

# Get the facts:

## Capital guaranteed or protected investments<sup>1</sup>



Wouldn't it have been great if you had been able to protect your investments from tumbling investment markets during the global financial crisis?

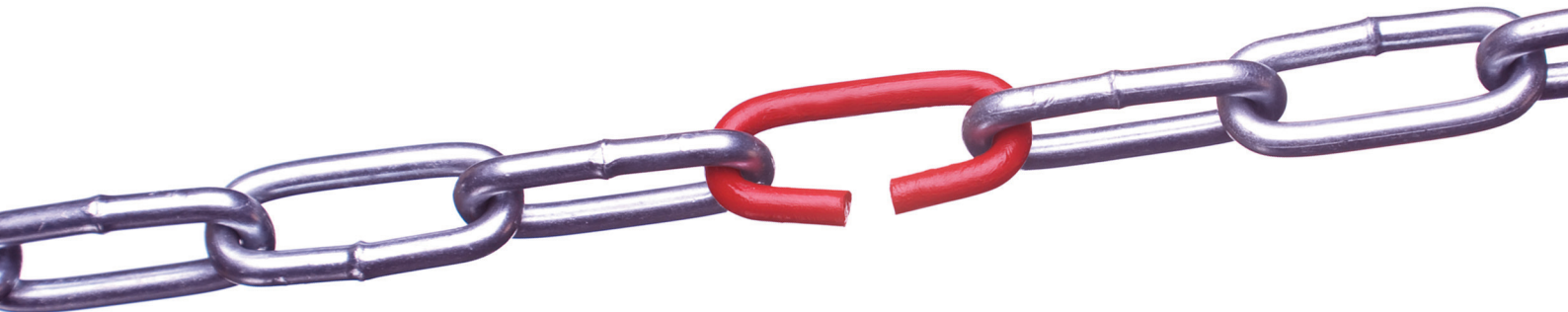
Investments that offer a capital guarantee or capital protection look like a great way to have your cake and eat it too. They claim to give you the ability to enjoy investment returns in the good times while protecting you from losing your money if it all goes pear-shaped.

Investors need to do their research, however, as capital guaranteed or protected products may not be the right option for everyone.

No investment is 100% secure. In certain extreme circumstances (for example, if the company providing the guarantee or protection goes belly-up), you can still lose your money.

Even if you are confident about the security of the guarantee or protection, you need to weigh up the cost of these products with the benefits they can provide.

<sup>1</sup> The information in this factsheet relates to capital guaranteed or protected investments that are not annuities. If you are looking for information on annuities, see the 'Retirement income' page on ASIC's FIDO website at [www.fido.asic.gov.au](http://www.fido.asic.gov.au).



### **What are capital guaranteed or protected products, and are they right for your investment objectives?**

Capital guaranteed or protected investments may interest you if you want to have exposure to investment markets, but want some protection against losing your capital.

Ultimately, the answer to the question 'Are these investments right for me?' depends a lot on what you are hoping to get out of your investments, including how much risk you are willing to bear, whether you need a regular income and whether you need access to your capital.

For example, if you are young and have a long investment horizon, you may want more exposure to growth assets, while people who are retiring may be more interested in preserving their savings.

### **How do these products work?**

When you invest in shares or other market-linked investments, there is a risk that the dollar value of your investment can go backwards as well as forwards.

Capital guaranteed or protected investments offer you the ability to earn a market-linked investment return, while having the security of knowing that you will at least get back the dollar value of your initial investment amount at the maturity date if investment markets turn sour.

For example, a capital protected investment linked to Australian shares may offer to pay investors a return equal to 80% of the cumulative growth in the S&P/ASX 200 share index over five years, with a promise that if the cumulative growth turns out to be negative you will still get back the original amount you invested at the end of the five years.

Most capital guaranteed or protected investments are for a fixed term, generally of five years or more, and fees usually apply if you want to exit the investment before the term is complete. The guarantee or protection generally only applies if you hold your investment for the full term.

### **How is the guarantee or protection provided?**

The guarantee or protection on your capital is achieved by structuring investments in a variety of ways:

- Some investments provide a guarantee by investing through a life insurance company.
- Others use a portion of the money you invest to buy a bond to provide capital protection and then invest the remainder of the money in options and other derivatives.
- Other ways of delivering a guarantee include combining a guarantee from a bank with hedge fund or derivative investments.

No two capital guaranteed or protected investments are the same, so you need to pay special attention to the structure, investment maturity date and terms and conditions that apply.

## 10 things to think about before investing in capital guaranteed or protected products

### 1 Investing in a guaranteed or protected product is not the same as putting money in the bank

Capital guaranteed or protected investments are structured, complex investment products, not bank deposits. Even though banks and other regulated deposit-taking institutions may offer capital guaranteed or protected investments, if you invest in one you don't have the same security or rights that apply when you put money into a savings or transaction account. The guarantee offered on capital guaranteed products is not the same as the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding, which protects some deposits at banks, credit unions and other authorised deposit-taking institutions.<sup>2</sup>

Different capital guaranteed or protected investments can have very different investment and legal structures. Make sure you read and understand the Product Disclosure Statement (PDS) or the prospectus for an investment to find out how the guarantee or protection is provided (for example, by a bond and a call option or by dynamic hedging).

It's also important to check where you would stand as an investor if the investment turns sour or the company providing the investment (the 'issuer') gets into trouble. Some capital guaranteed or protected investments are secured against separate assets, whereas with other investments, investors only rank as unsecured creditors if things go wrong.

### 2 The benefits of guarantees or protection need to be considered against their cost

Like any investment product, there are fees and costs involved in capital guaranteed or protected investments. You need to weigh up the cost of the protection against the benefits the product offers and consider what's right for you. The PDS or prospectus should contain information on all the fees and costs that apply, so always read it and ask the issuer or your financial adviser for more information if you don't understand something.

Generally, these products are more expensive than simpler investment products because of the extra cost of providing a guarantee or protection. This does not necessarily mean, however, that the returns will be higher, especially over the medium to long term. While investment markets can go up and down over short periods of time, in most investment classes the risk of a long-term decline is much less.

For example, while the probability of receiving a negative return on Australian share investments over one year may be 25% or more, some experts have calculated that the probability of receiving an overall negative return over five years is much less than 5%.<sup>3</sup> If you buy the investment through a financial adviser, a commission may be paid to the adviser as well. Several of these products do not pay any returns until maturity, which may not be suitable if you need regular income.

Some capital guaranteed or protected investments also limit the capital growth you are entitled to if the investment goes well. For example, your overall cumulative investment return over the life of the investment may be capped at 70%. While this sounds like a lot, it is a little less than an annual return of 8% per annum for a seven-year investment. If investment markets perform better than this, investors in a product with capped returns could miss out on the extra upside.

<sup>2</sup> The Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding is closed to new liabilities from 31 March 2010. For more information on the scheme, see [www.guaranteescheme.gov.au](http://www.guaranteescheme.gov.au).

<sup>3</sup> Frost, J. Capital guaranteed: the fine print, 1 February 2008. Retrieved from The Eureka Report [www.eureka.com.au](http://www.eureka.com.au), 27 May 2010.

### 3 The guarantee or protection is only as good as whoever stands behind it

Before you make an investment in these products, you need to assess the risk that the issuer or the provider of the capital guarantee or protection could fail to meet some or all of their obligations to you as an investor (for example, their obligation to return all your capital on the investment maturity date). In investment-speak, this is called 'assessing the counterparty risk'.

When you look at capital guaranteed or protected investments, make sure you find out which company is responsible for providing the guarantee or protection. This information should be clearly disclosed in the PDS or prospectus. Often the investment is issued by one company, while the underlying guarantee or protection is provided by another.

You need to consider the financial strength and stability of the company who actually provides the guarantee or protection, especially when it is provided over a number of years. Check if there are any circumstances in which the guarantee or protection could cease to apply (for example, if the issuer or the company that has provided the guarantee or protection becomes insolvent).

The following information in the PDS or prospectus can help you assess the counterparty risk of a guaranteed or protected investment:

- Which company is actually responsible for providing the capital guarantee or protection?
- If this is a different company than the issuer, are there any circumstances in which they can withdraw their guarantee or protection?
- If something goes wrong, what assets or other means does the issuer have to meet its obligations to investors in the product? Are investors secured or unsecured creditors?
- What is the financial situation of the company responsible for the guarantee or protection? What assets and liabilities do they have?
- If they have a parent company or are part of a group, are their liabilities guaranteed by the parent company or another company in the group? If not, you need to look at the financial situation of the specific company providing the guarantee or protection and not the parent company or the group as a whole.

### 4 Inflation can eat into your capital even if falling investment markets don't

Capital guaranteed or protected investments promise to at least return the money you initially invested at the end of the investment term. Nearly all of these products do not, however, make any adjustment to reflect changes in inflation.

Inflation means that the purchasing power of money declines over time, so a fixed amount of money (that is, your initial investment amount) is worth less in the future than it is today.

For example, if you were to invest \$100,000 today for five years, you would want to get back at least \$115,927.41 at the end of the five years to ensure that your money has not been diminished by inflation (assuming inflation is 3% per annum).

Most capital guaranteed or protected products do not include inflation in their protection and so will only promise to return you the original \$100,000 at the end of the five years.

### 5 You might not always be able to lock in investment gains when you want to

New guaranteed or protected products are being offered that allow investors to 'lock in' investment gains. This means that if the investment increases in value before it matures, you can increase the capital guarantee or protection to reflect the higher investment value. It's worth checking the details, however, as you can generally only do this at specific times (often only once a year). Investment markets can move quickly, so this feature may not be as beneficial as it seems.

# CAUTION

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## 6 Knock-out events can reduce or eliminate your investment earnings

Check the PDS or prospectus carefully to see if there are any 'knock-out' clauses that apply to the investment. Generally, if a knock-out event occurs (for example, the market price of the investment to which the product is linked falls more than 30% below the purchase price), investors lose all entitlements to any investment earnings. In this case, you would only be entitled to receive the amount you initially invested. This would be paid to you when the product matures, which could be many years away. Some investments call these knock-out events 'barrier' events.

## 7 Check if you are able to get your money out early

If there is a chance you may need to access your money in a hurry, carefully consider the investment terms and conditions relating to early redemptions. Most capital guaranteed or protected investments don't mature for five years or more, and hefty break fees can apply if you want to get out early. In addition, if you exit the investment early, the guarantee or protection may not apply, and you could get back less money than you originally invested.

## 8 Be aware of early termination clauses

On the flip side, some products give the issuer the discretion to terminate the investment early if any one of a number of events occurs. In this case, the capital guarantee or protection can end early too, whether you want it to or not. The PDS or prospectus should outline these discretions.

## 9 Be aware of the extra risks of borrowing to invest

Issuers of capital guaranteed or protected products may offer investors the option to borrow to invest in the product (often called 'gearing'). Some products are geared by as much as 100%, which means you borrow the entire amount that is invested. Even 100% geared products will still require you to put some of your own money in at the start. You should be aware that this money will be used to cover interest and set-up fees and

will not actually be invested. As a result, it is not covered by the capital guarantee or protection.

Regardless of how much you gear, the investment will need to earn a return high enough to cover the costs of interest and fees that come with borrowing, otherwise you will not break even despite any capital guarantee or protection.

You should check the PDS or prospectus, ask a financial adviser, or find independent research to work out how much the investment needs to earn before you would break even or make a profit.

## 10 Tax considerations should not be the sole driver of investment decisions

Many capital guaranteed or protected investments are marketed on the basis of the tax advantages they can offer to investors. While upfront tax advantages are appealing, a good investment is one that delivers you a real investment return, not just tax deductions.

Investors need to consider the investment merits and credentials of the underlying investment, any possible legislative changes that could affect the tax benefits and, finally, whether the fees and costs associated with making the investment are greater than any tax benefits received.

We all want to avoid the pain of seeing our hard-earned investment dollars go backwards. Investments with capital guarantees or protection, simple as they might sound, are actually more complex than regular investments.

Before you invest, make sure you do your homework. If you are clear on your investment objectives first, you have a basis for evaluating whether potential investments, including capital guaranteed or protected products, are likely to meet your needs and investment goals.

For help in thinking about your investment objectives, see ASIC's consumer website, FIDO, at [www.fido.asic.gov.au](http://www.fido.asic.gov.au).