A new tool for the treasurer?

The protected equity fund is not a traditional treasury tool, but is one worth taking a closer look at. Richard Bolchover from Close Fund Management explains why.

The UK's first authorised protected equity fund, offering investors exposure to the upside movement of stockmarkets while protecting them from the falls, launched in March 1994. This represented a revolutionary and innovative development, which aimed to balance the competing forces that lie behind most investment decisions: risk and return, and fear and greed.

Most investors, particularly those who are investing for the short- or medium-term, or who do not know at the outset what their investment period is going to be, need some assurance that the value of their investment will not decline precipitously. They are particularly concerned that the value does not either fall immediately after their initial investment or before they need to realise their investment. But investors also want to gain access to growth, and it is an axiom of the capital markets that, over the long term, the equity risk premium offers a return above and beyond the risk-free rate.

Here then was a product that offered some of the benefits of both worlds. It contained risk and offered an exposure to good expected returns. And it did so while offering daily liquidity and in an authorised form.

The genesis of these protected funds lay in a far sighted Government initiative in 1991 which had allowed a greater use of derivatives within authorised UK funds.

A coalition of Government departments, encompassing the DTI, the Inland Revenue and the Treasury, wanted to increase flexibility and innovation in UK funds, increase the choice available to investors, maintain the UK's competitive position and promote the UK derivatives markets. And the crucial elements that lie within the protected fund, namely insurance against market falls combined with a geared exposure to the market provided by the remaining assets within the fund, required the use of derivatives. The government's 1991 regulatory change thus paved the way for the protected fund.

> Why would anyone invest in risky stocks if over the long run they did not provide a higher return than the risk free asset?

Protected equity funds

Protected equity funds are typically UK-authorised unit trusts, which, while offering daily liquidity and instant access, offer protection cycles that can range from three months to a year.

The basic proposition of the quarterly protected product is this – the price of the fund at the end of the three months, or year, will be no lower than a stated percentage of the price at the beginning of the period, no matter how far the stockmarket has fallen. This percentage typically ranges from 100% to 95%. Therefore, the price of a 100% quarterly protected equity fund would be no lower on the last day of the quarter than it was on the first day, no matter how far the stockmarket had fallen. If the stockmarket has risen, then the fund price would have risen. The next protection level will be set at this new higher level. (See *Figures 1 and 2* overleaf).


Richard Bolchover

The investor base of protected equity funds is already extremely large and is not confined, as many other investments are, to a particular investor group.

Retail investors, life funds, pension funds, charities and corporates can all be found on the unitholder lists of these funds. These are funds that appeal to all types of investor and, given the essential characteristics of their return, are not subject to the whim of market fads or seasons.

Corporate treasurers who are using these funds point to six main reasons for their usage:

- portfolio diversification;
- exposure to the equity risk premium and its expected return;
- clear definition of risk;
- a hedge for equity liabilities;
- excellent credit risk; and
- instant access and liquidity.

Portfolio diversification

For most corporate treasurers, the protected equity fund is in some ways a very different asset to those they usually use. Its primary relationship is to the equity market, not to the money markets. The correlation matrix shown in *Table 1*, based on monthly data, shows clearly that the fund relies on the equity markets for its returns, and so offers treasurers an almost unique opportunity to diversify their returns away from the traditional benchmark, without increasing the absolute risk of the portfolio.

Expected return

It is a well-known dictum of financial markets that the risk of investing in equi-

TABLE 1

Correlation matrix of monthly moves between 31/01/96-29/09/00

	Close UK escalator 100 (UT) Indexed Perf 0/0 Net IRP £	FTSE 100 (IN) Indexed Perf 0/0 Net IRP £	Interbank £1 Month (IN) Indexed Perf 0/0 Grs IRP £	Interbank £1 Month (IN) Indexed Perf 0/0 Net IRP £	FTSE-A Brit Govt up to 5 yrs (IN) Indexed Perf 0/0 Net IRP £	FTSE-A Brit Govt up to 5 yrs (IN) Indexed Perf 0/0 Grs IRP £
Close UK Escalator 100 (UT) Indexed Perf 0/0 Net IRP £	1.0000	0.7658	0.0695	0.0513	0.0912	0.1337
FTSE 100 (IN) Indexed Perf 0/0 Net IRP £		1.0000	0.1424	0.1262	0.1255	0.1541
Interbank £1 Month (IN) Indexed Perf 0/0 Grs IRP £			1.0000	0.9902	0.4266	0.4482
Interbank £1 Month (IN) Indexed Perf 0/0 Net IRP £				1.0000	0.4291	0.4491
FTSE-A Brit Govt up to 5 yrs (IN) Indexed Perf 0/0 Net IRP £					1.0000	0.9862
FTSE-A Brit Govt up to 5 yrs (IN) Indexed Perf 0/0 Grs IRP £						1.0000

Source: Close Fund Management Ltd and Lipper

ties is rewarded. Why would anyone invest in risky stocks, subject to sudden precipitous falls if in the long run they did not provide a higher return than the risk-free asset? In constructing a protected equity fund, once the capital protection of the fund is secured, the remaining assets are invested in highly geared derivative instruments on the underlying equity market. It is these that give the fund exposure to the equity risk premium and to the returns that come with it.

Hedging equity liabilities

To the extent that treasurers need, for whatever purpose, to hedge out an equity liability, while not exposing their portfolio to the full risk of equity markets, the protected fund offers an alternative. Its returns, as *Table 1* shows, reflect to a degree the returns of the equity markets, while still protecting the portfolio against losses.

Clearly defined risk

Unlike any other traded asset, protected equity funds offer a pre-specified risk parameter. Investors in a 100% quarterly protected fund know for certain that at the end of the quarter, the price of the asset will be no lower than at the beginning. This is not even true for otherwise supposedly safe investments. There is, for instance, an 11% probability that the total return on short-term Gilts will be negative in a quarter. For certain types of investors, particularly those who cannot afford at a future date to have a portfolio value lower than they have today, this is an essential element in investment, and the protected equity fund offers virtually the only alternative to merely holding deposits.

Excellent credit risk

Protected equity funds are subject to all the risk spreading requirements of all other authorised unit trusts. A third-party trustee holds the assets of the fund in trust for the investors. Any over-the-counter derivatives are limited in size per counterparty and exchange traded derivatives benefit from the immense security provided by the clearing house.

Instant access and liquidity

Almost all protected equity funds offer daily liquidity. The price appears in newspapers and on all the data feeds. Money can be accessed at T+1, another benefit over straightforward equity investments.

Arming the treasurer

The protected equity fund is certainly not a traditional treasury tool. Nonetheless, it has proved very attractive to those treasurers who want to diversify their portfolios, who need or desire to add an element of equity return, and who need clearly defined asset risk parameters. It offers something different, for those who need it, and is a welcome addition to the treasurer's armoury. ■

Richard Bolchover is a Director at Close Fund Management, the specialist investment management division of the Close Brothers Group.
info@closefm.com

FIGURE 1

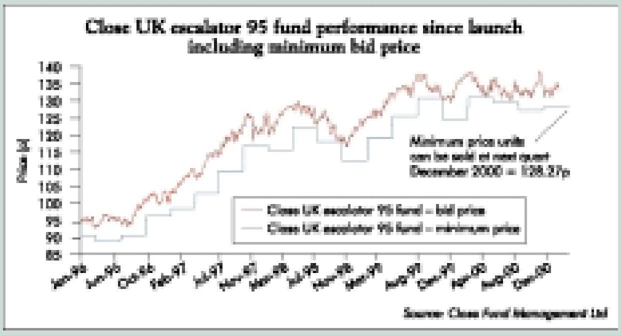

FIGURE 2