Dimensional

OUTSIDE THE FLAGS

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MAY 2013

No Free Lunches

It's the nature of investment that people will pay a premium for the promise of a "certain" outcome. But research shows these supposed guarantees often come with hidden costs and risks attached.

Imagine an investment product that is sold as lifting your chances of meeting your retirement needs from 60% to 65%. A second product proposes to increase your chances from 95% to 100%. Which is more valuable?

It seems clear that while both products offer a 5 percentage point increase in the probabilities of success, the second option is much more enticing. This is known as "the certainty effect" and is well documented among behaviouralists.[1]

According to this effect, we are predisposed to overweight small risks and will pay far more than the expected value to eliminate them altogether.

It shouldn't be a surprise, then, that an entire industry is based on the innate desire among consumers for perceived certainty in investment outcomes.

This industry produces what are known as "structured" products. These instruments are often marketed to consumers as "capital guaranteed" or "capital protected" and offer the prospect of a certain payoff in the future.

Aware of the popularity of these investments, the Australian Securities and Investments Commission recently released the results of a **study** of unlisted retail structured products that offer guarantees or protection of capital.[2]

It concluded that these products can entail complexities, conditions and risks which are not always well understood and which can deliver unintended outcomes.

While the products are sold as 'guaranteed', there are often mitigating phrases such as 'qualified', 'limited', 'conditional' or 'contingent' – all of which hold out the possibility that the whole of the investor's capital may be at risk.

1. Daniel Kahneman, 'Thinking Fast and Slow', FSG, 2011
2. 'Health Check on Capital Protected Products', ASIC, May 1, 2013

"Some investors may consider structured products to be equivalent, or a near equivalent, to cash or deposit accounts, when the risks of structured products are usually considerably higher," the regulator warned.

Problems with structured products include an opaque structure, which often exaggerates the likelihood of payoff and/or underestimates the fees to be incurred. Product issuers, while notionally being associated with a major financial institution, may in fact be separate entities with little financial substance.

Some products, through the use of internal gearing, also carry significant potential for investors to lose money beyond their initial investment. Others carry conditions that link the payoff to the performance of an underlying asset.

"The attractions of these products for investors may include the ability to participate in the upside of market performance, while having protection on the downside as well as potential tax advantages in some cases," ASIC said.

"However, the opaque and complex nature of some of these products can render their features and risks difficult for retail investors to understand."

A lack of liquidity–ease of access to your money–is another frequently cited problem with structured products, as are uncertain tax consequences.

And even if none of these risks are present, the guarantee of a payoff has to be weighed against the lower return than might be secured otherwise and the often higher fees than incurred by investing in simple stocks and bonds.

It is understandable that people would prefer to eliminate risk altogether than merely reduce it. But the perception of certainty and the reality are often far apart. And the cost of seeking a guarantee can be much higher than we anticipate.

As always, beyond diversification, there are no free lunches in investment.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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