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Promises & pitfalls come with capital-protected MF schemes

Mutual funds are offering schemes which cover your principal even in volatile markets. This may sound like a good investment option, but don't forget that the returns wont be commensurate with the rise in the benchmark index above a pre-set level, caution **Preeti Kulkarni & Vidyalaxmi**

WITH every market crash increasing investors' nervousness, it is not surprising to see products promising to soothe their frayed nerves being launched. Of late, fund houses are targeting retail investors with principal-protected products, which up until now were targeted at high net worth individuals (HNIs). As the name suggests, these instruments are designed to assure investors that irrespective of market conditions, their capital would be protected. "These instruments help you participate in the equity markets, while limiting the downside risk. As against a minimum ticket in the range of Rs 10-20 lakh for HNIs, a retail investor can start with Rs 5,000 by taking the mutual fund route," explains B Gopkumar, vice-president and head, financial planning group, Kotak Securities.

Some fund houses offer structured products in the form of equity-linked fixed maturity plans available to retail investors at the moment. These are close-ended products that invest in rated equity-linked notes / debentures (ELD) issued by rated non-banking financial companies (NBFCs), mainly Citi Financial, Barclays, JP Morgan, Deutsche and Merrill Lynch. Currently, Birla Sun Life AMC has floated two such schemes — Aviator - Series A and Gladiator - Series B — which close on July 30. Earlier, ICICI Prudential AMC and DWS Investments had launched similar plans.

■ The benefits

These products may appeal to first-time equity investors as well as wary investors who have burnt their fingers in the recent months. "Investors who are keen on returns from the equity market, while retaining their capital, can look at such products. Moreover, they offer decent post-tax returns," said Shrenik Shah, associate vice-president, Premier Banking, HSBC Bank.

The major part of the fund is invested in debt and a small percentage goes towards equities in the form of call options. "The debt portion ensures that your capital stays intact irrespective of market conditions, the equity component provides the upside," says PARK Financial Advisors' director Swapnil Pawar. An inherent principle of such products is the participation ratio, i.e. the ratio in which the ELD participates in the appreciation of the index it is benchmarked against. For instance, a participation ratio of 100% means a 10% rise in the underlying equity will result in a final return of 10%.

For example, if you invest Rs 100 in a capital-protected product, it will invest Rs 75 in debt and the rest in call options. After three years, Rs 75 would be worth Rs 100, thus fulfilling the capital-protection clause. Now, let us assume the index goes up by 50% during the period, some fund houses claim that your total return could go up to 70%. Thus, at the end of the three-year period, you would have Rs 170 in your kitty.

■ The flipside

This product is not without strings. Such instruments usually carry a knock-out level clause wherein, if its benchmark index rises beyond a particular level, your returns will not be commensurate with the rise in the index. The argument put forward is that it is a 'small' price that you pay in return for a capital protection.

For example, as per Birla Sun Life's Aviator Plan, if the Nifty goes up by 88% from its assumed base level of 5,000 to 9,400, the equity-linked FMP will yield a return of 123.20%. However, if it breaches the knock-out level of 100% and soars to 10,500 (110% rise), you will have to be satisfied with a return of 57% on maturity "What it essentially means is that your returns would be capped if the index rises beyond a particular level. Also, they are not as liquid as open-ended funds. If you withdraw your money before maturity, you will have to pay an exit load and also incur a loss if the NAV is negative at that point of time," informs Mr Shah.

This apart, the most serious concern about equity-linked FMPs stems from the ambiguity surrounding them. "Lack of transparency is the biggest risk in case of some of the schemes. The investor has no way of knowing how the issuers of the ELDs will use the money, unlike mutual fund schemes which make regular disclosures about their holdings. Although fund houses claim that the money is lent to AAA-rated companies, it does not necessarily mean that your money is in safe hands," says Transcend India's director Kartik Jhaveri. Though these instruments are promoted as low-risk products, credit risk does come in to play; hence, you need to make efforts to ascertain the issuer's credibility.

Besides, as these products come with a lock-in period, it makes sense to evaluate other options, although they might seem risky at the moment. "After all, if you stay invested in a diversified equity fund for three years, it could generate comparable returns too. Equities are meant for long-term investments and it is unlikely that you will lose your capital if you stick to your equity fund for three years," says a financial planner. Capital-protected schemes may seem like an ideal solution for tiding over volatility, but their complexity makes it imperative for investors to go through the fine print before committing any money.

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