

## Investment Philosophy



### 1. What are structured retail products?

#### 1.1 Overview

The term structured product is the name given to an investment with a pre-set formula for calculating returns and a pre-set formula for calculating risk. The investment is 'built' or 'structured' so that the client knows exactly which underlying asset or market their investment returns are linked to and how the 'upside' gains and 'downside' risks will be worked out. These parameters are set at the beginning of the investment term and cannot be changed.

The performance of a structured product can be linked to a wide range of markets. For example:

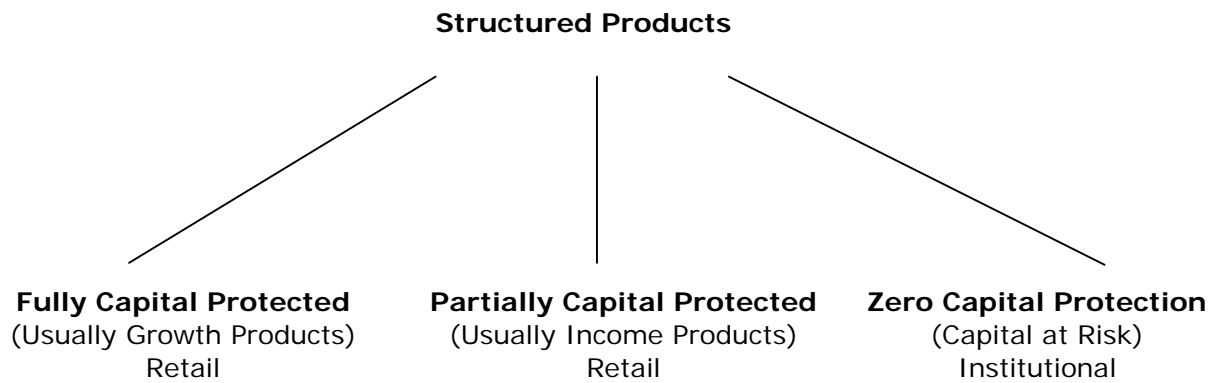
- sharemarket indices
- single stocks
- bond market indices
- single commodities or indices
- currency markets
- money markets
- managed funds
- hedge funds
- property indices (in a sophisticated market)

Performance is based on the underlying asset which has been selected and is not at the discretion of the product provider. Liontamer secures the returns and the risks by using customised financial securities issued by major global investment banks.

Investments are generally in the form of capital protected products but the terms 'capital protected product' and 'structured product' are often used interchangeably. However, structured products can also be structured without any capital protection at all. In our opinion, these are more suited to institutional investors. A good example are collateralised debt obligations (CDOs). Liontamer believes strongly in the concept of capital protection and will only deal with either fully or partially capital protected products for the retail market.

#### 1.2 Income vs growth products

Structured retail products typically come in two forms, growth products (which pay out a return at maturity and typically provide a strong form of capital protection) and income products (which provide a regular variable or fixed income but often with a risk to the capital return at maturity). Both types offer returns linked to an underlying asset.



Standard growth products have two main features:

- the investor's capital is fully protected at maturity; and
- investors receive a fixed percentage of the growth in the underlying asset, e.g. a sharemarket index for an equity product. The fixed percentage is referred to as the 'participation rate'. If the participation rate is 80%, an investor will receive 80% of the rise in the sharemarket at maturity. The participation rate can be more than 100%. The amount above 100% is called acceleration. An example of this is our COMBI Series and you can refer to our website on [www.liontamer.com](http://www.liontamer.com) for more details.

Our Easy and Super Series are examples of fully and partially capital protected funds. The Easy Series represent growth funds with full capital protection and up to 100% growth. The Super Series also represent growth funds but with accelerated growth and partial capital protection (with a safety net 40% below the starting index level).

Income products pay either a high fixed regular coupon or a variable coupon. Products with fixed coupons typically have capital at risk (and in our opinion, are more suitable for sophisticated investors or those under a high level of advice) i.e. the capital return is linked to the performance of the underlying asset. In the case of variable coupons, the capital return is typically 100%, but the level of the coupon reduces depending on the performance of the underlying asset. Our Money Series is a good example, paying a coupon of up to 7% each year and bonus at maturity dependent on the performance of the Deutsche Bank Dynamic Carry Index. For more details refer to our website [www.liontamer.com](http://www.liontamer.com)

## 2. Why capital protection?

As described above, Liontamer provides investments where the return is linked to a financial market (e.g. sharemarkets, commodities, money markets). Capital is protected from falls in the market (fully or partially), effectively providing an insurance policy wrap for savings. We create the insurance by investing in capital protected investments ("notes") from highly rated financial institutions.

Providing capital protection to retail investors while also providing access to new and innovative asset classes and investment strategies is the core of Liontamer's business. We are passionate about achieving both objectives because we believe:

- retail investors should not expose their entire portfolio to the volatility of certain asset classes without the peace of mind that their capital is protected;
- the products have wide appeal as they are suitable for all types of investors – cautious, balanced and aggressive investors; and
- we are experts in this area, having been heavily involved in these products in the UK and Europe and now in New Zealand.

There are two main reasons why capital protected products are so appealing for investors; these are theoretical and psychological.

## 2.1 Theoretical arguments

The theoretical aspects are based on investment research. Although investors lose around 2% a year in dividends (in world sharemarkets), the real cost is much less. Dividends get taxed, reducing them to around 1.5% and annual management charges on an actively managed fund are typically 1% – 1.5% per annum. With capital protected investments these annual charges do not exist; investors get what's on the tin. Furthermore, due to favourable market conditions, growth products are now available with acceleration, i.e. 100% plus participation.

Although there has not yet been a wealth of research material produced proving capital protected products are better than unprotected managed funds or indexed funds, we refer to two influential articles that support the theory that such products hold their own against hedge funds and index trackers.

**A. UBS Warburg** produced a report (the Alternative Investment Strategies Report) in June 2003 entitled "Fireflies Before the Storm". The table below compares the annual returns and risk (volatility) of index funds (tracking the S&P 500), capital guaranteed index funds (also tracking the S&P 500) and hedge fund of funds. The interesting observation is that the returns from capital guaranteed funds are only marginally below the returns from unprotected index funds but the risk is significantly lower due to the capital protection. Hedge funds are also less risky than index trackers, but the returns are below those of capital protected index funds.

	<b>S&amp;P 500</b>	<b>Capital guarantee</b>	<b>Hedge fund of funds</b>
<b>Annual returns</b>	8.6%	8.4%	7.3%
<b>Risk (volatility)</b>	16.3%	5.9%	6.3%

Figures 1994 to June 2003

Quote: "It probably is pretty safe to assume that those private investors who have been in guaranteed structures during the bull as well as the bear market that followed, are likely to never do anything else again" FIREFLIES BEFORE THE STORM JUNE 2003

**B. Harvard Business School** produced a Working Paper (#98-070) in January 1998 that supports capital protected products. Simulations were run which compared the performance of a pension fund to a benchmark of US treasuries. The table overleaf

shows how continuous 5 year investments into a capital protected fund outperformed other strategies and undershot the benchmark on fewer occasions.

Portfolio values at age 64		
Investment strategy	Average value \$000 USD	% of results below target
100% US Treasuries	\$466	0%
100% S&P	\$856	34.3%
60/40 Equities / Bonds	\$654	28.6%
Age adjusted	\$618	26.5%
1 year rolling capital protected investment	\$581	10.8%
5 year rolling capital protected investment	\$950	11.6%

Full copies of these articles are available on request.

## 2.2 Psychological arguments

The psychological aspects of capital protection are based on the belief that investors see two types of risk when they are investing:

- a) risk to their original capital
- b) risk to their returns i.e. that their gains could be volatile and quickly eroded.

Very few managers break 'risk' down into these two categories. However, if an investor is asked about their attitudes, the majority have a far more conservative view of volatility on the downside, than they do of volatility on the upside. Investors are happier to place their returns at risk, than they are to place their original capital at risk. Protected investments allow investors to separate these two aspects. They can invest into riskier underlying assets, while protecting their capital from erosion. No other product allows a restructuring of risk and return to suit the needs of investors.

As investment managers we need to recognise that we are managers of risk as well as return. Traditional methods of forcing investors into long term investment portfolios of highly diversified assets as the only method of controlling risk, needs to be questioned. These conditions are quite inflexible and alienate many investors. The end result is that a large number of investors stay in very cautious cash based investments as the stepping stones are not in place to manage the downside risks they fear.

The UBS Warburg article referred to above espouses the theory that absolute return managers, unlike relative return investors, are managers of risk as well as return and comments (on page 67) that "[a]mong the pivotal objectives of absolute return investing are, unlike with relative return investing, avoiding absolute financial losses, preservation of principal, as well as actively managing portfolio volatility."

The article goes on to state: "We believe that the purpose of risk management and risk management products is asymmetric returns. By asymmetric returns

we mean a return profile that is not available 'in nature', but is artificially managed to meet the end investors' risk preferences more efficiently. Our belief is based on some assumptions of which an important one is that investors are loss averse, that is, volatility on the downside is not the same as volatility on the upside."

This approach is particularly effective when products are offered in a wrapper that investors are comfortable with, such as term deposits.

### 3. How is capital protection provided?

'Capital protection at maturity' means that an investor will receive back at least their original investment amount (full capital protection) or a fixed percentage of their investment amount (partial capital protection). It is important to note that the protection only applies at the end of the fixed term. In Liontamer's Australian unit trust structures, the original capital is protected from erosion because we invest in protected investments ('notes') issued by a global investment bank with a Standard & Poor's credit rating of at least A. These investments are designed to return the full original capital amount. In the case of partial capital protection, the fund will remain fully protected unless the underlying market declines by more than a pre-set level and fails to recover.

The capital protection in our existing 12 funds is provided as follows:

- the global investment bank provides the underlying structure and wraps it in a security that it issues, called notes;
- investors buy units in an Australian unit trust and the pay-off they receive mirrors the performance of the notes;
- technically Liontamer has purchased a zero coupon bond and a call option. The zero coupon bond component provides the capital protection and the call option provides the return.

The diagram below illustrates how the structure works, using the example of a \$100 investment and a three year product linked to a world sharemarket index.

