GUARANTEED PRODUCTS – NOT THAT WONDERFUL

Banks and insurance companies love selling investment products that offer a capital guarantee. They are easy to sell because investors get a warm fuzzy feeling that their capital is safe and growing. These products are particularly popular *after* a big stock market crash as investors don't want to suffer losses again. Unfortunately, this is precisely the time when you don't need a guarantee because it is unlikely that the market will collapse again in the near future. Many of these guaranteed products offer a stock market return with the benefit of capital protection. This seems to be a great deal for investors as you get stock market growth without the risks. The problem is that most of your stock market growth comes from dividends which you don't earn with guaranteed products.

HOW GUARANTEED PRODUCTS ARE STRUCTURED

There are hundreds of different types of guaranteed products, so for this article we focus on 5 year products that offer a stock market investment with a capital guarantee. These products usually offer you a 100% capital guarantee and link your investment growth to the performance of a stock market index. Your growth is calculated by the movement of the index over the five years. So, if the All Share Index starts at 26,000 and grows to 35,000 after five years, the index performance is 34%. Most guaranteed products will not give you 100% of the index growth, they will usually limit your growth to 75% of the index performance. In this example your total return would be 25.5% over the 5 years. This is a total return and not an annual return.

WHY NOT USE THESE PRODUCTS?

If you are prepared to lock away your capital for five years, you really don't need a capital guarantee. If you are scared of losing your money, you could take 25% of your capital and invest it in the index yourself (via an ETF) and place the balance in a 5 year RSA retail savings bond. In the history of our stock market to date, you would not have lost money with this type of investment. If your retail bond only gives you 8% per year, you would get all your capital back plus 10% growth just from the bond. In addition you can get anything from 0% to 50% additional growth from the index ETF. This means you could have between 110% and 160% growth for a five year investment with no lock ins. If you were to split the capital 50:50 between the bonds and the index, it is still unlikely that you would lose money over five years.

Dividends contribute more than 60% of your growth from shares but most guaranteed products don't give you the dividend income. This means you are sacrificing more than 60% of your potential returns. Dividends are such an important part of share price growth that you would be better off not investing in shares if you don't get the dividends because the compounded effect of dividends will protect you from capital losses over time.

Because a guaranteed product needs to run for a fixed term, you will be heavily penalised if you decide to draw your capital before the term expires. You will lose the benefit of your capital guarantee and you might end up losing some of your current market value.

Our final concern is the value of the guarantee. You need to ensure that the company offering the actual guarantee is financially sound. As we saw in the financial crisis, you cannot simply rely on the fact that a large financial institution provides the guarantee, it could collapse and leave your investment worthless.

ARE THERE ANY GOOD GUARANTEED PRODUCTS?

The term of any guaranteed product should not be longer than 3 years. If you want to invest in shares you need to hold them for five years at least. If this is not possible then a guaranteed product makes perfect sense. A guarantee also makes sense if you are investing in a high risk market (e.g. Russian or Brazilian shares) and you are not in a position to monitor your investment properly.

You should not be too concerned about stock market movements – they are a normal part of life for investors in shares. The real threat to your money is inflation, which poses a far bigger danger to long term savings than stock market risk. The effects of inflation are not dramatic, so we don't really feel them over one or two year periods. It is only once we see the compounded effects after a few years that we realise how harmful inflation really is.

In summary, be brave and invest directly in the stock market and don't choose guaranteed products that are not designed in your best interests.