

# Global Frantech Group



## The Art of “Total Return Investment”

By  
Dr Thomas Klepsch

2003 Track record of structured TRF investments:

- USD 500M for Global Communications (closing March 4)

# The art of Total Return Investing

In times of declining equity indices and meagre returns on plain vanilla bonds, institutional investors find it more and more difficult to get an appropriate return on their capital. Relative returns cannot be consumed if negative and if realised in meagre amounts may not pay for exponentially growing liabilities. In this sense, it does not matter whether those returns are archived against a broad market index or some kind of an universe representing similar investment strategies. All that matters is the total return on the investment.

This are the times when investment advisors are increasingly hinting at "Alternative Investment Funds" (AIF) or "Total Return Funds" (TRF). Their advise is quiet simple - a relative small portion of the institutional capital should be placed in TRF. The rational behind this advise is not as simple to understand: A 5% investment in TRF - even yielding 15% per annum - will improve the overall institutional performance by a meagre 0.75%. Nowadays this is not enough to compensate for the losses in equity portfolios and is only a minor improvement on the achievable plain vanilla bond returns. But the risk – those advisors may argue – is contained to the 5% of the institutional capital placed in such an investment vehicle. In this sense they are right! But - someone may reply – for running the risk of losing 5% of my capital, I really want to have a return that makes a significant difference for my entire portfolio. At this point starts the art of total return investing.

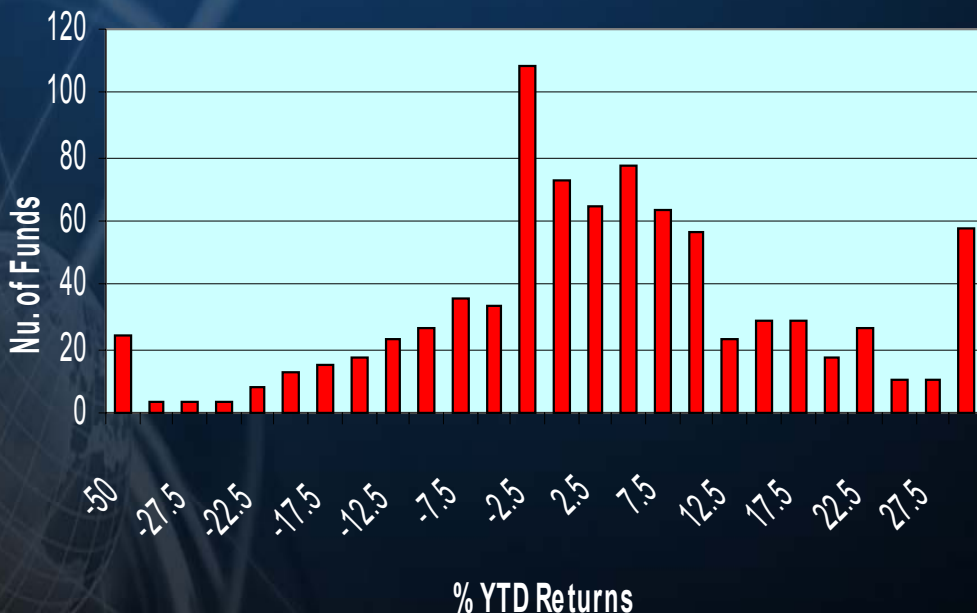
# No "Hedge Fund",...

In opposite of recommending an outright investment into TRF, the art starts by selecting a bond linked to the performance of a particular alternative investment fund.

The TRF industry is quiet heterogeneous: The discrepancies between funds starts with their investment strategy, its implementation and monitoring procedures keeping alone appropriate risk monitoring tools and risk containment policies. On top of this, a well implemented and back-tested investment strategy may simply not live up to expectations. Subsequently, TRF differ tremendously in their return and volatility characteristics.

## Single Managers Funds (total 854) in 2002

Source: e\*hedge investment solutions



■ Single Managers Funds (total 854)

## ... an AIF linked bond please!

Although e\*hedge® reported an average return of their single manager fund universe (about 860 different hedge funds) of 4.08% for 2002, only about 20% funds have been able to generate returns of far above 12%. On downside, losses of up to -50% have been reported by 46% of reporting hedge funds. The significant differences in the universe is a clear signal for the industry heterogeneity. This implies a sizeable risk for any institutional investor of not picking the best performing funds or to achieve a total return well below expectations. Furthermore, the traditional diversification strategy does not work: Nobody would be satisfy with a total return of 4.08% pa in hedge funds

Hence, the institutional investors have two possibilities: A pure gambling strategy of an outright investment in TRF – placing a bet on the persistency of track records or back tested return promises – or to participate in the fund return via a special bond structure. In the second scenario, the bond issuer takes the risk of picking the right TRF.

Those bonds are called "Alternative Investment Fund linked Notes". Their principal components are an unconditional and irrevocable issuer guarantee for the principle including a modest annual coupon and an attached call option on the fund return. In other words, the bond issuer guarantees the initial investment plus an interest income over the life-time of the bonds. In the same moment, the bond issuer promises to link the redemption payment of the bond to the performance of a particular fund. In mathematical terms, at redemption the institutional investor will always receive the higher of the two amounts

$$\max(100\%; 100\% * ((NAV_{(t+n)} / NAV_{(t+0)}) - x))$$

whereby the bond issuer usually retains the right to participate in the underlying fund performance with an amount (x).

## Leverage for your investment...

The above mentioned bond has another very interesting feature. It presents a senior claim on the balance sheet of the issuer. Normally, the issuers are highly rated international investment banks. Without entering into the regulatory details of the inter-banking market, it can be said that highly rated inter-banking claims receive a favourable regulatory treatment. Hence, banks can lend money to each other at significantly low rates not available for institutional investors.

The art of total return investment continues by using the special characteristics of the inter-banking market for leveraging your investment. Instead of purchasing the bond directly from the issuing bank, the bond is purchased from another bank. This creates a plain-vanilla inter-banking claim subject to a favourable regulatory treatment and subsequently low borrowing costs.

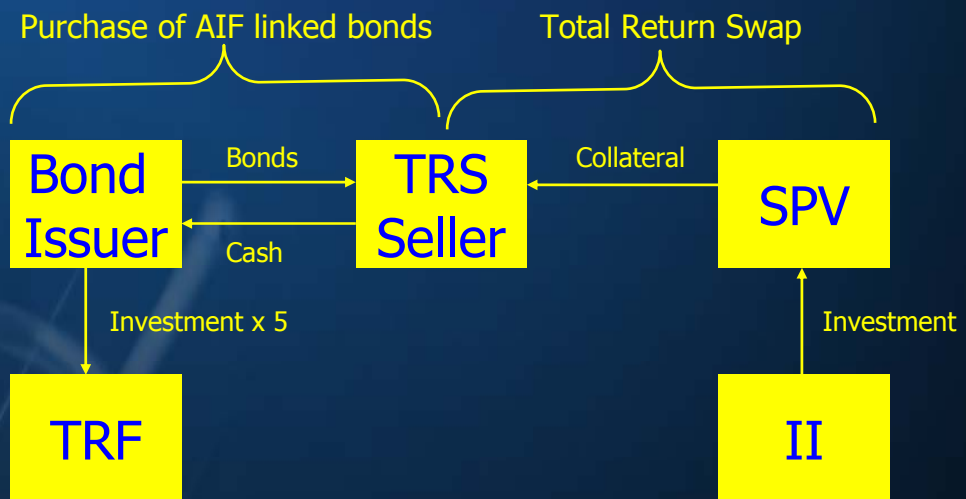
The central question to answer is how to secure the full participation in the AIF linked bond returns by getting them bought by another bank. The answer lies within the structure of "Total Return Swaps". In principle, TRS create an agreement between a bank and an institutional investor that forces the bank to purchase a particular security and to return at the end of the investment period only the profit to its institutional customer.

Why banks are doing this? Because they are maximizing the return on their balance sheet. Firstly, they have an inter-banking exposure that attracts a favourable regulatory treatment. Secondly, for this exposure they can charge some interest rates. Thirdly, they force the institutional investor to take the entire downside risk of the investment.

## ... with a Total Return Swap

At this point, the structure of a Total Return Swap should have become clear. The bank only lends its balance sheet to the institutional investor whereby the latter retains the full economic exposure – the downside risk as well as the upside potential – of the investment. Hereby, the bank demands for its balance sheet lending some interest payments and a certain amount of collateral. Both factors are setting a virtual limit on the available bank funds in a TRS transaction.

The art of total return investing continues by limiting the overall downside risk that an institutional investor wants to take via the creation of a Special Purpose Vehicle.



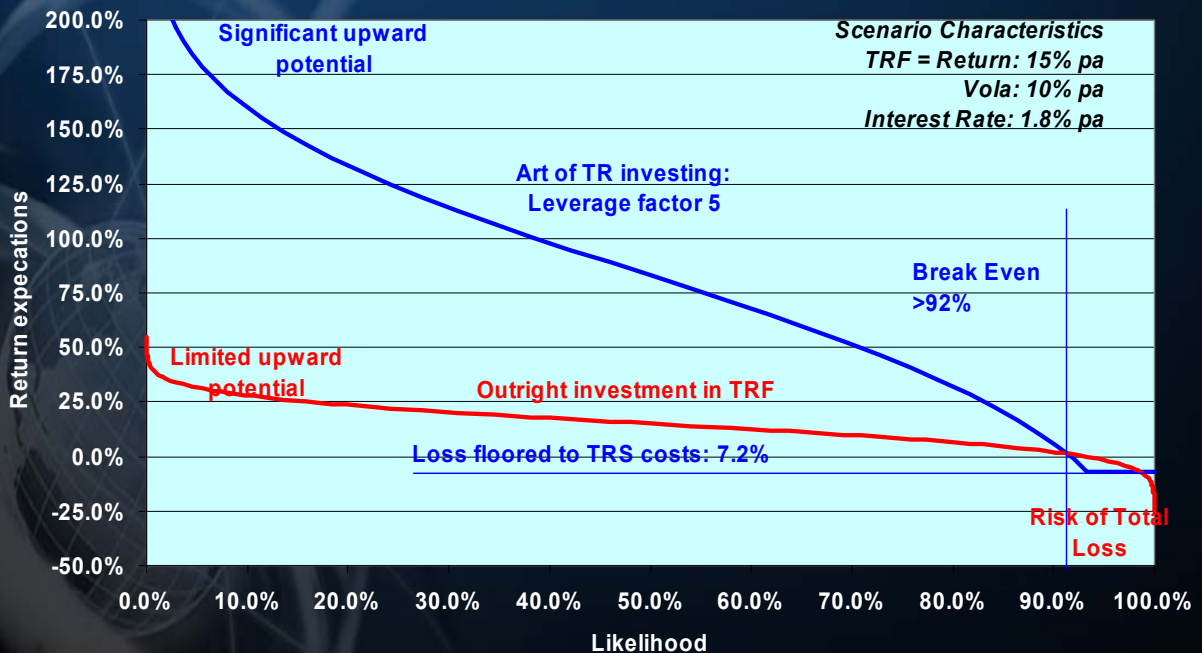
In practise, a leverage factor of 5 is quite common implicating that the bank purchases AIF linked notes in a volume that exceeds 5 times the original capital that the institutional investor has foreseen for an exposure towards hedge funds. The factor 5 changes significantly the initially given investment example: A 5% investment in TRF leverage by 5 - yielding 15% per annum - would improve the overall institutional performance by a sizeable 3.75% gross. If we deducting the fees for the TRS - say 4% pa - this number would still be significantly above 3% at the entire portfolio. At this point, a partial investment in TRF starts to make sense.

## But what is about risk?

If the TRF do not deliver the promised return, there is still the bond fully guaranteed by the issuing bank. As long as the issuing bank remains solvent, there is no downside risk for the principle in the TRS structure. However, the institutional investor bears the costs steaming from the interest rate payment embedded in the TRS structure. Those leverage costs are only of minor importance compared to the downside risk embedded in an outright investment in TRF. And with regard to the above mentioned solvency assumption of the bond guaranteeing bank: The default probability of a highly rated investment bank is extremely low, but is such an event occurs the entire TRF investment would be at risk. But if would occur any institutional investor would have to worry about much more than only 5% of the portfolio.

## The risk return equation

Return/Risk equation of structured  
Total Return Investments



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