A Challenging Guarantee

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When it comes to money, the word ‘guarantee’ conveys a sense of safety and assurance.

No worries. No volatility.

The investment industry marketing boffins know all too well the appeal of that word ‘guarantee’. It sells products.

After the 1987 market crash, capital guaranteed funds — offered by large insurance companies — gained in popularity.

Investors wanted safety and a slightly higher rate of return. The old ‘have your cake and eat it too’ mentality.

For a while, the capital guaranteed funds delivered on their promise.

Investors cared little about the assets backing the guarantee or how the ‘slightly higher’ returns were being generated.

All they saw — courtesy of the financial planner — was ‘CAPITAL GUARANTEED’ and a better rate of return than the banks were o

Guess where the insurance companies invested the majority of the capital guaranteed funds?

Government bonds? No.

Bank deposits? No.

Commercial property (office buildings)? Yes.

This is an extract from an RBA research paper titled ‘Three Australian asset-price bubbles’ (emphasis mine):

> ‘***The collapse in the commercial property bubble*** [in 1991]*, coinciding with a recession,* ***was actually associated with great***

Insurance companies — in pursuit of higher returns — abandoned all prudent investment management and invested too heavily in t

The collapse of the bubble exposed the folly of their reckless decision.

The funds were frozen. Interest payments ceased and never resumed.

In due course — many years later — the capital guarantees were honoured.

Investors in capital guaranteed products learned the hard way…what the big print giveth, the small print taketh away.

The latest ‘guaranteed’ product catching investor attention (and money) is the annuity.

Annuities have a particular appeal with risk-averse retirees who are in receipt of an age pension.

Annuity marketing cleverly taps into the worries and uncertainty associated with share market volatility. The pitch goes as follows: ‘G

In addition to the certainty of a ‘guaranteed’ income, some annuities attract income and asset test sweeteners that can increase age

Security and more age pension…the big print really does giveth an attractive offering.

What about the small print?

Australia's largest provider of annuities by a country mile is Challenger.

In *The Australian,* on 5 October 2017, an article titled 'Challenger shrugs off concerns about investment portfolio quality' looked a little closer at the fine print:

'*The country's largest provider of retirement annuities, a form of longevity insurance that helps to provide savers with income in r*

'*At the same time,* ***it appears guidelines from the prudential regulator APRA have been incentivising the sector to take o***

'*Challenger, which sells long-dated products that provide a guaranteed source of annual income for retirees, must find investme*

Looks like a classic and all-too-familiar case of 'reach for yield'.

The challenges facing Challenger — trying to generate sufficient return in a low interest world — is a global problem.

Earlier this year, the Swiss-based Financial Stability Board — an international that was formed after the 2009 G20 summit to monitor the global financial system — highlighted the risks of investing in this environment (emphasis mine):

'*…the low-interest-rate environments could cause pension funds, particularly defined benefit (DB) plans, to "reach for yield", in p*

'*Furthermore,* ***recent moves into higher-risk credit securities and credit-intensive alternative assets could result in large***

Should market condition deteriorate, there will be 'large and unexpected losses'…sounds eerily familiar to the 1990s commercial property market, doesn't it?

Here's the big print from the Challenger Guaranteed Annuity Product Disclosure Statement (PDS):

'*The Challenger Guaranteed Annuity (Liquid Lifetime) creates a regular cash flow for life, regardless of how long you live or how investment markets perform.*'

On page 18 of the PDS (where the small print is found), there's a titled 'Counterparty Risk':

'*This is the risk that we become unable to meet our commitments to you. However, we are subject to detailed legislative and reg*

'*Challenger is regulated under the Life Act (which governs the provision of annuities in Australia) and the prudential standards m*

'***Even so, unforeseen and extreme circumstances that might impact our ability to make payments to you can never be c***

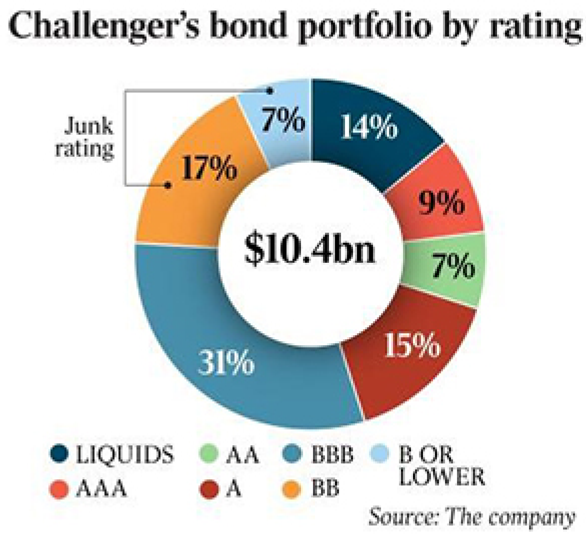
The guarantee is only a guarantee on the proviso that there are no unforeseen and extreme circumstances.

If *The Australian* article is taken at face value — '…*it appears guidelines from the prudential regulator APRA have been incentivising the sector to take on riskier asset-backed securities*' — then the declaration of APRA's active compliance supervision is cold comfort for investors.

The changing composition of the risk in the Challenger portfolio should also make investors look beyond the word 'guarantee'.

The portfolio has a 24% exposure to 'junk' bonds.

Of even greater concern is the 31% exposure to BBB-rated securities.



Source: The Australian
[Click to enlarge]

To quote *The Australian* article (emphasis mine):

> *‘…a large 31 per cent of the $10.4bn portfolio is rated BBB —* ***just one notch above junk****. That’s up from 25 per cent in 2016,*

See the skew that’s happening here?

Exposure to AAA securities — the highest quality — is reducing. While the exposure to BBB securities — one notch above junk — is increasing.

That’s not a good sign.

This is all starting to have a very familiar ring to it.

According to Challenger, there’s no cause for alarm because it is required to hold enough capital to withstand a one-in-200-year shock event.

What does a 200-year shock event look like?

Is it a Great Depression-like collapse in the share market?

Or a repeat of the 1990s commercial property collapse?

Portfolio models based on past events are useless.

Why? Well, never before in the history of money have we had such a sustained and coordinated attempt to achieve asset price inflation.

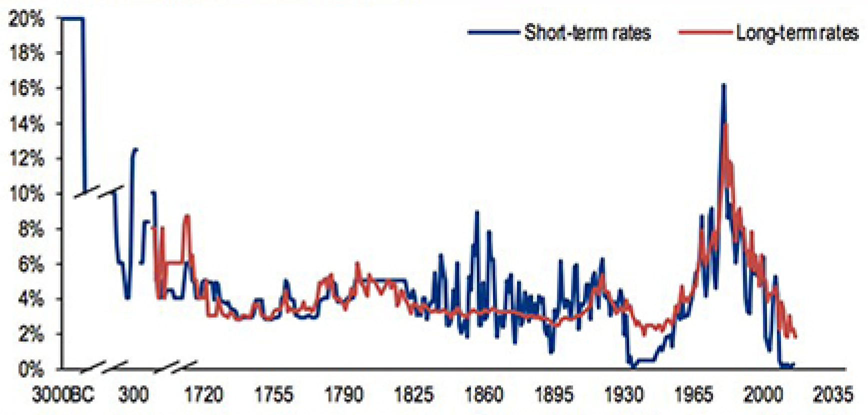
Markets — shares, property and fixed interest — have, all been pushed to historic highs. We have no historical precedent for the investment climate we are faced with today.

It’s impossible to predict a 200-year shock event.

At the turn of this century, in 2000, who would have believed that we’d be experiencing a one-in-5,000-year event?

No one. Yet here we are.

Chart 1: The lowest interest rates in 5000 years



Source: BofA Merrill Lynch Global Investment Strategy, BoE, Global Financial Data, Homer and Sylla 'A History of Interest Rates'
Note: the intervals on the x-axis change through time up to 1700. From 1700 onwards they are annual intervals. Full methodology available upon request

Source: Market Watch
[Click to enlarge]

The extreme measures, employed by central banks to keep the illusion of growth alive, have taken us to where no other generation or civilisation has ever been before.

Surely that must ring some alarm bells somewhere. But no one is listening.

And even if we narrow our focus to the past 200 years, a recent Deutsche Bank report titled 'Next Financial Crisis' provides sobering reading.

'*Figure 57 updates our analysis looking at an equal weighted index of 15 DM* [Developed Market] *government bond and 15 DM* [Developed Market] *equity markets back to 1800.*'

A reading of 100% = most expensive, whereas a reading of 0% = cheapest.

Figure 57: Aggregated 15 DM country average bond (nominal yields) and equity percentile valuations (100% = most expensive; 0% = cheapest)

Source: Deutsche Bank, Global Financial Data, Bloomberg Finance LP

Source: Zero Hedge
[Click to enlarge]

The conclusion (emphasis mine):

'*As can be seen, at an aggregate level,* ***an equally weighted bond/equity portfolio has never been more expensive****.*'

This is **the most expensive** market mix (50% government bonds and 50% shares) in over 200 years.

The historical perspective on the rarity of the situation we find ourselves in makes it impossible to predict how devastating the fallout could be. Rendering one-in-200-year models useless.

In my experience, guarantees are rarely worth the paper they're printed on.

However, I will go out on a limb and offer my own guarantee…

I guarantee that when the greatest asset bubble in history finally meets its pin, this will end very badly.

The only other guarantee you should place some faith in is the government's guarantee to protect deposits under $250,000 with approved deposit-taking institutions.

To learn more about how to protect your capital from the impending collapse in markets, please go here.

Regards,

Vern Gowdie,
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Vern Gowdie has been involved in financial planning in Australia since 1986. In 1999, Personal Investor magazine ranked Vern as c

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