Wealth Creation

Capital protected lending

Aon Hewitt Financial Education Series

Capital protected lending products are investments guaranteeing that you will receive your original investment amount back at maturity. If the market goes up you will receive any gain on the investment, but if the market goes down you will still receive your original investment back and you won't be liable for the loss. It is important to note that the majority of capital protected products are only protected at maturity. That means that if you exit the product before the maturity date you may realise a loss, and you may also be liable for break costs or exit fees.

An additional risk with a capital protected product is that you may still make an overall loss on the investment, because of the fixed investment period. If the asset decreases in value, you will still receive your original capital back at maturity but you may have to pay the annual interest cost for the remainder of the term. As such, you may still make a loss from the strategy.

A final point to note is that you will pay a higher cost for the capital protection. In other words, if you invested in a capital protected product versus the same product without the capital protection, it would cost you more to invest in the capital protected product.

How does Capital Protection work?

There are a number of different methods of capital protection, and each works differently and varies in cost. The most common are:

- Put options
- Zero coupon plus call
- Constant proportion portfolio insurance (CPPI) also known as threshold management

As the method used will differ depending upon the product, you should discuss this with your financial adviser before making an investment.

Example

Andrew invests $100,000 into a 7-year capital protected product. At the end of year 7 the investment is worth $180,000. Andrew gets to keep the full $180,000, but may be liable for tax on the gain of $80,000.

Simon invests $100,000 into a different 7-year capital protected product. At the end of year 7 the investment is only worth $95,000. As the product is capital protected, Simon will receive his full $100,000 back. He will not incur a loss of $5,000.

Risks of Gearing

While the rewards from gearing can be high, there are also a number of risks that you need to be aware of:

- **Gearing can magnify losses**: As gearing magnifies the potential return you may receive on your investment, it can also magnify the losses if your investment declines in value.
- **Risk of interest rate changes**: You need to ensure that you could manage the interest repayments if interest rates were to increase.
- **Importance of gearing into growth assets**: Gearing costs money. Each year you need to pay the annual interest on the loan. If the investment you have geared into isn't growing in value then you should reconsider the strategy.
- **Risk of loss of cash flow**: You should only borrow to invest if you have the financial ability to absorb the effect of potential falls in investment values, and/or the increased cost of interest payments. Another risk is that the income from the investment (rent or dividends) may decrease or temporarily cease, which may place a burden on your cash flow.

Please refer to the 'Overview of Gearing' fact sheet under the Wealth Creation Financial Education Series for more details on each of the above risks.

Before considering a gearing strategy we strongly recommend that you discuss this with your financial adviser.

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