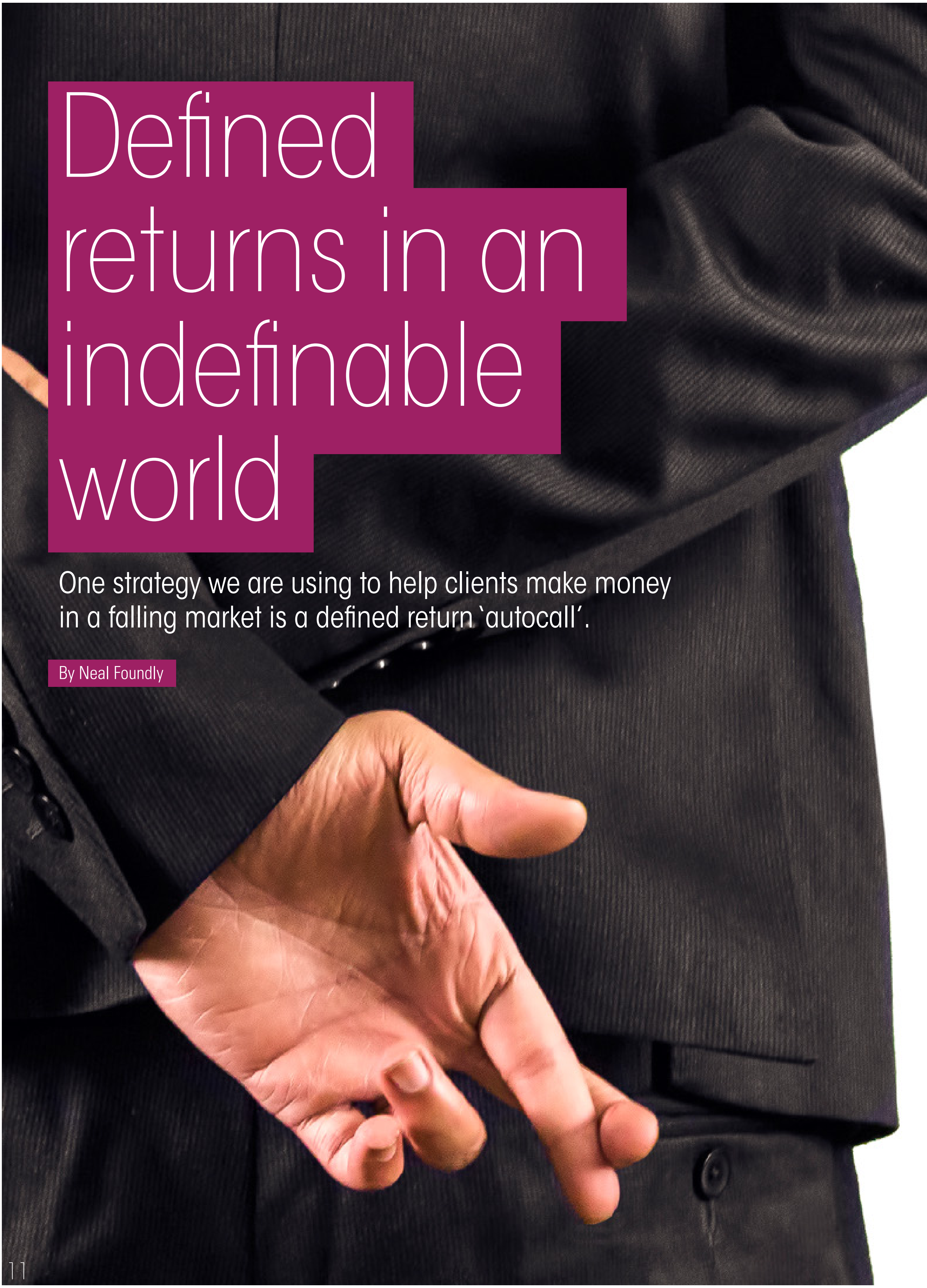
Defined returns in an indefinable world

One strategy we are using to help clients make money in a falling market is a defined return 'autocall'.

By Neal Foundly



The article in this edition 'Nervous markets call for vigilance and planning' shows how markets could fall 20% in the event of a crash. If that happens, you can still make money with certain investments.

This article focuses on just one of the strategies that we use, which is called defined returns.

On 2 December 2014, we bought a plan from Barclays that promised to pay 9.15% a year in certain circumstances.

This product, known as an 'autocall', is essentially an agreement with Barclays that they pay us a defined return a year - similar to coupons for a bond - if the FTSE 100 index stays within certain limits for the next six years. The 9.15% is a fixed payment and does not compound up over the life of the product.

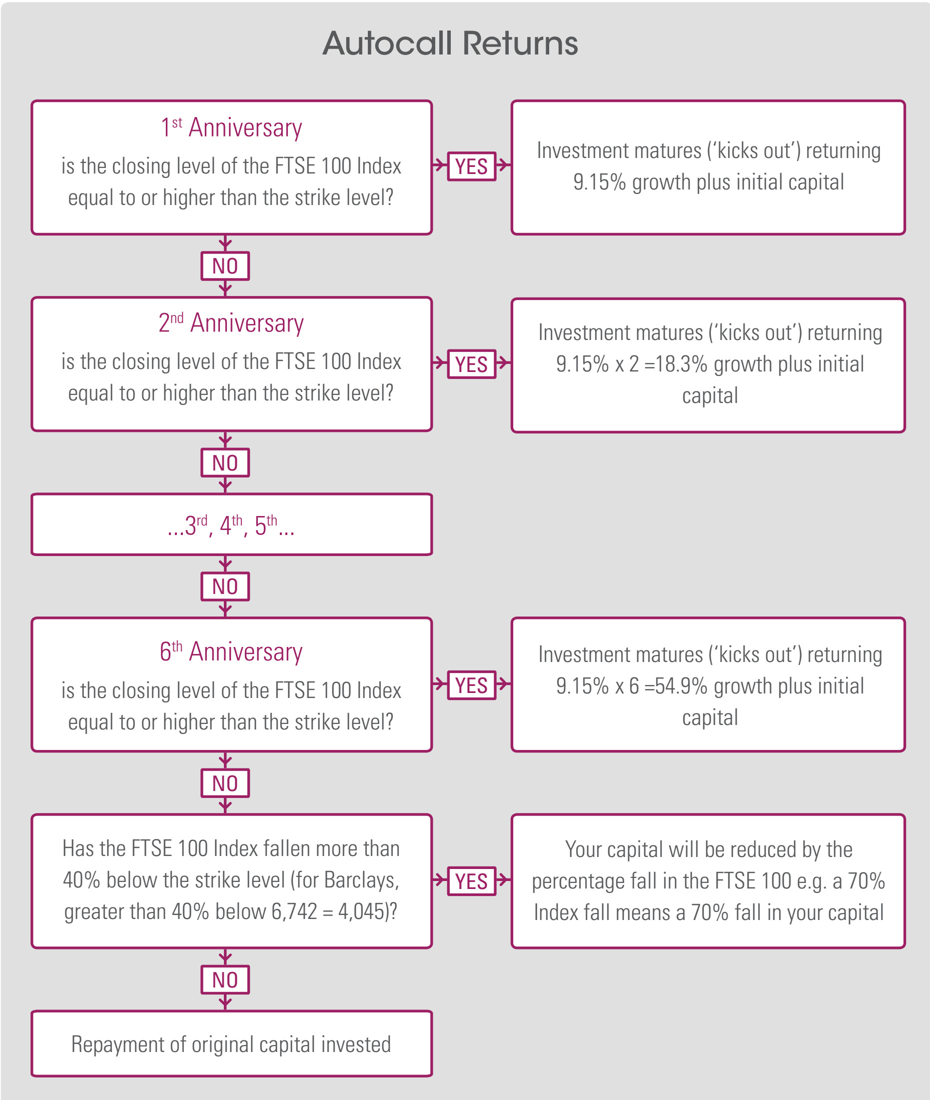
On the day a provider launches an autocall product, it records the level of the FTSE 100 as the 'strike level', which in this case was 6,742.

There are different potential outcomes for investors in this product. The flowchart shows these scenarios with the returns to investors depending on the level of the index.

Attractive comparisons

The FTSE 100 Index at the time of writing is 7% below the strike level of 6,742, whereas the product is priced at 101p - representing a rise of 1%.

To provide a basis for comparison, let's compare buying the autocall with investing in a FTSE tracker fund.



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If the level of the stock market does not change over the 12 months to December (the Barclay's product anniversary), the returns on holding a tracker fund would only be the market's dividend yield, which would be around 3.5%.

In contrast, however, if we buy the Barclays autocall product today and the FTSE 100 Index recovers to close equal to the strike level of 6,742 (and it 'kicks out') in December, then it will provide an annualised return of a whopping 59.7%. If the market does not quite reach 6,742 by this December, but does so by December 2016, then the return will still be a generous 14.2%. That is very attractive, which is why we are buying it for new clients and topping up where appropriate for existing clients.

Risks and costs

What is in it for the investment banks? Well, arguably, this is a form of casino banking and the banks take a slice out of each component that the product comprises.

Autocall products are not without risk. If the product never kicks out, and the FTSE 100 closes on 2 December 2020 below 4,045, then the investor will lose capital. If Barclays goes bust then all the capital could conceivably be lost. We will be discussing the risks in more detail in a future article, but suffice to say that we carefully control the risks and exposures for our clients to minimise any potential losses while providing significant return opportunities.

If you would like us to assess how your portfolio would stand up to a market crash, please contact us for a no-cost, no-obligation report.