



ARE YOU WORRIED ABOUT THE VALUE OF YOUR MONEY?

Some Thoughts On 'Safer' Investments

How Safe Is Safe?

As advisors we are encouraged to explain to Clients that **nothing is completely without risk**. In practical terms though, what does this mean? For example, if you have anything up to £50,000 deposited with a UK Bank or Building Society (we'll abbreviate this to BBS – it'll save space later!) the UK Government guarantees your deposit – so the only two risks are that the BBS goes bust - and at the same time so does UK Plc. Most of us could live with this level of risk. So let's call this **'almost no risk.'**

The real question is **"what do you get in return for almost no risk?"** The answer for as long as most of us can remember is – **"not enough to keep pace with cost inflation."** So the longer you leave your money deposited at almost no risk, the less it is worth.

Before everyone starts emailing to quote the fantastic headline grabbing rates that some BBS's are offering on their current crop of ISA's (and it's true – they are very good indeed) reflect on recent reports suggesting that BBS's are 'scamming' customers by offering headline grabbing rates of interest to get the business, and then quietly dropping the rate back down to less than 1% at the end of the first year. If you're nimble and aware you'll already have moved your cash to the next provider in line – but otherwise . . .

We're looking in this article at three different investment groups that all, in their different ways limit the risk you take whilst offering the potential for positive returns – that is, **returns greater than the rate of price inflation**.

The three are:

- Structured Products
- Guaranteed Products
- Absolute Return Funds

Above these three in risk terms you are looking at 'mainstream' stocks & shares investments in any or all of the world's stock-markets. Perhaps you already have such investments, either individually chosen by you or maybe as a part of a collective, through a Unit Trust/OEIC (maybe within an ISA) or an Investment Bond? Perhaps you've watched your money grow and felt pretty good at the time - only to see it **wiped out in the face of a market 'correction.'**

If you're investing for the medium to long term you have probably been fairly relaxed about the ups and downs of the markets. But even so, after the past couple of years of economic turmoil and with some analysts predicting that many of the world's stock-markets could 'flat-line' for the next 10 years, an **understandable degree of nervousness** may be creeping in.

The insecurity you feel when things don't seem to be within your control will be heightened if you're relying on your invested money to provide income either now, or in the near future. Anyone close to retirement can be forgiven for wondering just what standard of living lies ahead if things don't settle down soon. In this situation it is almost certainly time to look carefully at the risks you are taking and to **rigorously 'rebalance' the portfolio into lower risk sectors** where you feel these are too high. We can help with this.

Structured Products - A Level Up From Deposit Accounts

In General

Although there are some exceptions to this general rule (and we'll cover one of these in particular later) in essence Structured Products (SP's) allow you **to take a limited 'bet'** about the future of a particular stock-market - often the UK FTSE 100 - whilst giving a pretty reasonable capital guarantee in case you're wrong. **Your return is fixed at outset**, so you will know before investing what the possible percentage gain is going to be.

Using FTSE 100 based products as the example, the 'bet' you're making is that at the end of the investment period (usually between 3 and 5 years) the FTSE index will be higher than it was at the start. You don't have to say how much higher; any gain at all is enough to pay out. Most commentators, however gloomy in the short term, would reckon that over the medium to longer term western stock-markets are likely to rise, so this doesn't seem an unreasonable or particularly risky bet.

However, one small point to note here (to save disappointment later) - the calculation is nearly always made as 'simple' interest, meaning that it's not compounded year by year. So if you invested £40,000 over 3 years at a return of 7% pa., your maximum return would be £8,400 (£40,000 x 7% x 3).

Arguably the downside comes in the amount you could be giving away in settling for a fixed return. Suppose for example the market grew by 60% over a 5 year period, and your SP guaranteed a return of 7% a year you would get 35% (7% x 5 years) not 60%. Is that a price worth paying for the security of knowing in advance what you're going to get?

Looking at the products available as we write, the fixed returns are **between 6% and 8% gross** a year. This is a great deal better than you're going to find in any ordinary Bank or Building Society deposit account.

Kick-Out Plans

A variation that we find particularly interesting is, as an alternative to a flat fixed term, what's known as a 'kick-out' plan. Again these are normally given a 3 to 5 year plan term, but the beauty of the kick-out is that **you get a number of chances to earn the projected payout**. With a 5 year plan paying 7% a year for example, it works like this:

1. You invest your money for a minimum of 2 and a maximum of 5 years
2. If at the end of year 2 the FTSE 100 has risen **at all** from its opening level your money is returned in full, with an interest payment of 14%. We would then look for a new investment
3. If it hasn't made a gain, you go on to the end of year 3. Once again if the index has risen from its original starting point your money is fully returned with an interest payment of 21% - but if not you move on to year 4
4. The gain is guaranteed at 7% each year at whatever point the FTSE has risen above its starting point so, if that is at the end of

year 4, the gain is 28% and that, plus the original sum invested, is returned. Otherwise you move to the final year

5. If there is any gain at all in the FTSE 100 compared to the original level, your starting capital is returned with a full 35% interest payment

Many of the newer products on offer give a guarantee that if the FTSE index is lower at the end of the period your initial investment is fully returned. Some, in exchange for the promise of a higher annual return if things go well (meaning that there is some growth in the index), will return your initial capital in full unless the index has dropped below 50% of its starting value. In our view, with the index running at about 5,700, the likelihood of it dropping down to, and then below, 2,850 over the next 5 years is minimal. Over the past 20 years the lowest the index sank to was around 3,400 – well above the 50% safety net level. This therefore looks **very much like a guarantee that your money is secure**.

A Variation on the Theme – Senior Life Settlements

So far then, we've talked about the type of Structured Product that's based on the growth or otherwise of a market index of stocks and shares. However, the principle of taking a limited 'bet' can be extended beyond this horizon. One product that we've been looking at very closely is based on 'Senior Life Settlements.' As the name implies, this has nothing at all to do with the FTSE. Instead it is about how long people live, and specifically how long those, living in the USA with health problems and who've bought Life Insurance policies, will live.

The principle is that investors buy a 'pool' of Life Policies from those who wish to surrender them. The price they offer to the seller is greater than that offered by the Life Company. These policies are then held until the death of the insured, and if that death is within the term of the policy, the investment group receives the death benefit.

The skill is in buying policies where death is more likely to occur – thus investors usually concentrate on 'impaired life' policies since, although these will be more expensive on the market, the chances of them paying out will, statistically, be greater. The gross target return is between 9-10% and all the evidence of the past few years is that this is what they achieve and exceed. SP's based on Senior Life Settlements claim, and would appear to be, low risk investments. The main risk is that the pool of policies bought by the investment group fails to meet their mortality expectations, but in today's world the underlying mortality statistics are pretty well known. Our advice would be to offset this potential risk by setting your expectations lower (be less greedy!) – say down to the same level as for FTSE index linked SP's – somewhere around the 6-8% mark.

This type of SP will also allow you to withdraw the 'profit' earnings it makes as income. This could be useful.

The specific risk to your capital is more difficult to work out. It's not a bet against an index so there's no absolute level to measure against and therefore no direct threat to your initial investment. It's also an open-ended contract so there's no fixed term. Hypothetically though, and precisely because there is no fixed term of years, if it happened that a large percentage of investors all wanted their money out at the same time this could cause a cash-flow problem and might mean a delay in returning your funds. As we see it then, this product is low on the risk scale.

The Underlying Risks of Structured Products

Apart from the stated risks, what else might lie underneath one of these SP's that could be dangerous? The thing that we, as your advisor, look out for is the strength or weakness of the company or organisation that sets up the deal. This is not so much about the brand name on the prospectus, but more about who holds the purse backing the 'bet.' This third party is known as the 'Counter-party.' In the past there was a degree of secrecy about just who was backing a particular offering and SP's came in for an amount of regulatory criticism. Now things have been made much clearer and it's possible to form a reasoned judgement on the total viability of the product.

Taxation

All the capital gains and income generated within SP's are taxable. However, most are capable of being ISA'd up to the current personal limits - £5,100 or £10,200 depending on what type of SP you're investing in.

Guaranteed Funds

Guaranteed funds allow you to **choose the level of capital protection** that will suit your risk tolerance – anything from 100% down to around 70%. However, on the basis that there's no such thing as a 'free lunch' you can safely reckon that the higher the level of protection you want, the more it will cost.

These funds work on the principle that a proportion of your capital is used to buy a fixed interest Bond the return on which, over the fixed term of the investment, will make enough to give you back the guaranteed percentage of your capital you wanted, even if

everything else turns sour. 'Everything' in this context is usually **an investment in a broadly based basket of FTSE listed shares**. Because a slice of your money has already been used up in buying the guarantee there is clearly less left to invest in these shares. This means that your participation in market growth is always going to be less than 100%. If securing your capital whilst achieving a return a little ahead of inflation is what you want, then this type of bond could be what you're looking for.

As an example, one of the big investment names, Zurich, is presently offering a 5 year fixed

term bond where all of your capital is guaranteed; you will get up to 70% of the FTSE's growth during the term, with a minimum return (if there is no growth) of 3 ¼% a year.

You should note that these really are fixed term contracts - **you cannot take your cash** out at any intermediate point. The positive returns you make are taxed in the same way as a bank account. However, because these **are** essentially bank deposit accounts, they can be held within a cash ISA up to the new annual limit of £5,100 and as such would not be taxed at all.

Absolute Return funds

These have become quite trendy – Absolute Return (AR) sounds like just what we all want. Beware though; AR funds are the riskiest of the three 'safer' investment types we're discussing here.

That is because AR **does not mean that you will get a positive return**. They are simply funds invested directly into a basket of shares that are reckoned by the fund managers to be capable of performing well even in bad market times. "Surely" you say – "shouldn't fund managers be doing that in **every** fund anyway?" Well yes, but . . .

AR funds are rated as cautious on the risk/reward scale; the fund picking the managers do has this caution as its trademark – that is, they try to minimise any potential loss. Because of this

positioning they're not necessarily geared to maximise returns in the good times.

To make AR funds work, good fund picking is vital; so the **skill of the fund manager is central**. To aid us in choosing the most successful we use a number of research tools. Principal amongst these is Citywire; an organisation whose main function is to monitor and record the activities, successes and failures of all the key players in the market.

If you're an investor who's been 'rattled' by the stock-market roller coasters in the past few years, these AR funds may be where you want to go. They should be less volatile and so give a steadier return.