Managed Risk

Case Study

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Strategy overview

Use Wrap Capital Protection to encourage a risk-averse client invested in cash and other income products to reallocate back into growth assets.

Key terms

- Wrap Capital Protection – refers to a solution on Wrap which gives advisers the ability to protect their client's holdings.
- Protection Portfolio – the value of the combined value of the managed fund and the BT Capital Protection Fund.
- Protection Term – the term selected by the adviser for Wrap Capital Protection.
- Minimum Outcome – the minimum value of the Protection Portfolio at the end of the Protection Term.

Hypothetical client information

- Heather is 45 and has $200,000 in superannuation.
- Heather had an 'aggressive' allocation through the GFC and saw the value of her account fall 25–30% at its worst.
- As a result of this experience, Heather adopted a risk-averse attitude and moved her investments to cash and income products.

Client problem

As a result of Heather's risk aversion, her portfolio has developed a concentration risk to cash and income products. When combined with the current downward pressure on interest rates, the performance of Heather's portfolio balance is impacted by:

- Interest rate 'roll risk' – the risk that maturing amounts are 'rolled' into lower yielding versions;
- longer dated income products offer little interest rate uplift for committing to longer terms; and
- reduced access to franking credits.

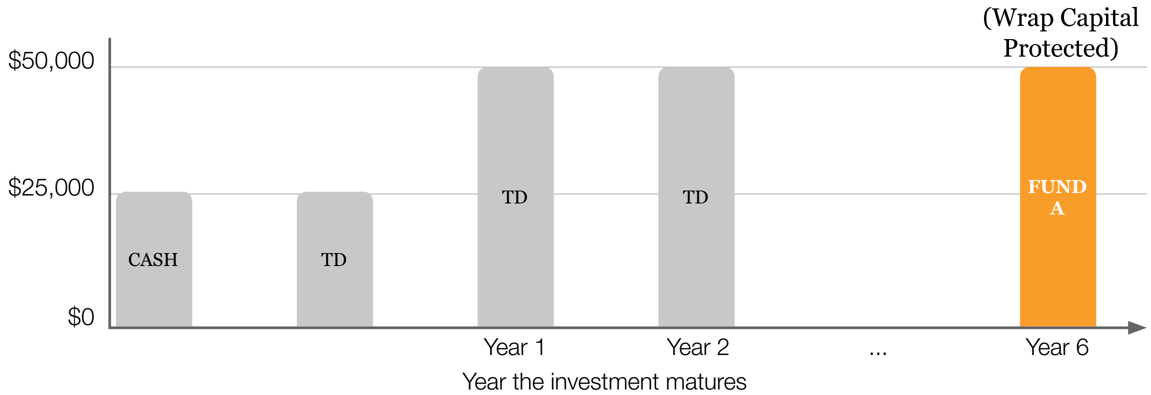
Adviser opportunity

Heather risks reducing the longevity of her portfolio by not participating in growth assets. The opportunity for Heather's adviser is to make investing for growth opportunities less about the ups and downs of performance and more about potential outcomes for her portfolio.

The solution

With Heather's agreement, her adviser reallocates some of Heather's portfolio back to growth assets with Wrap Capital Protection. Heather's adviser uses Wrap Capital Protection over an Australian Equity Fund to invest $50,000 with a 6 year maturity. The adviser also elects to reinvest the distributions to ensure the Minimum Outcome is at least maintained (as Heather doesn't need income until age 65). The remainder of Heather's portfolio stays in shorter dated cash and fixed interest products. The initial portfolio construction and associated maturity profile would look like:

Maturity Profile and Asset Allocation



This chart provides an indicative asset allocation on the day the adviser implements the portfolio as described in the case study. The time frames refer to the expected duration of the asset and are not projections of a future position or expected returns.

Should the investment in the Australian Equity Fund not perform, Heather will receive her Minimum Outcome at the end of the term. What she would have missed out on when compared to a fixed interest product is the potential interest. If however the Australian Equity Fund performs well, Heather will have access to growth. Over time Heather's adviser will look to use Wrap Capital Protection to encourage more of Heather's assets to market exposure over time.

Comparative features of Wrap Capital Protection for client positioning

	CASH ASSET	WRAP CAPITAL PROTECTION
Return of capital	Government Guarantee	Minimum Outcome
Income	Floating or fixed interest rate	Distributions, with potential for franking credits
Growth	None	Equity market exposure
Additional Fees	Nil	1.2% p.a. and Fund MER
Liquidity	Yes with penalty interest for early termination	Yes however Minimum Outcome only at maturity

Heather will incur an additional cost of 1.2% for the assets invested via Wrap Capital Protection. Heather's adviser explains the additional cost with reference to the benefits of exposure to growth assets in Heather's portfolio, in particular:

- Similar to cash products, Heather can rely on a Minimum Outcome in Wrap Capital Protection at maturity.
- Higher yielding Australian Equity Funds may provide distributions which may offer a similar income profile to that of cash and term deposits but the dividends must be reinvested to ensure the Minimum Outcome is maintained.
- Australian Equity Funds may generate a strong franking credit stream, which may impact the after tax return of the overall portfolio.
- The flexibility to alter the Wrap Capital Protection facility at any stage if Heather's circumstance changes.

The results

Wrap Capital Protection matures at the completion of the 6 year term with the following outcomes:

- If the Protection Portfolio has increased in value by the end of the protection term:
  - The Minimum Outcome would have increased from its initial value as a result of the Growth Capture feature. Heather could maintain her Minimum Outcome at its original level by withdrawing some of the investment.
  - Heather has experienced market growth that she otherwise would not have if she had invested in cash.

  Note: If Heather increased her Minimum Outcome this would lead to an increase in her exposure to the Capital Protection Fund, resulting in the sale of units in the Australian Equity Funds (with possible CGT implications).

- If the Protection Portfolio has not increased in value by the end of the protection term:
  - Heather can expect to receive on the Minimum Outcome. In this case Heather has foregone the interest she might have earned by investing in cash.
  - If markets had grown during the term then fell prior to the end of the term, the Minimum Outcome may have increased to a higher level than the initial value as a result of the Growth Capture feature. This would have partially or fully offset the potential foregone interest.
  - It is likely that a significant amount of Heather's exposure in the Australian Equity Fund has been replaced with exposure to the BT Capital Protection Fund. This will result in the sale of units in the Australian Equity Funds (with possible CGT implications).
- Subject to the number of units held in the Australian Equity Fund during the term:
  - the income generated from distributions on an after tax and fees basis (see 'Detailed Workings') may compare relatively well to cash interest;
  - Franking credits may partially offset the impact of the fee.
  - As always each client's individual tax situation is different and therefore tax impacts for individuals will vary.

Each quarter, Wrap Capital Protection may automatically increase the Minimum Outcome if the investor's protected investment has grown. So as the fund experiences positive performance through unit price growth or distribution re-investment it may automatically increase the level of the Minimum Outcome at the next lock-in date.

Client outcomes

- The income potential of Australian Equity Fund may provide a similar income return to income products such as cash and term deposits, particularly on a post tax basis with the benefits of franking credits.
- The Minimum Outcome (and Growth Capture feature) provided Heather with a consistent perspective on her worst case scenario if markets failed. It matches Heather's experience with Term Deposits and the comfort they provide with a (minimum) known return at maturity.

Adviser outcomes

- The Adviser has positioned the features of the Wrap Capital Protection favourably against those of cash products to provide a cautious client with the comfort to increase their growth asset exposure.
- The client conversations shift from overall investment performance and account balance to monitoring the Minimum Outcome.
- Should the value of the Protection Portfolio rise during the term, the adviser has the ability to increase the Minimum Outcome, or partially withdraw from the investment to reduce the Minimum Outcome. This provides the opportunity for an advice based conversation with the client.

Detailed workings

A hypothetical example tax calculation comparing the after tax income of cash products in Term Deposits (TD) and Wrap Capital Protection (WCP) over an Australian Equity Fund Protection Portfolio:

TD Rate	5.20%
Fund Yield	5.00%
Growth in fund distribution	0.00%
Fund Franking	80.00%
Tax Rate	15.00%
Assumed average exposure to Australian Equity Fund	75.00%
On an investment of $100,000.	

Superannuation Client	**TD**	**WCP**
Income Return	$5,200	$3,750
Franking	–	$1,285
less Tax @15%	$780	$755
add Franking	–	$1,285
Post Tax & Credits	$4,420	$4,280
Less Protection costs	–	($1,200)
After-tax income	**$4,420**	**$3,080**

Pension Client	**TD**	**WCP**
Income Return	$5,200	$3,750
Franking	–	$1,285
less Tax @15%	$0	$0
add Franking	–	$1,285
Post Tax & Credits	$5,200	$5,035
Less Protection costs	–	($1,200)
After-tax income	**$5,200**	**$3,835**

The above example assumes no capital growth over the protection term. As a result the managed fund MER can be disregarded as the additional cost of the MER is returned to the client via the Minimum Outcome and does not reduce income received.

The protection cost is assumed to be 1.2% pa. Assumed Term Deposit rate is 5.2% p.a. and the Fund Yield is 5.0% p.a.

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For more information

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