

THE VALUE OF A GUARANTEE DEPENDS ON WHAT YOU PAY FOR IT.

In this uncertain climate, private investors understandably seek security for their investments including, if possible, the sacrosanct 100% capital guarantee. In the current environment does this type of solution make sense for investors?

THE SHORT ANSWER:

In an environment of ultra-low interest rates capital-guaranteed products have lost their 'raison d'être'. Capital-guaranteed products no longer offer any potential for performance in the current interest-rate environment, even though it is still possible to buy them, perhaps more for the benefit of the provider than the investor.

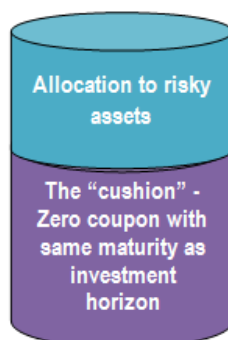
THE LONG ANSWER:

To answer this question, we need to remind ourselves of the basic mechanism of a target-dated fund with a 100% capital guarantee at maturity:

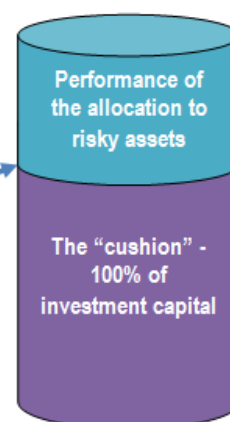
Part of the capital is invested in low-risk bond assets (generally zero coupon-type government bonds*) that at maturity will return 100% of the amount invested (excluding default risk). The size of this allocation is inversely proportional to the level of interest rates, in other words the guaranteed element needs to be a bigger part of the overall investment when interest rates are low i.e. now.

The remaining portion of the capital is invested in risky assets with the objective of achieving capital growth through this allocation.

At the start of the investment



At maturity



* A zero coupon bond is one that pays no interest, so the annual yield of the bond is known through to maturity.

HOW MUCH DO I NEED TO HOLD TO GUARANTEE A 100% RETURN OF CAPITAL?

The question we must ask ourselves is this: at current interest rate levels, how much is an investor required to allocate to low-risk bonds in order to provide a guarantee of the capital invested at maturity and how much is left over for the allocation to performance generating assets? The table below simulates the capital necessary to secure a capital guarantee under various interest-rate regimes of which the current period is on the last line. How much to invest to guarantee a 100% capital return at maturity: Simulation of zero coupons depending on interest-rate levels

Term period (years)	5	8	10	15	20	25	30
Interest rate	To obtain 100 at term, an initial capital investment is required of:						
1%	95	92	91	86	82	78	74
2%	91	85	82	74	67	61	55
3%	86	79	74	64	55	48	41
4%	82	73	68	56	46	38	31
5%	78	68	61	48	38	30	23
When using the current zero coupon curve*	0.35%	0.68%	0.86%	1.16%	1.27%	1.30%	1.32%
	98	95	92	84	78	72	67

*Source: CNO - 29/05/2015

Thus for a 10-year investment, one currently has to invest 93% of one's initial capital to achieve no capital loss at term, leaving only 7% (assuming no leverage is used) to invest in risky, performance-generating assets. On the other hand, in periods of higher interest rates, the problem is reversed: for example, with interest rates at 5% one has to invest 61% of one's initial capital to guarantee 100% of the capital invested at a 10-year horizon. This leaves 39% of the initial capital to invest in risky assets, which may seem a lot.

A capital guarantee in a low interest-rate environment is costly in terms of likely performance. The 100% guarantee works best when rates are high but the risk taken can be too high whereas the capital protection level could have been more ambitious and exceeded 100%. An alternative is to seek more flexible solutions where the level of capital protection at maturity depends on the level of interest rates, which leaves room for a significant allocation to risky assets that will permit an attractive level of capital growth by maturity.

CONCLUSION

You would be better served long-term with a carefully chosen investment strategy, regular monitoring of the funds and an understanding about the consequences of falling markets – rather than resorting to an expensive guarantee. This is an advice driven process that we provide.



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