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Can't guarantee wealth creation

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Highest NAV-guarantee products work only if one holds till maturity.

Highest net asset value (NAV) guarantee products are being marketed in a big way for insurance products. Such schemes are eliciting an interest as any product having the word guarantee sees investors relax in the knowledge that all will not be lost. But you need to understand that there is no guarantee on performance, though there is one, on receiving the highest NAV achieved within a certain period in the entire tenure of the product. These important connotations need to be clear before you decide to purchase the product. Since it is a recent introduction, we do not have much performance data to analyse. For this reason, the performance across schemes cannot be compared.

However, the highest NAV guarantee is not just a marketing gimmick. It is, indeed, possible to pay it at maturity by using certain investment methods. As an investor, what you need to understand is that it will not give you the guarantee of receiving the peak performance of the equity market at any time. These products use an investment process called the Dynamic Portfolio Protection, based on the underlying principles of constant portfolio proportion insurance (CPPI). CPPI is essentially a trading strategy, which ensures a fixed minimum return is achieved, either at all times or, typically, at a set date in future. A similar principle is used in capital protection-oriented funds.

How it works

In CPPI, there is an asset allocation between performance assets and safe assets. Performance assets can be equity and safe assets could be any of the debt papers available in the market, of varying maturities. The CPPI model gives the investor participation in the upside of the rising market, while protecting the downside during a fall. This is achieved by continuously rebalancing the asset allocation. Unlike capital protection-oriented products, which try to protect the principal invested (fixed amount to be protected), in the highest NAV guarantee products, the guaranteed value (highest NAV) keeps moving. Thus, the variation in technique used here is known as Dynamic Portfolio Protection, which constantly rebalances the asset allocation, depending on market conditions. It is pertinent to note that the asset allocation is based on certain rules and mathematical algorithms, and is totally non-discretionary.

The following example will capture the essence of what happens in the highest NAV guarantee product (refer table). Let us say that at the beginning, the NAV is 10. It is a 10-year product, guaranteeing the highest NAV over the first seven years of the product. Lets see the NAV movement for the first four years of the product. The NAV keeps moving up. In that duration, say, 17 is the highest NAV achieved. It becomes payable at the end of the tenure, even if later the NAV falls to, say, 12. To pay according to the NAV of 17, the scheme will invest Rs 11.31 in a debt paper, giving a return of six per cent over seven years (the period remaining till maturity); then, the maturity will be Rs 17.01 The balance Rs 5.69 will continue in equity to give additional boost to the returns. Even if this Rs 5.69 invested in equity falls to zero, the highest NAV of 17 will be payable from the debt portion.

This rebalancing continues to ensure the highest NAV achieved at any point in time be payable at the end of the product. This is a very simplistic representation of what happens in the product. In reality, there are other factors in play, like continuous change of NAV which requires continuous rebalancing There would also be deduction towards mortality charges and other administrative charges, etc. Premature redemptions will affect the corpus of the fund. Besides, we have looked at simple debt-equity

composition. There might be derivatives involved which will add to complexity of the product.

Positives
These products clearly protect wealth. They can form a part of a strategy to hedge profits booked from super-normal gains from various asset classes towards a future requirement. For example, if you have already accumulated a corpus for some requirement like your child's education in the future and are looking at some growth but more of protection, this product can come handy. Please ensure the tenure matches your fund requirement dates.

It provides peace of mind to risk-averse investors, while giving some participation in equity.

Negatives
It protects, but does not augur well as a tool for wealth creation. It will not let you participate entirely in equity markets. Initially, the exposure to equity will be high but it will gradually veer towards becoming a debt product, as seen by the example mentioned above.

It cannot be the primary source of risk cover. Being a unit-linked insurance product, it normally provides the higher of the sum assured or fund value in case of death. You can withdraw any time after five years but in that case, the highest NAV guarantee does not hold. The guarantee works only on holding till maturity.

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