Title: Capital Protected Products: Look before you jump

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The World changed on March 09, 2009. As the global economies came out of recession and US Dollar remaining weak, the financial tsunami in form of capital flows spilt all over the world, resulting in synchronized rise in all risky asset classes such as stocks, commodities etc. Indian stock markets have not been isolated from the financial tsunami. FIIs inflows in 2009 crossed USD 15 bn (around Rs 69,000 crs) and the Indian stock markets rallied from the bottom by more than 100%. Though the recent Dubai debacle proved as a set back to the risk appetite and reminded the investors world over that the fear of unknown is much bigger than the fear of known.

Retail investors who stayed invested through the turmoil of 2008, benefited from the rise. For new investors the bottom of the markets has been fairly elusive. Now with the markets on the rise, the questions that cross investors mind is "What to do now? Buy, Hold or Sell ". Ultimately these questions lead to the fact that "Whether my capital will be protected or not, if I hold or buy now?".

In such a situation many a times, investment advisors suggest structured products such as Capital Guaranteed Plans or Capital protection Plans, offered by portfolio managers or mutual funds. What these plans do is offer is to protect your capital from downsides (zero loss) in the stock markets. But there is no free lunch in this world. The capital protection usually comes in form of investors giving up some portion of future returns that otherwise would have been accrued to him.

SEBI in 2006, re allowed the introduction of Capital Protection Oriented Funds (CPOF). The registered portfolio managers offered capital protection through the structured products route. The performances of such products are often linked to the performance of an underlying asset class such as gold or an index such as NIFTY.

We will focus on what the investors should be aware of before, investing into an Equity (stock markets) linked Capital Protection plan.

The SEBI regulations state that the CPOFs should have the capital protection embedded in the portfolio strategy and no external third party guarantee (such as from bank etc) or insurance should be used. SEBI also stipulates that the CPOFs will also be close ended funds, viz investors cannot exit before the maturity of the fund, which is usually 3-5 yrs. SEBI regulations also makes it mandatory for the CPOFs to be rated by credit rating agencies such as CRISIL in order to give some confidence to the investors.

There are various capital protection portfolio strategies that are used to tailor such products. Without going into the technical details on the strategies, I will quickly name them:

1. Static Hedge
2. Dynamic Hedge
3. Constant Proportion Portfolio Insurance
4. Dynamic Portfolio Insurance

In short, such strategies are customized with a mix of debt instruments of high quality (bonds and debentures) and Stocks. The debt instrument proportion is very high, which is expected to provide the capital protection on maturity and the stock proportion to provide higher capital appreciation. Globally leverage is also used to enhance the returns from the stock portion of the portfolio, though SEBI does not permit it for mutual funds, being a little risky..

Lets now come to some characteristics of CPOFs and the risks of the same:

1. Such plans are offered by mutual funds as well as stock brokers through there PMS (Portfolio Management Schemes). Investors have to be more cautious when relatively non reputed brokers with no track record offer such products. The lack of experience in the product design might be a source of risk for the investor..
2. Usually CPOFs and related products are close ended and the horizon is 3-5 years. So the money can't be taken out by the investors prior to the maturity of the plan.
3. The capital protection comes from the portfolio strategy and not in form of a bank or corporate guarantee etc. If the fund manager commits an error in implementing the strategy, there are chances that the capital protection might disappear, and investors might incur capital losses. So Rs 100 invested, may be lower at maturity. That's precisely the reason such plans are known as Capital Protection "Oriented "Plan and not "Protected" Plans
4. The so called capital may be protected but, the income or returns from the CPOF are not. The income or return is not guaranteed. Technically it might go to zero percent too.
5. The returns from the equity linked CPOFs may not be exactly equal to the returns from the underlying index. It will be lower due to various costs incurred by the fund manager assuming no leverage is used. It can be higher if leverage (borrowing or using options/futures) used by the fund manager (subject to regulations). Please refer to Chart I & II below.
6. If leverage is used in the portfolio strategy, the chances of capital and revenue losses are higher, if the strategy goes against the investor.
7. Another risk stems from the fact that the debt portfolio which consists of bonds which might default resulting in capital losses. The company that had issued the bonds failed to repay its debt.
8. The transaction costs (brokerage etc) are higher for some of the capital protection strategies, due to frequent churn between equities and debt.
9. Sudden and rapid changes in the interest rate levels may expose the product to reinvestment risks.

It's very important for the investor to not to get tempted to the packaging and selling of CPOFs by brokers and intermediaries. The understandings of the above risks and the suitability of the product are indispensable prior to making any investment

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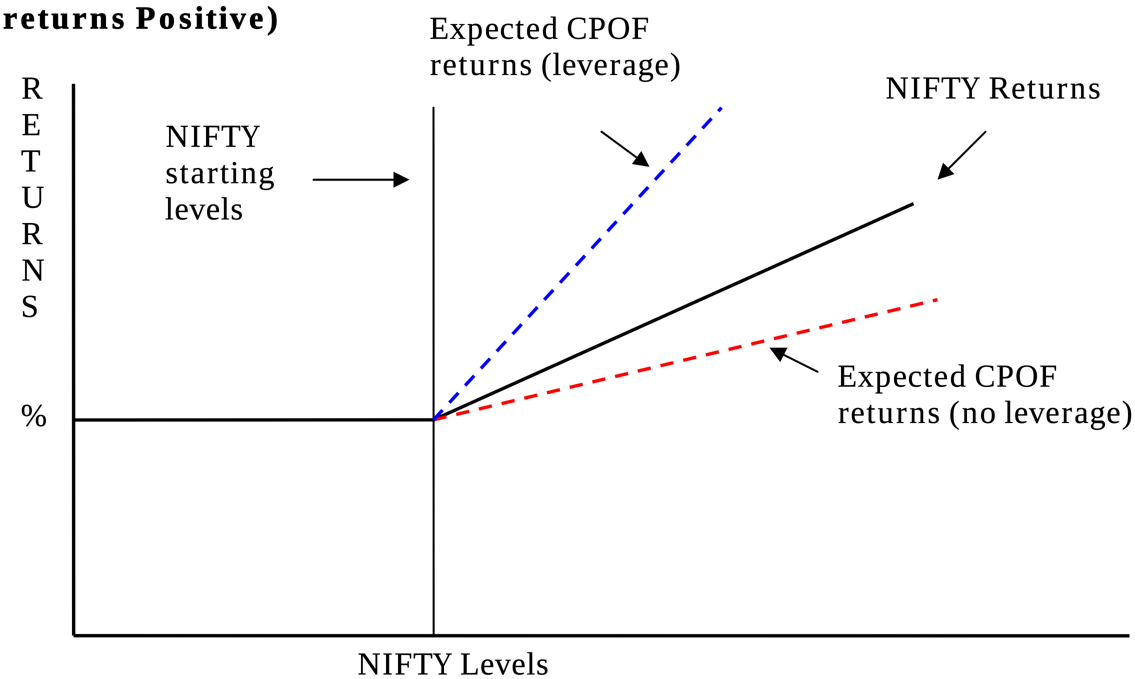
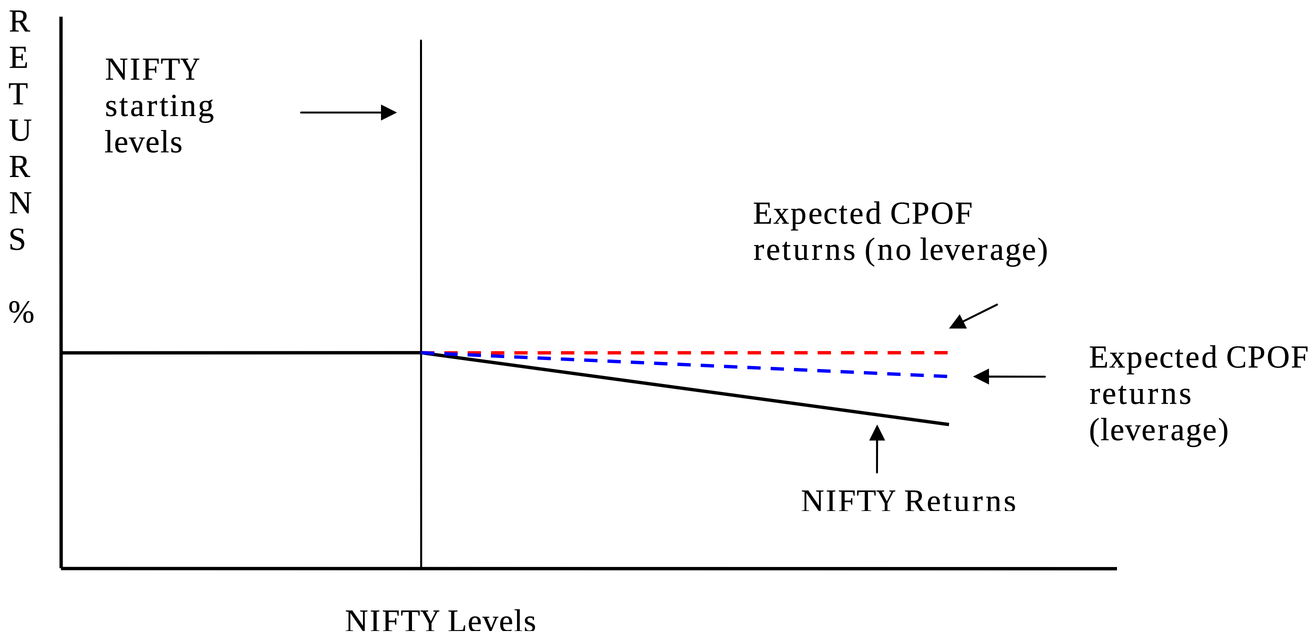
ANNEXURES: These charts are only for illustrative purposes. Actual results may vary depending on the structure and strategy of the product.

Chart I: A typical payoff in an Capital Protected plan (If Nifty returns Positive)



For Chart II Please refer to the next page.

Chart II : A typical payoffs in an Capital Protected plan (If Nifty returns Negative)



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