



“On The Money Report”

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“Principal Protection Funds Stink!”

This is a direct quote from Morningstar’s Inc.’s Brian Portnoy.

His reasoning is illuminated in the following report.

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“The Investor’s Advocate”
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Feature | Brian Portnoy

Is a Safe Investment Also a Smart Investment?

A user's guide to funds that guarantee your capital.

All gain, no pain.

That's what an increasing number of mutual fund companies are promising these days. In response to gut-wrenching market declines, fund shops have been launching products that guarantee your original investment. But with investing, like everything else in life, there's no such thing as a free lunch. While some guaranteed products are reasonable investments, many others are expensive, confusing, and inappropriate for investors with long-term goals.

Are any of these guaranteed funds right for you? The answer's in the details. Although their names promise similar benefits, there are big differences between "stable-value" and "principal-protection" offerings. Stable-value funds often yield more than money-market funds, but their high costs seriously dim their appeal. We're far more skeptical about principal-protection funds, which are more about

marketing than sound investing. Bottom line: Understand what you're buying—and why.

Stable-Value Funds: Better than Cash (Maybe)

Stable-value funds are essentially insured bond portfolios. So-called "wrappers," issued by insurance companies, guarantee the principal and maintain a stable net asset value (hence the name). So the fund's NAV never fluctuates, just like a money-market fund, even though it aims to deliver a higher yield. To that end, each fund typically owns short- to intermediate-maturity bonds spread across different sectors. But these funds vary in credit quality. For example, some own only AAA rated bonds, while others, including **Scudder Preservation Plus Income** DBPIX, dip a bit into high-yield paper.

Stable-value funds are a legitimate way to invest cash at very low risk, and a sizable percentage of 401(k) assets are currently invested in them. Yet only recently have they become available for direct purchase by individuals in an IRA account. These choices include the Scudder fund as well as **PBHG IRA Capital Preservation** PBCPX and **Gartmore Morley Capital Accumulation** NMIRX.

Stable-value funds can make for an attractive alternative to money-market funds. In 2002 so far, they have returned around 2% to 3%, while most money-market funds now yield less than 2%. (The historical comparison to bond funds is trickier, because most retail stable-value funds have very limited records.)

But there are some catches: First and foremost is the cost. The use of insurance usually pushes a fund's expense ratio into the stratosphere. The average short-term bond fund costs 82 basis points annually (or 0.82%)—and many good ones cost far less. Most money-market funds are cheaper still. Yet the price tag for a stable value fund can run well over 1%. **Oppenheimer Capital Appreciation** OCAPX costs 1.59% annually, for example. Thus, expenses erode their potential advantage over most bond funds.

Redemption fees, found on most stable-value funds, also detract from their appeal. Typically 2% of assets, this fee is triggered when money-market yields exceed that of the

Questions to Ask about Any "Guaranteed" Fund

- 1 Does it match your goals?** Estimate whether you can meet your goals—retirement, college, a new house—with limited or no growth in your capital. You might need to buy a fund that takes on more risk, and fewer costs, to meet your goals. If you need substantial capital appreciation, these aren't the right funds for you.
- 2 Does it match your time horizon?** Read the fine print on how long your investment is locked up. Stable-value funds can be good cash-management tools, but principal-protection funds can tie up your capital for five to 10 years.
- 3 What's the total cost?** Exorbitant costs are the deal breaker with many guaranteed products. Because they carry high expenses stemming from insurance contracts, stable-value funds can lose their edge over bond funds. Principal-protection funds frequently have steep expense ratios and hard-to-understand redemption fees, in addition to high sales charges (or loads).
- 4 Are there better alternatives?** Depending on the expenses and restrictions, a stable-value fund might be more attractive than a money-market fund. But don't forget: Conservative bond funds can offer good total return with not much volatility. With principal-protection funds, if you're getting a bond fund in disguise, just buy a bond fund for a fraction of the price. For hybrid exposure, buy a tested, cheap hybrid fund or build your own basket of zero-coupon bonds and an S&P 500 index fund.

Guaranteed Funds at a Glance

Stable-Value Funds

Fixed-income portfolios with insurance contracts that maintain a constant net asset value

Pros: Low volatility, frequently yield more than money markets

Cons: Expensive, potential redemption fees, limited upside

Principal-Protection Funds

Hybrid stock/bond portfolios with insurance that guarantees principal after several years

Pros: Downside protection

Cons: Very expensive, limited upside, locks away money for years, confusing strategies.

fund. So don't expect to move your cash easily when better opportunities call. Finally, take note that the fund's guarantee is from the private sector, not the government. At this point, we have little reason to suspect the guarantees are flimsy, but it's also fair to say that many of these offerings have not been stress-tested. To be safe, double-check who's insuring your fund.

Principal-Protection Funds: Buyer Beware

So-called principal-protection funds are advertised as hybrid funds that mix both stocks and bonds in the same portfolio. There's typically an offering period, when investors can sign up, and then a guarantee period, when everyone's money is invested on the same day and is then locked away, usually for five or seven years. If your investment is in the red after that time, then the fund company will return the whole principal, less certain expenses and your load.

The promise has definite allure, because it involves not only upside equity potential, but also a money-back guarantee if the market stays in a funk. As with stable-value funds, the guarantee often relies on an insurance contract. But most principal-protection offerings are sufficiently conservative so that the insurance won't be necessary. While the asset allocation is discretionary, these funds are usually heavily tilted toward zero-coupon Treasury bonds that, at maturity, will safeguard the investment without the insurance. The balance of the fund is typically invested in S&P 500 stocks.

This sounds like a reasonable, albeit conservative, hybrid strategy. But there are many downsides. First, these funds are heavily weighted toward bonds, sometimes entirely.

ING Classic Principal Protection I APPAX is now 90% in bonds while **Smith Barney Capital Preservation Fund** SPNAX, which launched only recently, held only bonds and cash at the end of April 2002. Less risky than stocks, a bond-heavy fund means less risk that the asset manager and insurance company will lose their dough.

Why is this a problem? Because contrary to fund company promises, these offerings have very limited upside. In most cases, they

eventually resemble ordinary government-bond funds, so investors expecting equity upside won't get it.

But your capital's safe, right? Yes, but you'll pay a king's ransom for it. Expenses on most principal-protection funds are a deal breaker, in our opinion. In addition to a sales load, the Smith Barney offering came with a 1.95% annual price tag. Another recently launched offering, **Index Principal Protected Stock**, costs a jarring 2.25% per year. Put bluntly: These expenses are so high, especially relative to super-cheap government-bond funds, that the potential gain from these funds is minimal.

Other problems abound. Who's calling the shots at your fund is up for grabs. That's because the insurance company providing the guarantee can usurp asset-allocation duties if it thinks management is taking on too much risk. These funds also face a structural flaw: In order to protect capital, they're designed to buy more bonds when stock prices fall—in other words, buying high and selling low. In managing risk, investment performance often drops out of the equation.

Any investor considering a principal-protection fund needs to scrutinize its prospectus, which can be annoyingly opaque. Some other issues to consider: Are there early redemption fees? Can you partially redeem your shares without voiding the guarantee? Do you have just one single day at the end of the guarantee period to redeem, after which the guarantee is void? Are you allowed to hold the fund beyond the guarantee period?

Conclusion: No Free Lunch

Our general concern is that investors are fleeing to "guaranteed" funds out of panic rather than matching investment goals with appropriate securities. Fund companies took advantage of investor greed with a slew of new Internet funds in 1999—now they're banking on fear. Stable-value funds can make sense, but principal-protection funds are largely folly. If you're averse to losing money in the equity market, then there are plenty of conservative offerings that are more affordable and less perplexing. ■■■