INSURANCE SECTOR EDUCATION AND TRAINING AUTHORITY

LEARNER GUIDE

Unit Standard Title:	**Apply knowledge and skill to explain the application of structured long term insurance portfolios**
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Apply knowledge and skill to explain the application of structured long term insurance portfolios

Introduction

Insurance is a must when it comes to securing your assets and your family's future. It's essential to create and protect your wealth. Most of us work this hard and try to grow our wealth so that one day when we retire, we can enjoy the best of our golden years. What if we lost everything we worked for because we were ignorant and not insured for it? How would we feel?

The importance of having a structured insurance portfolio makes provision for the bad days or years we may have through an unforeseen circumstance. Nobody is infallible and the decisions we make today can certainly make our lives a whole lot easier when it comes to replacing a stolen car, a house ruined by fire or an accident that renders you incapable of working and providing for your family.

Different insurance portfolio options

The beauty of having a structured short and long-term insurance portfolio is that it takes care of these needs. A short-term insurance portfolio would generally cover you for your home, car, valuables and third party insurances. A long-term insurance portfolio will cover you in the event of death, disability and dread disease.

- Short-term insurance can be bought over the phone with any short-term insurance company
- Long-term insurance covers all the basic needs of protecting your income and family. These products relate to both personal and corporate requirements.

In this learner guide you will learn and demonstrate an understanding of the application of structured long term insurance portfolios.

Module 1:

The features of structured long term insurance portfolios

This Module deals with:

- The components of a structured long term insurance portfolio with reference to guarantees and market exposure
- The term and liquidity constraints of a structured long term insurance portfolio with reference to a particular product
- The fee structure of a structured long term insurance portfolio product and an indication of the impact of the fee on the performance of the product
- The use of tranche based products with reference to pricing, benefits and features of selected products
- The relationship between the returns in a structured long term insurance portfolio and the returns in the market and an indication of why there is a difference
- The difference between surrender value and intrinsic value of an investment with reference to conditions under which it is reasonable to exit a structured long term insurance portfolio

For you to be able to assist a client to select the best portfolio and invest money wisely you should know the features of structured long term insurance portfolios. This is covered in this Module.

1.1 The components of a structured long term insurance portfolio with reference to guarantees and market exposure

- **The Money Market**

More commonly known as cash, the money market is the market where liquid and short-term borrowing and lending take place. The instruments traded in the money market are generally very safe investments and return a relatively low interest rate that is suitable for temporary cash storage, i.e. bank accounts.

The money market is there for trading short-term instruments, where the “term to maturity”, i.e. the period from the date when trading takes place to the date of redemption of the loan, is of a short-term nature, i.e. one year or less.
Money market instruments are not traded through an exchange, but through telephone trading and OTC (over the counter) trading by a number of the larger banks and financial institutions. While there are no guarantees, money market instruments have an intrinsic guarantee as it remains in cash instruments so you get your initial cash back and growth known as interest.

Money market instruments are generally;

- Cash;
- Bankers acceptances (BA);
- Treasury bills;
- Promissory notes;
- Negotiable certificates of deposits (NCD);
- Short-term debentures;
- Bank deposits

- **The Capital Market**

For the investor who has large amounts available to invest for longer periods, there are numerous investment vehicles available in the long-term investment and loan market, called the capital market. These investments are referred to as bonds. This must not be confused with home loans or Mortgage Bonds. The major issuers of bonds in South Africa are the Republic of South Africa through the Treasury and semi-governmental bodies such as Eskom, Development Bank, Telkom, Transnet and Land Bank. (This is an IOU where government owes you.) Bonds are traded on the Bond Exchange of South Africa. (www.bondex.co.za). Bonds typically pay a lump sum payment on maturity (the original amount), as well as interim interest (known as a coupon) payments at regular intervals, normally every 6 months.

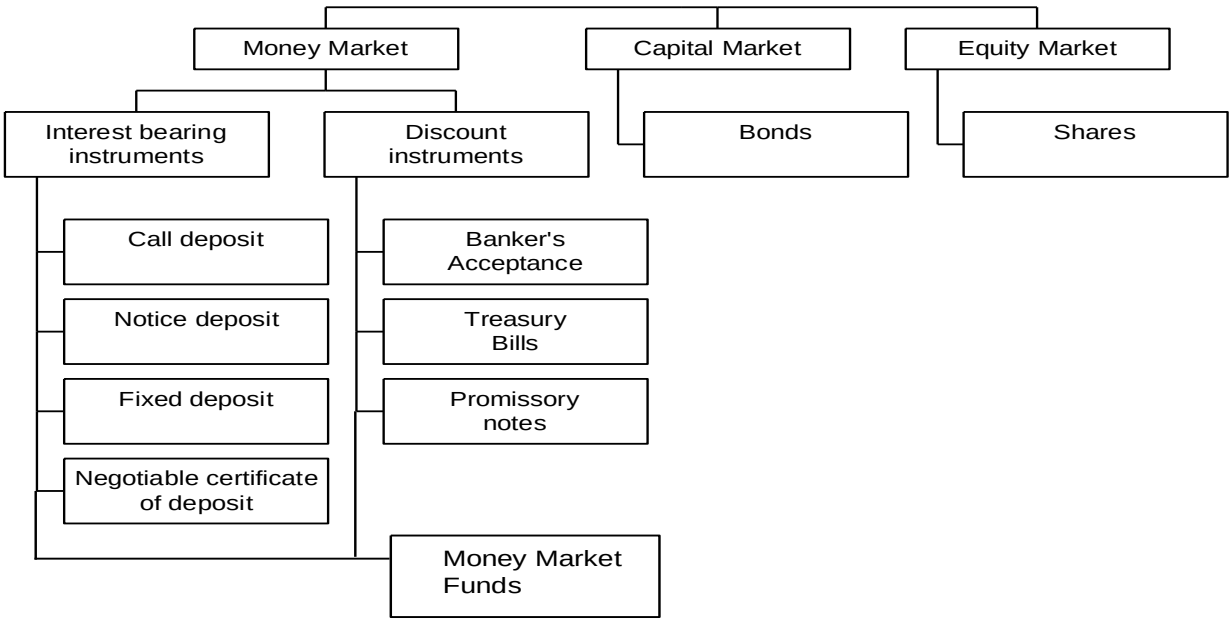
Capital market instruments are;

- Zero coupon bonds where you buy the bond at a discount e.g. R100 000 that you paid R80 000 for and get the principle amount (R100 000) at maturity. The maturity value is guaranteed by the Borrower (government).
- Government bonds where you receive interest payments normally every 6 months and repayment of your original capital at maturity, again guaranteed.

- **The Equity Market**

The equity market is the market where equities are traded. Equities, known as ordinary shares, are shares issued by a company, which if held, make the holder a part owner of the company and gives them the right to vote at annual general meetings, elect directors and benefit from profits of the company in the form of dividends, if declared. Equities are not guaranteed and subject to market conditions and fluctuations in their value.

- **The Markets and their underlying instruments**



1.2 The term and liquidity constraints of a structured long term insurance portfolio with reference to a particular product

Structured products have been shrouded in uncertainty and allegations of hidden fees, low liquidity, unwind costs and complex payoff profiles that often left investors wanting for returns. In some instances, in order to fund any guarantees, investors

would agree to forego dividend returns in exchange. The longer the investment remains invested, the higher the potential return, so term is important and as such short term investments should not venture into the realm of equities or exchange traded funds. In light of this sentiment, is there still space for structured products in an investor's portfolio?

Offshore analysis shows that between 15 and 25 percent of high net worth individual portfolios consist of alternative investments, including structured products. The value to the high net worth individual is the assurance that capital is protected while still gaining exposure to the market.

Let us first focus on the asset management process and the illustrious alpha - the goal of generating excess returns above market returns over a period of time.

Many have argued that this can be achieved in the local market due to market inefficiencies, arbitrage opportunities and the stock picking capabilities of top fund managers.

In the quarterly report for ETF Q4 2012 we look at Figure 1 where it can be seen how difficult it has been for active fund managers to beat the index. If we look at the percentage of funds that beat an index like Top 40, we see only 33% beat the index over 5 years.

Figure 1: Percentage of active funds beating the indices

	1 year	3 years	5 years	7 years	10 years
Benchmark 1: FTSE/JSE Top 40 TR ZAR	20.88%	35.06%	33.33%	20.41%	52.94%
Benchmark 2: FTSE/JSE Top 40 SWIX TR ZAR	14.29%	12.99%	15.15%	18.37%	29.41%
Benchmark 3: FTSE/JSE Mid Cap TR ZAR	12.09%	0.00%	1.52%	0.00%	0.00%
Benchmark 4: FTSE/JSE Dividend Plus TR ZAR	16.48%	1.30%	0.00%	n/a	n/a
Benchmark 5: FTSE/JSE RAFI 40 TR ZAR	26.37%	32.47%	9.09%	n/a	n/a

Source: Morningstar, general equity

With this in mind should we rather focus on the proliferation of exchange traded funds that have emerged? Most notable of these for local investors, with regards to offshore exposure, is the emergence of Satrix.

This is where structured products come to the forefront, where investors seek to participate in the upside associated with exposure to equity markets but avoid the danger of sharp market corrections or long-term bear markets.

The structured alternative is especially relevant offshore, where hard currency capital protection often holds value for the local investor. Investors looking to use structured products in their portfolios should note:

- First, the underlying capital protection should be provided by a sound financial institution with a strong balance sheet.
- Second, all fees, annual and upfront, must be fully disclosed, and all returns and the capital guarantee must be net of fees.
- Third, deal only with reputable institutions and individuals you can trust.
- Then come the fundamentals that set some of the products in the market apart from the masses.

While traditionally liquidity has not been available to investors, or has been available at high costs, the new-generation products usually incorporate liquidity at minimal cost. With the advent of Exchange Traded Funds and Index trackers, liquidity is readily available. However changing market conditions means the investor runs the risk of "cashing in" when markets are in a slump and losing possible growth.

Most important, however, is the effective exposure the investor gets to the market. This means the investor is faced with the option of investing in the market directly - thus being exposed to the cyclical nature of markets - against gaining market exposure over the long term - with capital protection and geared participation in market performance on the upside. In such a case, structured products should be part of the portfolio of any investor seeking to achieve maximum performance for manageable risk.

1.3 The fee structure of a structured long term insurance portfolio product and an indication of the impact of the fee on the performance of the product

Performance fees are increasingly becoming the order of the day. They are being introduced by asset managers, product providers and even some financial advisers. At first glance, performance fees seem to be a carrot to provide you with better returns, but you need to be very careful that you are not simply rewarding someone for providing you with performance that you would receive anyway from the markets.

Performance fees are fast becoming the preferred way for the financial services industry to garner profits from investors. It is becoming common for asset managers, financial advisers and hedge fund managers to charge performance fees, which, when combined with other costs, may reduce the performance you receive on your investment to very ordinary levels.

In simple terms, a performance fee is charged as a percentage of any out-performance of an investment relative to a benchmark, which may be inflation or an index, such as the JSE's All Share index (Alsi).

Performance fees come in a variety of forms. Some are simply a fee for achieving performance above (and sometimes a percentage below) a benchmark; some are ratcheted up in line with different levels of return exceeding a benchmark; some are charged over and above normal flat fees. Increasingly, performance fees are being structured so that the asset manager shares at least some of the pain for under-performance. However, performance fees are also becoming complicated, with no two asset managers calculating and charging them in the same way.

Some asset managers feel that there is no single performance fee structure that satisfies all investors, and therefore in every performance fee formulation there are positives and negatives.

- **Performance fees in principle**

The financial services industry, particularly the life assurance industry, is adept at hiding costs. In recent years, this has become more difficult, because all costs must now be declared in terms of the Financial Advisory and Intermediary Services Act, specifically the Code of Conduct. Full disclosure is also a requirement when you invest in an endowment or sinking fund product in terms of the Policyholder Protection Rules, provided for under the Long-term Insurance Act.

However, disclosing costs does not necessarily make it any easier for you to work out their actual impact, particularly when they are declared in a long list, sometimes as a rand amount, sometimes as a percentage of what you invest and sometimes as a percentage of your total assets. It becomes even more difficult to calculate the effect of costs on an investment when you add performance fees to your calculations.

The concept of only paying for what you get- by way of performance fees - is "massively appealing from an intuitive or emotional point of view".

Three factors determine what profits an asset manager earns. They are:

- The assets under management;
- The actual fee charged; and
- The cost of running the business.

Assets under management, in turn, depend on two factors: market returns in general and relative performance.

This means that performance has always been a critical ingredient in the financial success of any asset manager. Under-perform and investors vote with their feet. Out-perform and you collect new funds. So, a massive incentive has always existed for managers to ‘give it their best shot’, long before performance-based fees came into vogue.

- **How to understand investment costs**

The best way to judge the effect of costs on an investment, including one that has performance fees, is to use three calculations:

1. Annual reduction in yield.
2. Reduction in maturity value.
3. Total expense ratio.

1. Reduction in yield

Annual reduction in yield (RIY) is the amount by which the capital you have invested will be reduced by costs each year sometimes calculated daily or even monthly. Product providers should give you the RIY value as both the percentage and the rand amount by which costs will eat into your capital and growth.

It is difficult to show the RIY as a single figure when the investment has a performance fee. In this case, you need to see the impact of costs at different levels of return, particularly if the performance fee is variable and moves up in tandem with increased performance.

You should ask for the RIY in the following ways so that you can properly identify the effect of costs:

- On the basis of no investment growth. This enables you to identify the effect of all costs, excluding, in most cases, performance fees.
- On the basis of various percentage gains in your capital. If the performance fee is fixed, no matter what your investment actually returns, you should be provided with the impact of costs on annual returns of, say, five, ten and fifteen percent. If the performance fees are scaled upwards in tandem with investment returns, you should be given the RIY on each percentage point increase in performance fees.

2. Reduction in maturity value

Reduction in maturity value is similar to RIY, but it gives you a better idea of the full impact of costs over the term of your investment.

As with RIY, you should be provided with the impact of costs under different investment scenarios. If there is no fixed investment term, ask for the reduction in maturity value over five, ten and twenty years.

- The RIY and reduction in maturity value calculations must include all costs, including upfront charges, commissions and fees, annual costs and layered costs, particularly when you are investing through a multi-management-type structure.

- Be wary of buying an investment if a product provider refuses to give you the RIY and reduction in maturity value. If your request is met with excuses, such as the costs cannot be provided because they are "embedded", you can be sure that the costs are embarrassingly and excessively high. A good example is the "structured" investments provided by life assurance companies, many of which have bombed out for investors.

3. Total expense ratio

Investopedia defines total expense ratio (TER) as a measure of the total costs associated with managing and operating an investment fund such as a mutual fund (collective investment scheme). These costs consist primarily of management fees and additional expenses such as trading fees, legal fees, auditor fees and other operational expenses. The total cost of the fund is divided by the fund's total assets to arrive at a percentage amount, which represents the TER. (Advisor fees have not necessarily been added.) Investopaedia goes on to explain that the size of the TER is important to investors, as the costs come out of the fund, affecting investors' returns. For example, if the fund generates a return of 10% for the year but has a TER of 4%, then the gain is reduced to roughly 6%.

1.4 The use of tranche based products with reference to pricing, benefits and features of selected products

In structured finance, a tranche is one of a number of related securities offered as part of the same transaction. The word *tranche* is French for slice, section, series, or portion.

In the financial sense of the word, each bond is a different slice of the deal's risk. Transaction documentation usually defines the tranches as different "classes" of notes, each identified by letter (e.g. the Class A, Class B, Class C securities) with different bond credit ratings (ratings).

The term "tranche" is used in fields of finance other than structured finance (such as in straight lending, where "multi-tranche loans" are commonplace), but the term's use in structured finance may be singled out as particularly important. Use of "tranche" as a verb is limited almost exclusively to this field.

How tranching works

All the tranches together make up what is referred to as the deal's capital structure or liability structure. They are generally paid sequentially from the most senior to most subordinate (and generally unsecured). The more senior rated tranches generally have higher bond credit ratings (ratings) than the lower rated tranches. For example, senior tranches may be rated AAA, AA or A, while a junior, unsecured tranche may be rated BB. However, ratings can fluctuate after the debt is issued and even senior tranches could be rated below investment grade (less than BBB). The deal's indenture (its governing legal document) usually details the payment of the tranches in a section often referred to as the waterfall (because the moneys flow down).

Tranches with a first lien on the assets of the asset pool are referred to as "senior tranches" and are generally safer investments. Typical investors of these types of securities tend to be conduits, insurance companies, pension funds and other risk averse investors.

Tranches with either a second lien or no lien are often referred to as "junior notes". These are more risky investments because they are not secured by specific assets. The natural buyers of these securities tend to be hedge funds and other investors seeking higher risk/return profiles.

"Market information also suggests that the more junior tranches of structured products are often bought by specialist credit investors, while the senior tranches

appear to be more attractive for a broader, less specialised investor community". Here is a simplified example to demonstrate the principle:

Example

- A bank transfers risk in its loan portfolio by entering into a default swap with a "ring-fenced" SPV ("Special Purpose Vehicle")
- The SPV buys gilts (UK government bonds)
- The SPV sells 4 tranches of credit linked notes with a waterfall structure whereby:
    - Tranche A absorbs the first 25% of losses on the portfolio, is the more risky.
    - Tranche B absorbs the next 25% of losses
    - Tranche C the next 25%
    - Tranche D the final 25% is the less risky.
- Tranches B, C and D are sold to outside investors
- Tranche A is bought by the bank itself

- **Benefits**

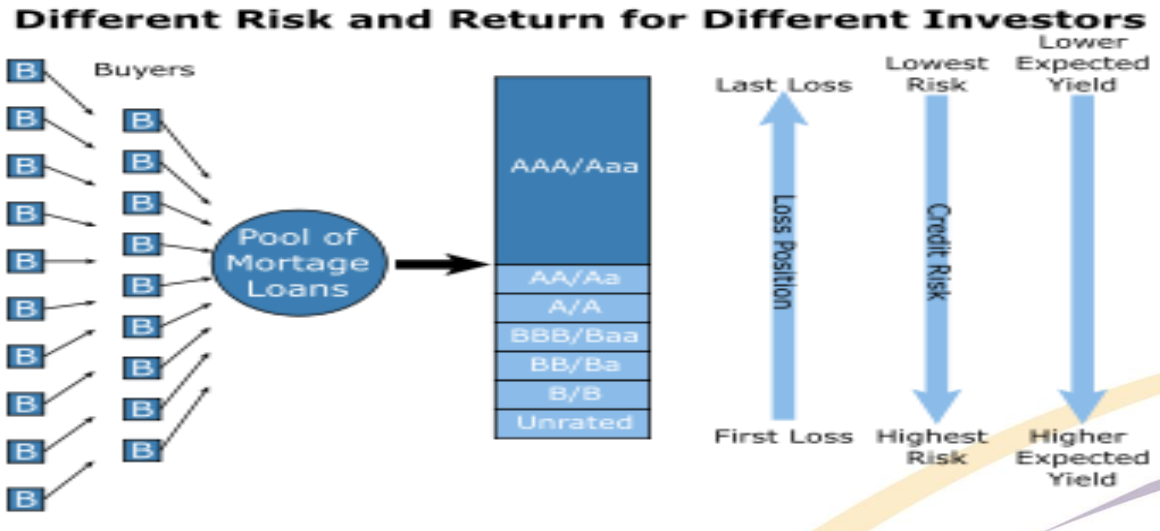
Tranching offers the following benefits:

1) Tranches allow for the "ability to create one or more classes of securities whose rating is higher than the average rating of the underlying collateral asset pool or to generate rated securities from a pool of unrated assets". "This is accomplished through the use of credit support specified within the transaction structure to create securities with different risk-return profiles. The equity/first-loss tranche absorbs initial losses, followed by the mezzanine tranches which absorb some additional losses, again followed by more senior tranches. Thus, due to the credit support resulting from tranching, the most senior claims are expected to be insulated - except in particularly adverse circumstances - from default risk of the underlying asset pool through the absorption of losses by the more junior claims."

2) Tranching can be very helpful in many different circumstances. For those investors that have to invest in highly rated securities, they are able to gain "exposure to asset classes, such as leveraged loans, whose performance across

the business cycle may differ from that of other eligible assets." So essentially it allows investors to further diversify their portfolio.

Risks



Risk, Return, Rating & Yield relate

Tranching poses the following risks:

1) Tranching can add complexity to deals. Beyond the challenges posed by estimation of the asset pool's loss distribution, tranching requires detailed, deal-specific documentation to ensure that the desired characteristics, such as the seniority ordering the various tranches, will be delivered under all plausible scenarios. In addition, complexity may be further increased by the need to account for the involvement of asset managers and other third parties, whose own incentives to act in the interest of some investor classes at the expense of others may need to be balanced.

2) With increased complexity, less sophisticated investors have a harder time understanding them and thus are less able to make informed investment decisions. One must be very careful investing in structured products. As shown above, tranches from the same offering have different risk, reward, and/or maturity characteristics.

3) Modeling the performance of tranched transactions based on historical performance may have led to the over-rating (by ratings agencies) and underestimation of risks (by end investors) of asset-backed securities with high-yield debt as their underlying assets. These factors have come to light in the subprime mortgage crisis.

1.5 The relationship between the returns in a structured long term insurance portfolio and the returns in the market and an indication of why there is a difference

Knowing the relationship between the returns in a structured long term insurance portfolio and the returns in the market will assist clients to make informed decisions. In finance, a structured product, also known as a market-linked product, is generally a pre-packaged investment strategy based on derivatives, such as a single security, a basket of securities, options, indices, commodities, debt issuances and/or foreign currencies, and to a lesser extent, swaps. The variety of products just described is demonstrative of the fact that there is no single, uniform definition of a structured product. A feature of some structured products is a "principal guarantee" function, which offers protection of principal if held to maturity.

For example, an investor invests R100; the issuer simply invests in a risk free bond that has sufficient interest to grow to R100 after the five-year period.
This bond might cost R80 today and after five years it will grow to R100. With the leftover funds the issuer purchases the options and swaps needed to perform whatever the investment strategy is. Theoretically an investor can just do these themselves, but the costs and transaction volume requirements of many options and swaps are beyond many individual investors.

As such, structured products were created to meet specific needs that cannot be met from the standardized financial instruments available in the markets. Structured products can be used as an alternative to a direct investment, as part of the asset allocation process to reduce risk exposure of a portfolio, or to utilize the current market trend.

A market portfolio is a portfolio consisting of a weighted sum of every asset in the market, with weights in the proportions that they exist in the market (with the necessary assumption that these assets are infinitely divisible).

This is only a theoretical concept, as to create a market portfolio for investment purposes in practice would necessarily include every single possible available asset, including real estate, precious metals, stamp collections, jewelry, and anything with any worth, as the theoretical market being referred to would be the world market. As a result, proxies for the market are used in practice by investors. These proxies cannot provide an accurate representation of the entire market.

The concept of a market portfolio plays an important role in many financial theories and models, including the Capital asset pricing model where it is the only fund in which investors need to invest, to be supplemented only by a risk-free asset (depending upon each investor's attitude towards risk).

Group activity

In groups, explain the relationship between the returns in a structured long term insurance portfolio and the returns in the market. Clearly indicate of why there is a difference.

1.6 The difference between surrender value and intrinsic value of an investment with reference to conditions under which it is reasonable to exit a structured long term insurance portfolio

The cash value of an insurance contract, also called the cash surrender value or surrender value, is the cash amount offered to the policy owner by the issuing life carrier upon cancellation of the contract. This term is normally used with a life insurance contract.

To receive the cash value, the policyholder is normally obliged to surrender the policy received at outset of the contract to the issuing life insurance company as documentation of rights under the contract.

Cash values are usually agreed for the case of premature cancellations in those forms of insurance contracts, especially life insurance contracts, in which a portion of the premiums go toward an investment, like whole life insurance or endowment life insurance and other forms of permanent life insurance. Such amounts are often certain to be paid, either in case of death or in case of survival, and therefore not under risk. The contract determines for each possible cancellation date the related cash value. If the investment of premiums is contractually made in an individual account, the cash value is the value of the investments in that account at any particular time. Such cash value credited to an individual account during the tenure of the policy keeps growing with every payment of premium. It also increments due to interest credited.

The policyholder may also be able to use the cash value as collateral on a loan.

The cash value will often be similar or even equal to the reserve to be held by the insurance company for the net obligations from the contract. As such, the amount is usually invested and earns investment income for the insurance company which is to some extent forwarded to policyholders of participating contracts.

Since often initial premiums are not invested but covering initial costs associated with selling the contract (up front or front-end fee), the amount available may be significantly lower than the sum of premiums paid for some time, initially even zero. Later, interest credited might compensate that initial loss.

The value of the investment is often subject to a surrender charge (also known as a penalty) in determining the cash value. A surrender charge offsets the costs associated with selling the contract and allows these contracts to be sold with little or no up front fees. Surrender charges are imposed when a contract is cancelled within a set time frame. Any cancellation after that time frame is not subject to a surrender

charge. Typically surrender charges decrease on an annual schedule until they disappear altogether.

In finance, intrinsic value refers to the value of a security which is intrinsic to or contained in the security itself. It is also frequently called fundamental value. It is ordinarily calculated by summing the future income generated by the asset, and discounting it to the present value.

- **Options**

An option is said to have intrinsic value if the option is in-the-money. When out-of-the-money, its intrinsic value is zero.

The intrinsic value for an in-the-money option is calculated as the absolute value of the difference between the current price (S) of the underlying and the strike price (K) of the option, floored to zero.

For a call option

$$IV_{call} = \max \{0, S - K\}$$

while for a put option

$$IV_{put} = \max \{0, K - S\}$$

For example, if the strike price for a call option is R1 and the price of the underlying is R1.20, then the option has an intrinsic value of R0.20. The total value of an option is the sum of its intrinsic value and its time value.

- **Equity**

In valuing equity, securities analysts may use fundamental analysis- as opposed to technical analysis- to estimate the intrinsic value of a company. Here the "intrinsic" characteristic considered is the expected cash flow production of the company in question. Intrinsic value is therefore defined to be the present value of all expected future net cash flows to the company; it is calculated via discounted cash flow valuation.

An alternative, though related approach, is to view intrinsic value as the value of a business' ongoing operations, as opposed to its accounting based book value, or break-up value. Warren Buffett is known for his ability to calculate the intrinsic value

of a business, and then buy that business when its price is at a discount to its intrinsic value.
(In layman's terms, he buys a share that is cheap relative to its actual value - like buying a new BMW for half the normal price.) (Two major types of "equity" are ordinary shares, and preference shares. Ordinary shares are more common, but preference shares normally include a higher, more secure dividend.)

- **Real Estate**

In valuing real estate, a similar approach may be used. The "intrinsic value" of real estate is therefore defined as the net present value of all future net cash flows which are foregone by buying a piece of real estate instead of renting it in perpetuity. These cash flows would include rent, inflation, maintenance and property taxes.

Module 2:

How insurers construct and manage structured long term insurance portfolios

This Module deals with:

- Analysis of an investment to determine whether it is managed actively or passively and an indication of how value is created within the investment
- The market exposure in a specific portfolio in terms the potential risk and return of the investment
- The effect of different economic conditions on the ongoing and final performance of a structured long term insurance portfolio

2.1 Analysis of an investment to determine whether it is managed actively or passively and an indication of how value is created within the investment

Active management (also called *active investing*) refers to a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index. (Remember in the Module 1 Figure 1 above where we saw that only 33% of active fund managers beat the index in 5 years.) Investors or mutual funds that do not aspire to create a return in excess of a benchmark index will often invest in an index fund that replicates as closely as possible the investment weighting and returns of that index; this is called passive management.

Active management is the opposite of passive management, because in passive management the manager does *not* seek to outperform the benchmark index.

Ideally, the active manager exploits market inefficiencies by purchasing securities (stocks etc.) that are undervalued (cheap) or by short selling securities that are overvalued. Either of these methods may be used alone or in combination. Depending on the goals of the specific investment portfolio, hedge fund or mutual fund, active management may also serve to create less volatility (or risk) than the

benchmark index. The reduction of risk may be instead of, or in addition to, the goal of creating an investment return greater than the benchmark.

Active portfolio managers may use a variety of factors and strategies to construct their portfolio(s). These include quantitative measures such as price/earnings ratio and PEG ratios, sector investments that attempt to anticipate long-term macroeconomic trends (such as a focus on energy or housing stocks), and purchasing stocks of companies that are temporarily out-of-favor or selling at a discount to their intrinsic value. Some actively managed funds also pursue strategies such as merger arbitrage, short positions, option writing, and asset allocation.

The effectiveness of an actively-managed investment portfolio obviously depends on the skill of the manager and research staff but also on how the term active is defined.

Many mutual funds purported to be actively managed stay fully invested regardless of market conditions, with only minor allocation adjustments over time. Other managers will retreat fully to cash, or use hedging strategies during prolonged market declines. These two groups of active managers will often have very different performance characteristics.

Approximately 20% of all mutual funds are pure index funds. The balance is actively managed in some respect. In reality, a large percentage of actively managed mutual funds rarely outperform their index counterparts over an extended period of time because 45% of all mutual funds are "closet indexers" funds whose portfolios look like indexes and whose performance is very closely correlated to an index but call themselves active to justify higher management fees.

Only about 30% of mutual funds are active enough that the manager has the latitude to move completely out of an asset class in decline, which is what many investors expect from active management.
Of these 30% of funds there are outperformers and underperformers, but this group that outperforms is also the same group that outperforms passively managed portfolios over long periods of time.

Due to mutual fund fees and/or expenses, it is possible that an active or passively managed mutual fund could underperform compared to the benchmark index, even though the securities that comprise the mutual fund are outperforming the benchmark, because indexes themselves have no expenses whatsoever. However, since many investors are not satisfied with a benchmark return a demand for actively-managed continues to exist. In addition, many investors find active management an attractive investment strategy in volatile or declining markets or when investing in market segments that are less likely to be profitable when considered as whole. These kinds of sectors might include a sector such as small cap stocks.

Advantages of active management

The primary attraction of active management is that it allows selection of a variety of investments instead of investing in the market as a whole.

Investors may have a variety of motivations for following such a strategy:

- They may be skeptical of the efficient-market hypothesis, or believe that some market segments are less efficient in creating profits than others.
- They may want to manage volatility by investing in less-risky, high-quality companies rather than in the market as a whole, even at the cost of slightly lower returns.
- Conversely, some investors may want to take on additional risk in exchange for the opportunity of obtaining higher-than-market returns.
- Investments that are not highly correlated to the market are useful as a portfolio diversifier and may reduce overall portfolio volatility.
- Some investors may wish to follow a strategy that avoids or underweight certain industries compared to the market as a whole, and may find an actively-managed fund more in line with their particular investment goals. (For instance, an employee of a high-technology growth company who receives company stock or stock options as a benefit might prefer not to have additional funds invested in the same industry.)

Several of the actively-managed mutual funds with strong long-term records invest in value stocks. Passively-managed funds that track broad market indices such as the S&P 500 have money invested in all the securities in that index i.e. both growth and value stocks.

Disadvantages of active management

- The most obvious disadvantage of active management is that the fund manager may make bad investment choices or follow an unsound theory in managing the portfolio. The fees associated with active management are also higher than those associated with passive management, even if frequent trading is not present. Those who are considering investing in an actively-managed mutual fund should evaluate the fund's prospectus carefully. Data from recent decades demonstrates that the majority of actively-managed large and mid-cap stock funds in United States fail to outperform their passive stock index counterparts. (Remember in Module 1 Figure 1, only 33% of active managers outperform their benchmark over a 5 year period.)

- Active fund management strategies that involve frequent trading generate higher transaction costs which diminish the fund's return. In addition, the short-term capital gains resulting from frequent trades often have an unfavorable income tax impact when such funds are held in a taxable account.

- When the asset base of an actively-managed fund becomes too large, it begins to take on index-like characteristics because it must invest in an increasingly diverse set of investments instead of those limited to the fund manager's best ideas. Many mutual fund companies close their funds before they reach this point, but there is potential for a conflict of interest between mutual fund management and shareholders because closing the fund will result in a loss of income (management fees) for the mutual fund company.

- Passive management (also called passive investing) is a financial strategy in which a fund manager makes as few portfolio decisions as possible, in order to minimize transaction costs, including the incidence of capital gains tax. One

popular method is to mimic the performance of an externally specified index called 'index funds'. The ethos of an index fund is aptly summed up in the injunction to an index fund manager: "Don't just do something, sit there!"

- Passive management is most common on the equity market, where index funds track a stock market index, but it is becoming more common in other investment types, including bonds, commodities and hedge funds. Today, there is a plethora of market indexes in the world, and thousands of different index funds tracking many of them.

The concept of passive management is counterintuitive to many investors.

The rationale behind indexing stems from five concepts of financial economics:

1. In the long term, the average investor will have an average before-costs performance equal to the market average. Therefore the average investor will ***benefit more from reducing investment costs than from trying to beat the average.***

2. The efficient market hypothesis, which postulates that equilibrium market prices fully reflect all available information. It is widely interpreted as suggesting that it is impossible to systematically "beat the market" through active management, although this is not a correct interpretation of the hypothesis in its weak form. Stronger forms of the hypothesis are extremely controversial, and there is some debatable evidence against it in its weak form too. For further information see behavioural finance

3. The principal-agent problem: an investor (the principal) who allocates money to a portfolio manager (the agent) must properly give incentives to the manager to run the portfolio in accordance with the investor's risk/return appetite, and must monitor the manager's performance.

4. The local elasticity of the market, while usually theorized not to be conducive to any particular investment strategy, can in fact be favorable in many cases to a stable strategy, setting passive management apart from its more change-prone counterparts.

5. The capital asset pricing model (CAPM) and related portfolio separation theorems, which imply that, in equilibrium, all investors will hold a mixture of the market portfolio and a riskless asset. That is, under suitable conditions, a fund indexed to "the market" is the only fund investors need.

Some active managers may beat the index in particular years or even consistently over a series of years. Nevertheless the retail investor still has the problem of discerning how much of the outperformance was due to skill rather than luck, and which managers will do well in the future. Figure 2 comes from ETF Q4 2012.

Figure 2: Performance of funds and ETFs over three years

Rank	General Equity Funds and ETFs	3 year return (annualized)	Percentage of funds beaten	TER
1	Foord Equity R	20.86		2.54
2	Marriott Dividend Growth R	19.85		1.15
3	Harvard House MET Equity	19.80		1.49
4	STANLIB SA Equity R	19.70		1.14
5	Imara MET Equity	19.31		1.80
6	Momentum Best Blend Specialist Eq A	19.30		1.67
7	STANLIB Equity R	18.99		1.22
8	Satrix Divi	18.89	90.00%	0.45
9	Old Mutual Active Quant Equity A	17.72		1.13
10	FG Mercury Equity FoF A1	17.36		1.21
16	Prudential Equity A	15.99		2.67
17	Satrix Swix ETF	15.98	79.00%	0.45
18	Investec Active Quants A	15.93		2.08
30	STANLIB Index R	14.59		0.61
31	Prescient Equity Quant A1	14.53		0.59
32	RMB Top 40 ETF	14.46	60.00%	0.21
33	FNB Growth	14.37		1.46
41	Nedgroup Inv Rainmaker A	14.18		1.74
42	Satrix RAFI	14.17	48.00%	0.52
43	Sasfin Equity	14.15		1.27
44	Oasis General Equity A	14.15		1.73
45	Investec Equity R	14.11		1.14
80	Element Earth Equity A	8.23		1.72
81	Element Islamic Equity A	5.67		1.75

Source: Morningstar

Implementation

At the simplest, an index fund is implemented by purchasing securities in the same proportion as in the stock market index. It can also be achieved by sampling (e.g. buying stocks of each kind and sector in the index but not necessarily some of each individual stock), and there are sophisticated versions of sampling (e.g. those that seek to buy those particular shares that have the best chance of good performance).

Investment funds run by Investment managers who closely mirror the index in their managed portfolios and offer little "added value" as managers whilst charging fees for active management are called 'closet trackers'; that is they do not in truth actively manage the fund but furtively mirror the index.

Collective investment schemes that employ passive investment strategies to track the performance of a stock market index are known as index funds. Exchange-traded funds are never actively managed and often track a specific market or commodity indices.

Globally diversified portfolios of index funds are used by investment advisors who invest passively for their clients based on the principle that underperforming markets will be balanced by other markets that outperform.
Investment advisors should also analyse the market exposure in a specific portfolio in terms the potential risk and return of the investment. This will enable them to plan effectively. Possible risks associated with structured long term investment portfolios include

- liquidity
- tax
- performance, and
- underlying instruments or components

2.2 The effect of different economic conditions on the ongoing and final performance of a structured long term insurance portfolio

In order to construct and manage structured long term insurance portfolios effectively insurers need to understand the effect of different economic conditions on the ongoing and final performance of a structured long term insurance portfolio. Impact of different market conditions includes,

- Interest rates
- Bull/bear market
- Inflation, and
- Currency movements

Money Supply

The money supply is regarded as being relevant. One view is that many economic problems, including inflation, can be traced to excess in money supply, although others doubt this. Most, however, probably feel that the supply of money affects the fixed interest market more directly than the general equity market, but bear in mind when interest rates are low it is cheaper for companies (Equities) to borrow money to fund growth.

Balance of payments (Imports and exports)

South Africa trades internationally, therefore the balance of payments figures are of great importance. Trade depends on imports and exports and, while internal policies can influence both, external influences, such as a recession in other parts of the world, and particularly the state of the economy of the USA, have significant effect.

Commodity Prices

The balance of payments and the economic welfare of South Africa are greatly impacted by the gold price. The world prices of platinum, diamonds and other minerals that are exported, such as coal, also have a significant effect, while the importance of the oil price is not to be forgotten. Commodity prices and their effect on the general economy can have an impact on interest rate decisions.

Reserves

The figures relating to the level of South Africa's reserves, which are published by the SA Reserve Bank, must be monitored closely as they are of importance to investors and can also result in interest rate changes.

The Consumer Price Index

The Consumer Price Index shows the movement of retail prices and is the measure used for inflation. There is typically quite a strong correlation between the rate of inflation and interest rates, since interest rates are often raised in order to dampen inflationary pressures in the market.

Other indicators

Figures are also published by the SA Reserve Bank when there is a new issue of stock to investors for cash. In times of heavy new issue activity, large sums of money can be taken out of investor's pockets and this usually ha an effect on stock exchange prices. Consumer expenditure is another statistic relevant to an investment. Cars and household wares are more important as they are more sensitive to economic cycle. Hire purchase sales, which are published monthly, are an important indicator of consumer durable expenditure. The Central Statistics Services publishes detailed figures covering a wide range of activities.

Currencies

The stability of the rand against major international currency also has a direct effect on our market. A foreign investor would require a currency to be stable to obtain maximum benefit from the return received in Rands.

Foreign Markets

South Africa is one of the major emerging markets in the world. A large number of our stocks are dual listed on other stock markets in the world. Negative or positive sentiments on these markets will also influence share prices.

Sentiment or optimism

Investor's sentiment can be affected by reports and company results.

Political Stability

Political stability plays an important role in setting the climate for business confidence in a country and also supporting positive sentiment towards the region within the country is situated.

Climate

Even the country's climate can have an effect on equities, either in the broader sense or on specific shares. Example: a serious drought will adversely affect the share price of food producers and heavy rains or other natural events may have a negative affects on the share price of insurers.

Group activity

Explain the impact of the following market conditions on the ongoing and final performance of a structured long term insurance portfolio with examples:

i. Interest rates
ii. Bull/bear market
iii. Inflation, and
iv. Currency movements

Module 3:

The suitability of a structured long term insurance portfolio investment for a specific client

This Module deals with:

- The risks associated with structured long term insurance portfolios
- Situations where it is appropriate to recommend a structured long term insurance portfolio to a client with reference to the client's total portfolio and investment objectives.

Not all structured long term insurance portfolio are suitable to all your clients. Clients needs varies therefore structured long term insurance portfolio suitable for client A will not be a good option for client B. As an insurer you need to understand this. This will enable you to plan, understand risks and recommend suitable structured long term insurance portfolio for each of your clients.

3.1 The risks associated with structured long term insurance portfolios

Asset Class	Advantages	Disadvantages
Fixed interest investments	• Fixed interest investments offer a reasonable return with relatively low risk involved. They play an important role in the overall mix of an investment portfolio, both in providing a regular income for reinvestment and in allowing short term "parking" of funds earmarked for future investment in equities or properties. • The secondary market in these instruments means that they are relatively liquid. • The tax concession on the first R23 800p.a. for those natural persons under 65 and R34 500p.a. for those natural persons over the age of 65 (2013/2014 tax year). • R23 800 of interest per annum means that at current interest rate of 5% an amount of R119 000 can be invested without tax consequences. • They do not trigger CGT. • They are low risk.	• The main drawback of fixed interest investments lies in the fact that historically the average yield offered to the investor is lower than, for example, equities. • Exemptions applies to interest and dividends from South African sources, • The specialized nature of the bond market means that specialized knowledge is needed if investors are going to "trade" in fixed interest bonds. • Another problem could be the fact that the general minimum investment sizes are not inconsiderable. Even fixed deposits often carry a minimum amount of R1 000 or R2 000, while investing in fixed interest bonds requires large capital amounts unless access is gained through a fixed interest investment trust. • Any excess of the concession is taxed at the individual's marginal rate.

Asset Class	Advantages	Disadvantages
Equity investments	• Equities have proven that they are able to deliver yields, which over the long term offer investors a good real return. • The stock market ensures ready marketability, while access can be obtained in relative small value units, especially through the unit trust system. • Dividend income can grow in Rand amounts over time, resulting in an increasing income stream. This is because, even though dividends declared when expressed as a percentage of the current share price tend to stay relatively stable over time, when expressed as a percentage of the original price they generally increase dramatically as can be seen from the table below which has based on the JSE all Share Index. • Dividends are not taxed in hands of the recipient (15% dividend withholding tax). • There are concessions for natural persons with regards to CGT.	• Shares in companies, which are not listed on the stock exchange are generally not too easy to sell in times of need. Fees payable to stockbrokers or fund managers need to be considered as they do affect smallish transactions quite significantly. • Equities are not usually seen to be good collateral for loans • The natural disadvantage, which springs to mind when thinking of equities, is that of the risk factor. Although steps can be taken to control some or all of the factors, it is still true that equity investments experience relatively extreme volatility over time. • Another drawback could be that the income produced from shares is normally relatively low (of the order of 2-6% pa). • On sale of the shares they trigger CGT
Property	• The capital value of property generally rises	Apart from the risk factors and the problem of maintenance

Asset Class	Advantages	Disadvantages
	steadily over time • Obviously a house could be used to provide residential accommodation for the investor, thereby shielding him from the prospect of escalating rental payments. (Primary resident has exclusion of first R2 000 000 of the gain.) • A good property can generate a regular income and, interestingly enough, this may be an escalating income. • Loans may be taken out using property as collateral	costs, which need to be factored into the calculation of the potential yield, the other disadvantages are as follows: • Capital profits made on investment property trigger CGT. • Costs associated with the registration of property, legal fees, etc. are relatively high and these generally result in property investments being seen as long term ventures. Rental is taxable; • It may be a problem to find a suitable tenant for property from time to time; • Yields have not historically been that high • Normally a relatively large amount of initial capital is required, although this may be at least partially obviated by use of syndicate groups, property trusts or even financial borrowing against the property; • Marketability is a problem in most cases;
Insurance policy Investments	The use of insurance policies as part of the retirement planning savings offers diverse advantages. • The proceeds of a policy on death before retirement can be paid directly to the beneficiary, thereby	• Any life police is deemed property and will be subject to estate duty. • Policies traded on the second hand market trigger CGT. • Administrative charges are seen to be somewhat high.

Asset Class	Advantages	Disadvantages
	allowing for more speed of payment and avoiding the executor's fees. • Policies may be traded on the second hand market • After maturity policies may be open-ended and amounts drawn as and when needed, meaning that the capital is easily and effectively turned into income. • Life policies enjoy some protection from creditors, especially retirement annuities • Pension payments from retirement funds are not included in the deceased's estate for estate duty purposes. • Some forms of policy, such as RA, offer special tax advantages. • Because of the regular nature of premiums payments and the penalties on early termination, insurance policies are often seen as a form of compulsory retirement savings for those who may not otherwise have the discipline to do so. • Smoothed bonus and similar portfolios offer considerable security.	• The investment is generally seen as a long term one with early surrender penalties acting as a deterrent to liquidity; • The taxation applicable to the growth of the investment portfolio is seen to be a little penal for many, especially those with lower income levels. • The end result of the various plans are not generally seen to be up to the level of certain other investments, although this usually depends largely on the type of investment portfolio underlying the policy and the associated level of risk.

Asset Class	Advantages	Disadvantages
	• Loans are generally available and the investment can be ceded as collateral • Life cover and other benefits may be added	
Hard Assets	• Because the investor often becomes attached to the items and interested in them, there is less chance of them being sold off before retirement. • Appreciation may be considerable • The assets may fulfill useful purpose in themselves as commodities	In the normal course of events it is not usual to employ hard assets as a large part of retirement planning outside of countries of political or military instability. • Unless it is classified as a personal use item, the sale of the asset will trigger CGT. • Specialist knowledge is often needed in the buying and selling process. • Owners may become attached to the items and hence not want to sell them. • The minimum investment amount in most hard assets is considerable, purely because the items, being valuable, are expensive. • Hard assets do not generate an income as a rule • There is a cost factor involved in the preservation and protection of the assets • While hard assets can usually be turned into cash readily, the realisation value is dependent on a willing

Asset Class	Advantages	Disadvantages
		(and able) buyer's market.

3.2 Situations where it is appropriate to recommend a structured long term insurance portfolio to a client

Group activity

In groups, explain situations where it is appropriate to recommend a structured long term insurance portfolio to a client with reference to the client's total portfolio and investment objectives.

Most of the time clients do not have an idea of how to invest their money. In such situations it is appropriate to recommend a structured long term insurance portfolio to a client. Ensure that the recommendation takes into account a client's total portfolio and investment objectives.

Needs analysis will enable you to understand the client before making your recommendation.

Module 4:

Interpretation of the performance of a structured long term insurance portfolio investment in relation to other classes

This Module deals with:

- A comparison of competitive structured long term insurance portfolio products in terms of features, risk and potential return
- An evaluation of a structured long term insurance portfolio investment against an alternative traditional investment product

4.1 A comparison of competitive structured long term insurance portfolio products in terms of features, risk and potential return

The main characteristics to consider with an investment are:

- **Return:** A return is basically the profit the investor makes on his/her investment. It may take the form of income such as interest or dividends or the form of capital growth where the value of the investment is increased and sold for a higher amount than when it was bought. This return may be subject to taxes like income tax or capital gains tax.

- **Risk:** The risk associated with an investment is an indication of the likelihood that the investor may lose all or part of his initial investment. The more risk an investor takes, the bigger the reward he/she expects. If there is a high risk that investors will lose part or all of their capital, they will expect a higher return in compensation.

- **Liquidity:** how easily the money can be accessed

- **Tax Implications:** The product's tax efficiency.

A. Potential Return on Investment

Investors generally invest in a product in the hopes of either earning income or achieving capital growth.

a) Income	Income may take the form of: • Interest • Dividends • Rental **Interest** is either money we earn when we deposit money in a bank, buy a government bond or buy a property unit trust. **Dividends** are a portion of a company's profits paid out to shareholders as a return on their investment. These are cash payments whose value depends on the level of profits made. Payment of dividends is not guaranteed, i.e. if there are no profits, there may be no dividends.
b) Capital growth	Capital growth is achieved when an investment is sold for a higher price than when it was initially bought. This will trigger CGT.

It is important to consider risk, return, taxation and exemptions or abatements.

	Risk	Return	Taxation	Exemptions/Abatement
Equity (1)	High	Dividends	• Add to income fully deductible • Tax free in hands of investor	• 100% exempt as already taxed • 28% company tax and • 15% dividends withholding tax. • Effectively taxed at 38.8%
Equity (2)	High	Capital Growth	• Capital gains tax • deduct abatement • add inclusion to income • calculate income tax due	Abatement (Person only) • Natural person 30 000 p.a. • Natural person 300 000 death Inclusion • Natural Person 33.3% • Company 66.6% • Trust 66.6%
Cash	Low	Interest	• Add to income • interest exemptions	Interest exemptions (Person) • under 65 first 23 800 tax free • over 65 first 34 500 tax free
Property (1)	Medium	Rental	• Add to income	Expenses incurred • Deduct expenses incurred in rental of property, (*not expense of a capital nature*)
Property (2)	Medium	Capital Growth	• Capital gains tax • deduct abatement • add inclusion to income • calculate income tax due	Abatement (Person only) • Natural person 30 000 p.a. • Natural person 300 000 death Inclusion • Natural Person 33.3% • Company 66.6% • Trust 66.6%
Bonds	Low	Interest	• Add to income • interest exemptions	• Interest exemptions (Person) • under 65 first 23 800 tax free • over 65 first 34 500 tax free

B. Potential Risk of Investment

Investment risk is the chance that an investor may lose all, or part of, their capital invested. It is measured by the **volatility** of the investment, i.e. how much the price of the investment fluctuates for example the constant increase and decrease in share prices or unit trust prices. Unlike risk, which is the increase and decrease of one's chances of losing money, volatility indicates a share or unit trusts vulnerability to market trends.

The greater the risk, the greater the expected return to compensate for this additional risk. Risk can be regarded as a spectrum with bank deposits at the very safe end and equities at the other extreme.

It is important to note that although an individual investment may be high risk, when combined with an array of other investments, the overall risk of the portfolio can often be lowered.

C. Liquidity

A major consideration when investing is how soon the investor needs to access their money (i.e. liquidity). A non-liquid investment takes time to sell and money can be lost if a sale is rushed when there is no demand for example, property in a recession.

When considering the liquidity of an investment, one must take account any penalties that may be incurred if it is cashed in earlier than agreed. There could be significant charges for doing so. It is suggested that Investors hold a portion of their investments in stable, liquid instruments, such as money market unit trusts, in the event that they unexpectedly require access to cash. This will protect them from having to sell shares at what may be an inopportune time.

D. Tax Implications 2013/2014

Different investment products have different tax implications. The taxable portion of the income distribution in the hands of the investor depends entirely on how that income was derived.

a) Income Tax	• Income tax is paid on any interest or rental income earned, and where assets are actively traded for a profit in order to generate an income. • The first R23 800 of interest earned by a natural person under 65yrs and R34 500 for taxpayers over the age of 65, will be exempt from tax. • Local Dividends are currently tax-free *(foreign dividends are fully taxed with no exemptions).*
b) Capital	CGT was introduced on 1 October 2001 and is paid on any

Gains Tax (CGT)	capital growth made on the disposal of an investment. CGT applies to the profit or loss made between the market value (sale price) of the investment at the date of sale and at base cost. The base cost is defined as the price at which the investment could have been sold on October 2001. Unit trusts will only attract CGT when an investor sells units and not each time the fund manager restructures the portfolio. The first R30 000 p.a. profit is exempt from CGT for each natural person taxpayer per annum, thereafter, • 33.3% of the net capital gain is taxable for individuals (at their marginal tax rate. The maximum tax payable by an individual is therefore 13,3% (if on 40% marginal tax rate), (which would be on par with any share portfolio), depending on the marginal tax rate. The first R300 000 is exempt for deceased persons. • 66.6% for trusts and companies.

Insurance policies, such as endowments, are taxed at a rate of 30% within the fund in the case of natural persons. (This is the four fund approach.)

	Bank Deposit	**Bond Unit Trust**	**Equity Unit Trust**	**Endowment Policy**
Term	Short term	Medium term	Medium to long term	Minimum 5 years
Potential Return	Relatively low. Provides income in the form of interest. This can be reinvested and added to the	Should outperform cash and underperform shares over the long term Provides both interest	Should provide the greatest potential for gains over cash and bonds over time. Provides potential income	The return will depend on the underlying investments

	Bank Deposit	Bond Unit Trust	Equity Unit Trust	Endowment Policy
	capital value	income and potential for capital growth if the price of the bond strengthens	in the form of dividends, but this is not guaranteed and the investment return is more in the form of capital growth if the share price increases.	
Risk	Low	Medium	Medium to High	The level of risk will depend on the underlying investments
Tax	All growth is in the form of interest, which will incur income tax	Both the coupons (i.e. interest earned) and any increase in the capital value are considered to be income and will therefore incur income tax.	Dividends do not attract tax in the hands of the investor. Any capital growth made since October 2001 will incur Capital Gains Tax (CGT)	Taxed at a rate of 30% within the fund
Liquidity	Depends on whether call account, notice, or fixed	High - although may incur capital losses	High - although may incur capital losses	Minimum 5 year term, can surrender early, but at a penalty

	Bank Deposit	Bond Unit Trust	Equity Unit Trust	Endowment Policy
	deposit			may apply

4.2 An evaluation of a structured long term insurance portfolio investment against an alternative traditional investment product

- When investment markets collapse, there is often an irrational, ill-timed switch into investment products that offer some type of guarantee. More often than not, it is a jump from the frying pan into the fire.

- The preferable time to invest in guaranteed products is when markets are doing well, rather than when they are doing badly. And you need to be sure you are getting the right product at the right price to meet your needs.

- Traditionally, both capital and/or income guarantees have come from life assurance companies or bank term deposits. In order to provide the guarantees, banks and life assurance companies have to hold reserves, called capital adequacy requirements, to ensure they can meet the guarantees when they fall due.

- Money market funds are often perceived to have guarantees, but they guarantee neither the interest earned nor your capital.

- Life companies are prepared to take calculated risks to guarantee that you will receive a sum of money under all sorts of circumstances, ranging from contracting an incurable disease, to receiving a pension for life. Importantly, they now provide guarantees that you will not lose any of your capital in an investment product.

- Since the 1990s, guaranteed investment products have increasingly come from companies that employ mathematical whizz-kids and purvey what are broadly called alternative investments, most of which are rooted in the rapidly developing derivative investment industry.

- The credit crunch and consequent equity market meltdown have resulted in investors looking for guarantees and often unwisely selling their now down-in-value investments. By doing so, they lock in any losses.

- The switch is likely to be a double-whammy. With many life assurance guaranteed products, particularly smooth/stable bonus with-profit products, you are unlikely to receive sound returns immediately when the markets recover, because reserves have to be built up, particularly because maturing benefits have been paid out at the guaranteed rate, which may be higher than the value of the underlying assets.

- Even new-generation guaranteed products may be affected by the meltdown, mainly because a substantial portion of these products is underpinned by capital guarantees provided by banks.
- And the problem for anyone who switches into a new-generation guaranteed investment product is that he or she will have to be sure the institution is sound, which right now is very difficult for a lay investor to judge.

Types of alternative investment strategies

- Alternative investments, of which structured products are but one, are increasingly being seen as an option by investors whose savings have been ravaged by volatile traditional investment markets and who want, come what may, to protect their capital and ensure some consistency in their returns.

- Most alternative investment strategies aim to provide you with absolute (positive) returns – in other words, to protect the value of your capital and provide you with consistent returns.

- Some alternative investments, such as structured products, provide guarantees that they will protect your capital and provide you with a certain level of returns, while others, such as absolute return unit trust funds, hold out only a promise, but not a guarantee, that they will provide a certain level of returns and protect your capital.

- Most traditional investments in property, cash, bonds and shares provide what are called relative returns. These returns are measured against similar investments or against indices. The performance of your investment reflects the underlying market conditions, and rise or fall in value.

Alternative investment strategies are sometimes called a fifth financial asset class. In addition to structured products, they extend to investments in:

- **Derivatives**

A derivative is the broad term used to describe a financial instrument that derives its value from that of another instrument, such as a share or a bond. As their name implies, these investments are derived from some underlying security or instrument, and are not investments in the actual asset.

Most derivatives are based on a view of the future price of a share or a bond.

A derivative investment is a financial contract between two parties that confers rights and obligations to buy or sell a security or commodity at a certain price in the future. Among other things, derivatives include:

- **Futures**

A futures contract is an undertaking to buy or sell something in the future at a price agreed on now. Most of the early futures contracts were associated with farming. Farmers would, and still do, sell their crops when they are planted to what has become known as a commodity trader. The sale gives farmers the assurance that they will receive a set amount for their crop, even if there is an abundant harvest and prices fall through the floor. The people who buy the crops may be speculators or processors of the crop. The speculators look to a higher price when the crops are reaped than they paid for the futures contract, thereby making a profit. The processors look for certainty of price, to protect themselves against the possibility of the harvest being poor and prices going sky high.

- **Options**

An options contract takes a futures contract a little further. As the word implies, an option is the right to buy or sell something at a future date. It is not an agreement that will necessarily result in the transaction taking place. Historically, the largest trade in options has been in the bond market, where debt, mainly that issued by governments, is traded. People who buy and sell bond options do so on the basis of what they expect interest rates will be at a future date.

- **Warrants**

As with an option, a warrant gives you the right to buy (a call warrant) or sell (a put warrant) the underlying share on or before a fixed date in the future (the expiry date).

The price of the warrant moves freely from the price of the underlying share, reflecting the future views of investors. A warrant contract gives you the right to buy or sell shares at a fixed price at a predetermined time in the future. A warrant offers you low-cost exposure to selected shares (and some indices).

Warrants can be used to hedge share portfolios against adverse market movements, to gain market exposure at much lower cost than a direct purchase of shares on a stock market or as a speculative tool for traders. In effect, you are taking a view on the future price of a share or an index.

- **Hedge funds**

Hedge fund managers use different strategies to find inefficiencies in the market. These strategies range from differences in the prices of two companies that are about to merge or companies whose shares are thought to be over-priced, to differences in the value of currencies or buying up distressed debt at a discount.

The most popular strategy is called long/short, which means that the hedge fund manager attempts to make money from both bull markets (going long by investing in what are considered to be under-priced assets) and bear markets (going short by seeking out over-priced assets). Substantial use is made of derivatives.

- **Private equity**

Private equity investments are made in companies not listed on a stock exchange. Although they are considered alternative investments, in the true sense they are not. Most of the investments are simple ownership in which investors plan to make a capital gain and earn dividends over the long term.

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