Guaranteed Equity /Investment Bonds

by Jim Shoesmith

At present many investment managers, including strangely *National* Savings & Investments, are offering Guaranteed Equity/Investment Bonds (GEBs, or GIBs). While individual products vary, these generally pay a certain percentage (one offers 115%!) of any gains, but perhaps with a ceiling, in the UK stock market overall but with a guarantee that investors will get their money back if the stock market falls. Such a bond therefore offers investors the seemingly attractive 'no-loss' option of either winning or getting their money back (any casino or horse-racing gambler would give their eye-teeth for such an offer). And its 'free' as there are generally 'no upfront and no annual management charges'.

So where's the catch?

To appreciate the catch you first need to understand how the manager achieves this feat. *Simplistically* it is as follows.

The key factor is that the manager does *not,* paradoxically, invest the fund in equities: it is invested in government or company bonds, these yield, say, 6%. This bond investment protects the capital; the yield is used to both buy a FTSE100 option and to provide the manager's profit (fund managers can live quite happily on an annual charge of 2% so there is, say, 4% for the option). The manager also minimises administration costs by not allowing early redemption and issuing them in blocks with fixed start/end dates.

The option provider uses a combination of its own, *and borrowed,* funds to cover the option by buying the underlying shares and holding them for the duration of the bond; then selling them and passing over the realised gain to the fund manager satisfy the option (the option provider is at risk if the market falls over whole of the bond period). Each year the option provider therefore receives both the option money, say 4%, and the dividend income, say 3.5%, but has to pay out interest on the borrowings, say 6%. On a very safe ratio of 50% borrowing this means that the provider earns a respectable 9% yield per year (with the capital at risk only if the FTSE100 index is lower at the end than at the start); with more aggressive, but very possible, borrowings of 75% the yield is a very respectable 12%! The provider can enhance the gains, but at some risk, by such means as trading and the use of options.

The fundamental concept is that the investor is giving up dividend income (3.5% per year) in return for a guarantee of capital. But many studies have shown that dividend income has been a key element in portfolio growth, except for very short periods like the middle to late 1990s which saw bubble conditions is stock values.

So having shown that it is a good deal for the manager and option provider, is it nevertheless a good deal for investors?

Private (and institutional) equity investors cannot generally protect themselves against falls in the stock market in the longer term; cover through options is possible for short periods of a year or so, but is expensive and requires knowledge to set up and manage. So this type of bond does provide that cover and so for investors nervous about losing some or all of their capital it does provide some comfort. Paradoxically, at the height of the bull market (31st December 1999 when the FTSE100 peaked at a closing of 6930) few people worried about a severe decline in stock markets; whereas now that the market is more reasonably valued there is now much greater concern. But the decline, and the prospect of further declines, does concern people; hence the success of GEBs. Incidentally, they were not available in 1999; would an option provider has risked losing capital then?

The alternative for the private investor is to accept some risk to capital in return for bigger potential combined income/capital gains. To model this can be complex, but a simple model and assumptions should illustrate the main point. Assuming dividend yield of 3.5% and bond yield (after tax) of 5% (with income reinvested) and that the GEB pays out 100% of FTSE100 gains, the table opposite compares the gains/losses on an aggressive (=higher risk) portfolio of 70% FTSE tracker and 30% bond funds compared to the GEB.

The table shows that the portfolio is better than the GEB in all scenarios except a 41% cumulative fall in the market (the present fall in the FTSE100 from 6930 to the current 4500 is 35%, less than the 41%); dividend and bond income offsets most of the capital loss. On these, reasonable, assumptions investors are better off with their own portfolios rather than with GEBs.

Does their guarantee make them a safe and sensible investment?

Annual change in FTSE	**-10%**	**-5%**	**O%**	**+5%**	**+10%**
Cumulative change in FTSE over 5 years	-41%	-23%	0%	+28%	+61%
70% tracker and 30% bond portfolio					
Capital Loss due to 70% tracker content	-28%	-16%	0%	+20%	+43%
Dividend Income at 3.5% on 70% tracker	+18%	+18%	+18%	+18%	+18%
Bond Income at 5% on 30% bond content	+8%	+8%	+8%	+8%	+8%
Total portfolio capital gain/loss and income	**-2%**	**+10%**	**+26%**	**+46%**	**+69%**
GEB gain (over 4.5 years only, see * below)	**0%**	**0%**	**0%**	**+20%**	**+43%**
Portfolio better/worse than GEB	**-2%**	**+10%**	**+26%**	**+26%**	**+25%**

*Most, in an apparently sensible way, average the closing prices over the 6 – 12 months prior to the end of the bond period; this however really means that potential rises are reduced and provide a source of additional interest income *for the managers*.

Taxation makes GEBs even less attractive. They are very tax inefficient as the whole of the gain is taxed at the taxpayer's marginal rate in the one tax year in which they mature; this could therefore cause many people to pay tax on part or all of the gain at 40%. The portfolio income is however spread evenly over tax years and the capital gains can be deferred, or spread over a number of tax years.

One further problem with GEBs is that they are inflexible: investment must be made within a short period of a month or so, cannot be redeemed early (except through death) and must be redeemed on one fixed date.

The inflexibility carries through to the determination of the capital gain which is calculated at the start by the FTSE index on one predetermined day (10th November 2004 is the date being used by several current offerings) and at the end by a number of predetermined days; the GEB gain is therefore heavily determined by the index on those days which may or may not be representative of the index around that time.

The conclusion therefore is very clear: the traditional balanced bond/equity portfolio is a superior investment proposition compared to GEBs. This is the view not only of this writer but of a number of journalists and financial advisors (Alistair Birt in the Investors Chronicle of 23rd July 2004 and both Lucy Warwick-Ching and Personal View by Stuart Fowler in the FT on Saturday 25th September 2004).