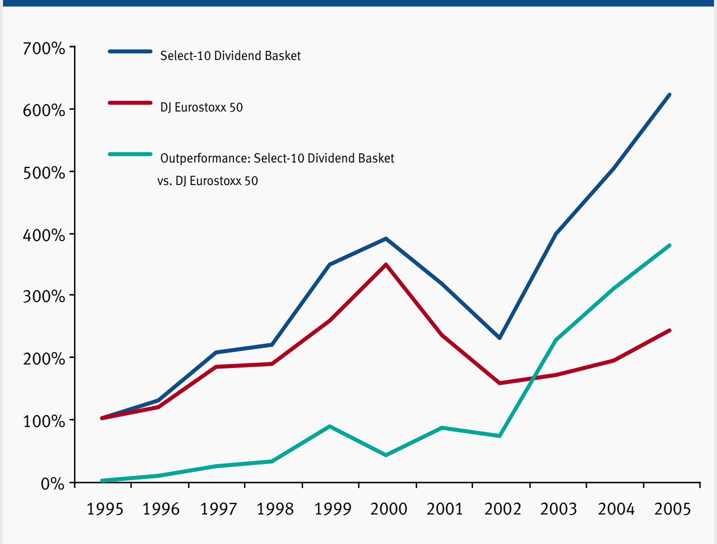
ACHIEVING STABLE RETURNS THROUGH DYNAMIC ALLOCATION

Dynamic asset allocation strategies are now widely used by investors as a way to maximise exposure in equities, while maintaining a good level of protection. During the last 10 years, investment banks have launched sophisticated alternatives to the basic Constant Proportion Portfolio Insurance structure (CPPI), which dynamically allocates capital between riskier assets such as equities and safer assets such as government bonds, with the objective of recovering the initial investment at maturity. When investors put €100 in a CPPI structure, a certain proportion of it is invested in a zero coupon bond.This zero coupon bond will be redeemed at 100 per cent maturity and will thus enable investors to recover their entire initial capital in the most adverse market scenarios. A multiple of this available part is invested in more risky assets. Everyday the difference between the zero coupon bond price and the NAV structure (eg the addition of the zero coupon bond and the risky asset investments) is closely monitored and the amount invested in the riskier assets is adjusted.

Innovative solutions launched by investment banks have used different techniques ranging from option based solutions that provide a minimum investment at all times in riskier assets, to volatility capping mechanisms and combinations of active and passive allocation models. Option models are linked to a synthetic portfolio that simulates rebalancing between high and low risk assets as the reference prices of the underlying changes. Other variations such as CPPIs with profit accumulators or CPPIs with sophisticated lock-in mechanisms and rolling guarantees have also been sold to investors. Unfortunately, the performance generated by many of these structures has so far been disappointing. Exotic features such as accumulators or best of lock-ins often put additional constraints in the basic CPPI model and thus increase the risk of the structure to be fully monetized. In such a case, the investor would be left with a zero coupon bond that would only provide him with its capital at maturity. However, option based models, often generate additional costs which affect the performance of the structures. This is particularly true when the maturities are less than seven or eight years. One could question the rationale of finding ever sophisticated models, which often lack flexibility, transparency and generate additional costs to investors.

Figure one: performance of Select-10 dividend basket



Source: Barclays Capital

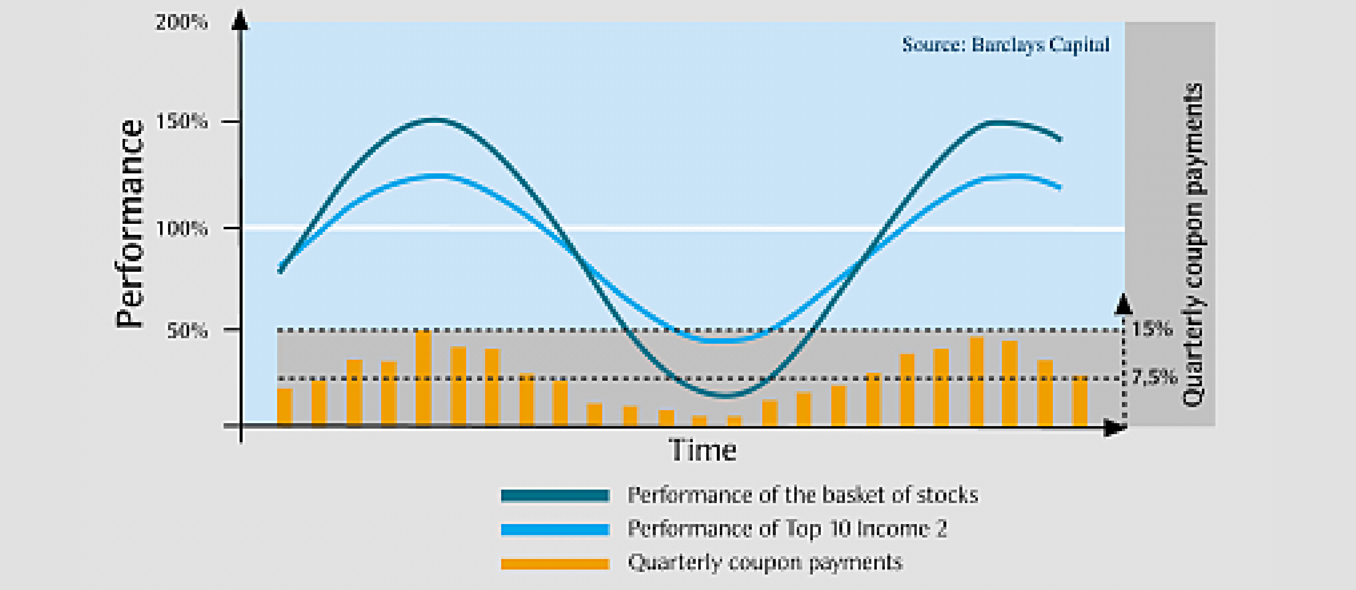
Today, investors are asking for more transparency and higher quality products. Their primary concern is not the exotic features attached to the structures but rather the quality of the underlying itself. This trend can be observed in most asset classes and in various products and wrappers. Factors such as the correction of stock markets in the spring of 2006 or the recent stabilisation of several commodity assets that have been buoyant over the past 5 years have given warnings to investors that the bullish cycle might be over. The investment decision process is being driven more and more by the quality of the product offering.

NEW SOLUTIONS

Barclays Capital, a leading derivative provider and a pioneer in CPPI structures, has been developing new solutions that not only dynamically allocate capital between safe and risky assets but also implement alpha generating strategies linked to underlying assets. These structures known as KINETIC have been successfully launched to several retail markets in Europe and in Asia. They provide end investors with techniques which were until now reserved for institutional investors and even hedge funds. The basic principle of the model is to carefully select a basket of underlying assets and to reshuffle it at regular intervals. The underlying baskets can be composed of stocks, commodities or even other kinds of assets. On top of this selection, a systematic derivative buy-write strategy is implemented in order to generate yields and to protect against sharp market corrections. As a result, investors do not need to wait for rallying markets to see the underlying basket of assets performing. More importantly, this construction is transparent and does not depend on a fund manager's ability to generate alpha. The model, which has proven past record performance over different market scenarios (bullish, bearish or stable), is implemented from day one.

The Top 10 Income Certificate is one of the latest KINETIC structures issued by Barclays PLC. This euro-denominated product has a maturity of six years and benefits from a full capital protection at maturity. The underlying is made out of a basket of 10 blue-chips stocks, chosen from the DJ Eurostoxx 50 index. The selection is based on the historical

Figure two: sensitivity of note and coupon relative to strategy performance



observation that high dividend stocks generally always perform better than others. These stocks are favoured by investors who are looking for yield generation. The basket is simply recomposed every year using the 10 highest paying dividend stocks in the index. Figure one shows the historical performance of the selection. Since 1995, an investment in these top 10 dividend paying stocks within the DJ Eurostoxx50 index would have generated a performance of nearly 780 per cent compared to 200 per cent in the index itself. On top of possible positive performance of the stocks, a systematic yield generating strategy is implemented. This yield is generated by selling call options on a regular quarterly basis. As such, option premiums are generated and are fully part of the strategy. This procedure is called 'overwriting' and has been widely used by institutional investors. Even in slightly falling stock markets, the strategy can generate stable income.

BULLISH STOCKS

Only very bullish stock-markets could generate better yields than this strategy. Part of the proceeds is invested in out of the money put option premiums with the aim of reducing the sensitivity of the basket to stock market falls. The target annual coupon of the strategy is equivalent to 10 per cent per annum. In most market conditions, the high dividends collected from the underlying stocks combined with the income generated by the overwriting strategy provides above markets yields. The Barclays Top 10 Income Certificate redistributes this income to investors on a quarterly basis.

The structure uses the CPPI techniques to allocate the initial capital between safe assets and the Top 10 underlying strategy. From a pure pricing point of view, the derivative buy-write strategy lowers the volatility of the underlying basket, thus enabling a significantly greater proportion of asset to be invested in the strategy itself. In the event of negative basket performance, the capital allocation moves from the Top 10 underlying strategy to monetary assets. Likewise, the proportion of assets invested in the underlying strategy can be increased to 150 per cent if the underlying stocks perform well. In addition, the partial hedge put in place by buying put options protects the portfolio against large drops in value of the underlying stocks and allows a regular distribution of high coupons. Figure two shows the sensitivity of the note to the performance of the strategy and outlines the fact that coupons can be paid even in adverse market conditions. The coupon level depends on the proportion of assets invested in the Top 10 underlying strategy. Higher levels of investment in the strategy generate higher coupon rates. The coupon rate is set at 10% of the investment in the Top 10 strategy. If the amount invested in the strategy drops to zero, no coupon is paid. The initial allocation to the underlying strategy of the Top 10 Income Certificate is equal to 65 per cent, which means that investors should expect annual coupons of 6.50 per cent at the beginning. If the underlying basket selection performs in line with expectations, the allocation to the strategy could increase and reach a maximum of 150 per cent, hence generating target annual coupons of 15 per cent a year. Finally, the investor also has a 100 per cent participation in any positive performance of the strategy at maturity and the investment is 100 per cent capital protected.

The same kind of strategies can be easily implemented in other asset classes. The range of KINETIC structures issued by Barclays Capital on different markets has had tremendous interest from investors. The combination of the simple and proven CPPI model, with an innovative and transparent way of selecting an underlying asset and a systematic method to generate alpha, provides a unique yield generating product to retail investors.

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