

Managing guaranteed products: how tight is your parachute?

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The first requirement of a guaranteed product: security

Investors want guaranteed products primarily in order to project accurate quantifiable results, in francs, and to answer their specific query: "What is the maximum amount of loss I'm facing with this investment?".

Traditional portfolio products - equities, bonds, even tailored products - cannot provide the investor with any certainty on this issue.

At best, managers will have some idea of what will probably happen. But even the most elaborate probability theories can be swept away by sudden market turns. How many customers thought they would lose money on bond-based investments in 1994, or in even 1999? Who would have guessed that equity investments would plunge 40% between July and the end of September in 1998? Or that the "Equilibre" fund would see a 15% decline over the same period? At that point, a demand for investment vehicles that could avoid this kind of surprise naturally began to surface. It so happens that guaranteed products naturally fit that requirement to a T.

The added plus of guaranteed products: comfort

On first analysis, you readily expect a guaranteed product to trend upwards to a guaranteed value at maturity. The real picture, however, is more complex. The insurance underpinning the product does not simply guarantee a given value at the end of a certain time period - it causes the investment to perform differently throughout its lifetime. The demanding guarantee commitment can only be honoured by applying adequate management policies, limiting the risk of loss from the very first day the customer invests.

The investor benefits from protection of the initial capital at maturity and from a management

technique which, by design, systematically avoids the most unwelcome market turns. It is this behavioural stability, which first appears to be an ancillary guarantee, that becomes the product's primary quality.

Consider an equity fund that carries a 5-year guarantee. In actual fact, there are very few scenarios in which the CAC 40 declines over a five-year period. Should you pay for insurance against an occurrence which is, after all, very infrequent? Perhaps it is not so useful. But it becomes useful if it means riding all the way to the end in greater comfort and security. Although it is difficult to estimate the cost of insurance against an improbable but catastrophic widespread crash, having high-quality shock absorbers is a precious advantage on a day-to-day basis.

To illustrate this, Table 1 compares the behaviours of two funds: one carrying a guarantee on 100% of the principal over three years, and a classic fund with constant 33% exposure to the CAC 40.

We assume that market conditions are such that these two funds follow the CAC 40 index trends to wind up at similar levels upon maturity, making it a fair simulation.

Both funds are observed in three-month market declines. We see that the sharper the decline, the stronger the shock-absorber effect. In a 30% downslide, the guaranteed fund slips only 5%, while the classic fund loses 10%. The former has only slid half as far, and the end of the guarantee period is still very far away.

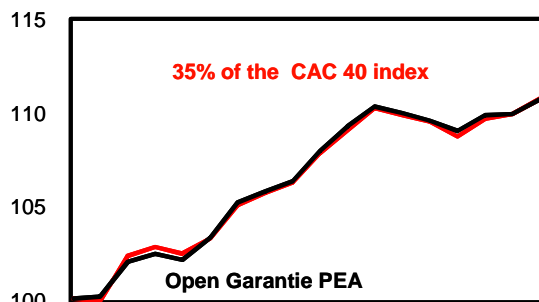
Launched in early 1998, Open Garantie PEA delivers a double guarantee. Each unit-holder is guaranteed that 5 years after the initial investment, the value at liquidation (NAV) will be at least equal to the higher of: the initial NAV, or 95% of the highest NAV over the 5-year period.

The fund's initial French market exposure was 35%. As seen in Chart 1, its behaviour over a 5-month uptrend from January to May 1998 was naturally very similar to that of a simulated fund with an identical 35% exposure to the CAC 40.

However, during the crisis of September-October 1998, the two funds behaved very differently. The management strategy dictated by the guarantee gave Open Garantie PEA a much smoother ride on the downcurve than the fund with 35% exposure to the CAC 40. This "shock-absorber" effect is perfectly illustrated in Chart 2.

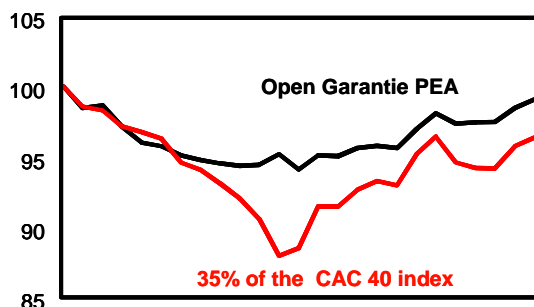
The unit-holder therefore benefits from the guaranteed protection of the fund, even though the maturity date is still a long way off.

Rise period: from January to May 1998



Source: SINOPIA's calculations, Bloomberg

Around the crack: from July to December 1998



Source: SINOPIA's calculations, Bloomberg

Impact of a market decline on a guaranteed fund and a traditional fund with similar indexation (table 1)

Market indice	Guaranteed fund	Traditional fund	Shock absorber effect
-10%	-2.1%	-3.1%	31%
-20%	-3.9%	-6.6%	42%
-30%	-5.0%	-10.4%	52%

Source: SINOPIA's calculations

Safety & performance: what kind of mix?

Once the vehicle is equipped with shock absorbers, most people find they want to adjust them for a smoother or firmer ride. If the guarantee coverage is fixed at 100% of the capital, adjusting the duration will change the overall results. In this manner you can obtain a "money market plus" fund with a 3-month guarantee or a more equity-based type fund guaranteed over 8 years.

However, you can make even finer adjustments by allowing some variation in the guarantee coverage. In this way, the products themselves offer a wider range of possibilities. This is the idea behind our guaranteed funds.

These funds carry a guarantee that does not cover 100% of the capital. Euro PEA Protection guarantees the investors that they will retain at least 90% of the initial investment in 5 years.

This type of fund is managed with a portfolio insurance strategy, and it holds the road in the same way as a guaranteed fund. However, as the guarantee is less demanding, it has more leeway to fluctuate-and consequently a greater market exposure.

Ultimately, this difference of risk in the fund will be more visible to the unit-holder than the difference in the guarantee level at the end of the period.

We could even regard this level of guarantee no longer as a simple financial plus, but as an adjustment tool to fine-tune the fund's overall performance.

Table 2 shows how this broadens the range of possible products.

It compares the market exposure for each fund and the sensitivity of its "shock absorber".

The +++ grade is assigned to a shock absorber that kicks in as soon as the market declines.

The first line features funds that offer guarantees covering 100% of the value at liquidation, but over different time periods (from 2 to 8 years). We see that the sensitivity of the shock absorber varies in inverse proportion to the initial exposure. It is therefore not possible to have the benefit of a fund with high market exposure and a sensitive shock absorber.

Main features of a fund with varying capital guarantees and maturity periods (table 2)

The following lines, with funds that offer guarantees covering 95% or 90% of the initial capital, do indeed combine both those features.

This makes it possible to devise a short guaranteed fund covering 90% of the capital but with market exposure of over 40%, whose shock absorbers rapidly kick in.

Adjusting the guarantee amount enables the fund to meet broader performance requirements in terms of exposure, and how it "hugs the road" in sharp market turns.

Guarantee level		2 years	3 years	5 years	8 years
100%	Initial exposure shock absorber	20% +++	25% +++	32% ++	40% +
95%	Initial exposure shock absorber	31% +++	33% ++	36% ++	44% +
90%	Initial exposure shock absorber	41% ++	43% ++	46% +	51% +

Source: SINOPIA's calculations

Bear in mind that the exposure levels used in Table 2 are closely linked to the market conditions in which they were simulated.

Reinventing traditional savings products using secure management techniques

By varying the maturity period and guarantee level, then, it is possible to design a family of tailored funds which all "speak" directly to the customer in terms of specific protection while meeting different investment requirements. The typically "cautious" customer would need greater protection, and a more aggressive investor would want a more dynamic line, with more flexible protection. These can now be combined with any maturity period.

Applying these principles to a varied guarantee scale - the same kind used by Sinopia for managing its open-ended guaranteed products - we see a possibility of devising a range of funds sustainable over the long term and offering a broad range of risk. This range could compete with or round out the current offer of tailored funds, by combining traditional management techniques - based on diversification and asset allocation - with the security of guaranteed products.

Perhaps these "tailored-protected" products, the 1999 innovation, can now enhance the simplicity of tailored products by adding on guarantees.

The guarantee is not the only attribute of a guaranteed product. The quality of management shines through for the entire life of the product. This is corroborated in Micropal, which put Open Garantie 100 products in their "Flexible Management" category, and rightly so as the portfolio is made up of variable proportions of French equities and bonds.

This gave the funds a chance to prove themselves against their non-guaranteed cousins. They snapped it up and showed what effective "guaranteed" management techniques can do: following Open Garantie 100 No. 4 in 1997, the Micropal Award winner in 1998 in this category was Open Garantie 100 No. 3. Each time, two other funds of the same family were among the first 5 winners in their class.

Who says guaranteed funds can't perform?

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