Q&A on capital protected unit trust funds

In the last month, investors have witnessed some unprecedented distress in the global financial markets. In response, policymakers in US and Europe have tried to get ahead of the deteriorating financial conditions with bold initiatives such as direct liquidity injections into capital markets, purchasing unsecured private sector liabilities, recapitalization of national banking entities with debt and equity issues, and sizeable interest rate cuts by the central banks.

With the recent collapse of a global investment bank like Lehman Brothers, the worry about the safety of capital has heightened. Investors are now more concerned about the return of their capital than the return on capital.

This article attempts to address some of the concerns that investors' may have regarding the 'safety' of their investment in capital protected unit trust funds. Some investors are wondering if their investments are truly protected, and how this capital protection works. It is hoped that this will reassure investors that their capital invested in such protected funds are indeed 'safe', if they continue to hold them until the stated maturity dates.

What are capital protected unit trust funds?

- They are investments that promise to repay 100% of your invested capital, when held until their maturity date, which can vary from 18-months up to 5-years.
- They are closed-ended, unitized funds that do not guarantee returns to investors but only promise to protect the capital invested at maturity.
- Further, they allow investors to participate in the potential upside from the investments, as a small portion of the initial capital is invested in risky assets like stocks, options or other derivatives that derive their value from underlying assets such as equities, bonds, commodities, indices, currencies and others.
- There are currently 45 capital protected (and guaranteed[1]) unit trust funds in Malaysia with various maturity periods. Assets under management (AUM) for these funds are worth approximately RM8.1billion, and represent about 13% of the total AUM of all private unit trust funds in Malaysia (estimate as at end-August 2008)[2].

How is my capital protected?

- Your capital in the fund is protected by the fund manager placing a large portion of the capital raised (normally in excess of 90%[3]) in Zero Coupon Negotiable Instruments of Deposits (or ZNIDs), which are money market instruments. The ZNIDs are issued at a discount, and compounds at a fixed interest rate to their par value (of 100%) at maturity, thus 'protecting' the initial capital.
- The Securities Commission (SC) guidelines for capital protected/guaranteed funds require that ZNIDs held to be of high-grade (that is, they are issued by local banks with rating of 'A' and above from approved rating agencies). This should give investors confidence as this 'protection' is provided by Malaysian banks, which are regulated by Bank Negara Malaysia (BNM) and are not likely to default on their obligations.
- Further, the fund manager would also diversify the risks by investing in a portfolio of ZNIDs, issued by four or five different banks.

[1] Capital guaranteed unit trust funds are managed in the same manner as capital protected funds, except that they have an additional guarantee on the capital, given by a bank. A fee is charged to the fund for this added feature.
[2] Source: Lipper
[3] Depending on maturity of fund, and prevailing interest rates.

- BNM announced on 17 October 2008 that all Ringgit and foreign currency deposits placed with financial institutions will be fully guaranteed by the Government. This guarantee would also cover the ZNIDs which is a form of deposits, providing extra security to investors who have invested in the capital protected funds.

Can I redeem my capital protected unit trust fund before maturity and what will happen?

- Yes, you can. But, you may not receive 100% of your initial capital back. The value that you receive would depend on the net asset value (NAV) – which is the sum of current market values of the options plus the ZNIDs of the fund, at the time when you redeem.
- If the NAV of the fund is higher than your initial price level, you will realize a gain (and vice versa, if NAV is below the initial price level – a loss). In deciding whether to redeem or not, investors should be aware of any exit charges that may be imposed (which can vary from fund to fund) when you redeem. The charges are stated in the fund's prospectus.
- As the fund draws closer to its maturity date, and the ZNIDs 'mature', NAV of the fund would be closer to its initial price level. So, it is always better to hold the fund to its maturity.

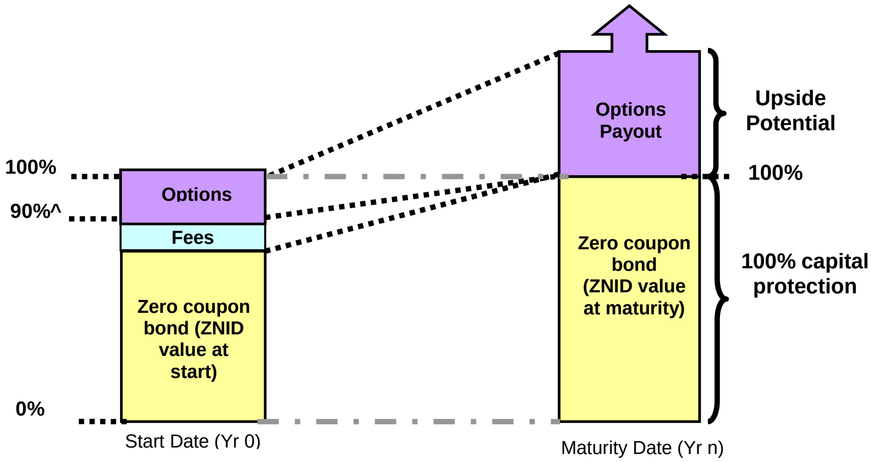
Is it possible that I will not make any returns from my capital protected unit trusts fund?

- Yes, with any investments that is entirely possible – there are no guarantees. However, the attraction of the capital protected fund is that your capital invested is protected at maturity, and there is some potential upside.
- The returns from the fund (whether periodic payments, like yearly dividends, or a lump sum payout at maturity) would depend on the investment's performance.
- Under the SC guidelines, up to 15% of fund's NAV can be invested in options/derivatives. This limits the extent of the exposure or maximum loss for the fund – the remainder of capital is safely invested in ZNIDs.
- If the option/derivatives do not perform i.e. 'out of the money' there may be no returns to the investors from the fund – plain and simple.

Some investors in Singapore and HK who invested in structured products have lost their capital, when Lehman Brothers went bankrupt; can something like this happen to my capital protected unit trusts fund in Malaysia?

- Not likely. The structured products they subscribed to are different, and are not capital protected funds. These are not marketed in Malaysia. One of the products sold to retail investors there was the 'minibond', which are related to credit linked securities and guaranteed by Lehman Brothers. Another was the Lehman structured notes, whereby 100% of the money raised were invested with the counterparty (in this case, Lehman Brothers). In both cases, when Lehman went bankrupt and defaulted on its obligations, the investors lost their capital.
- In Malaysia, the capital protected unit trusts funds are regulated by the SC and as explained, investment in options/derivatives with foreign counterparty is limited to not more than 15% of fund's NAV, thus protecting the investors from any capital losses.

Basic building blocks of capital protected fund



^Actual % of ZNIDs & options would depend on fund's maturity and prevailing interest rates.