DFP

PENSION & INVESTMENT CONSULTANTS

No Value in Tracker Bonds Now

Q. Investors and their advisors have invested billions in tracker bonds over decades – **How can they be poor value?**

A. Lower interest rates!

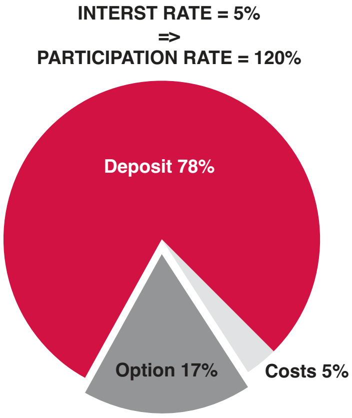
Interest rates are key to the value of tracker bonds.

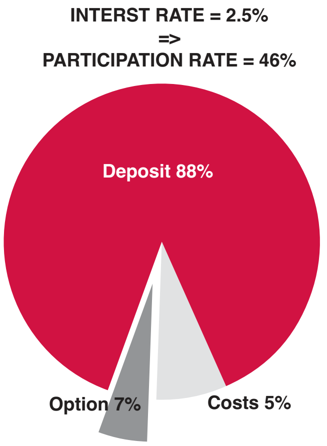
The bulk of money invested into tracker bonds is actually put on deposit - the deposit is set at a level which, together with interest, will repay capital at maturity. **The lower interest rates are, the greater the amount which needs to go on deposit.**

The more of the money which goes on deposit the less is available to buy the option – the option is what offers the potential bonus. The bonus is linked to the performance of a stockmarket index* or basket of shares at a rate known as the participation rate; less money available to buy the option implies a lower **participation rate.**

To illustrate just how crucial interest rates are, here are two scenarios for a Euro STOXX 50 tracker:

Scenario A. above would have been typical as recently as a year ago whereas B. reflects current interest rates. Because of a sharp fall in deposit rates, the amount available to buy the option **has collapsed from 17% to just 7%.** As a direct consequence the participation rate in the growth of the index has fallen from 120% to 46%.





This has fundamentally undermined the value of tracker products.

The poor value of trackers is illustrated by how easy it is to do the same job more efficiently: someone inclined to invest €100,000 in a tracker would almost certainly be better off doing a DIY job and putting €88,000 on deposit and €12,000 into a EuroSTOXX fund. Over 5 years sustaining the current dividend yield would return 19% of the amount invested in the fund. The portion of the €100,000 going on fees would be a fraction of the €5,000 or so consumed by the tracker.

almost always the capital return of the index – i.e. not including the dividend income

We estimate for this example **that** the index would need to rise by **40%*** before the tracker outcome would be better than the home-made alternative with the bulk of the more probable outcomes favouring the latter. That 40% threshold does not place any value on liquidity – any rational investor should require a premium to hold the significantly less liquid tracker.

Value and liquidity aside, the risks facing depositors have increased in recent months – **see Appendix**. While all depositors face these risks, they are more pronounced when the deposit is embedded in a tracker: a deposit placed directly with a bank can normally be withdrawn before its agreed maturity at a small or even no penalty.

It should be pointed out that there are scenarios in which the pay-out from the tracker bond could be much better (though the probability attaching to much better outcomes are very low).

Q. Is a "DIY tracker" **DFP's** preferred approach for Cautious Investors?

A. No – the return on a DIY tracker is still very much driven by deposit rates which are low and probably heading lower. **DFP** strongly suggests that risk- averse investors who want a better return invest in our Cautious Investment Portfolios.

The rates paid by Irish banks have been falling sharply of late – in the absence of problems relating to Ireland or the banks those rates should continue to fall towards broader Eurozone rates. Central Banks around the world have cut interest rates towards zero to support their struggling economies and financial systems. Depriving savers and investors of a return which compensates for inflation is known as **Financial Repression** and one of the classic ways in which previous debt crises have been resolved: the bad news is that the process typically lasts for several years.

Financial Repression is accompanied by less certainty around the security of deposits. The traditional 'bolt-hole' of tracker bonds is no longer a realistic option. In conjunction with our independent investment advisors, **Clarus Investment Solutions**, **DFP** has built a number of Model Investment Portfolios.

Some of these are tailored to suit those with a modest appetite for risk and who might normally prefer deposits or trackers. The portfolios are diversified in terms of the types of assets held and the institutions who provide the various components. The portfolios are monitored regularly, and from time to time may be rebalanced. Very competitive charges have been negotiated with the fund providers.

At **DFP**, we endeavour to provide our clients with clear and precise information on the asset classes that they are committing to. We avoid investments which have a low probability of performing but can be perceived by clients (incorrectly) as attractive as in the case of Tracker Bonds. In conjunction, with **Clarus Investment Solutions**, we can independently review the merits of all types of investment available.

Our approach to investments for clients is tailored to their requirements and the assets held within the portfolios can be amended to crystallise any upturn in markets and similarly limit any downturn. We believe that our approach works and this is supported by the performance of our various portfolios.

Appendix

Recent Changes In Risk Environment Facing Depositors

- **The Eligible Liabilities Guarantee** was withdrawn in March
- Since events in Cyprus it has seemed likely that depositors in EU banks will be in the firing line if banks need to be 'resolved' (likely to only affect amounts above €100,000) – this was part of the proposals which came out of the June 26/27 meeting of EU Finance Ministers
- The flexibility built into the proposed resolution regime may encourage large depositors to switch deposits from the periphery *("Fears grow for big depositors in euro periphery"* – Financial Times July 2nd)
- It is now evident that the **Deposit Protection Funds** around the Member States are substantially inadequate to cover their potential liabilities – the Irish fund stands at €388m.Progress towards a properly back-stopped EU - wide deposit protection regime is painfully slow.
- The IMF's 9th review under Ireland's bailout programme makes a number of references to the possibility of Ireland's banks requiring recapitalisation and questions PTSB's longer-term viability
- Some tracker bond investors in IBRC have been 'haircut'

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