markets.

The concept behind principal protected products is quite simple. You forego all or part of the interest you would normally receive on a term deposit in order to have the potential to earn higher returns. If for example you can invest \$100 today for 12 months at 6.50% you know you will receive \$106.50 when your deposit matures. If you give your bank \$100 today to invest in a principal protected product they will place \$93.90 on deposit at 6.50% to protect your initial principal. Over 12 months this \$93.90 grows to \$100 repaying your initial investment. This is called the "capital guarantee element" of the structure.

If your bank has only invested \$93.90 of your initial \$100 what happens to the balance? Firstly

your bank takes out its fee, which will typically be between 0.50% to 1.00% per annum depending on the complexity of the product and the size of the investment. For our example we are assuming a fee of 1.00%. We have now accounted for \$94.90 of your original investment.

The remaining \$5.10 is used by your bank to purchase a derivative instrument called an option. This option offers the potential of a return in 12 months time if a certain event happens such as

- ◆ The S&P 500 equity index appreciates over the 12 months.
- ◆ The Euro currency remains within a fixed trading range versus the US Dollar
- ◆ The Nasdaq Composite equity index falls over the next 12 months

The option gives the investment structure its "market linked element". The question of how much exposure you have to the market to potentially generate returns is a function of what is called the "participation rate".

Let us assume you want to benefit from possible appreciation in US shares over the next 12 months and purchasing a call option on the S&P 500 equity index costs 10.20%. If your bank buys 1 option and the S&P 500 goes up 20% in 12 months the option payoff or value at maturity would be 20%. However, after providing for the capital guarantee element and their fee your bank only has \$5.10 or 5.10% available to spend on options.

The participation rate is simply how much money is available to buy options divided by the cost of

those options – in this example 5.10 divided by 10.20 or 50%.

This term participation must be treated with caution however. The above example illustrates how it works for a simple "vanilla" option and the concept is very straightforward. Various structures have been developed for the mass retail and affluent markets however, where the sole purpose appears to be to maximise the participation rate for marketing purposes rather than create true economic benefit for the client.

One of the most overused and abused techniques which falls into this category is averaging or asianing. If considering an "asian style" investment, ensure that you understand what the participation rate relates to and compare the investment's potential return under various market scenarios versus more vanilla investments. What may sound too good to be true usually will be.

With the above vanilla structure however you will receive back at maturity your initial investment plus 50% of any appreciation in the S&P 500 equity index. If the market appreciates by 25% you will receive a return of 12.50% whereas if the market declines you will receive back your initial investment and are protected against market losses.

As this example illustrates derivatives are not the dangerous risky instruments many would lead us to believe. Used correctly they can offer enormous flexibility to capitalise on market conditions and can provide you with investment security while offering potential for enhanced returns versus conventional term deposits.

Whether you are contemplating investing in guaranteed funds, guaranteed bonds, principal protected notes or market linked deposits the basic concepts behind them will be the same. When investing in these products you are making a tradeoff between risk and return - ensure you fully understand what you are buying by reading the terms and conditions in detail so you can decide if that trade off makes economic sense for you.