Capital Guarantees

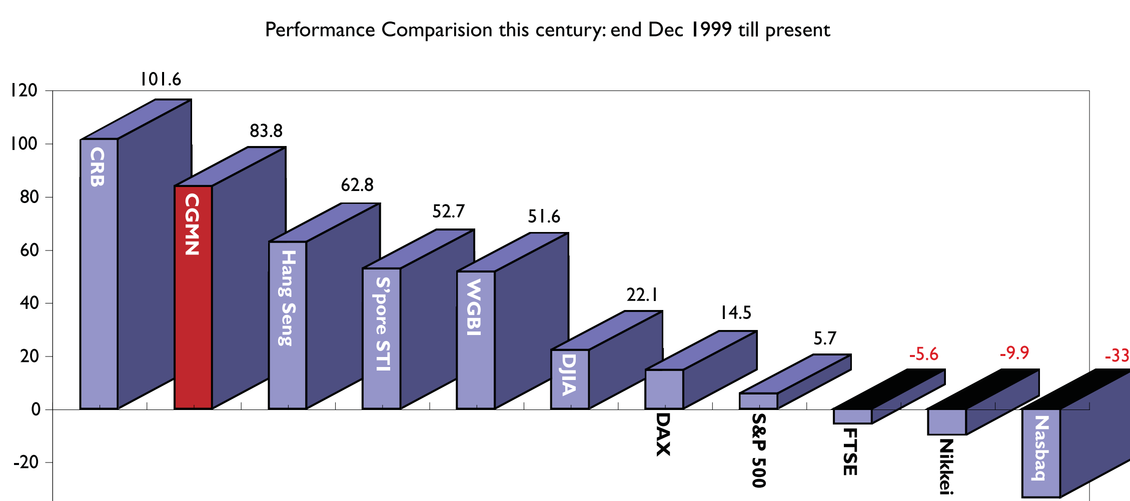
By Chris Cleary

In investing there is always a tension between the desire to maximize gain, and the wish to avoid loss. These are key parameters in the selection of financial instruments. You can shoot for the stars with micro-cap equities, most of which will after the up-down-down up-down-down emotional roller coaster hand you a return of -100%. Or you can aim just as high with options or futures, the former of which is also adept at dealing the -100% payout, and the latter, if you are neglectful or stubborn, even less. But then again, these instruments could hand you stellar returns. Or at least you think they will; otherwise you would not be induced to compromise your principal.

More moderate and sane forms of equity investing would appear to offer steady ongoing dividends and decent capital gains, or at worst reasonable preservation of principal. They do—except when they don't. It is not easy to know the future: if, when you put your money down for a stock, you are going to get the performance of, say, a BHP, an Intuitive Surgical, or a PetroChina rather than, say, a Ford, a Marsh McLennan, or indeed of an Enron.

The opposite approach is cash. Cash in a bank (not in a mattress: not many people do that). You will get a defined return and do not have to worry about your principal in nominal terms. However your defined return over time is not going to beat inflation, and inflation will also erode your principal. This is a simple fact of fiat money; governments can't resist printing the stuff. Over time, cash is a loser. Especially to real inflation: not the manipulated inflation statistic the government tries to pass off at the time.

Bonds too, over time, are fiat money victims. There has been a bull market in bonds since 1981 (arguably to 2004, or perhaps there is a little more to go) which has granted a temporary reprieve on the moniker, 'Certificates of Guaranteed Confiscation.' Your total return will be better than with cash as you have given up your principal for an agreed period. Yes, you will get your coupon payments—and no doubt your principal back too—but your principal will not have the buying power it did when it is returned to you, and your later coupons will not have the value of your earlier ones.



Key

CRB - Commodities Research Bureau index, i.e. a commodities index • **CGMN** - A capital guaranteed market neutral fund • **Hang Seng** - The flagship Hong Kong stock index
S'pore STI - The Singapore Straits Times index • **WGBI** - A world government bond index; this one is from Citigroup • **DJIA** - Dow Jones Industrial Average
DAX - Deutsche Aktien Index • **S&P 500** - Standard & Poor's 500 • **FTSE** - FTSE 100 • **Nikkei** - Nikkei 225 • **Nasdaq** - Nasdaq Composite

One way of reconciling this conundrum—of achieving returns above inflation but without risking principal—is to go for a market neutral fund with a capital guarantee. A market neutral fund will not move for long in the same direction as the stock market or the bond market; the fund managers are able to utilize profit opportunities going long or going short and thus capturing profits both ways. Your returns are likely to be smoothed by choosing a fund that is a blend of differing and non-correlating styles.

Needless to say, there are quite few funds like this around. Many of them seem to be designed to make fees for the fund's sponsors but sadly not for the investor. However, there are some that have provided comfort and reward for a generation of mass affluent. It is best to take advice on which of these funds may be in your interests; obviously a long and successful track record of similar issues from the fund house in question is the first thing you should be looking for.

The chart (left) shows the historical return of one such fund—chosen neither as a worst case nor a best case scenario. The performance is fairly mediocre for its fund house, and just after a very poor month. Other indices are cited in comparison for the period this fund has been in existence, which here is since the end of December 1999, i.e. data for this century

This period includes stock bear and stock bull years, which is par for the course; it includes perhaps the end of the global bond bull market, and the end of the old and the birth of the new commodities bull market. In these regular sample conditions, the market neutral fund selected comes out tolerably well. It would make a good core component in a portfolio: steady returns and medium volatility.

Of course, here we are now after four years of stock bull market and commodities bull market with the investing public getting re-accustomed to returns in excess of 20+%, eerily reminiscent of investor sentiment in 1999. We know that markets can't ascend at such pace forever, that they will come down and tack on some bear months or years onto those bull years. Funds like this will make money fine in bear years, just as they did in 2001 and 2002. They are there for the long haul.

The guarantee is from a major bank (AA- or better), which underwrites the whole package, guaranteeing you at least your principal at some future date, which can be between 5 and 15 years from the inception of the fund. The guarantee provides at least a psychological safety net–a real recourse you never want to see used. It also provides a level of discipline on the trading decisions as the guaranteeing bank—which should be third party, i.e. a different entity to the fund house and sub-funds involved—has oversight on the positions they are guaranteeing.

The better capital guaranteed funds offer either rising guarantees or have profit lock-ins. The guarantee might be raised every profitable year, or you might have a guarantee of say the higher of the guarantee and 80% of the fund's all-time high—meaning either way you need not fear large losses towards the end of the fund's term.

Such funds are fully managed packages. All the investor needs to do is decide to buy the package, or not, and later to keep it, or not. They make useful building blocks in constructing portfolios, and, in the present writer's opinion, offer advantages over bond funds in putting balanced portfolios together.

Finally, for investors looking for commodity upside—as shown in the CRB performance in out comparison chart—but wary of commodities as an asset class, there are also capital guaranteed commodities funds which enable you to buy commodity futures with their immense leverage but protect you from the downside with a 100% capital guarantee. A fund like this also has its uses in portfolio construction. JI

Capital guaranteed funds are available in a range of currencies—US$, AUS$, Euros, and Sterling. Advice on the selection of such funds is freely and readily available at the contact details here:

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