INTRODUCTION

GUARANTEED TO PROTECT AND SERVE

Capital guaranteed products appeal to both high net worth and retail investors, writes Elisa Trovato, but it is vital that the client knows just how the funds work and the issues they are likely to encounter

Capital protected products are engineered to offer peace of mind to investors who typically want to benefit from the potential rise of the equity market without having to risk their initial investment. Investors are guaranteed to have back their capital, or at least part of it, generally at maturity, plus a return, which is usually linked to the growth of the underlying investment.

"The demand for capital guarantee is a function of the panic in the market, the higher the panic, the higher the demand," says Ferdinand Haas, head of product solutions Europe at DWS Investments. "The big problem is that investors demand guaranteed products exactly at the wrong time, when markets have gone down rapidly, they are very cheap and risk premia are very high."

Every guaranteed product can be split into two components, the 'underlying' itself, typically an index or basket of indices, and the 'put' option on the underlying, which becomes more expensive as volatility goes up. "When volatility is high, the cost of insuring a portfolio is more expensive, which drives expected returns down. Smart investors should demand capital guaranteed products in times of market euphoria, when the price of ensuring your capital is rather low and the risk of markets dropping is quite high," says Mr Haas. "Building these products as efficiently as possible, given the current environment, is our key challenge."

Over the past 18 months the German asset management firm has built products that have constant exposure to volatility, which automatically de-leverage in highly volatile markets. "We have created a series of actively managed indices on various investment themes, where portfolio managers pick and build their portfolios and can change the index composition on a daily basis. We have then introduced a volatility adjusting mechanism which is completely automated," he says.

The so called vol-targets indices will always have a constant volatility, as the product built on them will have higher or lower exposure to the market, depending on whether the market is respectively less or more volatile.

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"By doing that we don't buy volatility when it is very expensive, and on the other hand, we are not invested in markets when they are highly volatile, and this has really helped our products in terms of performance," says Mr Haas.

This volatility adjusting mechanism is applied to both option based products, or formula funds, which are closed-ended funds whose payout is defined by a predefined formula, and CPPI (constant proportion portfolio insurance) strategies, where portfolio managers

make the necessary adjustments applying dynamic trading strategies.

Because of their nature, principle protected products can incur big after sales issues, explains Nicolas Gaussel, head of quantitative management at Lyxor Asset Management. "When markets do well, the principal protected product participates to only a percentage of the market rise and clients might be frustrated if they did not anticipate this effect. When markets decrease rapidly, and are very volatile, the product will have to reduce its exposure to markets until having no exposure at all, in order to protect the capital. If the markets go up again, the manager will not be able to invest again, the product is monetarised, ie no longer exposed to equity markets. This is a very nasty effect which sometimes creates a lot of frustration in clients," he says.

MISSING OUT

Many principal protected funds launched in 2000 that had five or eight year maturities were monetarised because of the tech bubble bursting, and the same happened during the recent financial crisis to similar funds that were launched in 2004 and 2005. "These products have done their job as they have protected investors' capital, but investors now feel they are stuck with this investment, because they are not participating in the current market rise," adds Mr Gaussel.

For formula funds, but also for CPPI products, it is critical that both the prospectus and distribution network sales force make clear that the investor runs the risk of not being invested in the market, he explains. "At Lyxor we prefer to offer solutions that avoid this monetarisation effect. For example, we believe that open ended products with a yearly guarantee ensuring that investors wil not lose more than 90 per cent of their initial capital, have the key advantage of protecting the principal and year after year, investors are sure to be exposed to the equity market"

In the affluent or high net worth segments structured notes with capital protection are generally more popular than capital protected funds, as they can be tailored to individuals' needs, and, having a quicker time to market, they can react to market themes more rapidly. But capital protected funds have traditionally appealed to the retail segment because of its diversification and daily liquidity. The majority of the €20bn total assets that the French firm manages in principal protected funds are sold to retail investors either through banking networks or insurance unit linked contracts.

"If you had the right story and people felt that the underlying would perform and they were comfortable with the protection, two to three years ago you could launch a fund and raise €1bn very quickly," says Mr Gaussel. Since Lehman's collapse, investors have started questioning the meaning of guaranteed funds and realised the importance of counterparty risk. Moreover, transparency has become top priority, he says. "My feeling is that clients are quite reluctant in investing in formula driven products because they had some disappointment in the past, they really ask for transparency to be sure that there are no hidden costs and that they can understand clearly what they invest in."

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Retail and high net worth investors use principal protected funds in different ways, believes Mr Gaussel. A wealthy individual invests in a capital protected fund to benefit from alternative sources of return given by exotic or riskier markets (such as Brazil or China), which they may not necessarily understand that well. "Investors will not have the full 100 per cent market rise, but part of it, but if the market goes down, they will lose, say, at most 15 per cent." For mass retail investors, for whom implementing a portfolio diversification is very difficult, it makes sense to invest in a full principal protected product on a diversified basket of indices, he says.

The returns of formula based products are predefined by the formula itself – for example returns will be 70 per cent of Eurostoxx 50 increase at maturity – and this may be perceived positively by investors. The drawback is that the portfolio manager will have no possibility to change the formula, to adapt to the market environment, says Lorraine Zafrani, head of structured management team at AXA Investment Managers in Paris. However, with CPPI products which are dynamically managed, investors will not know the returns they will get at the end, but the manager can change the exposure to the market, while still operating under the CPPI constraints,

ie the maximum risk budget, invest in different underlyings and have a diversified allocation.

"In the current environment, dynamically managed products that offer immediate protection and are redeemable every day, called Tipp [Time Invariant Portfolio Protection], are most suitable for clients," says Ms Zafrani. Tipp products are managed according to the same portfolio insurance technique used for CPPI strategies. "Both are daily managed, as every day we calculate the maximum exposure to the market and we will invest or disinvest the fund depending on the way the market has moved," she says. But unlike CPPI, which have a maturity date, Tipp products can be redeemed daily, with no redemption fee. Because of this liquidity, they protect only a percentage of the capital, typically 90 per cent or even 70 per cent of capital.

"With Tipp products that offer immediate protection, investors can decide to invest for, say, 6 months and then, if they believe that the risk in the equity market has reduced, they can redeem it and invest in an equity fund with no protection. These are good products for wait and see type of clients," she says.

MAKING THINGS CLEAR

As to the potential after sales issues associated with capital protection products, Ms Zafrani also emphasises that it is just a question of providing good information. "The solution is to give as much explanation as possible to clients. CPPI products involve a complex management and you have to translate a complex concept in easy words." Having already experienced the crisis in 2001, Ms Zafrani says she was well aware of the importance of explaining to clients that exposure to the equity market was going to be reduced. "We did reduce our exposure to the market before the crisis and clients were little impacted by it. And in 2009, some of the funds were exposed again to the equity market.

"I think it's a pity that people don't invest in CPPI products to secure their gains after periods of high performance," she says. For example these products, if having a five year maturity, would have been appropriate in the bull market that followed the tech bubble downturn, at the end of 2006. "To address this issue, we have put in place a feature in several of our funds so that when the performance increases, the guarantee will also be increased at maturity, as we give back to the client part of the increase of the net asset value of the fund, regardless of the market behaviour afterwards."

Ruggiero Gambino, head of offer innovation and management of personal banking at UniCredit Banca in Italy confirms that capital protection funds, specifically formula funds, have been in high demand over the past couple of years. "Formula funds are one of the best instruments for those clients who are risk averse but want to benefit from the potential of the equity markets. They were indeed most popular around 18 months ago, in a phase of high market uncertainty, as risk averse investors wanted to have the certainty to have the capital

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back at maturity and were not emotionally able to manage a volatile mark to market. We are now trying to move investors towards actively managed products, which on the medium to long term can give interesting returns, as long as clients' risk profile is in line with these products," he says.

Broad and liquid equity indices are largely the favoured underlyings. "We already make an effort to persuade them to enter the equity markets and niche markets would be even riskier. The option would cost more and that would make products less appealing," says Mr Gambino.

Structured products offering capital protection, as opposed to funds, have been traditionally preferred by banks as they are more profitable. Therefore asset managers who aim to sell capital protection funds - especially in non proprietary banking networks - face high competition. Nevertheless, compared to capital protected structured products, formula funds, in addition to diversification and daily liquidity, have the advantage of having smaller counterparty risk, says Mr Gambino, pointing out that UniCredit Banca does not sell structured bonds, but only plain vanilla bonds. "The structured product is linked only to the risk of a single issuer, whereas our capital protected formula funds are linked to several issuers that make up the collateral. In our case 90-95 per cent of the collateral are government bonds diversified by countries and maturities, and the remaining 5-10 per cent are UniCredit Group bonds."