AEGON | Befektetési Alapkezelő

Monthly outlook – December

Ádám Halóka – A Do-It-Yourself Capital Protected Fund? Here's the solution.

The major stock exchanges have just put a tempestuous month behind them. The American S&P500 lost 0.32%, and the BUX index 10.86% of its value. The share markets have fallen by a total of 2.42%. And investors in Hungarian bonds had no cause for celebration either, having suffered a 5.05% loss as a consequence of the yield hikes.

Due to the increasingly common losses of confidence in the equity markets, and the changes to domestic legislation, a substantial proportion of savers are showing a serious interest in capital and yield protected collective investment products. Recognising this demand, a few of the major Fund Managers launch several investment funds of this type in the Hungarian market every year. It's worth bearing in mind that these are usually closed-end funds, which means that the redemption opportunities are limited, and the full initial investment is only recouped at maturity. A characteristic of these products is that due to their structure, which is geared to protecting the invested capital, their profit potential is limited.

If demand arises for a capital protected product, product development has the task of identifying the current investment story and articulating the investment policy. The aim is for the portfolio manager to use the capital accumulated during the subscription period to develop a bond portfolio with a duration matching the term of the fund, in order to ensure the capital protection, and then to invest the money left over after this into profit-generating securities that fit in with the fund's profile.

I would like to offer assistance to those with substantial savings for compiling a portfolio that ensures the protection of their capital over a given investment horizon. To this end, I want to create a capital protected portfolio on 29 November 2010, which matures on 12.02.2014 and gives scope for speculation during its term. For the sake of simplicity I will disregard the costs in my example, but it is worth bearing in mind that investment funds of this type tend to charge annual asset management fees of 1.5%-3%.

The backbone of the portfolio is the 2014/C Hungarian government bond, the data of which I will use to compile the portfolio. For the purpose of my example this bond will be the only element included in the portfolio in order to ensure capital protection, although in practice the desired average duration can also be achieved by weighting the various maturities of the yield curve. The 2014/C was issued on 19.06.2003 by the State Debt Management Centre (AKK) with a 5.5% coupon, and matures on 12.02.2014. It is currently available for purchase with an annual yield of 7.7%, at a gross price of around 98.3%.

The payouts develop as follows:

Payout	Coupon	Time until payout (year)	Present value	Accrued interest
12.02.2011	5,500	0,21	5,42	4,37
12.02.2012	5,500	1,21	5,03	
12.02.2013	5,500	2,21	4,67	
12.02.2014	105,500	3,21	83,13	

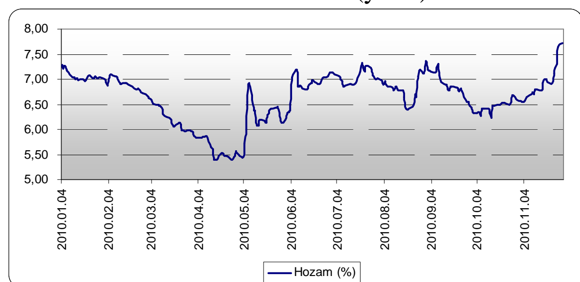
Source: AKK, AEGON Fund Management

Let's say that you have HUF 100 million in savings, 98.3% of which you invest in the above bond, which leaves you with HUF 1.7 million (100-98.3=1,7) to invest speculatively this year. You maintain the bond in the portfolio until maturity, and since the net price increases as maturity approaches your capital is protected, while at each payout you will have the opportunity to invest an additional HUF 5.5 million in speculative instruments. In other words, the invested HUF 98.3 million will be worth HUF 100 million upon maturity, while the money received from the coupon payments, and the HUF 1.7 million remaining from the initial investment, can be used for speculation. Thinking through the above, it is easy to see why

solutions like this have such limited profit potential. From the total available savings, you initially only have HUF 1.7 million to invest in the riskier assets of your choice, followed by HUF 5.5 million every subsequent year, as you have opted for security rather than a higher potential yield. It's important to note that the capital protection is only assured if you maintain the portfolio until the bond expires, since fluctuations in yields can affect its price prior to maturity.
The good news, however, is that derivative instruments with leverage can provide the opportunity to build up major positions using the relatively small sums earmarked for speculative investment. This is precisely what the portfolio managers of capital protected funds do. They might use the sums remaining following the bond purchase and received at the time of payouts, with substantial leverage, to build up maize or gold futures positions for example, as a means of influencing the overall performance of the entire capital protected portfolio through speculative investments. At the same time this technique is not without its dangers, since in these cases both the possible gain and the potential loss are multiplied, and to ensure the protection of the capital it is important that losses should not exceed the available amount. For this, it is advisable to use stop-loss orders or knock-out certificates.

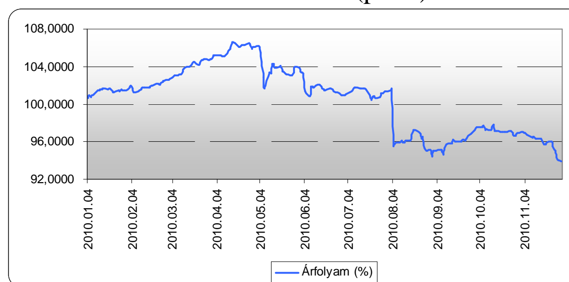
I'm sure anyone reading this is familiar with the relationship between bond prices and yields, in which the price of the lending securities falls as their yield rises, and vice-versa. There is greater scope for speculation if you succeed in buying the bond(s) serving to ensure stability at a high yield.

2010 data for the 2014/C bond (yield)



Source: AKK

2010 data for the 2014/C bond (price)



Source: AKK

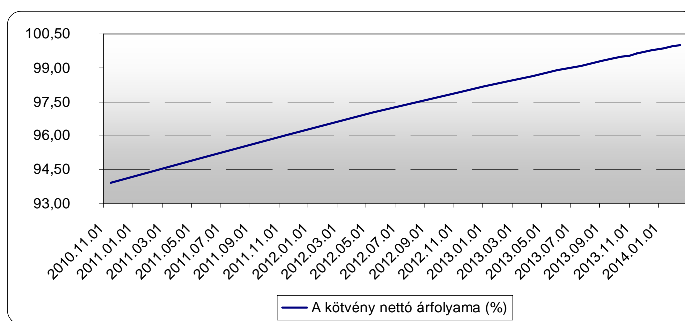
For the sake of argument, let's say that the original yield drops by 20 basis points in each monitored period. In this case the net price of the bond ensures the capital protection as follows:

2014/C

Yield (%)	Date	Net price of the bond (%)
7,71	29.11.2010	93,90
7,51	29.11.2011	96,02
7,31	29.11.2012	97,95
7,11	29.11.2013	99,62
6,91	12.02.2014	100,00

Source: AEGON Fund Management

2014/C



Source: AEGON Fund Management

After reading through the above, the pros and cons of capital protected structures are obvious. Based on my observations of market trends, I believe that investors' habits are presently undergoing a transformation, and the focus of attention is shifting away from the longer-term, 3-5-10-year products towards short-term investment funds that offer protection over periods as short as one year, and which exceed the yield potential of the money market funds.

These funds tend to favour the much shorter-term bonds and discounted bills, while maintaining the average duration at around one year. They distribute the amounts remaining after the bond purchases

between approximately five or six speculative transactions a year, exploring a wide range of asset classes for profitable, typically short-term trading opportunities. In this way both the rises and falls in the various currencies, raw materials and share indexes can result in gains for funds with an absolute-yield strategy.

This is precisely the investment approach that AEGON Fund Management applies in the case of its AEGON Ózon Derivative Capital Protected Investment Fund. While ensuring annual capital protection, it attempts to achieve a higher return than would be attainable with money market instruments. Thus we are betting on an increase in raw materials price in the near future, and an increase in the yield on emerging bonds, as well as a change in the exchange rate of undervalued currencies.

Recommended portfolio:

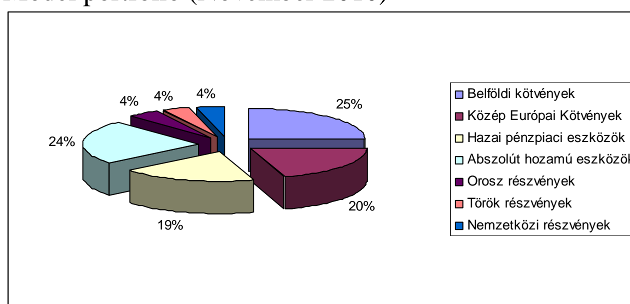
In the current market environment, AEGON Fund Management regards the following portfolio composition as offering the ideal combination of balanced performance and a medium risk profile:

Model portfolio (November 2010)

Assets	Weight
Domestic bonds	25.40%
Central European Bonds	19.79%
Domestic money-market instruments	18.93%
Absolute-yield instruments	23.66%
Russian equities	4.39%
Turkish equities	4.04%
International equities	3.79%

Source: AEGON Fund Management

Model portfolio (November 2010)



Source: AEGON Fund Management

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