

Product safety claims don't hold water

There is a vogue for complex products designed to tempt cautious investors with a seductive prospect of low risk and a chance of high returns. Don't waste your time on them, says **Stuart Fowler**

The Prudential Group has been busy encouraging independent financial advisers to distribute its 'PruFund' investment bond, the first of a new breed of 'smoothed investment fund'. The bond is split into two versions, one of which, Growth & Income, is the most clearly designed to be suitable in the market Prudential suggests IFAs should target - cautious investors sitting on their cash.

The PruFund is set to join a plethora of products that have tried in the past to tempt cautious investors out of safe harbour without straying far from land: with-profits, zero-dividend preference shares, cautious managed funds, corporate bond funds, guaranteed equity products and structured capital at risk products. Why, if this is supposedly safe territory, have so many of these products been wrecked there or disappointed their investors?

To answer the question, it is helpful to stay with the notion both of a safe harbour for money and of a widening spectrum of uncertainty of outcome the further you travel from safe harbour. The analogy fits both financial market risks and people's behaviour. Another aspect of the analogy is also helpful: a cautious investor can theoretically choose a suitable point on the risk spectrum by moving a lot of money a little way out or a little money a lot further way out. This distinction is important because suitability can then be seen to be not just a function of the

products but also amounts of money or relative exposure. This is the realization behind the calls for better education about 'asset allocation' - for professionals as well as their customers.

Most products aimed at cautious investors seek to attract the largest amount of money because the industry assesses its commissions and annual management charges on the amount of money. These products disappoint because the premiums or incentives offered by financial markets close to safe harbour are small (precisely because they have less risk to compensate) and so are frequently overwhelmed by the boat-builders' high charges. The way to escape this trap is to move smaller amounts further out where there is greater risk but also sufficient incentive in the form of expected returns after all charges.

A common failing is that the vessels are engineered to transform market risk, by attaching some form of stabilizer so you can venture further from land without additional risk. The oldest form of stabilizer is the with-profits fund. The idea was to use the capital in the fund to smooth payouts, by Peter's payout (in a favourable market environment) subsidizing Paul's (if his happens to mature when markets are low). This seductive notion turned out to be fanciful and risk was actually increased: Paul ended up subsidizing Peter.

The PruFund is interesting because its new, systematic approach to smoothing the daily path of unit values relative to the underlying market price of each unit is very limited in scope and will be suspended if the gap between the two triggers large redemptions. This is a tacit admission that smoothing cannot transform market risk: it can only be provided when it isn't needed, which means it looks good but is of no value to the average investor.

Financial markets do have instruments that can transform market risk, but at a price: derivatives. They can change the shape of the distribution of payouts from the symmetrical upside and downside that investors can intuitively grasp into one with floors and ceilings that are not symmetrical. The cost of the transformation is also difficult to see and the value proposition difficult to assess. For a boat-builder or a distributor, this is rich territory for misrepresenting, or playing on the customer's propensity to misconstrue, the proposition.

The most extreme example is precipice bonds. After several of these blew up with great loss, the FSA tightened up the way these 'structured capital at risk products' had to be described. It stopped short of the best form of disclosure: if you look through to the underlying financial derivative, what is the activity being performed by the buyer of that derivative? In the case of a precipice bond, the investor was providing catastrophe insurance to other investors who wanted protection against a large fall in the market. These other investors were willing to pay an option premium for this protection. What made the likes of Lloyds TSB, who packaged that premium as a high yield, think that their safe harbour customers wanted to be in the business of providing catastrophe insurance to investors way out of harbour?

Guaranteed equity bonds, flying off the shelves at the moment (including National Savings & Investments' shelves),

use a highly geared equity index option as a small part of the package so that a large amount of money can move safely out of harbour. Buyers tying up their money for five or six years in this sort of product have barely a one in three chance of maintaining the real value of their capital and as much chance of earning nothing as earning the 50% or so they probably think is available. These are odds cautious investors appear routinely to reject when faced with a straightforward choice between safe harbour and equities, so widespread regret is likely.

Corporate bonds may also disappoint by not living up to their billing as located just outside safe harbour. These make up nearly half the planned asset allocation of the PruFund 'Growth & Income' bond. For product builders, corporate bonds are useful because they produce a higher nominal yield, which automatically smoothes the path of returns and can be used to absorb high charges. But these yields are higher to provide an incentive to take extra risk, related to both the credit-worthiness of private borrowers and the lower liquidity.

The lesson for most investors is simple: limit your universe to cash deposits, inflation linked National Savings or index linked gilts (both of which are the right safe harbour if protecting against the risk of inflation eroding purchasing power) and equities. Think in terms of asset allocation, or the way you combine these few essential building blocks in response to both needs to protect wealth or assure living standards and aspirations to increase real spending power. And watch costs; they do not even need a storm to sink an otherwise sea-worthy vessel.