

## WOULD YOU GEAR INTO A CONQUISTADOR?

It hasn't taken long for the old school to beat their chests about the perils of borrowing to invest. Stirred up by the recent Budget changes to interest deductions for protected share borrowings, over the last few weeks the traditionalists have dominated the pages and airwaves, trotting out the old line that gearing doesn't add value to investment returns. Well, just like the cavalry generals didn't proclaim their redundancy before WW1, neither are the old school investment advisers going out without a whimper. But they need to do better than simply proclaim that gearing into investments is dis-economic – as the increasing body of evidence to the contrary is seriously undermining the credibility of the old school view. We'll look in a minute at another structured product designed for year end geared investing – ABN AMRO's "Conquistador" securities. First, let's recall some of the key elements of gearing into the equity market.

This month's ASX/Frank Russell 2007 Investing Report makes the stark observation that gearing into equities over the last 10 and 20 years has produced the highest return of any of the investments that were considered, including ungeared Australian shares and geared real property. Investors have 4 main choices regarding how they gear. If they have equity in their home they can draw down a relatively low rate line of credit and use this to fund their investments. Younger investors (call them "early wealth accumulators") often don't have much home equity and so will normally choose from either a margin loan, protected loan, or a 100% investment loan. The margin loan is risky and expensive, requiring around \$40 to start a \$100 loan (\$30 equity and (say) 10% interest). Protected loans are cheaper and less risky, with an upfront outlay of around 19% pa at current levels. (The interest rate and breakeven for a protected loan is higher than for a margin, loan but the start up costs are less). An even cheaper way to invest is to use a 100% investment loan over a capital protected product, at interest rates of around 10% at current levels.

So far, so good (if you buy into the relevance of gearing) – but what type of protected product works for this strategy. Its really simple, actually – start with a product that gives you exposure to an asset that you have some intrinsic demand for, and then look for a structure that is clean, low cost, and transparent. When judged against these criteria, unfortunately, many products don't pass muster – which is perhaps a better way to critique the protected gearing concept than simply asserting that it is always diseconomic!

ABN AMRO's new "Conquistador" Securities goes a long way towards satisfying these fundamental investment criteria. It is a 9 year capital protected product (too long a time frame for many investors) which is relatively low cost and transparent. It seeks to pay an income of 10% pa (but it can only do so in reliance on a geared underlying investment to some fixed income hedge funds – themselves intrinsically risky (recall Basis Capital)). Its capital growth potential is linked to investment into 2 other fund of hedge funds, one which targets returns from emerging (read "start up") hedge funds, and the other which invests in "global macro" futures and trading funds.

The product is engineered with reliance on backtesting using historical returns in relatively benign markets and on the expectation that these returns will persist. It has bamboozled the research houses who simplistically rely on this backtesting to determine whether the product is valuable or not. For an investor seeking exposure to these exotic assets, Conquistador is a great vehicle to do so. But for investors with a simpler approach – it may be better to look at more traditional forms of geared investing for 2008.

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