INSTITUTIONAL INVESTMENT INSIGHTS

THE HIDDEN COSTS OF CAPITALPRESERVATION

MAY 2026

Alan Cubbon
CAIM: Head of Research

Well hang on a minute, surely that title doesn't make sense?
Costs of capital preservation? Capital preservation is all about reducing costs – making sure I don't lose money. So how can that give rise to the opposite?

Unfortunately, any investment that's not in a risk-free asset comes with associated costs: be that in terms of return volatility, or failing to meet your return objective, or some other measure. If capital preservation is all that I want, then I can achieve that simply by investing in cash. But if I'd actually like to try and get a little more return, while still hanging on to my money, then things get a little more complicated.

Let me explain...

CAIM CROWN AGENTS INVESTMENT MANAGEMENT

PICTURING INVESTMENT OBJECTIVES

If capital preservation is all I care about then, as mentioned, I can achieve that objective by investing in cash, or a fixed-term deposit that matures at the end of my investment horizon: be that of one year, or however long it happens to be. Suppose my horizon is one year, and 1-year cash rates are currently 3%. Then, assuming the people I invest with don't go bust over the next year, I'm guaranteed to get a 3% return over the year and preserve my capital in real terms. That's regardless of what happens to the wider bond market. This is depicted in the simple chart below, where the return of the market is shown on the x-axis and the return of my investment strategy on the y-axis.

The fixed payoff from investing in cash

And yet, the market usually does better than cash. At least in "normal" times when yield curves are upward sloping and we're not recovering from some big recession. So what if I changed my mind and invested all my money in the market? Then the return of my strategy would have the profile below: the solid red line y=x. The dotted line is the cash payoff of the previous strategy.

The fixed payoff from investing in the market

That's nice when the market is doing well. But when the market does badly I'd like to fall back on my previous strategy of cash. So ideally I'd like to have the payoff profile as below. The new dotted line is the previous y=x market line.

The fixed payoff of whichever of cash and market does better

Remind you of anything? This is the hockey-stick payoff profile of an option.

MY IDEAL STRATEGY IS AN OPTION

My ideal strategy can then be characterised as an option strategy: where I've invested in the market but have an option to sell ("put") the market in a year's time if it does badly, so that I have a minimum one year return of the cash rate. Alternatively I've invested in cash but also have an option (a "call") to buy the market if it produces a higher return than cash.

This is where things start getting complicated. Options aren't free.

You can lock in a return of cash (ignoring bid-offer transaction costs and assuming your counterparty doesn't go bust) and you can lock in the return of the market (same assumptions). But you can't lock in the better of the two. In order to move between the two parts of the strategy you would need to buy an option to do that. Let's say we plan to invest in the market and want to buy an option to switch into cash if the market tanks. That has two consequences for our ideal strategy. One is that the cost of our option immediately subtracts from the return of our ideal strategy, moving the entire hockey stick vertically downwards. The other effect is that having bought the option we have less money left to invest in the market. So even if the market does better than cash over the next year, we'll only get a proportion of that performance. Similarly, if the market underperforms cash and we exercise our option to switch into cash, we will only receive the same proportion of the cash return.

So as a result, our ultimate payoff profile now looks something like this.

The payoff including option cost

In this illustration the cost of the option is greater than the return of cash, which means our payoff in bad times is below zero. In good times our payoff line diverges slightly from the y=x line as we could not invest 100% of our money after buying the option. The gradient of the line corresponds to the proportion of the market we could invest in. The option cost and this reduced gradient means we only end up getting back to a cash return level when the market is doing very well: in this illustration returning around 8% or more.

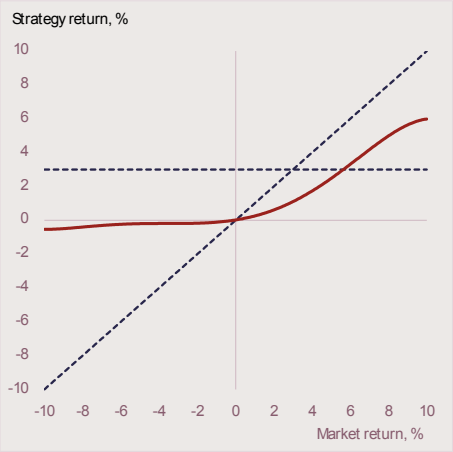
It's unlikely, then, that we will continue to regard this payoff profile as "ideal".

CAN WE DO BETTER?

Perhaps wanting to guarantee a minimum return of the cash rate was a bit ambitious. Perhaps we'd be content in preserving capital in nominal terms, meaning a minimum return of zero. This will reduce the cost of the option, though of course recurring returns of zero will steadily erode the purchasing power of our capital. learly this also adjusts the point at which the option to switch to this minimum return is exercised, consequently moving the "corner" of the hockey stick to the left. But we're still faced with the key aspect of our original dilemma, which is that you can't improve everywhere. If we want a better outcome somewhere, for example when the market does badly, then we're going to have to give up something when the market does well. So for example if we wanted to raise our minimum return we will have to give up some of our upside potential: perhaps reducing the proportion of our investment that follows the market and further reducing the gradient of the "market does well" section of the payoff line.

An alternative payoff profile

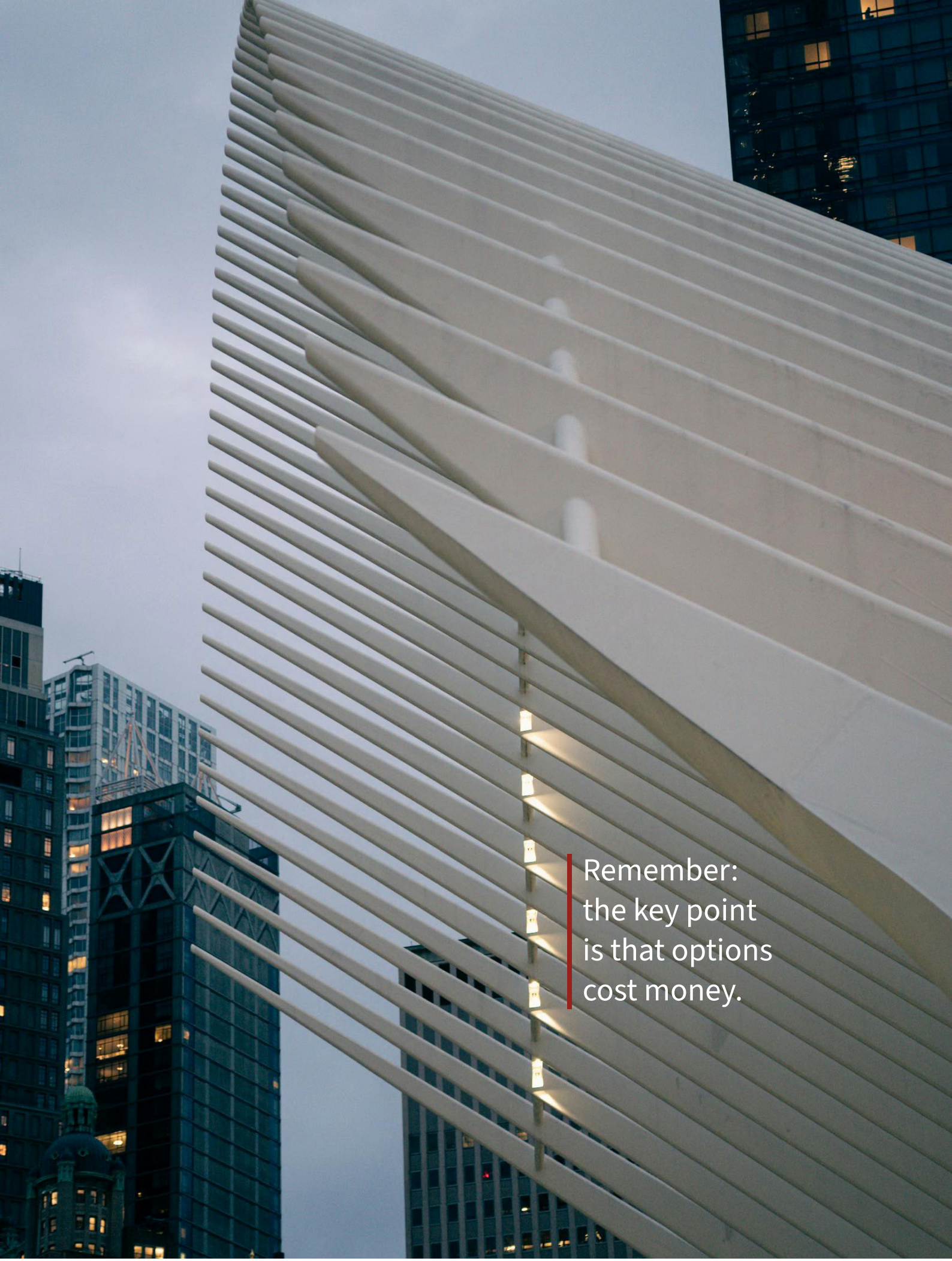
Possibly, an optimal payoff profile including costs



What we'd like is to get the red payoff line as close as possible to our optimum. Maybe if the market does very well we'd be happy to give up increasing proportions of upside at progressively higher market returns. Conversely, if the market does very badly then we'd allow ourselves to take slightly worse returns than if it had only modestly tanked. There's no reason, at least conceptually, why the red line should be made up of straight lines. It could be something as shown below:

The idea is that the payoff line is a strategy which closely reflects what an economist would call your "utility function". And what the Spice Girls would call "what you really really want".

If we wanted to raise our minimum return
we will have to give up some of our upside potential.


Remember:
the key point
is that options
cost money.

IN PRACTICE AN OPTION STRATEGY AS A BENCHMARK IS UNREALISTIC

The unstated, underlying narrative here is that once you've arrived at your optimal strategy you pass this on to a fund manager who will manage your money using this strategy as their performance benchmark. Conventionally the benchmark is a strategy which can be reproduced without risk: such as returning the market or returning cash. But it doesn't have to be this way. As an asset owner you are perfectly within your rights to specify to your fund manager that their benchmark is the better of the market or cash – a strategy which is not, as noted, an outcome that can be guaranteed. But whether it can be replicated or not, if you were to give a fund manager a benchmark that is an option, as has been discussed in this paper, what will the fund manager do?

For a start the manager may well react with some horror. Managing against an option strategy is much more complicated than against a more conventional benchmark such as just using one of the two parts of the option: just the market or just cash. Risk measures such as tracking error, which assume a symmetric distribution of returns, no longer work very well when the returns include optionality. So new measures (such as "expected shortfall") need to be used, with which the manager may be less conversant.

But more pragmatically, remember the key point is that options cost money. So if a fund manager were to mould their portfolio to look like the benchmark they are going to incur those costs, which comes straight off their performance.

Are they really going to want to take on those costs? Suppose you have two managers looking after your money, both benchmarked against the better of the market and cash. The first manager incurs the costs associated with the optionality of your chosen benchmark so as to align themselves with your "utility". The second manager decides to ignore the cash part of the benchmark and simply manages against the market and doesn't incur any option costs.

In the end the market does well and as a result the second manager, who ignored the complexities of your benchmark, ended up out-performing the more dutiful first manager. Which manager are you more likely to fire?

In the last 40 calendar years in the US dollar market, one-year cash has out-performed the Treasury market in only 13 years: and four of those were 2021 to 2024 when covid drove down yields and inverted the curve. So based on history the second manager can have reasonable expectations of out-performing his conscientious competitor for at least three years before having to explain to you, the money owner, why your capital was not preserved!

SO WHAT?

Nobody is going to start mandating or managing central bank reserves against a benchmark which is an option strategy. But the reality of the situation is that holding dual objectives of, for example, beating the market and preserving capital in real terms, are option strategies and therefore imply a cost. Which may well never be quantified, or even particularly large, or involve a portfolio manager handing over money to some bank's option dealing desk, but the cost nevertheless exists. And it's worth recognising that reality, because reality is the thing that when you ignore it, it doesn't go away.Famously – or infamously – 2022 painfully demonstrated that capital preservation is not always possible. And there have been other instances of under-performance through history. A better appreciation of the risks involved can do no harm in helping to plan for such eventualities.

DISCLAIMER

IMPORTANT NOTES

This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any Crown Agents Investment Management Limited ('CAIM') funds and has not been prepared in connection with any such offer.

This communication may only be used by a person in a jurisdiction where it is legally permitted to do so. The original recipient is responsible to ensure that no breach of local laws occurs in sharing its contents. This document should not be reproduced or distributed except via original recipients such as authorised financial advisers that are permitted to do so by local regulation and should not be made available to retail investors. This communication is not for distribution in the United States of America.

Any opinions expressed herein are those at the date of issue and cannot be depended on to predict future events. They do not necessarily reflect the views of CAIM. All data is sourced to CAIM unless otherwise stated. We believe that the information contained is from reliable sources, but do not guarantee the relevance, accuracy, validity or completeness thereof. Subject to UK law, CAIM does not accept liability for irrelevant, inaccurate, invalid or incomplete information contained, or for the correctness of any opinions expressed.

Past performance is not indicative of future performance. Investors whose reference currency differs from that in which the underlying assets are invested may be subject to exchange rate movements that alter the value of the investments. The value of investments and any income from them may fluctuate and investors may incur losses. All investments involve risks including the risk of possible loss of principal. Liquidity risk may delay or prevent account withdrawals or redemptions. High volatility of fund prices can result from unstable market conditions.

The investment opportunities described herein do not take into account the specific investment objectives, specific needs, knowledge, experience or financial circumstances of any particular person and are not guaranteed.

This document is produced and issued by Crown Agents Investment Management Limited, with Company Registration No. 02169973, and its registered office at 3 More London Riverside, London, SE1 2AQ which is authorised and regulated by the Financial Conduct Authority in the UK

(No 119207).

For complaints relating to CAIM's financial services, please contact enquiries@caiml.com.

CAIM | CROWN AGENTS INVESTMENT MANAGEMENT