

# Tracker Bonds

Since 2008 the financial markets have been in a state of turmoil. With constant streams of bad news, customer sentiment has taken a hit. As a result, over this time, we have seen a move from more traditional equity type investments with demand increasing for products with guarantees. Tracker Bonds have grown in popularity as a guaranteed product option. Tracker bonds aim to give clients access to stock market returns with the safety net of a capital guarantee

There are many different types of Tracker Products available in the market. When advising clients, it is important to understand how tracker products work and also what to bear in mind when differentiating amongst them. When choosing between products, it is important to remember client needs:

- 1) Security – this is the key need as clients see this type of product as an alternative to a deposit account.
- 2) Potential for Upside Return – clients will want to see some return on their investment.

## How Secure is the Tracker?

Tracker Bonds are sold by banks and insurance companies. Generally when a bank sells the product, the bank itself will provide the guarantee. If a life company sells it, it will use a third party bank to provide the return and guarantee on the product. There may also be situations where a bank may use a third party bank to provide the guarantee and return. For these products, the client has counterparty exposure to the ultimate provider of the guarantee. The product documentation will provide clear disclosures on who is providing the guarantee. It will clearly state that on maturity, the client's pay off will be based on what is received from the bank providing the guarantee. It will also state that if the provider of guarantee doesn't deliver on their obligations, the client may not receive the promised return on the product. It is therefore important to consider who the bank is that the client is exposed to. How does this provider of guarantee fit in with client need for security?

If a client is choosing this type of product for security, how can you assess the security of the provider of the guarantee? Easy ways to do this are to consider the views of ratings agencies. Ratings agencies are set up to give an

independent assessment of how likely someone is to pay their debts. Typically, ratings are expressed as letter grades that range, for example, from AAA to D to communicate the agency's opinion of relative level of credit risk.

Clients see Tracker Bonds as an alternative to deposit account and are looking for security. It is therefore important to consider the credit rating of the bank that is providing the guarantee.

## How Trackers are structured

The bank providing the guarantee and return will provide a structured deposit account. This account will be made up of two elements:

- a) Part to provide the guaranteed amount
- b) Option to provide upside return

The part to provide the guaranteed amount is put aside and will grow to the guaranteed amount over the term of the tracker bond. The amount needed here depends on the interest rate the bank is paying. Banks with strong credit ratings will not need to pay high interest rates to attract funding so will pay a low interest rate. Lower interest rates result in higher portion being put aside to provide the guaranteed return of capital.

Banks with weaker credit ratings from independent ratings agencies will need to pay higher interest rates so less is needed to be put aside to provide the guaranteed amount.

For example, for a product with a 5 year term, a bank with a strong credit rating paying an interest rate of 3.5% per annum might require to set aside 84% of the investment to provide the guarantee.

A bank with a weaker credit rating might need to pay an interest rate of 6% per annum and would require to put aside only 75% to provide the guarantee.

If a lower proportion is required to be set aside to provide the guarantee, a higher proportion will be used to pay for option to provide upside.

## Important points to consider when looking at potential for upside return

The portion of the structured deposit account used to buy an option provides for upside potential. While the security is the key reason why a Tracker product is bought, it is important to consider what generates upside potential.

The amount available to pay for the option depends on how much is left after providing the guaranteed amount. The more left over means better potential upside.

# A key way of assessing security is by considering the independently assessed credit ratings of the banks providing guarantees.

## **Protect Good Performance**

Good performance early on could be wiped out by bad performance late on. There are a number of approaches to protecting against this. Averaging over the last 6 months is commonly used but may not work if the last year is particularly bad. A better approach might be to look at something which locks in performance on a more regular basis, for example every year. This means that any positive performance early on in the term will be locked in and cannot be lost if later years are bad.

## **Protect against Bad Performance**

Like any investment, Trackers can be subject to the volatility of stock markets. In the current market turmoil it is a good idea to look for products which place some limit on the downside. If you have for example 100% exposure to an index you have 100% exposure to the gains in that index in good times but will also have 100% exposure to market crashes in times of turmoil. A better approach to this might be if there is some limit on the maximum fall a Tracker can be exposed to. An example of this might be a product which puts a floor on monthly performance. In this way if you have extreme market conditions, like July and August 2011, a monthly floor on returns would protect against the full impact of these falls.

## **Access**

Like any investment, access is important. Tracker bonds generally have a term of up to 5 years and clients would intend to invest for this term. There may be occasions however when clients need to call in their investment early. Because of this, it is a good idea to look for products which provide daily liquidity. Obviously it is not possible to provide the guarantee on early encashment but clients would be happy to know that they can encash at any stage. Whether there is access or not depends on the bank providing the guarantee and again returns to the security question. If the bank has a strong credit rating and is confident it will be easily able to replace early encashed investments, it will have no problem offering daily liquidity. However, banks with weaker credit ratings who need to pay higher interest rates to attract funding will be less likely to offer clients an early exit.

## **Conclusion**

Tracker bonds have grown in popularity over the last number of years as clients have looked for secure investments options. The main need of these clients is security. It is therefore important to consider the level of security offered by the provider of the guarantee on the products. A key way of assessing security is by considering the independently assessed credit ratings of the banks providing guarantees. It is also important to consider the structure to upside performance, including features such as annual lock-ins. Finally, access to funds earlier than planned can be an important feature as clients may need to access their money earlier than they had originally planned.