Capital Preservation versus Capital Growth

Over the past year, we have received feedback from clients and held discussions with them regarding investing into capital protected/guaranteed products. With recent articles again highlighting such products, it may be timely to explore whether such products are really as good or as bad as they seem.

Looking back in history, many of these products were launched and became popular following the stock market collapse in 2000/01. Such products addressed investors' fear of loss, and provided the possibility to make small gains while keeping the capital secure. However, with positive market performance in recent years, many of such products have underperformed, resulting in unsatisfied investors. In today's environment, it is debatable whether they are still attractive.

Let us take a moment to understand how these products are structured. For most of them, a large part of the investments are placed into fixed income instruments to protect and ensure that the capital would be intact upon maturity (excluding any fees & charges). The remainder is then placed into variations of more risky instruments such as currencies, derivatives, etc to generate additional returns to pay for "bonus" returns.

Some of the issues to consider include:

- Capital Protection - The capital is only protected upon maturity, which could be 5 years or longer. Funds redemption before maturity may result in losses. In the remote event of significant default in the underlying fixed income instruments, some losses may occur even at maturity.
- Fees & Charges – Fees & charges for capital protected/guaranteed products are usually higher. Investors need to be aware that after fees & charges are considered, losses may occur.
- Low Liquidity – Investors must be prepared to lock up the funds for an extended period, possibly 5 years or more. Funds withdrawal before maturity may lead to heavy penalties in addition to possible capital losses.
- Opportunity costs – Upside potential is limited, resulting in low capital growth. After several years, there is a possibility that the returns are lower than fixed deposit rates, or in the worst case, zero returns.

While capital protected/guaranteed products may suit some investors, we think that many investors may be better off with a diversified and prudently managed investment portfolio, focused on long-term consistent capital growth. Conservative investors also have the alternative to invest in a bond portfolio that can provide recurring income and preserve capital. In conclusion, while capital protected/guaranteed products are not inherently bad for investors, investors do need to understand their characteristics and whether they really fit their needs.