



## **Wealth Management Module**



**NATIONAL STOCK EXCHANGE OF INDIA LIMITED**

## Test Details:

Sr. No.	Name of Module	Fees (Rs.)	Test Duration (in minutes)	No. of Questions	Maximum Marks	Pass Marks (%)	Certificate Validity
1	Financial Markets: A Beginners' Module *	1686	120	60	100	50	5
2	Mutual Funds : A Beginners' Module	1686	120	60	100	50	5
3	Currency Derivatives: A Beginner's Module	1686	120	60	100	50	5
4	Equity Derivatives: A Beginner's Module	1686	120	60	100	50	5
5	Interest Rate Derivatives: A Beginner's Module	1686	120	60	100	50	5
6	Commercial Banking in India: A Beginner's Module	1686	120	60	100	50	5
7	Securities Market (Basic) Module	1686	120	60	100	60	5
8	Capital Market (Dealers) Module *	1686	105	60	100	50	5
9	Derivatives Market (Dealers) Module *	1686	120	60	100	60	3
10	FIMMDA-NSE Debt Market (Basic) Module	1686	120	60	100	60	5
11	Investment Analysis and Portfolio Management Module	1686	120	60	100	60	5
12	Fundamental Analysis Module	1686	120	60	100	60	5
13	Financial Markets (Advanced) Module	1686	120	60	100	60	5
14	Securities Markets (Advanced) Module	1686	120	60	100	60	5
15	Mutual Funds (Advanced) Module	1686	120	60	100	60	5
16	Banking Sector Module	1686	120	60	100	60	5
17	Insurance Module	1686	120	60	100	60	5
18	Macroeconomics for Financial Markets Module	1686	120	60	100	60	5
19	Mergers and Acquisitions Module	1686	120	60	100	60	5
20	Back Office Operations Module	1686	120	60	100	60	5
21	NISM-Series-I: Currency Derivatives Certification Examination	1000	120	100	100	60	3
22	NISM-Series-II-A: Registrars to an Issue and Share Transfer Agents – Corporate Certification Examination	1000	120	100	100	50	3
23	NISM-Series-II-B: Registrars to an Issue and Share Transfer Agents – Mutual Fund Certification Examination	1000	120	100	100	50	3
24	NISM-Series-IV: Interest Rate Derivatives Certification Examination	1000	120	100	100	60	3
25	NISM-Series-V-A: Mutual Fund Distributors Certification Examination *	1000	120	100	100	50	3
26	NISM-Series-VI: Depository Operations Certification Examination	1000	120	100	100	60	3
27	NISM Series VII: Securities Operations and Risk Management Certification Examination	1000	120	100	100	50	3
28	Certified Personal Financial Advisor (CPFA) Examination	4495	120	80	100	60	3
29	NSDL-Depository Operations Module	1686	75	60	100	60 #	5
30	Commodities Market Module	2022	120	60	100	50	3
31	Surveillance in Stock Exchanges Module	1686	120	50	100	60	5
32	Corporate Governance Module	1686	90	100	100	60	5
33	Compliance Officers (Brokers) Module	1686	120	60	100	60	5
34	Compliance Officers (Corporates) Module	1686	120	60	100	60	5
35	Information Security Auditors Module (Part-1)	2528	120	90	100	60	2
	Information Security Auditors Module (Part-2)	2528	120	90	100	60	
36	Options Trading Strategies Module	1686	120	60	100	60	5
37	Options Trading (Advanced) Module	1686	120	35	100	60	5
38	FPSB India Exam 1 to 4**	2247 per exam	120	75	140	60	NA
39	Examination 5/Advanced Financial Planning **	5618	240	30	100	50	NA
40	Equity Research Module ##	1686	120	65	100	55	2
41	Issue Management Module ##	1686	120	80	100	55	2
42	Market Risk Module ##	1686	120	50	100	55	2
43	Financial Modeling Module ###	1123	120	30	100	50	NA
44	Financial Services Foundation Module ###	1123	120	45	100	50	NA

\* Candidates have the option to take the tests in English, Gujarati or Hindi languages.

# Candidates securing 80% or more marks in NSDL-Depository Operations Module ONLY will be certified as 'Trainers'.

\*\* Following are the modules of Financial Planning Standards Board India (Certified Financial Planner Certification)

- FPSB India Exam 1 to 4 i.e. (i) Risk Analysis & Insurance Planning (ii) Retirement Planning & Employee Benefits (iii) Investment Planning and (iv) Tax Planning & Estate Planning
- Examination 5/Advanced Financial Planning

## Modules of Finitatives Learning India Pvt. Ltd. (FLIP)

### Module of IMS Proschool

The curriculum for each of the modules (except Modules of Financial Planning Standards Board India, Finitatives Learning India Pvt. Ltd. and IMS Proschool) is available on our website: [www.nseindia.com](http://www.nseindia.com) > Education > Certifications.

# Wealth Management Module

## *Background*

There is a growing demand in the market for professionals who can help people build their wealth. This module aims to equip people with the requisite skills to help in managing the wealth of their clients or themselves.

## *Learning Objectives*

- To understand the role of financial planning and its various stages, the concept of wealth cycle and life cycle, and the preparation of a financial plan and financial blood-test report
- To know how wealth management is different from financial planning and how the economy affects the wealth building efforts
- To appreciate the various dimensions of equity, debt, gold and real estate and their role, risks and application in the portfolio of individuals
- To understand how investment products such as derivatives and various types of funds and structured products can help in long term wealth creation and the risks underlying such products and services
- To select investments in a structured manner for wealth creation and a balanced approach to uncertainties
- To know how the risk profile of clients can be assessed and how asset allocation is an important element of wealth management
- To be oriented towards the kinds of risk that insurance can over protection against, and the safeguards required while buying life insurance, health insurance and other general insurance
- To develop competencies in the various elements of taxation and how investments are taxed
- To understand the dynamics that go into the preparation of an estate plan and know how to offer estate planning advice



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## Acronyms

AY	Assessment Year
CFP Board	Certified Financial Planner Board of Standards, Inc.
DPS	Dividend per Share
EMI	Equivalent Monthly Instalment
EPS	Earnings per Share
ETF	Exchange Traded Fund
FBR	Financial Blood-Test Report
FCFE	Free Cash Flow to Equity
FCFF	Free Cash Flow to the Firm
HUF	Hindu Undivided Family
IRR	Internal Rate of Return
MTM	Mark-to-Market
NA	Non-Agricultural
NAV	Net Asset Value
NSE	National Stock Exchange
NYSE	New York Stock Exchange
PAT	Profit after Tax
PY	Previous Year
RBI	Reserve Bank of India
SEBI	Securities & Exchange Board of India
SIP	Systematic Investment Plan
SRO	Self-Regulatory Organisation
STP	Systematic Transfer Plan
SWP	Systematic Withdrawal Plan
TDS	Tax Deducted at Source
TRI	Total Returns Index
ULIP	Unit-linked Insurance Plan

## **Distribution of weights of the Wealth Management Module Curriculum**

<b>Chapter No.</b>	<b>Title</b>	<b>Weights (%)</b>
1	Introduction: Financial Planning	8
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Note: Candidates are advised to refer to NSE's website: [www.nseindia.com](http://www.nseindia.com), click on 'Education' link and then go to 'Updates & Announcements' link, regarding revisions/updates in NCFM modules or launch of new modules, if any.

This book has been developed for NSE by Mr. SundarSankaran, Director, Finberry Academy Pvt. Ltd.

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# Chapter 1 Introduction: Financial Planning

## 1.1 Background

Everyone has needs and aspirations. Financial Planning is an approach to assess the adequacy of income and assets of a person to meet the financial requirements for fulfilment of these needs and aspirations.

The role of financial planning has been increasing in the market because:

- o Needs and aspirations of people are ever-increasing. This increases the financial challenge that people face. Clients need to be counselled on the difference between needs (essentials) and wants (desires). Prioritisation of expenses is critical for people who are struggling to make both ends meet.
- o Joint families are giving way to nuclear families. The nuclear family stays in a separate house. The rentals or the acquisition cost of a house, are an important financial need to plan for.
- o In a nuclear family, the individual is responsible for his immediate family. The extended family, staying under a different roof, cannot be expected to support the regular financial needs of the individual.
- o The period of earning for individuals is reducing, while the longevity (life span) of people is increasing. This means that incomes earned over a shorter time period need to finance the needs over a longer period of time. Hence the need for retirement planning.
- o Income levels are going up. Higher investible surplus needs to be invested prudently for the future. Hence the need for professional financial planning advice.
- o The financial assets and liabilities that are available in the market for various needs are getting more and more complex. It is difficult for a layman to have a comprehensive understanding of these financial products.
- o The role of "market" in the life of people is increasing. The rate of interest at which they can place money in a bank is also not certain. Global uncertainties lead to market fluctuations that individuals find difficult to handle. Therefore, clients look for investment advice.
- o Tax provisions keep changing. People need to plan their taxes and ensure that they take full benefit of the concessions available. This has opened the doors for professional tax advisers.

- o The government has its own financial pressures, because of which it is challenged in offering social security to people or protecting them from vagaries of the market.
- o Increasing complexities in family structure can create problems while bequeathing wealth to the next generation. Therefore, estate planning is important.

A professional financial planner helping individuals navigate these challenges is an important member of our society. The role and influence of financial planners is bound to grow in India.

## **1.2 Role of Financial Planner**

The financial planner's fundamental role is to ensure that the client has adequate money to meet various financial goals. While performing this role, financial planners offer some or all of the following services:

- o Preparing a financial blue print for the client's future
- o Advice on investment in share market
- o Advice on investment in small savings schemes and other debt instruments
- o Advice on investment in mutual funds and other investment products
- o Suggesting a suitable asset allocation based on risk profile of the client
- o Management of loans and other liabilities
- o Insurance planning and risk management
- o Tax planning
- o Planning for smooth bequest of wealth to the next generation.

## **1.3 Financial Planning Process**

US-headquartered Certified Financial Planner Board of Standards, Inc. (CFP Board), which grants the international CFP Certification, has laid down the following six steps-

- o *Establishing and defining the Client-Planner relationship*

Here the services that will be rendered by the planner and the remuneration for the planner will be mutually agreed.

- o *Gathering client data including goals*

The planner has to gather relevant client data that will help in understanding the client's financial status, goals and risk preferences.

- o *Analysing and evaluating client's financial status*

The planner has to analyse the data collected, so as to form a balanced opinion on the client's financial status.

- o *Developing and presenting financial planning recommendations and / or alternatives*

The planner has to recommend how the client can achieve the goals, given the financial status and risk preferences. Alternate approaches to achieving the financial goals are to be discussed, based on which the financial plan can be finalised.

- o *Implementing the financial planning recommendations*

If the client-planner relationship includes implementation of the plan, then the planner will assist the client in the activity. This might include involvement of manufacturers of various financial products, and several other experts, with whom the planner will co-ordinate.

- o *Monitoring the financial planning recommendations*

If the relationship provides for this role, then the planner will monitor the results at an agreed frequency and advise the client on any changes that are recommended.

#### **1.4 Contract and Documentation**

It is a good practice to set out the terms of the relationship in a suitable contract. The financial planning contract will include:

- o The parties involved
- o Key deliverables and other services to be rendered, and by whom
- o The data to be provided, and by whom
- o Assurances, if any
- o Limitations, if any. For instance, unpredictability of the markets and the consequent fluctuations in investment performance
- o Remuneration for the planner, and how these will be collected.

Proper documentation of the data collected, discussions held and recommendations made will help the planner manage the client relationship well.

Since the results of financial planning are affected by the market, the planner has to establish robust systems and documentation to protect against any legal claims that can come up in the business.

## **1.5 Client Data Collection**

In order to provide appropriate financial advice, it is important to understand the client and the family. This is facilitated through data collection, for which planners develop standard forms / questionnaires. Internationally, this data collection is often performed by *para financial planners*, who are not qualified to offer complete financial planning advice.

The data that is collected includes the following:

- o Client name, family status
- o Family structure i.e. age of dependents and independents who stay with the client or for whom the client is responsible
- o Residence – ownership / rented
- o Bank accounts, depository accounts, Permanent Account Number (PAN)
- o Various investment related advisers that the client deals with, their contact information and the nature of advice / services rendered
- o Income of each independent member of the family and the nature of such income and its stability / annual growth
- o Life-style including expense breakup and how they are expected to grow over time
- o Major financial goals, like child's education or marriage, the likely fund requirement and timing of such outflow

If in today's money terms, the client wishes to set apart Rs. 25 lakh to help the son start a business, and the requirement is likely to come up in 5 years, then the fund requirement in future will be Rs. 25 lakh X  $(1+10\%)^5$  i.e. Rs. 40,26,275/- assuming inflation at 10%.

Through such future value calculations, every need is translated into a future requirement of funds viz. a financial goal.

- o Assets owned, ownership details (held in whose name and when they were purchased), any specific purpose for which they are held, market value and how it fluctuates, any covenants that limit the re-sale of the assets or their realisable value for the client
- o Purpose, amount outstanding, interest rate, tenor and monthly outflow for various loans that may have been taken
- o Life expectancy based on mortality history of ancestors, and details of life insurance coverage for each earning member of the family

- o Medical history of the family, medical expense policy of employers and details of medical insurance coverage taken
- o Other risks that the client is exposed to, for example, fire or theft in family shop, and details of general insurance coverage taken
- o Details of key man insurance policies that may have been taken by the family business
- o Client's psyche, especially with respect to risk and market fluctuations.

## **1.6 Client Data Analysis**

Professional financial managers use software to analyse the data. Even MS Excel spread sheets can be used for the purpose. Broadly, the analysis seeks to profile the client on parameters such as

Position of client on the life cycle (discussed in 1.7)

Position of client on the wealth cycle (discussed in 1.8)

Risk orientation – How much risk *can* the client take? How much risk is the client *prepared to* take? Some planners use customised risk profiling software to assess this.

## **1.7 Life Cycle**

People go through various stages in the life cycle, such as:

- o Young and unmarried
- o Young and married, with no children
- o Married and having young children
- o Married and having older children
- o Retirement

Position on the life cycle determines the kinds of challenges the client is likely to face and therefore the approach to financial planning.

For instance, younger clients have the entire earning cycle ahead of them. Their insurance needs will be high. Those with dependents need to have adequate life insurance to protect the family against untimely demise.

At a young age, saving and spending habits are formed. Systematic Investment Plans (SIPs) (discussed in 1.10.1) are a good way to ensure that the client does not fritter away any money. They need to be educated on how starting saving early ensures a comfortable future.

Clients need to be advised to invest in a house, not only as an asset but also as a roof that will be useful in future. Depending on family structure and the family home, need for a house, can

become critical after marriage. While standard of living is a factor to consider, clients should not stretch themselves to an unsustainable financial position. They need to be advised on the kind of budget they should consider for the house, the type of loans that are possible etc.

Parents with older children need to prepare for sudden significant outflow, for education or marriage or such other requirement of children. They also need to plan for their retirement, not only in terms of financial assets, but also corporate perks that may not be available in future, such as medical re-imburement, accommodation, car, club facilities etc.

On retirement, if salary or business earnings were to stop, then clients need to be cautious in taking risks. At a younger age, the client can take greater risk. Asset Allocation (introduced in 1.9) is a key decision across the life cycle of the client.

## **1.8 Wealth Cycle**

As with life cycle, the position of the client on the wealth-cycle changes over time. The key stages are:

- o *Accumulation*

This is the phase when the client is in the early stages of employment, and major expenses are not imminent. Therefore, there is good scope to save money and accumulate wealth.

During the accumulation phase, the person can take more risk because future earnings can help the client recover from losses.

- o *Distribution*

This phase comes during retirement, when the client may not have much scope to accumulate wealth. Instead, the wealth needs to be protected, and used to meet expenses. The client may not be so concerned about growing the wealth, as in ensuring that the income is adequate.

- o *Transition*

This is a phase when a major financial goal is approaching. The client has to plan the liquidity for meeting the goal.

- o *Windfall Gain*

During this phase, the client acquires sudden wealth. This can come through several forms such as inheritance, winnings from lottery, one-time settlements or stock options.

The planner seeks to ensure that the client uses the windfall prudently, to build a sound portfolio of assets.



- o *Inter-generation Transfer*

Here, the client starts planning the transfer of wealth to the next generation. Older clients may have to plan the transfer for more than one generation.

## **1.9 Risk Profiling and Asset Allocation**

Client data analysis including positioning on the Life Cycle and Wealth Cycle will suggest the client's risk profile. Planners classify their clients into groups, such as:

- o Extremely Risk Averse
- o Moderately Risk Averse
- o Risk Neutral
- o Moderately Risk Oriented
- o Extremely Risk Oriented

The more oriented a client is to risk, greater the exposure that can be suggested to risky assets. In general, equity is viewed as the risky asset, while debt is considered the safer asset. Gold protects the portfolio in extremely adverse situations, where both debt and equity under-perform. Real estate is an illiquid asset that can grow over time, and also give rental income. Debt, Equity, Gold and Real Estate are asset classes. These are discussed in Chapters 3, 4 and 5.

Asset allocation viz. distribution of client portfolio between different asset classes is considered to be the most important role of Financial Planners and Wealth Managers. This is discussed in Chapter 8.

## **1.10 Systematic Approach to Investing**

In the long term, equity share prices track corporate performance. More profitable a company, higher is likely to be its share price. However, in shorter time frames, the market is unpredictable. Market fluctuations are a source of risk for investors. It is for this reason that clients are advised to take a systematic approach to investing. This can take any of the following forms:

### **1.10.1 Systematic Investment Plan (SIP)**

Though an SIP, an investor commits to invest a constant amount periodically. For instance, Rs. 10,000 per month. The investment is normally made in an open-ended equity-oriented mutual fund scheme or a gold fund of fund.

As the market fluctuates, the scheme's Net Asset Value (NAV) too will fluctuate. For the same investment of Rs. 10,000, when the NAV is higher, investor will receive fewer units; more units will be allotted when the NAV is lower.

In the example in Table 1.1, investor received the units at an average NAV of Rs. 12.16 per unit, during the period that NAV fluctuated between Rs. 12.00 and Rs. 12.30. Therefore, this investment approach is also called *Rupee Cost Averaging*.

Table 1.1

**Systematic Investment Plan**

<b>Month</b>	<b>investment (Rs.)</b>	<b>NAV (Rs.)</b>	<b>Number of Units</b>
<b>1</b>	10,000	12.00	833.333
<b>2</b>	10,000	12.05	829.876
<b>3</b>	10,000	12.20	819.672
<b>4</b>	10,000	12.15	823.045
<b>5</b>	10,000	12.25	816.327
<b>6</b>	10,000	12.30	813.008
<b>Total</b>	<b>60,000</b>		<b>4,935.261</b>

**Average Acquisition Cost = 12.16 per unit**

SIP guides the client along the prudent path of making investment a habit. It helps in long term wealth creation, while keeping the client away from the dangerous investment style of *timing the market*.

It is important to note that SIP offers some downside protection, by averaging the cost at which the units are acquired. But SIP cannot prevent losses, if the market keeps falling.

Investor can operationalize the SIP through post-dated cheques, electronic clearing service (ECS) facility offered by banks, or standing instructions given to the bank.

**1.10.2 Systematic Withdrawal Plan (SWP)**

An investor desirous of receiving a constant amount every month to meet expenses (say, Rs. 5,000), can structure this through an SWP. Based on the SWP instruction of the investor, the mutual fund will redeem units that would yield the requisite amount on the scheduled dates. The redemption would be at the prevailing NAV. Thus the units redeemed would vary inversely with the NAV (Table 1.2).

Table 1.2

**Systematic Withdrawal Plan**

<b>Month</b>	<b>Redemption (Rs.)</b>	<b>NAV(Rs.)</b>	<b>Units Redeemed</b>
<b>1</b>	5,000	12.00	416.667
<b>2</b>	5,000	12.05	414.938
<b>3</b>	5,000	12.20	409.836
<b>4</b>	5,000	12.15	411.523
<b>5</b>	5,000	12.25	408.163
<b>6</b>	5,000	12.30	406.504
<b>Total</b>	<b>30,000</b>		<b>2,467.631</b>

**Average Redemption Price : 12.16 per unit**

As in the case of SIP, the investor's transactions happened at an average NAV during the period. Both SIP and SWP are alternatives to timing the market. While SIP removes the element of timing the market while investing, SWP eliminates it while withdrawing from the market.

As is discussed in Chapter 11, taking money out of a debt scheme in the form of dividend entails income distribution tax. This can be tax-inefficient for investors in the lower tax bracket. It is better that such investors withdraw money from a debt scheme through an SWP.

**1.10.3 Systematic Transfer Plan (STP)**

SIP makes sense when an investor has a regular income e.g. monthly salary. Some incomes are occasional receipts e.g. annual bonus or other windfall instances mentioned in 1.8.

In windfall situations, clients are normally advised to invest the moneys in a safer debt scheme, such as a liquid fund. The benefit of liquid funds is not only easier liquidity, but also negligible transaction costs in the form of entry load, exit load and expense ratio.

The money parked in the liquid fund can be systematically transferred to the target equity or gold scheme. Thus, the investor gets the benefits associated with SIP. STP is a combination of SIP (into the target, equity scheme) and SWP (from the source, liquid scheme).

The working is illustrated in Table 1.3.

Table 1.3

**Systematic Transfer Plan**

<b>Month</b>	<b>Redemption (Rs.)</b>	<b>NAV (Rs.)</b>	<b>Units Redeemed</b>	<b>Investment (Rs.)</b>	<b>NAV (Rs.)</b>	<b>Units Acquired</b>
<b>1</b>	5,000	10.10	495.05	5,000	12.00	416.667
<b>2</b>	5,000	10.15	492.611	5,000	12.05	414.938
<b>3</b>	5,000	10.18	491.159	5,000	12.20	409.836
<b>4</b>	5,000	10.20	490.196	5,000	12.15	411.523
<b>5</b>	5,000	10.25	487.805	5,000	12.25	408.163
<b>6</b>	5,000	10.30	485.437	5,000	12.30	406.504
<b>Total</b>	<b>30,000</b>		<b>2,942.258</b>	<b>30,000</b>		<b>2,467.631</b>

**Average Redemption Price :** **10.20 per unit** (from source scheme)

**Average Acquisition Cost =** (into target scheme) **12.16 per unit**

**1.11 Financial Plan**

An important document created by the planner is the Financial Plan. It sets out how the financial goal is proposed to be realised. There are two approaches to the financial plan:

**1.11.1 Goal-based Financial Plan**

Here, every financial goal is considered separately. One such goal is shown in Table 1.4.

The goal-based financial plan can get more complex, when we provide for multiple goals, with a different asset allocation for each goal, and different projected returns for each asset class.

Table 1.4

**Goal-based Financial Plan****Goal-Oriented Financial Plan**

<b>Financial Goal:</b>	<b>Daughter's Marriage</b>			
Expected in (years):	3			
Current Cost (Rs.):	2,000,000			
Expected inflation:	10% p.a.			
Amount to provide in future:	2,662,000			=D7*(1+D9)^D5
Amount already provided	1,200,000			
Amount to provide	411,088 p.a. for 2 years			
Expected Investment Return	12% post-tax			
<b>Year-&gt;</b>	<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>
Current Investment	1,200,000			
Future value of Current Invnt.			1,685,914	
Amount to provide		411,088	411,088	
Which will grow to:				
Investment of Year 1			515,668	=E25*(1+D17)^2
Investment of Year 2			460,418	=F25*(1+D17)
<b>Expected Amount in Future</b>			<b>2,662,000</b>	

Goal-based financial plans are a usual starting point for the client-planner relationship. However, they suffer from the following limitations:

- A goal-based financial plan conveys how a specific financial goal is proposed to be fulfilled. However, it does not provide any information on the overall financial position of the client.
- Multiple financial goals with different asset allocations for each goal can be quite difficult to monitor and manage.
- The same investment for one goal may indicate a sell, and for another goal it may be a buy. Such recommendations, if strictly implemented, will increase the costs and taxes of the client.
- The inflows from an investment for a longer term goal, may help finance a shorter term goal. Such inter-goal management of cash surpluses are not possible through a goal-based financial plan.

### **1.11.2 Comprehensive Financial Plan**

A comprehensive addresses the above limitations of a goal-based financial plan. It provides complete information on the overall financial position of the client, and how the financial goals will be met periodically.

Multiple formats of Comprehensive Financial Plan are possible, for various situations. A sample Comprehensive Financial Plan is given in Annexure 1.1. As will be evident, the following are limitations of such a plan:

- Comprehensive financial plan takes a long time to develop.
- The client needs to be comfortable sharing all the information with the planner.
- Both client and planner may not appreciate the context behind the future values of cash flows, because these reflect the value of money in future (i.e. they are inflation indexed).
- Several assumptions are made in the Comprehensive Financial Plan. Inadequate understanding of their significance can lead to wrong interpretation of the Comprehensive Financial plan. This will result in improper recommendations for the client.

### **1.12 Financial Blood-Test Report (FBR)**

The Financial Blood-Test Report<sup>1</sup> is a snapshot of the client's financial position, represented pictorially.

- It clearly differentiates between what the client has already provided for, and the surplus or deficit.
- The assets are segregated based on market liquidity, as well as client's psychological comfort with liquidating them. For example, a client's residential house or collection of antiques may have a value, but are in the nature of "image assets", which are not for sale.
- The FBR also highlights potential inheritances, which are in the nature of "contingent assets".
- Even the insurance adequacy is captured in the snapshot.

A sample FBR is shown in Annexure 1.2.

Besides providing actionable information, FBR addresses most limitations of a Comprehensive Financial Plan:

- It is easier to develop. Only requires a basic calculator.

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<sup>1</sup> Chapter 31 of "Wealth Engine: Indian Financial Planning & Wealth Management Handbook" by SundarSankaran

- It translates the likely the future requirements of funds into their current money-equivalent. This makes it easier for both client and planner to understand and interpret them better.
- It minimises the assumptions that need to be made.

The limitations of FBR are:

- FBR does not explicitly show year-wise cash flows of the client. However, so long as client has adequate wealth invested in marketable assets, these can be disposed of when required. Thus, absence of information on the year in which they will be sold is not such a problem.
- As with a Comprehensive Financial Plan, FBR requires comprehensive information on financial goals, assets, liabilities, income and expenditure of the client. Therefore, it is advisable to proceed to FBR only when the relationship is deep enough for the client to share the requisite information.

### **1.13 Financial Planning in India**

Mutual Fund distributors and others involved in selling or distributing mutual funds need to pass the prescribed examination before they can start selling mutual fund schemes. However, no such requirements have been set for financial planners and wealth advisers.

Securities & Exchange Board of India (SEBI) has come out with a concept paper on the proposed regulatory structure for investment advisers. The highlights are as follows:

- o There is an inherent conflict of interest between a distributor earning a commission as agent of a product manufacturer (such as a mutual fund) and performing the role of financial adviser claiming to protect the investor's interests.
- o The proposed model to tackle this conflict of interest is as follows:
  - The person who interfaces with the customer should declare upfront whether he is a financial advisor or an agent of the manufacturer.
  - Advisers should be governed as follows:
    - They should be subject to Investment Advisors Regulations.
    - Advisors should acquire higher level of qualifications.
    - They may act as advisor to investor for multiple financial products.
    - They will receive all payments from the investor. There would be no limits set on these payments.

- Agents of product manufacturers may receive commission from the manufacturers. They will have to call themselves 'agents'. They cannot style themselves as financial advisers.
- o The activity of investment advice should be regulated under a Self Regulatory Organisation (SRO). Its duties would include registering and setting minimum professional standards, including certification of investment advisors, laying down rules and regulations and enforcing those; informing and educating the investing public; setting up and administering a disputes resolution forum for investors and registered entities etc. Persons desirous of registration as Investment Advisors shall obtain registration with the SRO established for the purpose. The SRO will be entitled to charge a fee for granting registration and an annual fee.
- o No person can carry on the activity of offering investment advice unless he is registered as an Investment Advisor under the regulations. On the other hand any person who has obtained the certificate of registration as an Investment Advisor must necessarily use the word "investment advisor" in his name.

This is aimed at eliminating confusion in the market through multiple terms such as wealth manager and private banking.

- o 'Investment Advice' will mean an advice written, oral or through any other means of communication given regarding investment of funds in financial products or products that are traded and settled like financial products purportedly for the benefit of the investor. It shall include:
  - (a) Financial advice; or
  - (b) Financial planning service or
  - (c) Actions which would influence an investment decision and are incidental to making
- o Independent investment advisors as well as representatives of investment advisors and intermediaries providing investment advice to investors will need to get registered.
- o The requirement of registration extends to banks providing investment advisory / wealth management services.
- o The following are exempt from these requirements:
  - An advocate and solicitor or law firm, whose offer of financial advice is solely incidental to his legal practice.
  - Chartered accountants who are registered under the Institute of Chartered Accountants of India providing of any investment advice is solely incidental to the accounting practice.



- Any person who publishes magazine/newspaper, where —
    - I. the newspaper is distributed generally to the public in India;
    - II. the advice given, or analysis or report issued, is promulgated only through that newspaper;
    - III. that person receives no commission or other consideration, apart from any fee received from subscription to or purchase of the newspaper, for giving the advice, or for issuing or promulgating the analysis or report; and
    - IV. the advice is given, or the analysis or report is issued or promulgated, solely as incidental to the conduct of that person's business as a newspaper proprietor.
  - Any person who owns, operates or provides an information service through an electronic, or a broadcasting or telecommunications medium, where —
    - I. the service is generally available to the public in India;
    - II. the advice given, or analysis or report issued is promulgated only through that service;
    - III. that person receives no commission or other consideration, apart from any fee received from subscription to the service, for giving the advice, or for issuing or promulgating the analysis or report; and
    - IV. the advice is given, or the analysis or report is issued or promulgated, solely as incidental to that person's ownership, operation or provision of that service.
  - Any stock broker or sub-broker as registered under SEBI( Stock Broker and Sub-Broker) Regulations, 1992, who provides any investment advice and not charging any consideration for such advice.
  - Any person offering exclusively insurance broking services under regulation of Insurance Development and Regulatory Authority.
- o The Individuals who wish to get registered under these regulations would need to satisfy the following criteria:
- Individuals should acquire a Professional Qualification from a recognized institute for e.g. Chartered Accountancy form ICAI, MBA in Finance or similar qualification from a recognized university or should have at least 10 years of relevant experience; and
  - Certification from NISM or such other organization approved by SEBI for this purpose
  - The individuals should conform to the Fit and Proper Criteria laid down in Schedule II of SEBI (Intermediaries) Regulations, 2008.

- o The investment advisory obligations are as follows
  - All information received and provided by the investment advisor would be in fiduciary capacity. The investment advisor will be responsible to maintain confidentiality of the investment advice provided to the client and information provided by the client. Advice should be given by the advisor in the best interest of the investor.
  - The Investment Advisors or their representatives would be required to do adequate risk profiling of the client before any investment service is provided to them. Based upon the risk profiling performed by the investment advisor or their representative suitable investment advice should be provided. The records of such risk profiling and investment advice should be maintained by the Investment Advisor.
  - Investment Advisors should not
    - Use any advertisement that contains any untrue statement of material fact or that is otherwise misleading. They should not use or refer to testimonials (which include any statement of a client's experience or endorsement).
    - Refer to past, specific recommendations made by the advisor that were profitable, unless the advertisement sets out a list of all recommendations made by the advisor within the preceding period of not less than one year and complies with other specified conditions.
  - No financial incentives/ consideration would be received from any person other than investors seeking advice. In case of advice regarding investment in entities related to the investment advisor, adequate disclosures shall be made to investor regarding the relationship.
  - Records in support of every investment recommendation /transaction made which indicates the data, facts and opinion leading to that investment decision would be maintained by the Investment Advisor. Records should be retained for at least 5 years. Systematic record of all advises provided would be kept including audio recording of any oral advice given.
  - The Investment Advisor would clearly indicate to its clients the fees and charges that are required to be paid by them. An investment advisor shall disclose to a prospective clients all material information about itself, its businesses, its disciplinary history, the terms and conditions on which it offers advisory services, its affiliations with other intermediaries and such other information as is necessary him to take an informed decision whether to avail of its services.
- o Investment advisors shall not accept funds / securities from investors, except the fee for investment advice. If Non-individual investment advisors (corporate entities) offer

assistance in execution services such as broking, custody services, DP services, accounting etc., they must make appropriate disclosures, clarify that the investor is under no obligation to use their services and maintain arm's length relationship through creation of Chinese walls. The choice of opting for execution services offered by investment advisor should be left to the investors. Fees and charges paid to service providers should be paid directly to them and not through investment advisors.

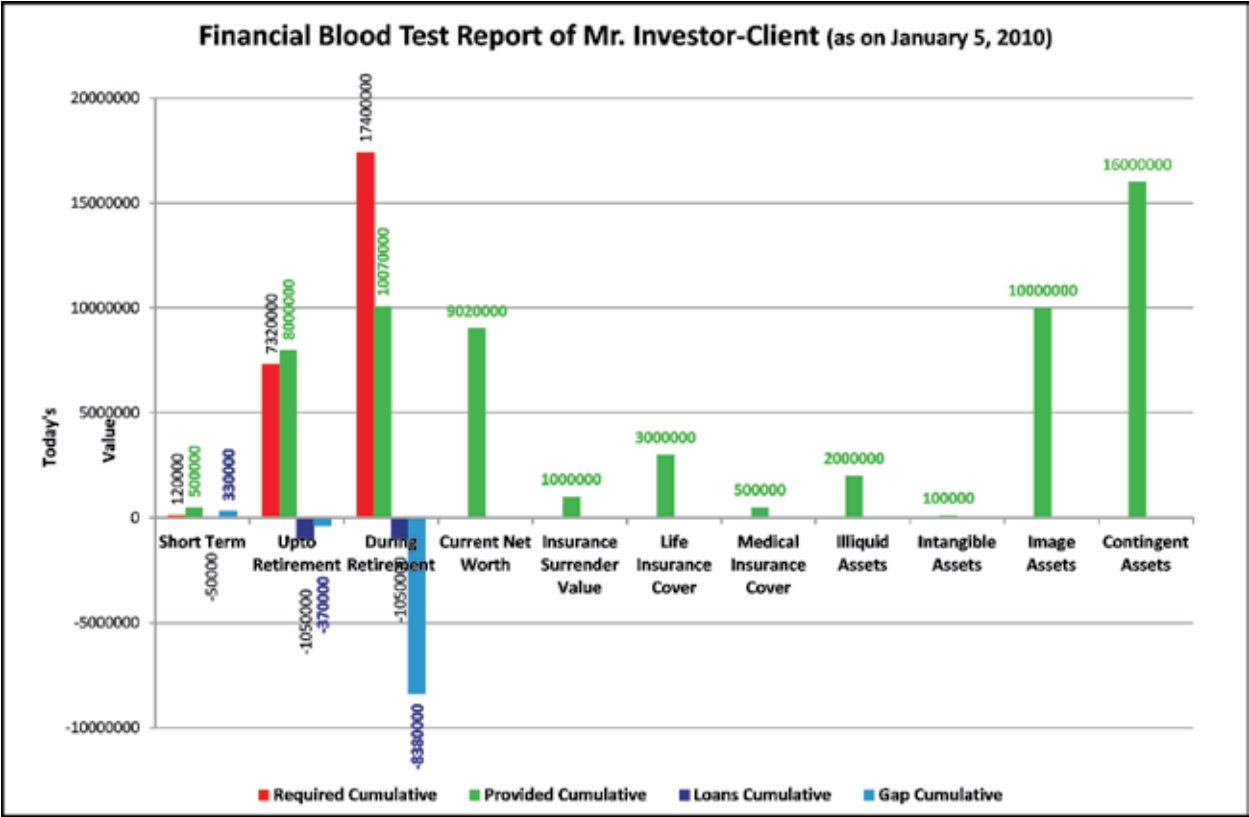
- o Other than sourcing of research reports, no other part of investment advisory activity can be outsourced.
- o The investment advisors shall not be liable for civil or criminal liability in respect of advice given unless the advice is negligent or mala-fide in nature. Any dispute between the investment advisor and his client would be resolved through grievance redressal mechanism or arbitration created by SEBI.

## Annexure 1.1

### Comprehensive Financial Plan

Year->	1	2	3	4	5	6	7
<b>Year-&gt;</b> Fund reqt for financial goals (split goal-wise)	-10,00,000	-20,00,000	-12,00,000	-50,00,000	-15,00,000	-14,00,000	-15,00,000
Less Savings & Income from Current Invt. Funding Gap	12,00,000	13,20,000	14,52,000	15,97,200	17,56,920	19,32,612	21,25,873
	2,00,000	-6,80,000	2,52,000	-34,02,800	2,56,920	5,32,612	6,25,873
Income on New Investments		16,000	16,000	33,190	33,190	70,244	1,36,318
Rent saved on house purchase					5,00,000	5,50,000	6,05,000
Investment Maturity/ Encash invt. (post-tax)		6,64,000		34,22,730			
Income loss on encashed invt		0	-53.120	-53.120	-3,26,938	-3,26,938	-3,26,938
<b>New investments during year</b>	<b>2,00,000</b>	<b>0</b>	<b>2,14,880</b>	<b>0</b>	<b>4,63,172</b>	<b>8,25,918</b>	<b>10,40,252</b>

Financial Blood-Test Report (FBR)



## Self-Assessment Questions

- ❖ Financial planning seeks to
  - Offer investment advice
  - Offer tax advice
  - Assess transmission plan
  - **Assess adequacy of income and assets for needs**
  
- ❖ Joint families giving way to nuclear families has reduced the need for financial planning.
  - True
  - **False**
  
- ❖ If in today's money terms, investor needs Rs.10lakh, and the goal is likely in 3 years with inflation at 10%, then the future requirement of funds for the goal is -
  - $\text{Rs. } 10,00,000 \div (1 + 10\%)^3$
  - **$\text{Rs. } 10,00,000 \times (1 + 10\%)^3$**
  - $\text{Rs. } 10,00,000 \div (1 + 10\%^3)$
  - $\text{Rs. } 10,00,000 \times \{(1 + 10\%) \times 3\}$
  
- ❖ In early stages of one's career, client is in \_\_\_\_\_ stage
  - **Accumulation**
  - Distribution
  - Transition
  - Windfall
  
- ❖ Systematic Withdrawal Plan is suitable for retired investors.
  - **True**
  - False

# **Chapter 2 Wealth Management & the Economy**

## **2.1 *Financial Planning to Wealth Management***

Financial planning seeks to ensure adequacy of assets and cash flows for meeting the financial goals of the client. In the case of a wealth management client, adequacy of assets is not an issue. The client will have the assets, though cash flow (liquidity) can be an issue if not suitably invested.

A wealth manager seeks to understand what the client wants with the wealth viz. grow the wealth with an openness to take risk; or consolidate the wealth with a conservative approach to risk; or preserve the wealth while avoiding risk to the extent possible. Different asset allocation mix would be appropriate for each of these profiles. This is discussed in Chapter 8.

In the case of a wealth management client, the stakes are likely to be large enough to invest time and effort in superior formats of transmitting wealth to the next generation, including creation of new structures like trusts. This is discussed in Chapter 12.

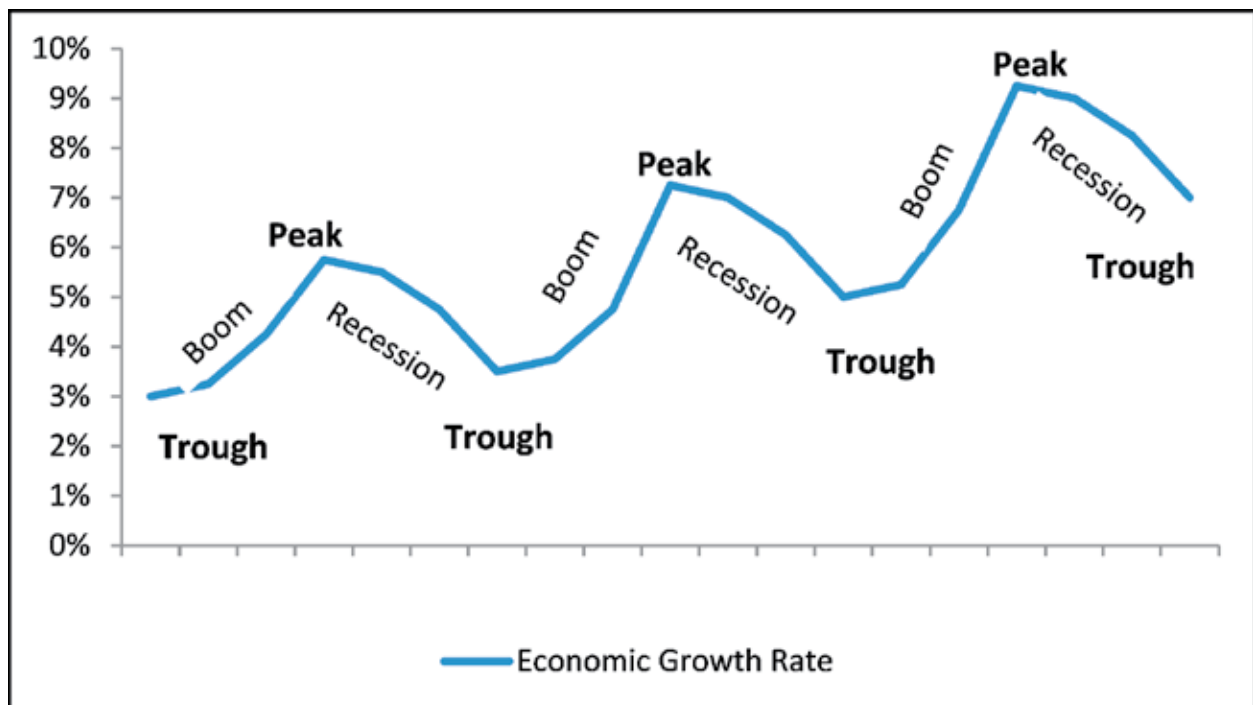
## **2.2 *Economic Cycles and Indicators***

It is the economy – local and global, that drives the performance of asset classes. Therefore, a wealth manager should have a good feel of where the economy stands and where it is headed.

Economic situation is often judged through its growth rate, which tends to move in cycles, as shown in Figure 2.1.

Figure 2.1

### **Economic Cycles**



From a trough, when the economy recovers, it is called a 'boom' or 'recovery'. Over a period of time, the economy reaches a peak and then starts declining. The decline phase is called a 'recession' or 'stagnation'. Finally it reaches a trough, from which the next boom starts.

In the normal course, one would expect that in recessionary situations, prices of goods and services in the economy would go down. This is quite understandable because the government as well as business is interested in boosting the economy by increasing the consumption level. Yet, there are times when economic stagnation is accompanied by high inflation. Such an economic situation is called 'stagflation'.

Economic signals can be read through economic indicators, which can be grouped as follows:

#### **2.2.1 Lag Indicators**

These are indicators that provide the information after the event has happened. For example, Gross Domestic Product (GDP), which is the sum total of the value of all the products and services that are produced in the country. After the GDP data is captured, we know whether the economy has improved or stagnated. Similarly, unemployment is a lag indicator of the economy. After the recession has hit, one finds unemployment figures are high.



### **2.2.2 Co-incident Indicators**

These indicators provide the information as the event is happening. For example, when the economy does well, one sees consumption of luxury goods and life style expenses increasing. In adverse economic situations, such consumption takes a decline.

### **2.2.3 Lead Indicators**

These provide the information before the event has happened. For instance, a consumer confidence survey or business confidence survey would give an idea of where the economy is headed. A bullish confidence survey indicates that the economy is likely to improve.

Markit, the global financial information services company calculates a Purchasing Managers' Index, which is a monthly data-driven snapshot of individual countries' economies. It is calculated based on inputs from senior purchasing managers in business. In India, it is available in collaboration with HSBC. Similar indices are brought out by industry chambers and the media.

Professional wealth managers keep assessing where various countries are headed. Accordingly, they decide the allocation of funds between countries.

Similarly, they decide on the allocation between sectors, based on economic situation. In recessionary situations, the investment may go to sectors like education and healthcare, where consumption is unlikely to decline. As the economy recovers, investment may go to sectors like luxury goods. Similarly, mining and energy stocks may find favour, because of the likely increase in commodity prices. When global trade improves, freight rates improve, thus making the shipping sector interesting.

The attractiveness of an investment also depends on valuation, a topic that is discussed in Chapter 3.

## **2.3 Interest Rate Views**

The economic scenario drives the monetary policy of Reserve Bank of India (RBI). In situations of high inflation and / or growth, RBI adopts a tight monetary policy, which leads to interest rates going up. If on the other hand, the economy is weakening, RBI adopts a liberal monetary policy, which leads to interest rates going down.

Interest rate movements directly affect debt. When interest rates are going up, it is better for investors to go for floating rate debt instruments; or fixed rate instruments of shorter maturities; borrowers will find it beneficial to opt for fixed rate of interest. When the interest cycle turns downwards, investors who have invested in fixed rate debt securities for longer tenors benefit; however, borrowers who have chosen fixed rate of interest will not benefit from the interest rate movement.

Interest rate is also affected by foreign exchange flows. If more international investors choose to invest in India, RBI will convert their foreign currency into Indian rupees. The resulting increase in rupee liquidity will soften rupee interest rates.

## **2.4 Currency Exchange Rate**

An investor investing in a currency other than the domestic currency is exposed to an additional risk – the risk that the exchange rate moves adversely.

Suppose an Indian investor were to invest USD 1 mn in shares of a company on the New York Stock Exchange (NYSE). At the exchange rate of 1 USD = Rs. 55, an amount of Rs. 5.5 crore would be invested.

If the investment were to appreciate to USD 1.2 mn, the investor would have booked returns on the NYSE of  $(1.2 - 1) \div 1$  i.e. 20%, in dollar terms.

The return in rupee terms would depend on the exchange rate. If the USD had appreciated to 1USD = Rs. 56 (i.e. by 1.8%), then the NYSE investment would be valued at USD 1.2 mn X 56 i.e. Rs. 6.72 crore. The gain in rupee terms would be  $(6.72 - 5.5) \div 5.5$  i.e 22.2%.

The 20% appreciating in the investment together with the 1.8% appreciation in the currency delivered a rupee return of 22.2%. The rupee return can also be calculated as  $[(1+20\%) \times (1+1.8\%)] - 1$ .

If instead, the USD had depreciated by 2%, the rupee return would have been  $[(1+20\%) \times (1- 2\%)] - 1$  i.e. 17.6%. The depreciation in the USD ate into some of the returns that the NYSE investment generated.

Exchange rates move on account of a combination of various factors:

- o Relative Inflation

If inflation in India is 10% and in the US it is 3%, then the rupee needs to depreciate – else, the country will lose its export competitiveness.

- o Interest Rate Differential

Higher rupee interest rate can lead investors to convert their dollars to hold their deposits in the form of rupees. The resulting increase in supply of dollars and demand for rupees will make the rupee stronger.

- o Foreign Currency Inflows

Foreign currency inflows into India can happen on account of various transactions, such as, higher exports, lower imports or greater investments by international investors into India. Each of these can cause the rupee to strengthen.

At different points of time, various factors drive the exchange rate. The international investor therefore needs to assess both the strength of the investment and strength of the currency, before making any foreign currency investments.

Investing outside one's geography also calls for an appreciation of differences in laws related to investment by foreigners or the repatriation of these investments. Restrictions on such transactions, in both, one's own country and the country where one proposes to invest, need to be studied. Also, profits may be subject to taxation in more than one country. All these factors need to be well understood before venturing into foreign investments.

## **2.5      *The Deficits***

Analysts monitor two key deficits, which are pointers to the likely direction of Government policy – Fiscal Deficit and Current Account Deficit.

### **2.5.1      *Revenue Deficit and Fiscal Deficit***

These reflect the strength or weakness of the country's finances. Table 2.1 illustrates the deficits of the central government, based on the Budget Estimates for 2012-13.

Revenue deficit shows that the revenue receipts are not even adequate to cover the revenue expenses.

Part of the revenue expenditure has gone into grants for creation of capital assets. Excluding this, the effective revenue deficit is calculated.

Fiscal deficit shows the extent to which the government had to rely on borrowings and other liabilities to fund its expenditure.

The expenditure includes interest payments. This is excluded from the fiscal deficit to arrive at the primary deficit.

It can be reasoned that a developing country needs deficit to finance its growth. Thus, deficit for financing capital expenditure can be justified. However, the revenue deficit is a concern, because it indicates that borrowings are required to meet even revenue expenditure.

As a long term solution to the problem, the Government enacted the Fiscal Responsibility & Budget Management Act, 2003. Under this the government is expected to control the deficit in a time-bound manner. However, exigencies such as the need to support the economy during the recent melt down, have come in the way of effective control over the deficit.

Table 2.1

**Central Government's Budget Estimates for FY 2012-13**

		Rs. '000 Cr.
1	Revenue Receipts	
a	Tax Revenue (net to centre)	771.1
b	Non-Tax Revenue	164.6
	1a + 1b	935.7
2	Capital Receipts \$	
a	Recoveries of Loans	11.6
b	Other Receipts	30.0
c	Borrowings & Other Liabilities *	513.6
	2a + 2b + 2c	555.2
Total Receipts		1 + 2
		1,490.9
3	Non-Plan Expenditure	
a	On Revenue Account	865.6
a1	Including Interest Payments	319.8
b	On Capital Account	104.3
	3a + 3b	969.9
4	Plan Expenditure	
a	On Revenue Account	420.5
b	On Capital Account	100.5
	4a + 4b	521.0
Total Expenditure		3 + 4
		1,490.9
5	Revenue Expenditure	3a + 4a
	5a Including grants for capital asset creation	1,286.1
		164.7
6	Capital Expenditure	3b + 4b
		204.8
7	Revenue Surplus (+) / Deficit (-)	1 - 5
	% to GDP	-350.4
		3.4%
8	Effective Revenue Surplus (+) / Deficit (-)	7 + 5a
	% to GDP	-185.7
		1.8%
9	Fiscal Surplus (+) / Deficit (-)	1 + 2a + 2b - (3 + 4)
	% to GDP	-513.6
		5.1%
10	Primary Surplus (+) / Deficit (-)	
	% to GDP	-193.8
		1.9%
\$ Excluding receipts under Market Stabilisation Scheme		
* Including drawdown of cash balances		
Source: Government of India Budget		

### **2.5.2     *Current Account Deficit***

The country earns foreign currency through exports of goods and services and investments made by non-residents into the country (Foreign Direct Investment, Foreign Institutional Investors etc.).

Foreign currency is used up in import of goods and services, loans given to non-residents and investments made outside the country by Indian residents.

The difference between the two needs to be met through either external borrowings or by using up the foreign currency reserves of the country.

Loans and investments are in the nature of capital account transactions. Imports and exports of goods and services and interest payments are in the nature of current account transactions.

India has a current account deficit i.e. the imports and interest payments are more than the exports. This is financed through a surplus on the capital account.

It may be noted that India follows a policy of free convertibility on the current account. This means that no permission needs to be taken for current account transactions (except for a select list of goods and services).

However, there are restrictions on capital account convertibility. Therefore, residents need to take permission of the statutory authorities for such transactions, beyond a basic exemption limit.

The Tarapore Committee laid down various parameters, on fulfilment of which the country can move to capital account convertibility.

We are some distance away from full convertibility, though there is a continuous relaxation in the transactions and limits beyond which statutory permission is required on the capital account.

## Self-Assessment Questions

- ❖ Wealth management service is normally offered to clients whose cash flows are inadequate to meet needs.
  - True
  - **False**
  
- ❖ Which of the following best defines the bottom of a cycle?
  - Recession
  - **Trough**
  - Peak
  - Freeze
  
- ❖ Which of the following is a lead indicator?
  - GDP growth
  - Unemployment number
  - Luxury goods consumption
  - **Consumer confidence index**
  
- ❖ Tight monetary policy is a feature of high inflation scenarios.
  - **True**
  - False
  
- ❖ India's budget is surplus on revenue account but deficit on capital account
  - True
  - **False**

# Chapter 3 Investment & Risk Management: Equity

## 3.1 *Role of Equity*

Equities are growth assets. In a portfolio, their role is to grow the investor's wealth, and protect him from inflation.

Equities may also offer a return in the form of dividend. However, in most cases, the portion of the yield of an investor coming through dividend is likely to be much smaller than the yield coming through capital gains.

## 3.2 *Active and Passive Exposures*

Whenever investors invest in equities, they need to decide whether they would prefer an active exposure or a passive exposure.

Stock selection is a feature of active exposure. Investors choose active exposure with a view to get returns that are better than the market. With active management, investors or their adviser, actively decide the stocks to invest in, and the stocks to dispose of. Alternatively, they invest in an actively managed fund. Active management comes with the risk of selecting wrong stocks and consequently losing money.

With a passive exposure, the investor is not seeking to beat the benchmark. He is looking for returns that are in line with the market. This is achieved by buying an index (such as the S&P CNX Nifty) or buying stocks in the same proportion as an index or investing in an index fund. The portfolio thus tracks the performance of the index.

Since the stock selection flows from the index, there is no active selection of stocks in the case of passive investment. Although losses on account of stock selection are eliminated, passive exposures can result in losses when the market itself is weak.

Despite the best efforts, factors such as timing lags in executing the investment decisions and costs associated with the investment activity will cause a deviation in performance as compared to the index. This deviation is called 'tracking error'.

Costs always cause a negative tracking error (i.e the investment performance will be lower than the index), while the timing lags can cause the investment performance to be better or worse than the index. Therefore, the overall tracking error in passive investment may be positive or negative.

In the case of index funds, cash maintained in the scheme could be another factor contributing

to tracking error. Since stock selection is not involved, index funds tend to charge very low fund management costs.

An investor who is bullish about the overall economy and not interested in beating the benchmark will prefer passive investment through a diversified equity index. In developed markets, significant moneys are invested in equities through such a passive approach. However, it is believed that in developing countries, active exposure offers scope for attractive returns.

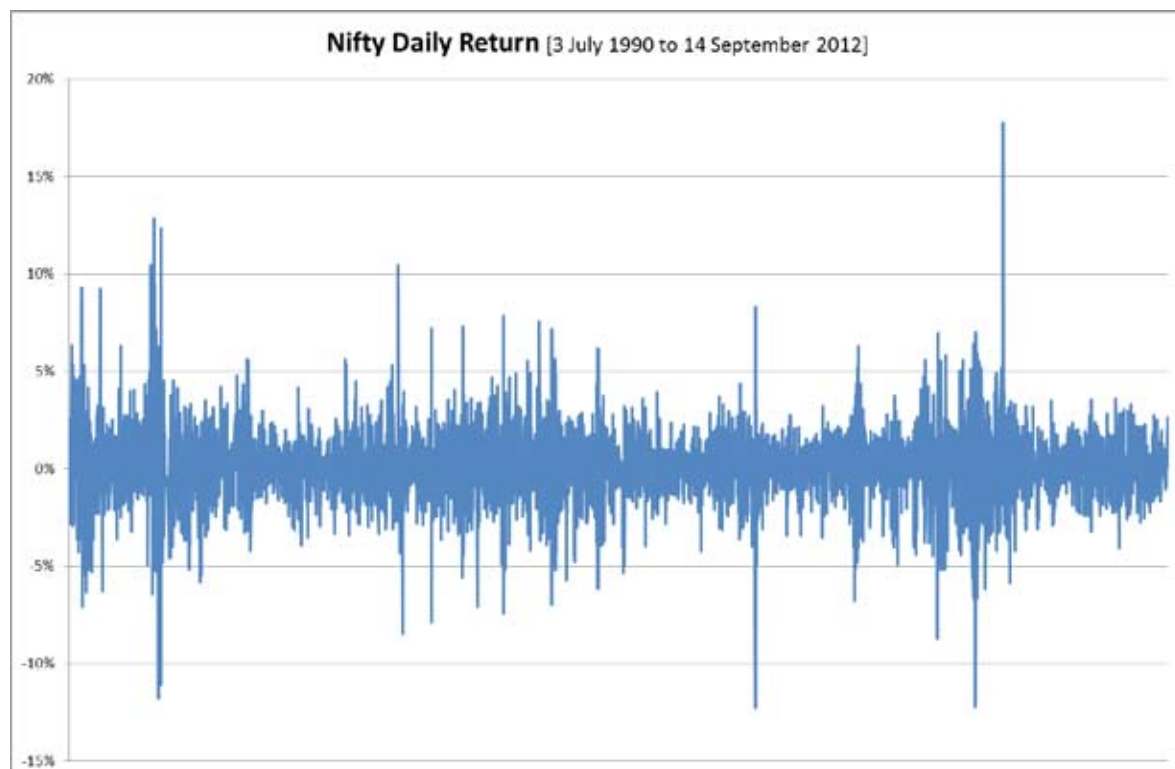
### **3.3 Returns from Passive Exposure to S&P CNX Nifty**

Figure 3.1 gives the daily returns from the S&P CNX Nifty since July 3, 1990.

Figure 3.1

#### ***Daily Returns from S&P CNX Nifty***

(July 3, 1990 to September 14, 2012)



(S&P CNX Nifty data is sourced from [www.nseindia.com](http://www.nseindia.com))

The returns are non-annualised. The choppiness of the market is evident from the graph.

Figure 3.2 provides the annual returns from the S&P CNX Nifty, as at the end of each financial year, since 1991-92. Even the annual returns have a wide range between +244% and -48%.

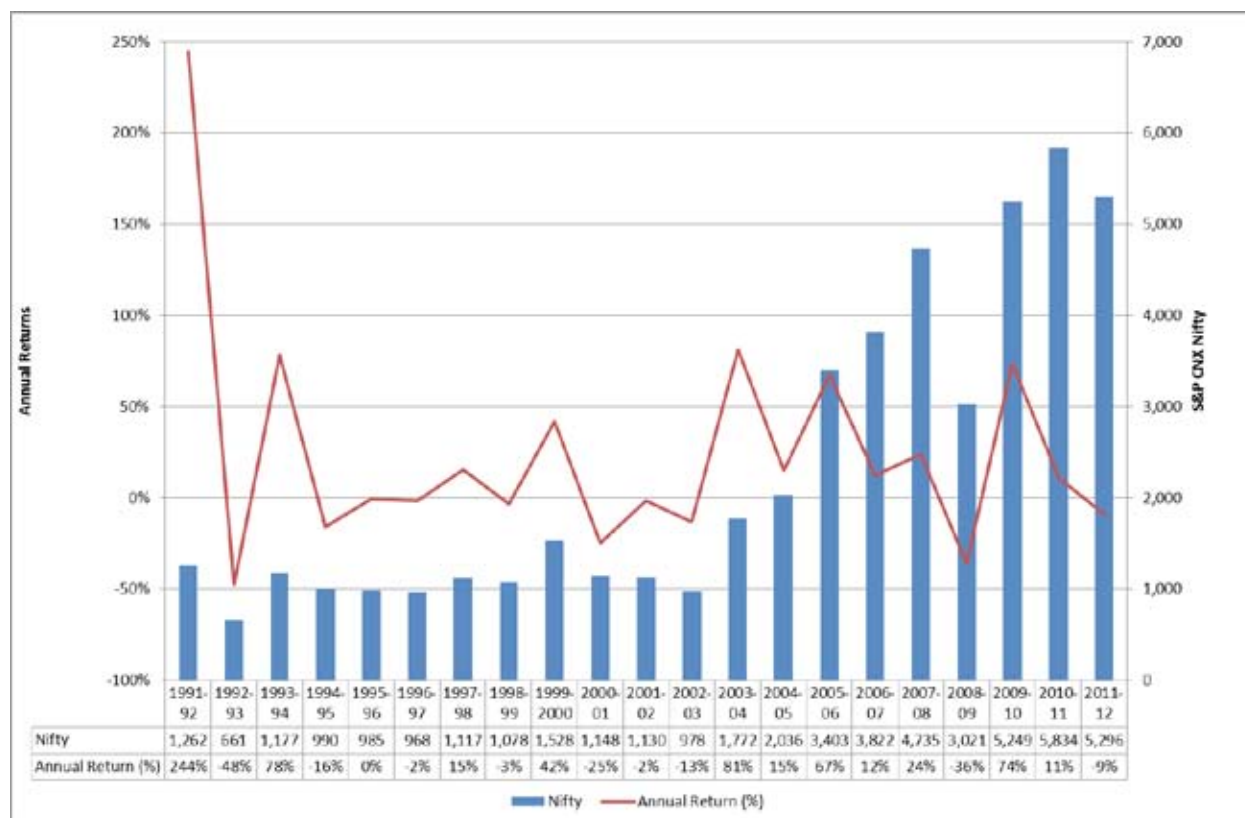
It is for this reason that investors are advised to invest in equities with a long term perspective.



Investing in equities with a horizon that is lower than 3-4 years is quite risky. Further, investing through an SIP ensures that the investor is able to average his investment acquisition cost over the SIP period.

Figure 3.2

### ***Annual Returns from S&P CNX Nifty***



(S&P CNX Nifty data is sourced from [www.nseindia.com](http://www.nseindia.com))

### ***3.4 Sector Exposure and Diversification***

Through active exposure the investor can create a diversified exposure that performs better than the index. Many institutions work on proprietary software models to create such portfolios.

Often the investor adopting active management looks for sectoral plays i.e. he wants to go under-weight or over-weight on specific sectors, as compared to the diversified index. This is particularly true of top-down investment approach, where the investor takes sectoral decisions and then decides on the stocks to buy within each sector.

On the other hand, in a bottom-up approach the investor focuses on good stocks to pick. In that case, sectoral distribution of the portfolio is not a conscious strategy; it is a consequence of the stock selection decisions.

Excessive exposure to a sector (also called “concentration risk”) can get quite risky, as investors in the technology sector and real estate sector have experienced.

### **3.5 Fundamental and Technical Analysis**

An investor opting for active exposure can select stocks through fundamental analysis or technical analysis.

Fundamental analysis is based on a study of the company’s fundamentals viz. its industry position, management capability, business strategy, financial strength and such other factors.

Study of the company’s financial statements is a key aspect of fundamental analysis. The approaches to fundamental valuation based on this are discussed in NCFM’s Workbook titled “Financial Markets (Advanced)” module. This is summarised in the next section.

Professional investors look for sufficient margin of safety in their investments. It is calculated as:

Margin of Safety = (Valuation based price – Current market price) ÷ Valuation based price.

Technical analysis does not get into the company’s fundamentals. It is not even concerned with the industry it belongs to. The technical analyst takes decisions based on the price-volume behaviour of a stock and / or the index.

This discipline believes that market price captures the thought process of all investors in the market. Based on this, views can be taken on future price behaviour – the direction it will take and at what level it is likely to encounter a resistance or a support.

The generally accepted principle is that fundamental analysis helps in deciding the stock to buy or sell. Technical analysis helps in timing the execution of the decision.

Long term investors rely on fundamental analysis. Short term investors including day-traders operate based on technical analysis.

### **3.6 Fundamental Valuation Approaches**

There are various approaches to fundamental valuation. Some of these are:

- o Dividend Discounting

A value for the initial period is calculated based on discounting of dividends for each year in the initial period. Discount factor used is the cost of equity.

A terminal value is calculated for the period of stable dividend growth, using the Gordon Growth Model  $[DPS \div (Required\ Rate\ of\ Return\ on\ Equity - Dividend\ growth\ rate)]$ . This needs to be discounted at the cost of equity to arrive at its present value.

Value of the share would be the sum of the value for the initial period and the present value of the terminal value.

- o Free Cash Flow

There are two facets to free cash flows – Free Cash Flow to the Firm (FCFF) and Free Cash Flow to Equity (FCFE).

FCFF is the operational cash flow that is available for servicing debt and equity investors. It is calculated as follows:

$$FCFF = PAT + Depreciation \ \& \ Amortisation + Interest \ (1 - Tax \ Rate) - Normal \ Working \ Capital \ Investment - Normal \ Fixed \ Capital \ Investment$$

Value of the firm is separately determined for an initial period and subsequent stable period, as in the case of dividend discounting method. However, the discount factor used is the weighted average cost of capital.

From FCFF, if the payments towards debt servicing are reduced, the balance belongs to equity investors. This is FCFE.

$$FCFE = FCFF - Interest \ (1 - tax \ rate) - Loan \ Repayment$$

This has to be discounted at the Cost of Equity to arrive at the Value of Equity of the firm. The value is separately determined for an initial period and the subsequent period of stable growth. The summation of the two is the value of the equity of the firm.

An alternate simpler approach to valuing the equity of the firm is given by the following formula:

$$Value \ of \ Equity \ of \ Firm = Value \ of \ Firm - Loan \ outstanding$$

The valuation based on yearwise FCFE is a more precise approach to the valuation.

- o Enterprise Value

Enterprise Value is calculated as Market Value of all the Company's Shares + Market Value of Company's Debt – Cash and Investments.

- o Earnings Multiple

Here the Earnings per Share is projected. This is multiplied by the expected Price to Earnings Ratio to arrive at the value of the share.

- o Price to Book Value

This approach entails projecting the book value of each share of the company. This is multiplied by the expected Price to Book Value Ratio to arrive at the value of the share.

### **3.7 Investment and Speculation**

The term 'investment' is generally associated with a longer investment horizon. Shorter term investments are referred to as 'speculation'. At times, the difference between investment and speculation can get subjective. What is clear however is that the speculator is taking more risk than the investor, and hopes to be compensated with higher returns.

### **3.8 Leveraging**

An investment approach where the investor relies on borrowed funds to support the investment position is called leveraging. This might take various forms, as follows:

- o Investing in a derivative instrument like a future or option. Derivatives allow investors to take positions that are a multiple of the funds they have committed to the transaction.
- o Margin trading, where a broker or other financier offers to fund a percentage of the investor's position on an ongoing basis. As the position goes up, the investor is able to avail of more funds; if the market goes down, the investor faces a margin call. This is to be fulfilled at very short notice. If the margin call is not met by depositing more money or securities, the margin financier will sell a part of the investment holding at the prevailing market price.
- o Term loan for a fixed period, which the investor deploys in the market. Depending on the security structure for the term loan, the short term margin call situations can be avoided. However, the investor may end up in situations where he is bearing interest cost for a period when the market does not offer any attractive opportunities.

Irrespective of the leveraging structure, the investor needs to realise that the capital invested is a form of protection against a loss. In the worst case, the investor can hold on to the position in a weak market, until it recovers.

Since the capital invested is lesser in leveraging, the investor needs to be sure he has adequate access to capital or other securities to bear the consequences of market declines. The need for such capital can be seen in Table 3.1. The financier will use the Rs. 60,000 to reduce the loan from Rs. 600,000 to Rs. 540,000, which is the borrowing limit based on revised investment value.

This requirement of additional capital comes up during weak market conditions, which is the phase when it is difficult to mobilise capital. Inability to raise the capital at short notice leads

to distress sale of the investments in a weak market. This can be quite costly, particularly when the market decline is a temporary aberration.

Alternatively, the investor will have to bring in securities to the extent of the entire amount of loss (Rs. 100,000 in Table 3.1). Thus, the market value of securities will go back to Rs. 10,00,000, which is required to support the Rs. 6,00,000 loan.

Leveraging can deliver superior returns in favourable market conditions; but it can deliver significant losses in adverse market conditions. Therefore, leveraging is a risky approach to investment.

Table 3.1

***Capital Requirement***

	<b>Unleveraged Position</b>	<b>Leveraged Position</b>
Investment Value (Original)	10,00,000	10,00,000
Borrowing Limit	0%	60%
Loan (Original)	0	6,00,000
Own Capital (original)	10,00,000	4,00,000
Market Decline	10%	10%
Loss	1,00,000	1,00,000
Investment Value (Revised)	9,00,000	9,00,000
Borrowing Limit (Revised)		5,40,000
<b>Additional Capital Required to continue position</b>	<b>0</b>	<b>60,000</b>

## Self-Assessment Questions

- ❖ An investor looking for returns in line with the market will opt for
  - Active investment
  - Speculation
  - **Passive investment**
  - Leveraging
  
- ❖ Passive investment protects the investor from any losses
  - True
  - **False**
  
- ❖ Discount factor used in Dividend discounting is
  - **Cost of equity**
  - Cost of debt
  - Weighted average cost of capital
  - Price-Earnings
  
- ❖  $FCFF + \text{Loans} = FCFE$ 
  - True
  - **False**
  
- ❖ Leveraging is a conservative approach to investment
  - True
  - **False**

# Chapter 4 Investment & Risk Management: Debt

## 4.1 *Role of Debt*

Debt is an income asset. With most debt investments, the proportion of yield that an investor gets out of regular return is likely to be much higher than any capital gains.

Although debt is not meant to provide significant capital gains, such gains (or losses) are possible when yields in the market change significantly.

Debt may not protect investors against inflation. However, it fluctuates less than growth assets like equity. Therefore, it is considered less risky. Debt provides a stabilising influence in a portfolio that also includes growth assets.

## 4.2 *Deposits and Debt Securities*

An investor seeking fixed income through debt exposure can place his funds in fixed deposits (with a bank or company) or debentures.

Fixed deposits entail commitment of funds for a period. Early exit from these deposits would depend on the conditions set by the investee company, when the deposit was accepted. Since the deposits are not traded in the market, they offer a perception of stability in values.

On the other hand, debt securities like debentures can be traded in the market. This contributes to liquidity of the investment, independent of the issuer. The trading also contributes to transparency in pricing.

The value of debt securities in the market keeps changing in line with changing views of market participants. Investment vehicles like mutual fund schemes are expected to mark their investments to the prevailing market prices. Such mark-to-market (MTM) valuation contributes to volatility of their net asset values (NAV).

Fluctuations in value of debt securities or debt fund NAVs lead most investors to believe that these are more risky than deposits. Fundamentally however, an investor who placed moneys in a 3-year 10% fixed deposit and a 3-year 10% non-convertible debenture will feel short-changed in both investments, if yields in the market were to go up to 11% p.a. for similar investments. Since deposits are not traded, there is no facility to capture their prevailing market value; transparent trades in the market ensure that the current value of debt securities is captured and publicised.

### 4.3 Valuation of Debt Securities

Debt securities are valued based on discounted cash flows. This is discussed in NCFM's Workbook titled "Financial Markets (Advanced) module".

- o The valuation of a perpetual debt instrument is given by the formula,

$$P = A \div y$$

Where,

'P' is the price

'A' is the annuity, Rs. 600

'y' is the yield, 6%.

- o A discount instrument is valued as,

$$P = MV \div (1 + y)^n$$

Where,

'P' is the price

'MV' is the maturity value

'y' is the yield

'n' is the balance tenor

- o A normal coupon bearing debt instrument can be valued as follows:

$$P = \{CF_1 \div (1 + y)^1\} + \{CF_2 \div (1 + y)^2\} \dots\dots\dots + \{CF_n \div (1 + y)^n\}$$

Where,

'P' is the price

'CF' is the cash flow

'y' is the yield

'n' is the time period to which it relates. Decimals can be used for part of the year. For example, cash flow at the end of 18 months is denoted by 1.5.

### 4.4 Yields and Interest Rate Risk

The investor's yield from a debt investment can be calculated using XIRR function as shown in Table 4.1, for a discount instrument that is trading at Rs. 7,996.11 on February 28, 2013 and is expected to mature at Rs. 10,000 on February 28, 2017.



Table 4.1

**Use of XIRR function in MS Excel**

	U28		$f_x$	=XIRR(T25:T26,S25:S26)		
	R	S	T	U	V	W
23						
24		<b>Date</b>	<b>Cash Flow</b>			
25		28-Feb-13	-7,996.11			
26		28-Feb-17	10,000.00			
27						
28		<b>Internal Rate of Return</b>		<b>5.75%</b>		
29						

This is a generalised function that can be applied in a range of situations. It can be easily extended to an investment that entails multiple stages of investments (e.g. subscription in parts) and returns (e.g. regular interest apart from principal redemption). Each such outflow is shown as a negative, and inflow is shown as a positive number, with the relevant date on which the cash flow is expected.

A decline in yields in the market leads to an increase in the value of fixed coupon debt securities previously issued and vice versa. Thus, debt securities fluctuate in value based on changes in market yields. A longer tenor debt security will fluctuate more than a shorter tenor instrument.

Modified duration is an estimate of the sensitivity of debt values to changes in yield. It answers the question – if yields in the market were to change by 1%, how much would the debt security change in value?

Suppose a debt security issued on January 1, 2012 at par (Rs. 10,000) is to mature at par on December 31, 2013. Coupon of 12% is payable annually. Modified duration of the security can be calculated, as shown in Table 4.2.

This implies that if yield in the market were to go down by 1% to 11%, the security would gain value by 1.69%; if yield were to go up by 1% to 13%, the security would lose value by 1.69%.

Table 4.2

**Calculation of Modified Duration**

	D52		$f_x$	$=C52/(1+12\%)^B52$	
	A	B	C	D	E
47					
48	<b>Date</b>	<b>Period</b>	<b>Cashflow</b>	<b>PV of CF</b>	<b>Product</b>
49	(1)	(2)	(3)	(4)	(2) X (4)
50	01-Jan-12	0.0	-10,000		0
51	31-Dec-12	1.0	1,200	1,071	1,071
52	31-Dec-13	2.0	11,200	8,929	17,857
53	<b>Total</b>			<b>10,000</b>	<b>18,929</b>
54				(a)	(b)
55					
56	<b>Duration</b>		(b ÷ a)		<b>1.89</b>
57					
58	<b>Modified Duration</b>		[Duration ÷ (1+12%)]		<b>1.69</b>
59					

Modified duration can be calculated using the 'MDURATION' function in MS Excel, as illustrated in Table 4.3.

Table 4.3

**Use of MDURATION function in MS Excel**

	E60		$f_x$	$=MDURATION(A50,A52,12\%,12\%,1)$		
	A	B	C	D	E	F
47						
48	<b>Date</b>	<b>Period</b>	<b>Cashflow</b>			
50	01-Jan-12	0.0	-10,000			
51	31-Dec-12	1.0	1,200			
52	31-Dec-13	2.0	11,200			
59						
60	<b>Modified Duration</b>		(using mduration)		<b>1.69</b>	
61						

**4.5 Interest Rate and Debt Investments**

The previous discussion highlighted that -

- Debt securities change in value in the market.

- The value of debt securities goes up when yields in the market go down.
- Longer tenor debt securities appreciate more in a declining yield scenario than shorter tenor debt securities.
- While yields may change in either direction, fixed deposit values do not reflect the impact of yield changes.

Therefore, it would make sense for investors to prefer deposit-type instruments when debt-yields are rising in the market. Debt securities –that too, of long tenor – should be preferred when debt-yields are falling in the market.

Interest rate views are shaped by the reading of the economy, as discussed in Chapter 2.

The tax implication for the investors is however different for deposits and debt securities. This is discussed in Chapter 11.

## **4.6 Credit Exposure and Debt Investments**

Debt securities issued by the government are called 'sovereign debt'. The government has the means to fulfil its obligations on all debt securities, which it has issued, that are denominated in the local currency (e.g. Rupee-denominated debt securities issued by Government of India). Therefore, they do not suffer a credit risk. This is the reason sovereign yields are the best (lowest in the market).

Yields in the market for non-sovereign issuers are higher because they entail a credit risk. The difference in yield for a non-sovereign issuer as compared to sovereign yield for the same debt tenor is called 'yield spread'.

The yield spread for any issuer is determined by its credit rating. Poorer the credit, higher the yield spread. Therefore, one avenue for an investor to receive higher yield is by compromising on the credit risk (i.e. going to lower credit quality). This will however increase the risk of default by the issuer on interest and / or principal.

Chances of a company defaulting on its obligations are much higher during weak economic conditions. In such situations therefore, the investor prefers to compromise on yield and invest in safer instruments. Favourable economic situations can lead investors to take higher credit risk.

Even if the economy is in good shape, weak companies can default. The possibility of default is captured by its credit rating, which is based on the company's financials and other factors.

A reading of the economy and interpretation of the issuer's financial strength are therefore factors that help a debt investor decide on the credit risk to take.

Shrewd debt investors buy into non-sovereign debt in anticipation of an improvement in its credit rating, or sell them in anticipation of a deterioration of credit quality.

## 4.7 Concentration Risk

As in the case of equity, excessive concentration of portfolio in a sector can be risky. For example, in an economic turmoil, real estate sector runs into trouble. A debt portfolio that has significant exposure to real estate or cement or steel sectors can suffer huge defaults. Therefore, diversification across sectors is a useful strategy even in debt portfolios.

## 4.8 Passive Investments in Debt

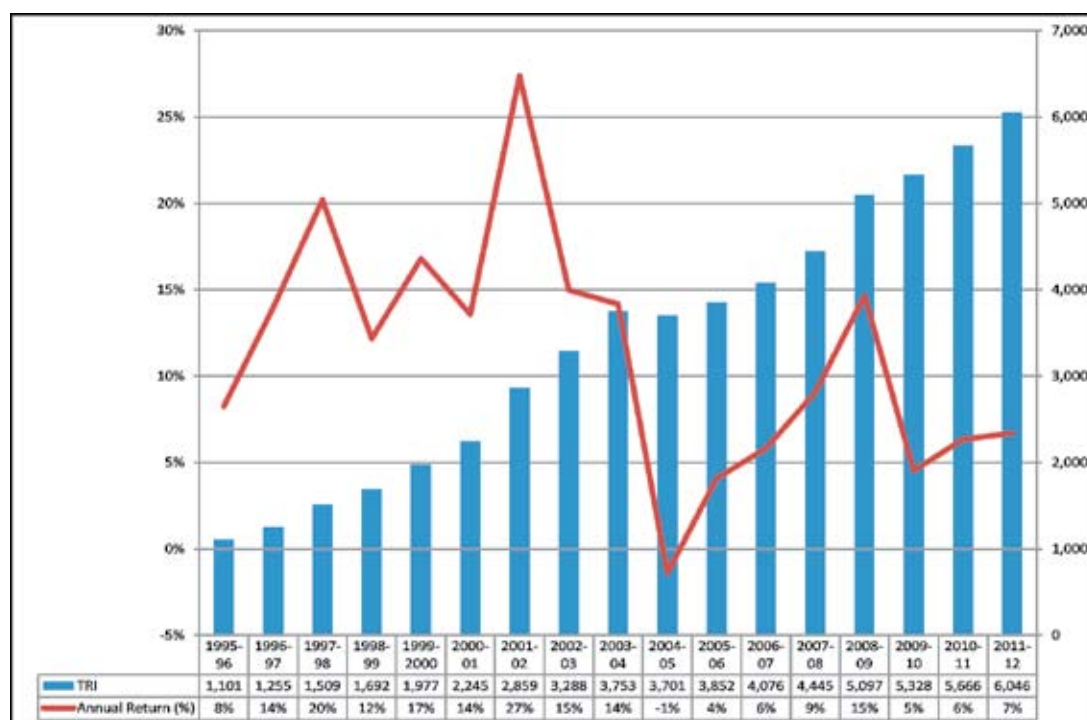
As in the case of equity, passive investment is possible through a debt index. However, there are issues unique to debt, which make such an investment approach complex.

ICICI Securities' Total Return Index (TRI), which is based on government-securities of various maturities, has its base as August 1994 = 100. Returns on the TRI can be viewed to understand the annual return profile on debt securities. This is shown in Figure 4.1.

The returns on government securities have gone as high as 27%, in 2001-02 (when yields fell) and gone as low as -1% (when yields rose).

Figure 4.1

**Annual Returns from Debt**(as measured through TRI)



(TRI Data is sourced from [www.icicisecuritiespd.com](http://www.icicisecuritiespd.com))

## Self-Assessment Questions

- ❖ Debt is \_\_\_\_\_ asset
  - **Income**
  - Growth
  - Inflation protecting
  - Risky
  
- ❖ Lack of trading gives fixed deposits a sense of stability.
  - **True**
  - False
  
- ❖ Perpetual debt is valued as
  - $P = MV \div (1 + y)^n$
  - **$P = A \div y$**
  - $P = MV \div (1 + y)^n$
  - $P = \{CF_1 \div (1 + y)^1\} + \{CF_2 \div (1 + y)^2\} \dots\dots\dots + \{CF_n \div (1 + y)^n\}$
  
- ❖ Deposits are preferable if interest rates are going down.
  - True
  - **False**
  
- ❖ As credit risk increases, yield spread increases too.
  - **True**
  - False

# Chapter 5 Investment & Risk Management: Alternate Assets

Assets other than debt and equity are referred to as alternate assets. The two that commonly find place in the portfolio of wealth investors are gold and real estate.

The extremely wealthy investors also invest in art, wine, horses etc. But these are relatively opaque and illiquid markets.

## **5.1 Gold**

### **5.1.1 Role of Gold**

Gold is a safe haven asset that investors opt for, in the event of any problems in the physical world (e.g. war) or the financial world (e.g. serious global recession or lack of confidence in financial markets).

Since the turn of the century, gold has also offered Indians a good hedge against inflation, though this was not the case in the 1990s.

Gold prices in India are determined from the international prices of gold. Therefore, any weakness in the rupee raises gold prices in India. Thus, it operates as an international asset for Indian residents to invest in.

Across the country, gold can be quickly sold or pawned to raise money. Gold is thus more liquid than financial assets like equity.

### **5.1.2 Gold Investment Routes**

Investors in India can invest in gold through various routes:

- **Physical Gold**

This is the most popular route. Several investors hold gold in the form of ornaments. However, given the making charges and losses in the process of making ornaments, this is the least advisable form of investment in gold. Ornaments also suffer from lack of transparency on the caratage (purity) of the gold.

It is therefore better that physical gold be held in the form of coins and bars. These need to be hallmarked for the caratage.

Physical gold, held in any form, suffers from the following limitations:

- Cost of storage in lockers
- Fear of loss through theft

- Costs entailed in insuring against theft or other contingencies
- Capital gains on sale will be treated as short term capital gains, unless the gold is held for more than 3 years
- Wealth tax is payable on the value of gold held

#### ▪ Gold ETF

The concept of ETF was explained in NCFM's workbook titled "Mutual Funds (Advanced) module". Each unit of a Gold ETF represents a certain quantity of gold. Generally it is 1 gram. The NAV of a gold ETF unit closely tracks the price of gold. Investors have the convenience of buying and selling them through the internet on NSE's equity trading platform, NEAT.

A significant benefit of not holding physical gold is that the investor does not need to worry about purity of the gold. Further, since the investment is held in electronic form, the costs and problems associated with physical gold are avoided. Demat charges however need to be incurred.

In the case of most Gold ETFs, the units can be converted into physical gold only if the investment is large (typically, 1 kg).

Gold ETF offers the following tax benefits, as compared to physical gold:

- Wealth tax is exempted on investments in Gold ETF.
- So long as the ETF units are held for more than 1 year, the capital gains would qualify as long term, with the incidental lower rates discussed in Chapter 11.

#### ▪ Gold Index Funds

These are structured as Fund of Funds, which receive money from investors and invest in one or more Gold ETFs.

Gold Index Funds offer all the benefits of Gold ETF. However, the investor cannot convert the units into physical gold even if the investment is large

The main benefit of a gold index fund is that the investor need not have a demat account or stock broking account. Gold Index Funds can be bought from any mutual fund distributor or directly from the mutual fund. Investments through SIP are also possible.

The Gold Index Fund in turn invests in ETF Gold, in order to give investors the gold exposure. This additional layer adds to the cost, as compared to ETF Gold.

#### ▪ E-Gold

Gold can also be held in the form of electronic Gold certificates. These have their benefits

in long term holding of gold at lower cost. This is in its nascency in India. Further, the tax benefits available for investment in Gold ETF and Gold Index Funds are not available for E-Gold.

- **Gold Futures**

A benefit of Gold futures is the leverage available. Only the margin payment needs to be made, initially. If the margin is 20%, then for the same initial outflow as the other forms of investment in gold, the investor can take 5 times the position.

The investor should however be mindful of ongoing margin payments that may have to be made, if gold prices decline during the tenor of the futures contract.

Futures are essentially short-term contracts that need to be rolled over regularly to create a long term exposure. The repeated rolling over can be cumbersome, besides adding to cost.

- **Gold Sector Fund**

A few schemes of mutual funds invest in shares of gold mining and processing companies. These are gold sector funds.

An investor in a gold sector fund is taking exposure not to gold directly, but to shares of the gold companies. Although gold prices do affect the share prices of gold companies, other factors too come into play. For instance, if a gold company is not efficient, then it may report poor profits despite attractive gold prices.

### ***5.1.3 Rupee returns from Gold***

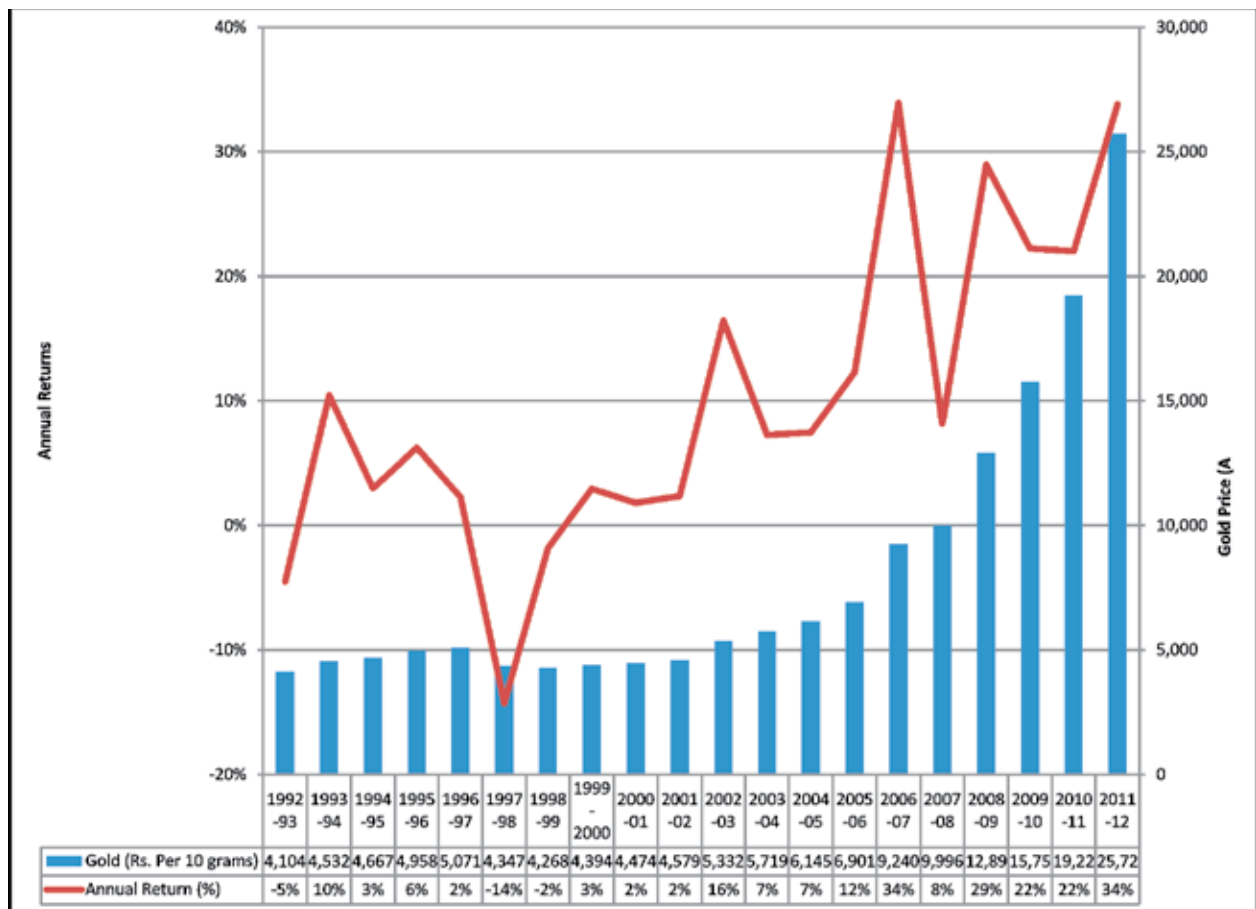
The returns from gold, based on average gold prices for each year, released by RBI, are shown in Graph 5.1.

The annual returns have fluctuated between -14% and +34% during the last two decades. Gold has however performed well during the last decade.



Graph 5.1

### Annual Returns from Gold in India



(Gold Price data is sourced from [www.rbi.org.in](http://www.rbi.org.in))

## 5.2 Real Estate

### 5.2.1 Role of Real Estate

Like equity, real estate is a growth asset. It also offers an income stream through rentals that can be more attractive than the dividend yield from equity investments.

Real estate is less volatile than equity. It goes up and down on a more secular basis. Given the inherent demand for occupation from a large population, the long term trend appears to be up.

Unfortunately, real estate is an illiquid asset. A related problem is the lack of transparency on pricing etc.

Unaccounted money has a significant role in real estate sector. This is a major problem given the non-standard nature of the asset and the lack of transparent pricing.

Transaction costs associated with real estate ownership, in the form of stamp duties, registration charges and brokerage are high.

### **5.2.2 Real Estate Investment Routes**

Investors can take exposure to real estate through any of the following routes:

- **Physical Investment in Land**

The investment may be in agricultural land or non-agricultural (NA) land for residential purposes or land reserved for specific purposes such as industry, school, tourism etc.

The documentation requirements for investment in agricultural land are more stringent. The land owner needs to be a farmer, as evidenced by a Farmers' Certificate. Agricultural land is cheaper than NA land. Some investors buy agricultural land and go through the legal process and cost for converting it into NA Land. On conversion to NA, the land value appreciates significantly.

When land is reserved for a specific purpose, it has a limited market. This can affect the gains from the investment.

Investment in land suffers from the following limitations:

- Land records in various parts of the country are subject to manipulation. Therefore, verification of ownership is cumbersome and fraught with risk.
- At times, restrictions on purchase or use of land are known much later. Investors are known to lose money when it is subsequently found that it is forest land or tribal land.
- Encroachments on land are common. Once encroached, it becomes difficult to get rid of the encroachers, who are at times backed by local leaders.
- Land might get acquired by the government for public purpose. In that case, the investor may not get the full value.
- Purchase and sale of land entail stamp duty and registration charges that are high.
- Many sellers expect to be paid for their land through unaccounted money. This makes it difficult for honest tax payers to invest in land.
- Land valuation can be quite subjective. The market is not transparent.
- Land is not so liquid.
- Land generally does not offer rental income.
- There are limitations on access to bank finance for purchase of land.

- **Physical Investment in Property**

The appreciation in real estate comes out of the land; buildings depreciate. Therefore, subject to the limitations mentioned above (many of which are also applicable to buildings), investing in land offers a better return on investment (in percentage terms) than investing in land and building.

Another aspect to consider is residential versus commercial. Experts believe that growth prospects are better with residential property, while rental prospects are better in the case of commercial.

The following are the benefits of investing in land and building or such other property:

- Financing from banks or other such intermediaries become possible.
- Rental income is possible.
- Encroachment risk is lower than in the case of investment in land alone.
- Property, especially in cities is more liquid.
- The role of unaccounted money is lesser.

- **Real Estate Sector Funds**

Mutual funds offer real estate sector schemes that invest in shares of real estate companies. As in the case of Gold Sector fund, the upside is more closely linked to the profits and share prices of the real estate companies, than the real estate asset values. Despite appreciation in real estate values, real estate companies may fare poorly on account of poor management, financial weakness etc.

- **Real Estate Mutual Funds**

SEBI has permitted the launch of real estate mutual fund schemes that will invest directly in real estate. Thus the investment performance will get delinked from the profits or share prices of the real estate companies.

Under the SEBI policy, the schemes need to be close-ended. These may be floated by the traditional mutual fund companies or even real estate companies that meet specified criteria.

Since the underlying asset viz. real estate is illiquid in nature, real estate funds (venture capital / private equity as well as mutual funds) can suffer illiquidity problems, even when they are doing well in terms of valuation.

The role of subjectivity in valuation of real estate and therefore the NAV is higher than in the case of other asset classes.

Given the role of unaccounted money in the sector, the investor needs to be cautious about potential siphoning of gains from the fund through cash transactions in real estate deals. As a policy, SEBI has barred these funds from indulging in such cash transactions.

The lack of transparency in the underlying asset market enhances the role and significance of ethical conduct on the part of the fund manager.

Investors should invest with fund managers they trust. This principle, which is applicable for all investments, is even more applicable for real estate mutual fund investments.

SEBI has restricted the investments that the schemes can make. For example:

- Direct investment in real estate has to be in cities with population over a million.
- Construction has to be complete and the asset should be usable. Project under construction is not a permitted investment.
- Investment cannot be made in vacant land, agricultural land, deserted property or land reserved or attached by the government or any authority.
- At least 75% of the net assets is to be invested in direct real estate, mortgage backed securities and equity shares or debentures of companies engaged in dealing in real estate assets or in undertaking real estate development projects.
- At least 35% has to be invested in direct real estate.
- The combined investment of all the schemes of a mutual fund:
  - o In a single city cannot exceed 30% of the net assets
  - o In a single real estate project cannot exceed 15% of the net assets
  - o Cannot exceed 25% of the issued capital of any unlisted company.

As in the case of gold, capital gains arising of transactions in physical real estate will be long term only if held for 3 years. However, capital gains arising out of units of real estate mutual fund schemes will be long term if held for 1 year.

No real estate mutual fund schemes (other than real estate sector funds) have been launched under the SEBI mutual fund regulatory framework.

▪ Real Estate Venture Capital / Private Equity Funds

A few companies have floated real estate investment vehicles, structured as venture capital or private equity funds. These are targeted at high net worth investors. As per current SEBI policy, minimum investment requirement for an investor is Rs. 1 crore.

These funds are outside the purview of SEBI mutual fund guidelines. Therefore, the investors need to take greater responsibility in monitoring their investments.

- Other Real Estate backed securities

It is possible to structure a range of securities, with real estate exposure as the underlying. The possibilities, as seen earlier, include real estate projects, real estate company shares, real estate company debentures or even loans to buyers or owners of real estate. The investor has to understand the nature of the exposure, and the consequent risk-return trade-off before investing.

### **5.2.3 Real Estate Indices**

A few indices based on shares of real estate companies exist. Similarly, there are indices based on real estate projects in different parts of the country. For instance, the National Housing Bank brings out Residex, which is based on real estate values in 15 cities. The indices need a longer track record, before they can be used as a basis for assessing real estate returns in the country.

## Self-Assessment Questions

- ❖ \_\_\_\_\_ is a safe haven asset
  - Equity
  - Debt
  - **Gold**
  - Real Estate
  
- ❖ Since India is a major consumer of gold, prices set in Mumbai determine the international prices of gold.
  - True
  - **False**
  
- ❖ Wealth tax is exempted in the case of
  - Gold ornaments
  - Gold coins
  - **ETF Gold**
  - None of the above
  
- ❖ Real estate is inherently
  - **Growth asset**
  - Income asset
  - Defensive asset
  - Safe haven asset
  
- ❖ Real Estate is less volatile than equity
  - **True**
  - False

## Chapter 6 Investment Products & Services

Each asset class represents a market, which has its own unique influences and features. Positions taken in the market can be long or short.

- In a long position, the investor buys the investment, with the hope that it will rise in value. When it rises, the investor can sell and book a profit.
- In a short position, the investor sells the investment, with the expectation that it will fall in value. When it falls, the investor will buy back the investment and book a profit.

The pay-off in any security is symmetric. When price of the security goes up, the party that is long on the security will benefit; the counter party (which will be short on the security) will lose. The position is reversed when the price of the security goes down.

The payoff on long and short positions on a stock at different price levels is shown in Graphs 6.1 and Graph 6.2.

When an investment is sold, the buyer will expect to be delivered the security. The time frame in which the buyer expects delivery therefore affects the time frame for which a short position can be held. Shorter the settlement cycle, shorter the short-selling horizon available, in the normal course. However, if the short-sold security can be borrowed, it allows the short-seller to hold the position for a longer time.

Securities lending mechanism provides a format where investors who own a security and do not wish to sell it, can lend it to a short-seller for a price. The incentive for the security lender is the additional income, beyond the interest / dividend that will normally be earned by the owner of that security.

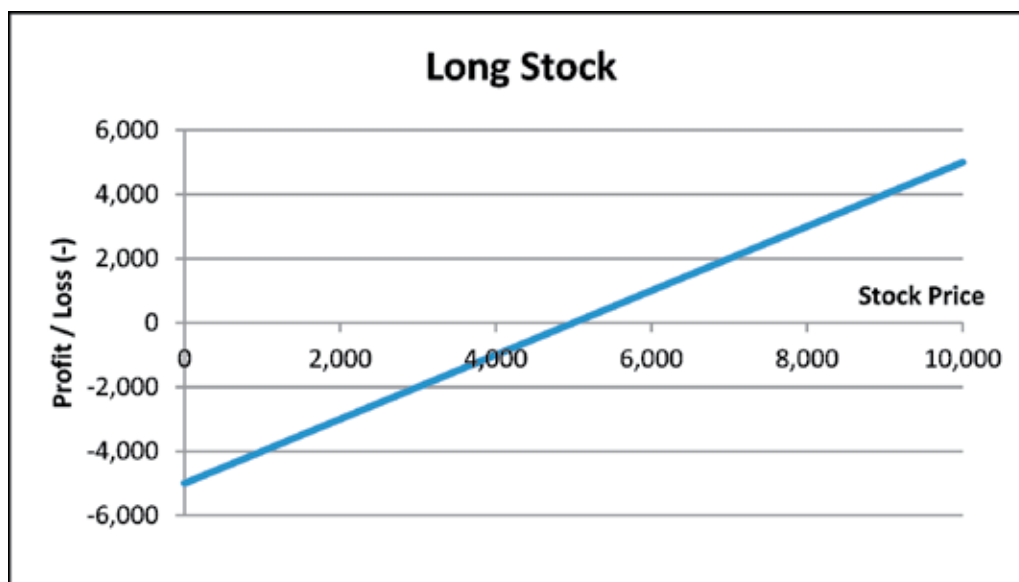
The market needs to be liquid enough to allow such sell and buy transactions, so that market participants can book profits. A liquid market ensures pricing transparency. Securities lending and borrowing mechanism allows investment positions that are not constrained by shorter settlement cycles.

Margining systems applied by the exchange / settlement house ensure the solvency of the market. Even if a market participant defaults on his obligations, the margins collected from him help the settlement house ensure that the counter-party is not affected by the default. This boosts the confidence of participants in the market.

These elements are well entrenched in the equity markets in India, and to a lesser extent in the debt market. Various investment products and services are offered by intermediaries to help participants benefit from the markets. These are discussed in this Chapter.

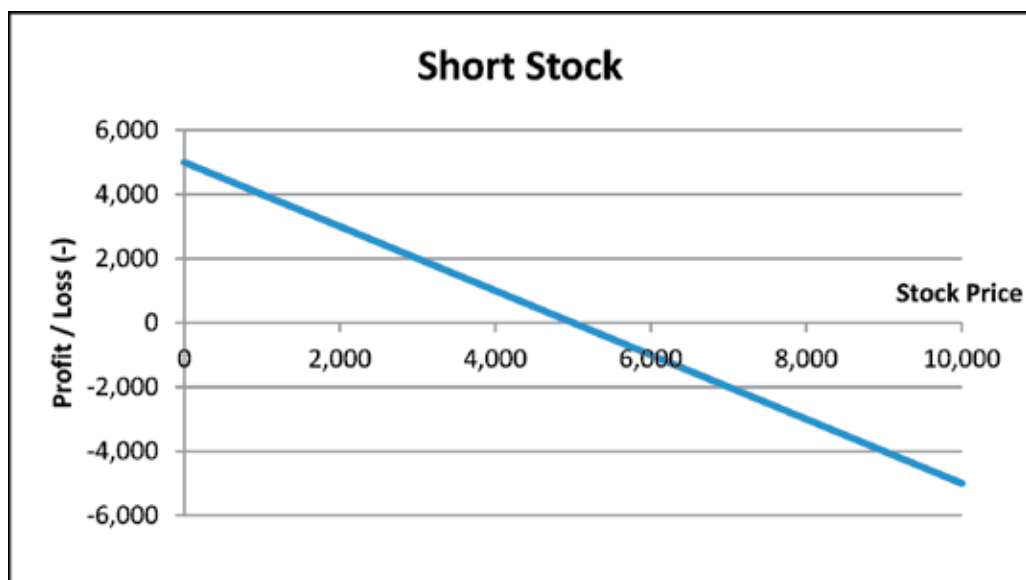
Graph 6.1

**Long Stock**



Graph 6.2

**Short Stock**



## 6.1 Derivatives

Derivatives are contracts that represent financial exposure to an underlying security or index or parameter.

The same exposure can be taken, either through the underlying cash market (debt, equity



etc.) or a derivative (with debt, equity etc. as the underlying). A benefit of derivative is the leveraging. For the same outgo, it is possible to have a much higher exposure in the derivative market, than in the underlying cash market. This makes it attractive for speculators and hedgers, besides normal investors.

Futures and options are two commonly traded derivatives.

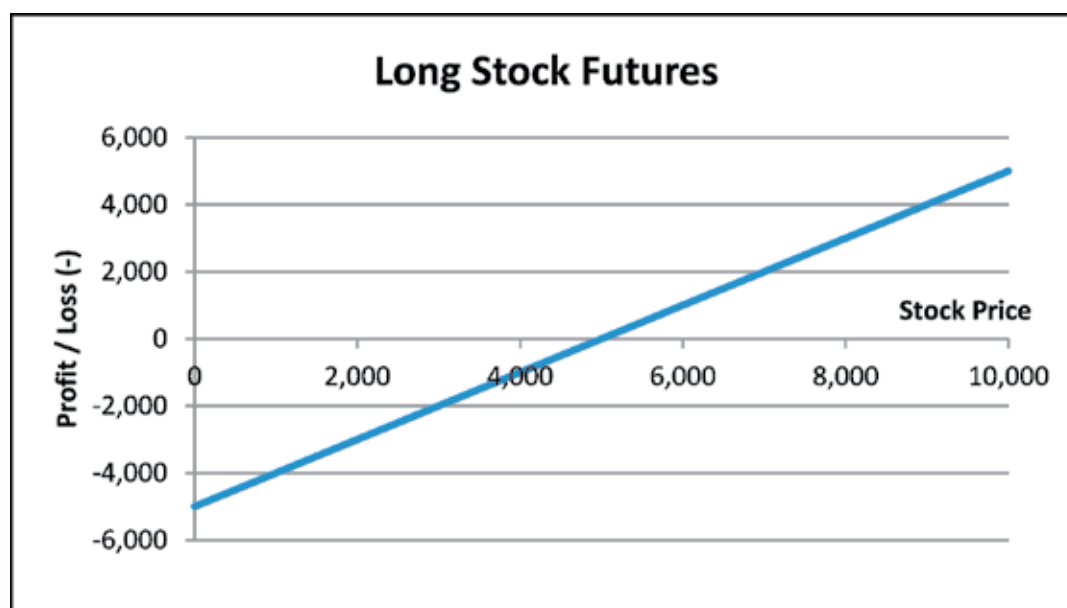
### **6.1.1 Futures**

As in the case of a stock, both the parties to a futures contract (buyer and seller) have an obligation i.e. the buyer needs to pay for the asset to the seller; and the seller needs to deliver the asset to the buyer on the agreed date (settlement date).

The payoff in a futures contract therefore is symmetric like that of the underlying, as shown in Graphs 6.3 and 6.4.

Graph 6.3

#### **Long Stock Future**



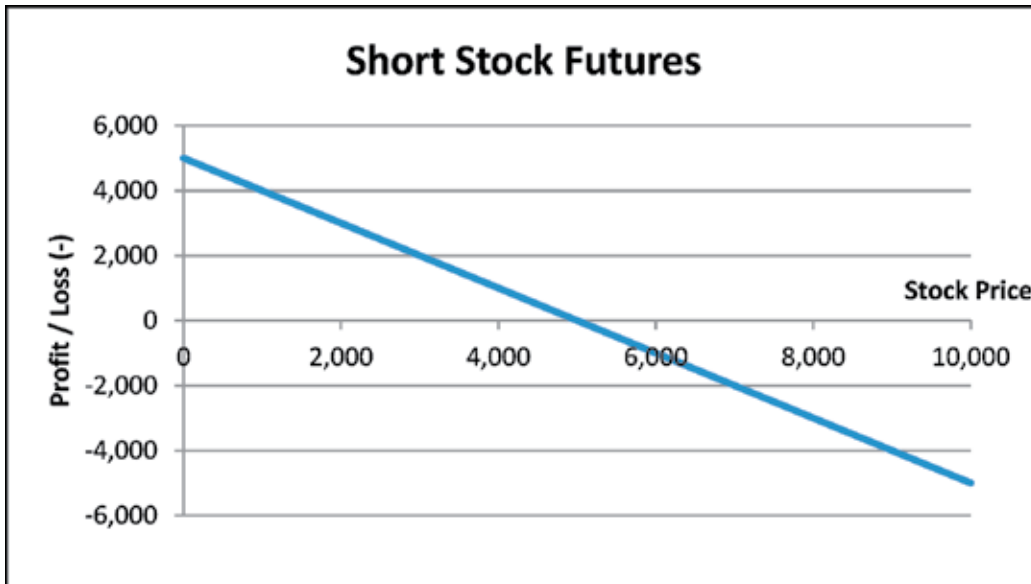
### **6.1.2 Options**

In case of options, only the seller of the option (the option writer) is under an obligation; not the buyer of the option (the option purchaser).

- In a call option, the buyer of the option has the right to BUY the underlying;
- In a put option, the buyer of the option has the right to SELL the underlying.

Graph 6.4

## Short Stock Future



The option buyer may or may not exercise his right. In case the buyer of the option does exercise his right, the seller of the option must fulfil his obligation:

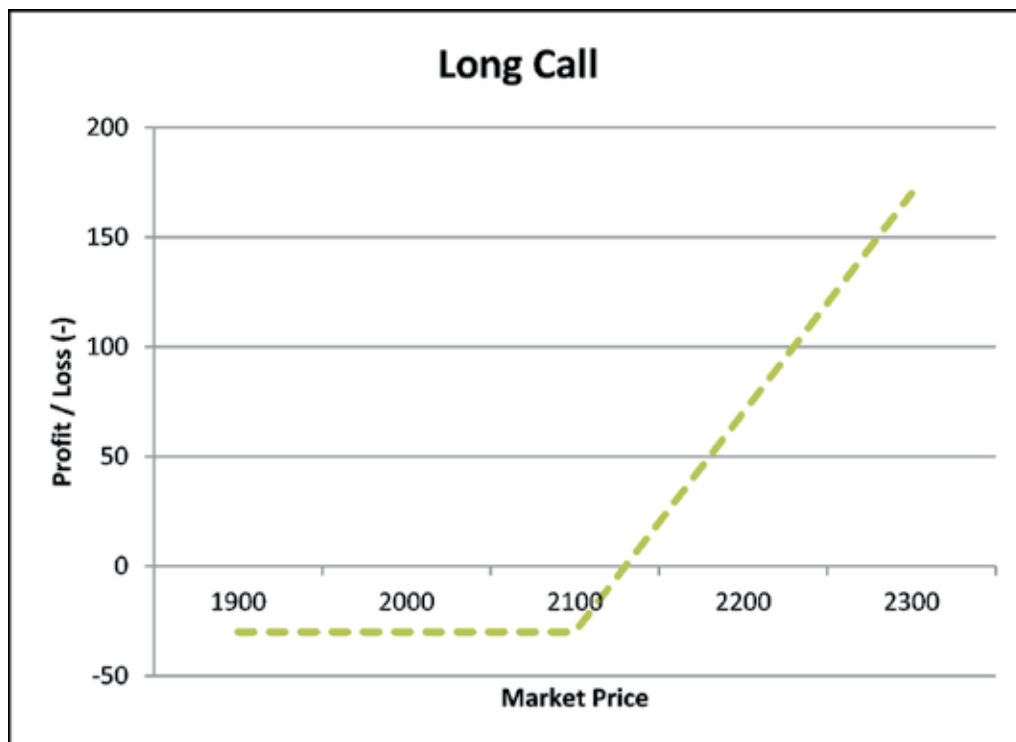
- In a call option, the option-seller has to deliver the asset to the buyer of the option;
- In a put option the option-seller has to receive the asset from the buyer of the option).

This asymmetric nature of the relationship leads to an asymmetric pay-off structure, as shown in Graphs 6.5 to 6.8. The asymmetric relationship is depicted as a bent line.

- The option buyer pays a premium, which is his maximum loss. This is indicated by the part of the line that is parallel to the X-axis in Graph 6.5 and 6.7. As the stock price crosses (higher for a call option; lower for a put option) the exercise price, the option buyer starts recovering the option premium. This is indicated by the slanting line in Graph 6.5 and 6.7.
- The option seller receives a premium, which is his maximum gain. This is indicated by the part of the line that is parallel to the X-axis in Graph 6.6 and 6.8. As the stock price crosses the exercise price (higher for a call option; lower for a put option), the option seller starts losing money. This is indicated by the slanting line in Graph 6.6 and 6.8.

Graph 6.5

**Long Call Option / Call Option Buyer**



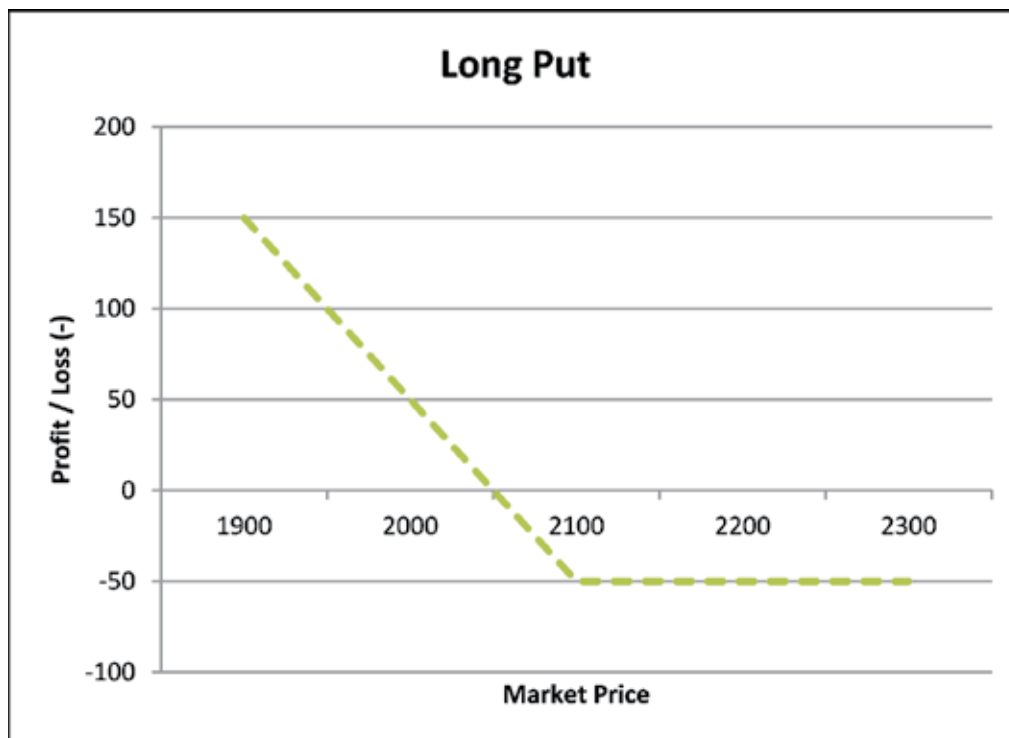
Graph 6.6

**Short Call Option / Call Option Seller**



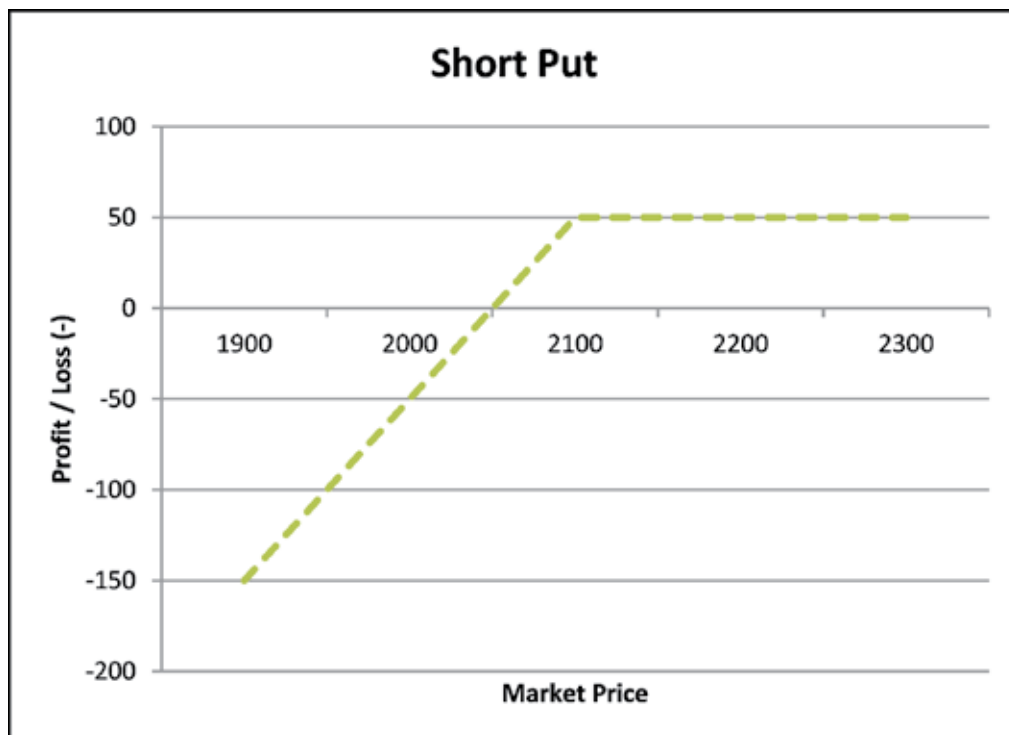
Graph 6.7

**Long Put Option / Put Option Buyer**



Graph 6.8

**Short Put Option / Put Option Seller**



The asynchronous nature of option contracts makes it a candidate for inclusion in several complex products that are aimed at creating asymmetric payoff structures for the investor.

## **6.2      *Mutual Funds***

Mutual Funds offer schemes that invest as per their investment objective. Investors invest in schemes that are in line with their financial goals. The wealth manager needs to recognise the following highlights of the nature of each type of mutual fund scheme:

- o Debt schemes are seen as safer than equity schemes. Debt securities at least have a maturity date, on which the company is expected to repay the principal amount. Equities do not offer such a comfort; recovery of moneys from equity investments is therefore entirely exposed to market risk. Hybrid schemes, which invest in a mix of debt and equity, are seen as more risky than pure debt schemes, but less risky than pure equity schemes.
- o Amongst debt schemes, money market / liquid schemes are least risky because they only invest in short term debt securities. As seen in Chapter 4, lower the modified duration, lesser the fluctuation in debt security value (and consequently the NAV of debt schemes) when interest rates in the market change.
- o Gilt Funds invest only in government securities (which are the safest form of debt investment, from a credit risk point of view). Yet, their NAV can fluctuate significantly, depending on the portfolio maturity. This price risk in the portfolio is the reason Gilt funds are viewed as more risky than liquid schemes.
- o Exposure to non-government corporate securities (which have a credit risk) contributes to the higher risk in diversified debt funds.
- o High yield funds (also called junk bond schemes) are highest in risk among debt funds because of their investment philosophy viz. they invest in debt securities that offer superior yield (which is generally paid by companies of inferior credit quality). Therefore, the portfolio of high-yield funds suffers a high degree of credit risk.
- o Amongst equities, some companies have relatively stable and profitable operations. These shares of such companies fluctuate less, yet they offer an attractive dividend yield. They are therefore called income stocks. High weightage of such equities in the portfolio of equity income / dividend yield funds contributes to their low risk among equity schemes.
- o The relatively low risk of value funds comes out of their value investment philosophy viz. invest in equities of under-valued companies (that are available at relatively low valuations) and hold on to them for a longer term. The downside risk in such equities is

therefore relatively less; in a portfolio of such equities (also called value stocks), the few that perform will generate very high returns, which will make up for some investments in the portfolio that may not perform.

- o Unlike income stocks and value stocks, growth stocks are equities of companies that are fast growing. These are generally available in the market at high P/E ratios. In a market decline, they also suffer large falls.
- o Index funds mirror an index. Different indices have varying weightages to higher risk growth stocks. The element of higher risk equities makes index funds riskier than value funds.
- o The portfolio of diversified equity funds is determined by a fund manager. There is a risk of poor stock selection by the fund manager. Therefore, diversified equity funds are riskier than index funds.
- o Growth funds have large exposure to higher risk growth stocks. This contributes to the high risk of such funds.
- o Sector funds invest in only one sector - unlike diversified equity funds which invest in multiple sectors. A benefit of investing in multiple sectors is that some may perform well, and make up for some others that may not perform well. The risk in a sector fund is that if that specific sector runs into trouble, then the fund performance will be severely affected. Therefore, sector funds are viewed as highest risk among equity funds.
- o The risk in hybrid funds depends on the extent and kind of debt and equity securities they invest in. A few nuances:
  - When a scheme talks of capital protection, consider the basis for that capital protection. Is it backed by government securities? If not, there is a credit risk; in that case, you need to be cautious about the capital protection statement.
  - If the scheme invests in government securities that would mature along with the scheme, then both credit risk and price risk are controlled. This makes the scheme relatively safe. Fixed Maturity Plans (FMPs) based on government securities are therefore low risk.
  - Fixed maturity plans can also be constructed on a portfolio of non-government securities. The resulting credit risk may be further accentuated through large exposures to a single sector. Such Fixed Maturity Plans are obviously risky to invest in.
  - Monthly Income Plans (MIPs) have an element of equity exposure, which contributes to the risk. If the market falls significantly, the mutual fund will not have the profits

to pay a dividend. Therefore, the monthly income in an MIP needs to be viewed with caution - the monthly income is not guaranteed.

### **6.3      *Venture Capital / Private Equity Funds***

These funds largely invest in unlisted companies. Venture capital funds invest at an earlier stage in the investee companies' life than the private equity funds. Thus, they take a higher level of project risk and have a longer investment horizon (3 – 5 years).

Private equity funds typically have a shorter investment horizon of 1 – 3 years. While their focus is on unlisted companies, they do invest in listed companies too. Such deals, called Private Investment in Public Equity (PIPE) are increasing in India.

Unlike mutual funds, which accept money from investors upfront, venture capital funds and private equity funds only accept firm commitments (a commitment to invest) initially. A part of the firm commitment may be accepted in money. The balance moneys are called from the investors, as and when the fund sees investment opportunities.

Just as investors bring money into the fund in stages, the fund returns money to investors in stages, as and when some investments are sold. On maturity of the fund, the unsold investments may be distributed to the investors in the proportion of their stake in the fund.

Venture capital funds and private equity funds do not operate under the kind of strict guidelines that are applicable to mutual funds. Therefore, these funds have greater freedom in their investments and operations; investors (unit-holders) in these funds have greater responsibility to protect their interests. This is quite unlike mutual funds, where SEBI has made the trustees responsible for protecting investors' interests.

### **6.4      *Hedge Funds***

These are a more risky variant of mutual funds which have become quite popular internationally. These are aimed at large investors. They operate with high fee structures, and are less closely monitored by the regulatory authorities. From a fund management perspective, the risk in hedge funds is higher on account of the following features:

- Borrowings

Normal mutual funds accept money from unit-holders to fund their investments. Hedge funds invest a mix of unit-holders' funds (which are in the nature of capital) and borrowed funds (loans).

Unlike capital, borrowed funds have a fixed capital servicing requirement. Even if the investments are at a loss, loan has to be serviced. However, if investments earn a return better than the cost of borrowed funds, the excess helps in boosting the returns for the

unit-holders. The following example illustrates how borrowing can be a double-edged sword for the fund.

Scenarios->		A	B	C
a.	Unit-holders' Funds (Rs. Cr.)	1,000	100	100
b.	Borrowings (Rs. Cr.)	0	900	900
c.	Total Investment (Rs. Cr.) [a+b]	1,000	1,000	1,000
d.	Return on Investment (%)	15%	15%	5%
e.	Return on Invt. (Rs. Cr.) [c X d]	150	150	50
f.	Interest on loan (%)		7%	7%
g.	Interest on Loan (Rs. Cr.) [b X f]	0	63	63
h.	Unit-holders' Profits (Rs.Cr.) [e-g]	150	87	-13
i.	Profit for Unit-holders (%) [h ÷ a]	15%	87%	-13%

The 15% return in the market was boosted through leverage of 9 times to 87% return for unit holders in a good market; in a bad market the same leverage dragged the unit-holders' return down to -13%.

The borrowing is often in a currency that is different from the currency in which the investments are denominated. If the borrowing currency becomes stronger, then that adds to the losses in the fund.

- Risky investment styles

Hedge funds take extreme positions in the market, including short-selling of investments.

In a normal long position, the investor buys a share at say, Rs. 15. The worst case is that the investor loses the entire amount invested. The maximum loss is Rs. 15 per share.

Suppose that the investor has short-sold a share at Rs. 15. There is a profit if the share price goes down. However, if the share price goes up, to say, Rs. 20, the loss would be Rs. 5 per share. A higher share price of say, Rs. 50 would entail a higher loss of Rs. 35 per share. Thus, higher the share price more would be the loss. Since there is no limit to how high a share price can go, the losses in a short selling transaction are unlimited.

The high risk nature of hedge funds, call for caution on the part of investors.

## 6.5 Structured Products

Over the last few years, high net worth investors have been offered structured products. These are pass-through debt or hybrid products outside the mutual fund structure. The product may be sold to investors on the promise of yield linked to performance of risky assets and some kind of protection of downside. For example, it may be offered as principal protection plus X% of the upside in the S&P CNX Nifty.



Suppose it is a 5-year principal protected scheme, offered at a time when sovereign yields for 5 years are in the range of 8%. An investment of Rs.  $100 \div (1 + 8\%)^5$  i.e. Rs. 68.06 in a zero coupon issued by the government will mature to a value of Rs. 100. This takes care of the principal protection. The balance amount, Rs.  $100 - 68.04$  i.e. Rs. 31.96, is invested in risky assets. Part of the upside on this goes to the investors, subject to tax, expenses etc.

An investor who wants only 80% of the principal protected can have a larger allocation to the risky assets, and thus benefit more from an appreciation in the risky assets. If the risky assets do not perform, then a loss up to 20% can come up (80% of the principal being protected).

The moneys collected are invested in a mix of risk-free assets (sovereign debt) and growth assets (equity, gold etc.). The mix of risk-free and growth assets is decided based on some portfolio insurance models and the investor's risk profile (extent of principal protection desired).

Investors need to appreciate the following risks in structured products:

- **Model Risk**

Some structured products are based on portfolio models. Models have their inbuilt assumptions – and ranges over which they perform as desired. These are not always intelligible to the lay investor. Often, issuers use proprietary models that are not shared. Thus, it becomes difficult to objectively assess all risks in the investment.

- **Marked to Market Risk before Maturity**

Principal protection, if available, is only on maturity. During the tenor of the instrument, its value can fluctuate with the market.

- **Issuer Risk**

Even if the investment pool makes money, payment is still subject to credit risk of the issuer.

- **Liquidity Risk**

Structured products are sold privately to high net worth investors. Even if these are listed, they may not be traded. Therefore, liquidity can be an issue.

- **Transparency Risk**

Although SEBI recently came out with various information requirements, the transparency and disclosure standards are weaker than in the case of mutual funds.

## **6.6 Portfolio Management Services (PMS)**

PMS is an investment facility offered by financial intermediaries to larger investors. The PMS

provider keeps receiving money from investors. Unlike mutual funds, which maintain their investment portfolio at the scheme level, the PMS provider maintains a separate portfolio for each investor.

An investor who chooses to operate multiple PMS accounts will need to go through a separate KYC process with each intermediary. Each will provide a separate statement of the investor's account in its own format.

The cost structure for PMS, which is left to the PMS provider, can be quite high. Besides a percentage on the assets under management, the investor may also have to share a part of the gains on the PMS portfolio; the losses are however borne entirely by the investor.

PMS have an unconstrained range of investments to choose from. The limits, if any, would be as mentioned in the PMS agreement executed between the provider and the client.

Variants of PMS structure exist. In some cases the PMS provider has the discretion to decide on investments. In other cases, approval of the client has to be taken for each investment. Some PMS providers operate on 'advice only' basis.

PMS are regulated by SEBI, under the SEBI (Portfolio Managers) Regulations, 1993. However, since this investment avenue is meant only for the larger investors, the mutual fund type of rigorous standards of disclosure and transparency are not applicable. The protective structures of board of trustees, custodian etc. is also not available. Investors therefore have to take up a major share of the responsibility to protect their interests.

## Self-Assessment Questions

- ❖ The pay-off in \_\_\_\_ is asymmetric
  - Index
  - Security
  - Future
  - **Option**
  
- ❖ \_\_\_\_\_ helps short-sellers hold security positions beyond the settlement cycle
  - Margining
  - Derivatives
  - **Securities lending**
  - Rolling settlement
  
- ❖ In which of the following is it possible for an investor to take a short position
  - Security
  - Future
  - Option
  - **All the above**
  
- ❖ In which of the following does an investor take the maximum project risk
  - Hedge fund
  - **Venture capital fund**
  - Private equity fund
  - Mutual Fund

# Chapter 7 Investment Evaluation Framework

Investments should meet the financial goals of the investor, while being within the risk parameters that the investor is comfortable with. The risk in various asset classes and investment products has been discussed in the previous chapter. Combinations of asset classes in an investor's portfolio viz. asset allocation, is discussed in the next Chapter.

How does an investor choose between two investments that appear to meet his risk-return expectations?

## 7.1 Risk-Return Framework

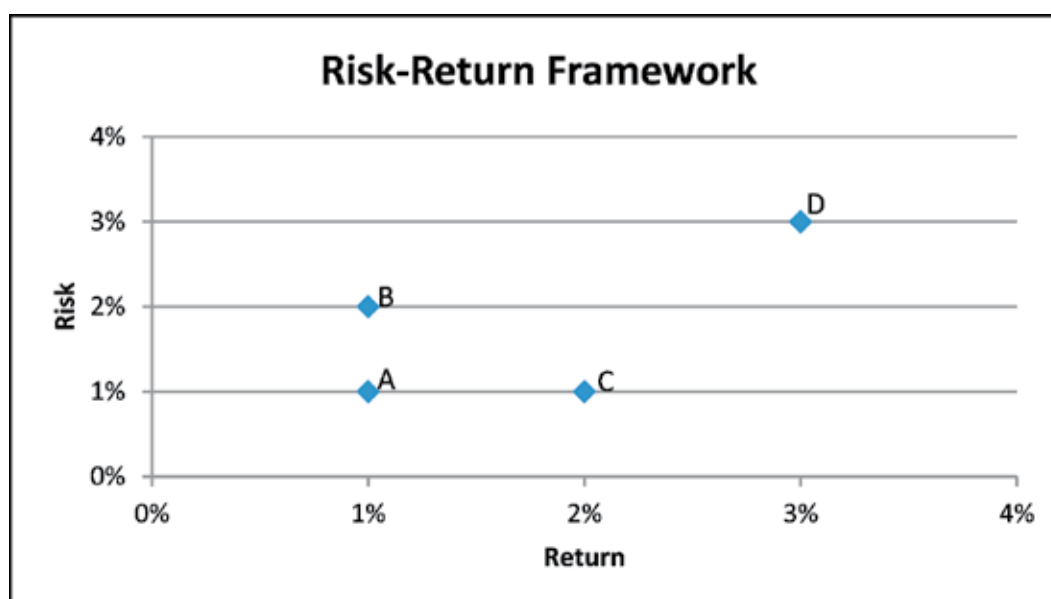
A normal investor is expected to select more return to less return; and less risk to more risk. Suppose the investor were to choose between four portfolios, as follows:

Portfolio	Return	Risk
A	1%	1%
B	1%	2%
C	2%	1%
D	3%	3%

Graph 7.1 depicts the portfolios pictorially, on the risk-return plane.

Graph 7.1

### Portfolio Choice



Portfolios A and B offer the same return of 1%. But Portfolio B has a risk of 2%, as compared to 1% in the case of Portfolio A. Therefore Portfolio A is superior to Portfolio B.

Portfolios A and C have the same risk of 1%. But Portfolio C offers a return of 2%, as compared to 1% for Portfolio A. Thus, Portfolio C is superior to Portfolio A (which in turn was superior to Portfolio B).

Between Portfolios A, B and C, the reducing order of preference is C A B. What about Portfolio D? It offers higher return for higher risk. Risk adjusted return metrics aid decision making in such situations.

## **7.2 Risk**

In the above matrix, how was risk measured? Two measures of risk are commonly used in financial markets - Standard deviation and Beta.

### **7.2.1 Standard Deviation**

In layman's language, this is the extent to which the scheme returns deviate from its own past standards. This can be easily calculated using the MS Excel function 'STDEV' as follows:

- o Enter a series of regular historical returns for an investment, in a set of continuous cells. The regularity may be daily, weekly, monthly etc.
- o In a different cell enter '=stdev' and then select the range of cells where the regular historical returns are entered. If the range of cells is C1 to C30, the formula in the cell would be entered as '=stdev(C1:C30)'. The value that is returned in the cell is the standard deviation.

A high standard deviation would mean that the scheme deviates more from its past standards i.e it is more risky.

Standard deviation is used in the case of debt and equity investments.

### **7.2.2 Beta**

This is a measure of risk that can be used for equity investments.

Unlike standard deviation which uses its own past standards for the calculation, Beta measures risk as compared to a diversified equity index. Therefore, two sets of returns are required for each period – the investment return and index return.

Beta can be easily calculated using the MS Excel function 'SLOPE' as follows:

- o Enter a series of regular historical returns for an investment, in a set of continuous cells (say C1:C30). The regularity may be daily, weekly, monthly etc.

- o Enter the returns for the diversified equity index for the same periods. Suppose these are entered in cells D1:D30.
- o In a different cell enter '=slope' and then select the two sets of data, separated by a comma [=slope(C1:C30,D1:D30)]. The value returned in the cell is the Beta.

A higher beta would mean that the investment deviates more as compared to the diversified equity index i.e it is more risky.

If the beta is more than 1, it means that the investment is more risky than the market. A value of beta that is less than 1 would mean that the beta is less risky than the market.

Since index schemes mirror the portfolio of their benchmark index, their risks are expected to be similar. Therefore, beta of an index scheme would be close to 1.

### **7.3 Risk Adjusted Returns**

Risk-adjusted returns are a composite measure of performance. They help investors assess how well the returns are covering for the risk taken in investing. Some of the metrics that are used in the investment world are:

#### **7.3.1 Sharpe Ratio**

Suppose an investor earned 12% return from an investment portfolio, whose standard deviation is 0.5.

Further, let us say that a risk-free return of 7% would have been possible, if the same money was invested with the government.

Thus, the portfolio yielded a return that was higher by 12% minus 7% i.e. 5%. This is his risk premium, a premium earned for the risk taken.

If the risk premium of 5% is divided by the standard deviation of 0.5, we get a value of 10%. This indicates that for every unit of risk taken (as measured by standard deviation), the investor earned a return of 10%. This is the Sharpe Ratio. It is calculated as (Portfolio Return minus Risk free Return) ÷ Standard Deviation of the Portfolio Returns.

In a comparison of two portfolios of the same type, the one with the higher Sharpe Ratio is considered to have delivered superior risk-adjusted returns.

Sharpe Ratio can be used for assessing debt and equity investments.

#### **7.3.2 Treynor Ratio**

Treynor ratio uses beta, instead of standard deviation, as a measure of risk. It is calculated as (Portfolio Return minus Risk free Return) ÷ Beta of the Investment.

In the above example, if Beta of the portfolio was 1.25, then Treynor Ratio would be  $5\% \div 1.25$  i.e. 4%.

This means that for every unit of risk taken (as measured by beta), the investor earned a return of 4%.

In a comparison of two diversified equity portfolios, the one with the higher Treynor Ratio is considered to have delivered superior risk-adjusted returns.

Treynor Ratio is to be used only for evaluating diversified equity portfolios.

### **7.3.3 Alpha**

Alpha is a measure of the portfolio manager's performance.

In the process of managing a non-index scheme, the portfolio manager may take a risk (as measured by beta) that is different from the market risk; the portfolio returns too are likely to be different from the market.

Logically, if the portfolio manager took a higher risk than the market, he ought to deliver a return that is higher than the market. Alpha compares the return which ought to have been generated (for the risk taken) by the scheme with the return that was actually generated. The difference between the two is out-performance (if actual return is higher) or under-performance (if actual return is lower).

Between two managers of competing diversified equity portfolios, the one with higher alpha is considered to have delivered better risk adjusted returns.

The concept of alpha is technically correct, only for diversified equity schemes.

## **7.4 SSELECTIVVELLY-Invest Classification Scheme for Investment Products<sup>2</sup>**

The ever widening range of investment products does create confusion in the market place. The positives of a product, effectively marketed, can cover up the risk elements inherent to the product. This can lead the investor to take wrong investment decisions.

SSELECTIVVELLY-Invest Classification Scheme that helps the investor to get a comprehensive understanding of any investment product. The following drivers of risk and return are the attributes of SSELECTIVVELLY-Invest:

- o Source (Issuer)
- o Sector — for non-government exposures

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<sup>2</sup> Chapter 29 of "Wealth Engine: Indian Financial Planning & Wealth Management Handbook" by SundarSankaran

- o Exposure (Asset Class)
- o Liquidity (offered by Issuer / Issuer's agent / Market)
- o End (Maturity)
- o Cost
- o Tax Exemption
- o Insurance level
- o Vehicle

(The structure through which investment is being made, e.g. Direct, Mutual Fund, Insurance, PE Fund, VC Fund, Structured Product, etc.)

- o Valuation
- o Exchange Rate
- o Leverage (asset class)
- o Leverage (foreign currency)
- o Yield



## Self-Assessment Questions

- ❖ Which function can be used in MS Excel to find out the beta of an investment portfolio?
  - Beta
  - Stdev
  - Covar
  - **Slope**
  
- ❖ If return and risk of three portfolios are as follows: Portfolio X (1%, 1%), Portfolio Y (1%, 2%), Portfolio Z (2%, 1%). Which is the superior portfolio?
  - X
  - Y
  - **Z**
  - X and Z
  
- ❖ Portfolio manager's outperformance is measured through
  - Beta
  - Sharpe
  - Treynor
  - **Alpha**
  
- ❖ Which aspects of leverage are covered in SSELECTIVELY-Invest classification scheme for investment products?
  - Only asset class
  - Only foreign currency
  - **Asset class and Foreign currency**
  - None of the above

# Chapter 8 Risk Profiling & Asset Allocation

## 8.1 Risk Profiling

The concept of risk profiling was introduced in Chapter 1. It is an exercise to determine how much risk is appropriate for an investor.

Risk profile is subjective. Few investors have the ability or objectivity to determine their risk profile appropriately. Therefore, determining risk profile based on a question to the client – “How much risk can you take?” is not a suitable approach. The adviser needs to understand the risk profile of the client in a deeper sense. This is done by asking several questions, as part of a structured data gathering exercise. Some of these are:

- What is your age?

A younger person is more likely to be able to handle market downsides psychologically. Further, the person has a longer earning period in future, to make up for any losses.

- How many earning members are there in the family?

The more the number, greater may be the ability to handle market risk.

- How many dependent members are there in the family?

A client who does not have any responsibility towards dependents is in a better position to take risks than someone who has several dependents in the family.

- How stable are the income streams in the family?

Stability of income cycles are an important requirement before the client should consider taking market risks.

- What is the level of the investor's current wealth, in relation to the fund requirement for various needs?

An investor who has adequate wealth to take care of the needs is better placed to take market risks.

- What is the liability and loan servicing requirement of the client?

Loans need to be paid, irrespective of the earning cycle. Therefore, heavy loans are a reason to limit the risk that the client is exposed to.

- If the market were to fall down by 25%, how will you respond?

Such questions help in understanding the psyche of the investor. The investor who believes in increasing his position when the market falls is obviously comfortable with

risk and losses. If a market fall were to trigger an exit from the investment with whatever can be recovered, then the client is not a candidate for risky approaches to investment.

Some advisers use risk profile models where the investor responds to a standard set of questions. The response determines the investor's risk score / grouping. Although the models disclose the risk profile objectively, it is important to recognise that risk profile of a person is extremely subjective.

## **8.2      *Why Asset Allocation?***

The discussions on various asset classes in the previous chapters highlight the unpredictability of markets. Different asset classes perform well in varied economic and market scenarios.

The analyst seeks to interpret the leading indicators and anticipate likely market trajectory. However, it is not possible to predict the market with certainty.

An approach to balance the uncertainty is to invest in a mix of asset classes. This ensures that some asset classes in the portfolio perform well, when others don't. Such distribution of investments portfolio between asset classes is 'asset allocation'.

Perpetual debt represents an extremely portion of the debt market. Thus, most debt has a date on which the principal is scheduled to be repaid, independent of prevailing interest rates. This feature of debt makes it safer than equity. Many investors find it difficult to handle the fluctuations in equity prices.

Allocation of investment between risky and relatively less risky asset classes makes it smoother for the investor to fulfil his financial goals.

## **8.3      *Strategic Asset Allocation***

Distribution between asset classes based on risk profile of the investor is called 'strategic asset allocation'. Let us consider a few examples:

- o A young investor, who is in the accumulation phase can afford to take more risk. Even if he were to lose money, he can recover it from future earnings. Besides, he is exposed to inflation over a long period. His portfolio needs to include a liberal portion of risky growth assets that are likely to protect him from inflation. Such an investor may be advised to have an equity-debt mix of 80:20.
- o A senior citizen is exposed to inflation too. However, the exposure is for a shorter time period determined by life expectancy. Besides, the senior citizen may not have a future earnings stream to make up for losses. The physical health of the person too may or may not be in a position to handle the shock of investment losses. These factors mandate a

significantly lower exposure to risky assets. Equity-Debt mix of 20:80 is quite common for such investors.

- o A client who is in transition mode knows that a large requirement of funds is coming up. This will call for liquidity in the short term. When the liquidity requirement comes up, the market conditions may not be favourable. Therefore, the client should exit some investments much earlier and park the funds in debt. This will increase the debt component in the investment portfolio, for even an investor who can take risk. Once the purpose for which the liquidity was required is settled, the investor goes back to the strategic asset allocation suggested by the risk profile.
- o A client who has earned windfall gains may choose to invest them in risky assets. But it would not be advisable to invest all the money at the same time. The investor may therefore opt to invest in a liquid fund, with a STP into an equity fund. Until the STP is completed, the investor will find himself over-invested in debt.

These examples are illustrative. Specifics of situations may vary. The strength of the wealth manager lies in understanding the client's risk profile and suggesting the most appropriate asset allocation.

## **8.4 Tactical Asset Allocation**

Investors who are oriented to take risk do take asset allocation calls based on their views of the market. When they feel the market is undervalued they increase their exposure to equity. They exit their equity investment when the view is that the market is overheated. Such an approach to investments is called 'tactical asset allocation'.

Tactical asset allocation is clearly a risky style of investing. Wrong market calls can cause serious losses to the investor. Therefore, this approach is suitable only for wealth investors who are in a position to take risk.

## **8.5 Fixed Asset Allocation**

An investor who practices fixed asset allocation will seek to maintain the allocation even when the market moves.

Suppose an investor's portfolio is structured with equity to debt mix of 30:70. In a short period, if the equity market were to go up by 70%, 30 will become 51. During this phase, if debt gave a 5% return, 70 would have become 73.5. Thus, the equity-debt mix has now become 51: 73.5, which can be re-written as 41:59. The complexion of the portfolio has changed.

An investor adopting fixed asset allocation will re-balance the portfolio in such a situation. This would entail selling some equity and re-investing in debt. Thus, the investor ends up

booking profits in the rising market. Until the desired asset allocation is reached, the investor will keep investing fresh surpluses in the asset class where he is short.

Portfolio re-balancing does entail costs such as brokerage and stock exchange charges. Profits booked may also become liable for short term capital gains. Further, frequent trading is likely to lead the income tax officer to conclude that the investor is speculating. The tax implications of this are discussed in Chapter 11.

Most investors therefore do not try to re-balance more frequently than annually, unless there is a significant change in the valuations of, or views about an asset class.

Most mutual fund schemes operate with a fixed asset allocation, though within a wide investment range defined in the Offer Document. For instance, the proposed investment distribution may be defined in the Offer Document as follows:

Equity and equity related securities 70 – 90%

Debt and debt related securities 10 – 30%

Mutual fund schemes do not pay a tax on their capital gains or losses. So portfolio-rebalancing is more efficient when it is handled by the scheme, as compared to any other investor.

## **8.6 Flexible Asset Allocation**

Let us continue with the previous example of investor with Equity: Debt mix of 30:70, which changed to 41:59 when the market changed. We saw that an investor adopting fixed asset allocation will re-balance his portfolio to arrive at the targeted equity: debt mix.

An investor who adopts flexible asset allocation will allow the equity : debt ratio to drift. There will be no re-balancing in line with the market. As is demonstrated later in this chapter, this kind of lazy approach to investment is not desirable.

A few mutual fund schemes adopt flexible asset allocation as part of their scheme structure. This is not meant to be lazy investing, but part of a tactical approach to investment. The scheme retains its flexibility to increase exposure to any asset class, depending on the fund manager's view on the markets.

Flexible asset allocation schemes can help investors benefit from swings in the returns in different asset classes. However, as seen earlier, tactical asset allocation is risky. Further, since the asset allocation of the scheme is not known in advance, the investor has to accept the following uncertainties:

- He does not know how well the asset allocation will fit in his risk profile.
- He does not know whether his investment will be taxed as an equity scheme or a debt scheme.

## **8.7      *Asset Allocation Returns in Equity and Debt***

Let us look at how a portfolio with equal passive investment in equity and debt would have performed in the period since 1995-96.

For the evaluation, the returns discussed in Chapters 3, 4 and 5 are used. Thus, equity exposure is assumed to be in S&P CNX Nifty; debt portfolio is assumed to track the TRI returns. Costs and taxes are ignored.

### **8.7.1      *Fixed Asset Allocation with Annual Re-balancing***

As seen in Graph 8.1, Rs. 100 invested at the commencement of 1995-96 would have grown as follows:

Equity	Rs. 534.8
Debt	Rs. 594.2
50:50 mix of Equity and Debt	Rs. 680.5

### **8.7.2      *Flexible Asset Allocation***

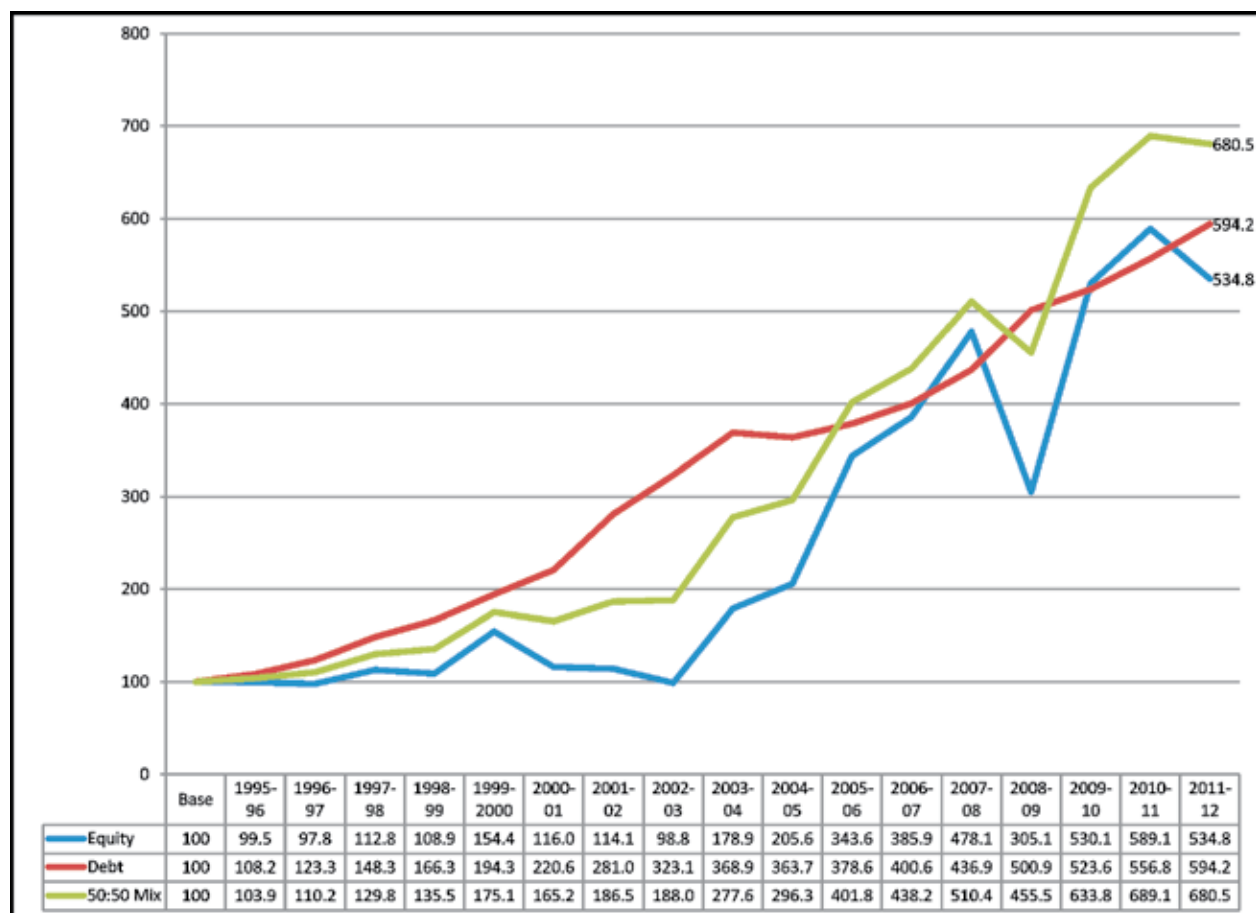
The results are shown in Graph 8.2. Rs. 100 invested at the commencement of 1995-96 would have grown as follows:

Equity	Rs. 534.8
Debt	Rs. 594.2
50:50 mix of Equity and Debt	Rs. 564.5

The 50:50 mix performance is between the performance of the two asset classes. It is distinctly lower than in the case of fixed asset allocation with annual re-balancing. The merits of re-balancing are obvious.

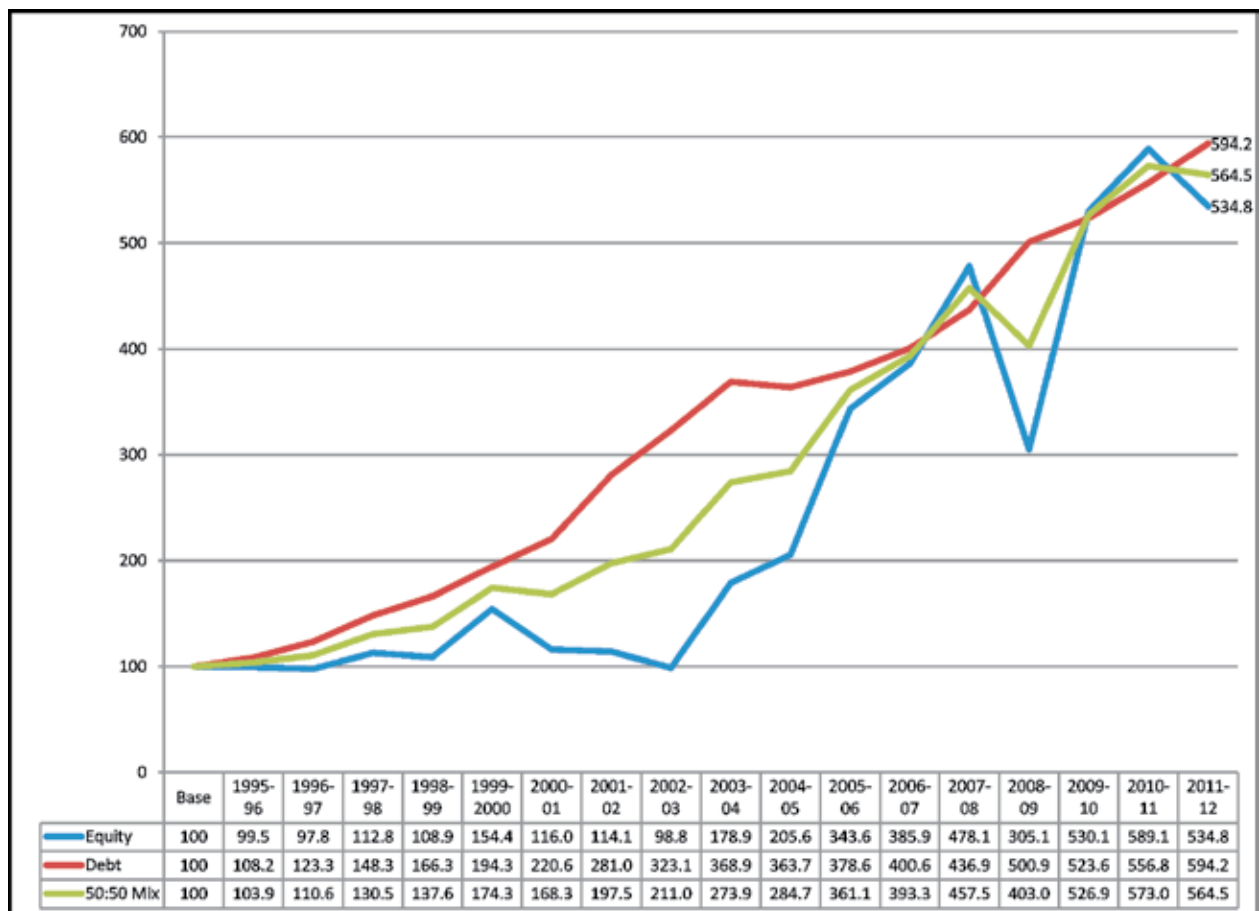
Graph 8.1

**Fixed Asset Allocation (Equity & Debt) - Annual Re-balancing**



Graph 8.2

### ***Flexible Asset Allocation (Equity & Debt)***



## **8.8 Asset Allocation Returns in Equity, Debt and Gold**

Let us now extend the discussion, by including gold. The portfolio now has an equal mix of debt, equity and gold.

### **8.8.1 Fixed Asset Allocation with Annual Re-balancing**

The results are shown in Graph 8.3. Rs. 100 invested at the commencement of 1995-96 would have grown as follows:

Equity	Rs. 534.8
Debt	Rs. 594.2
Gold	Rs. 551.2
One-third each in Equity, Debt & Gold	Rs. 680.8



### 8.8.2 Flexible Asset Allocation

As seen in Graph 8.4, Rs. 100 invested at the commencement of 1995-96 would have grown as follows:

Equity Rs. 534.8

Debt Rs. 594.2

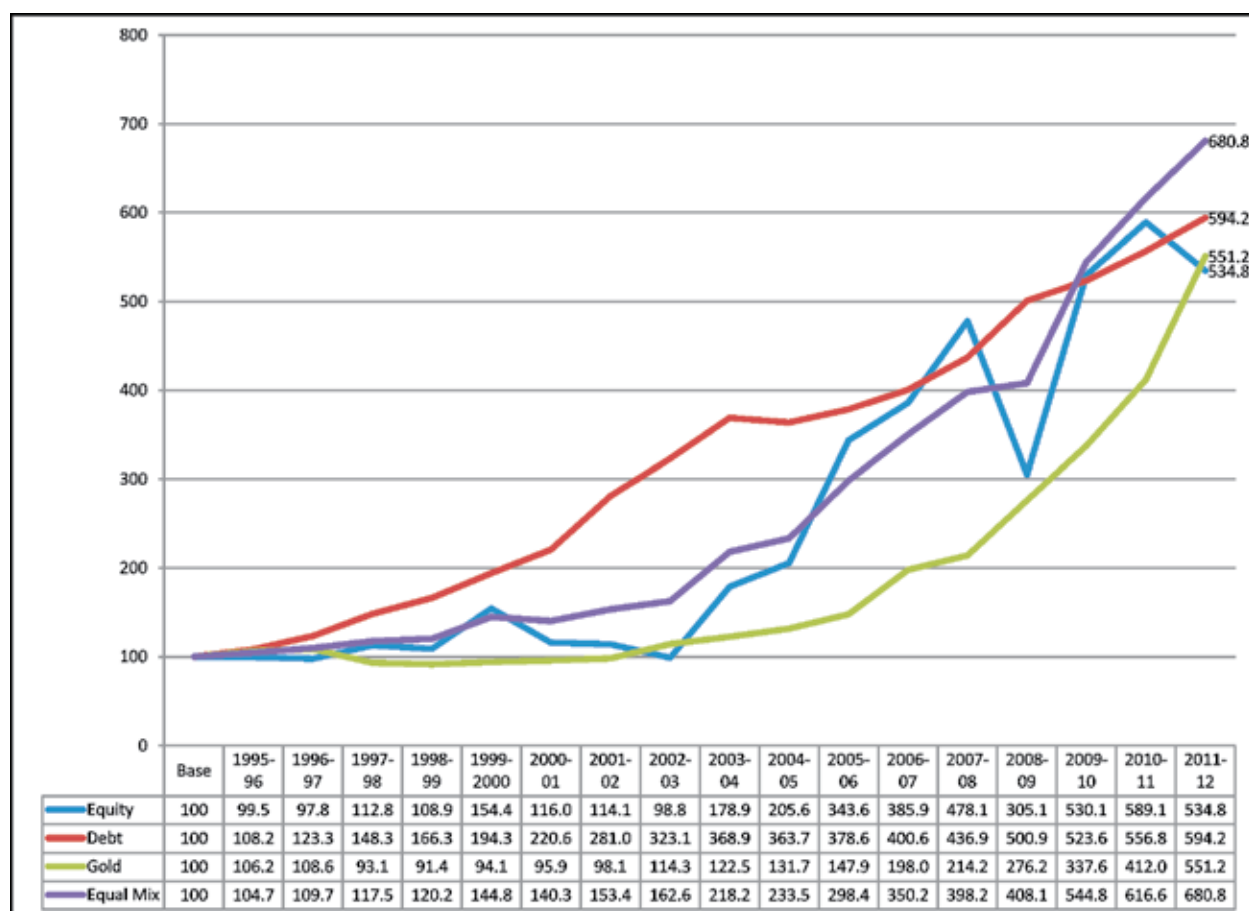
Gold Rs. 551.2

One-third each in Equity, Debt & Gold Rs. 560.0

Asset allocation helped even when the illustrated was extended to three asset classes. The utility of re-balancing is visible too.

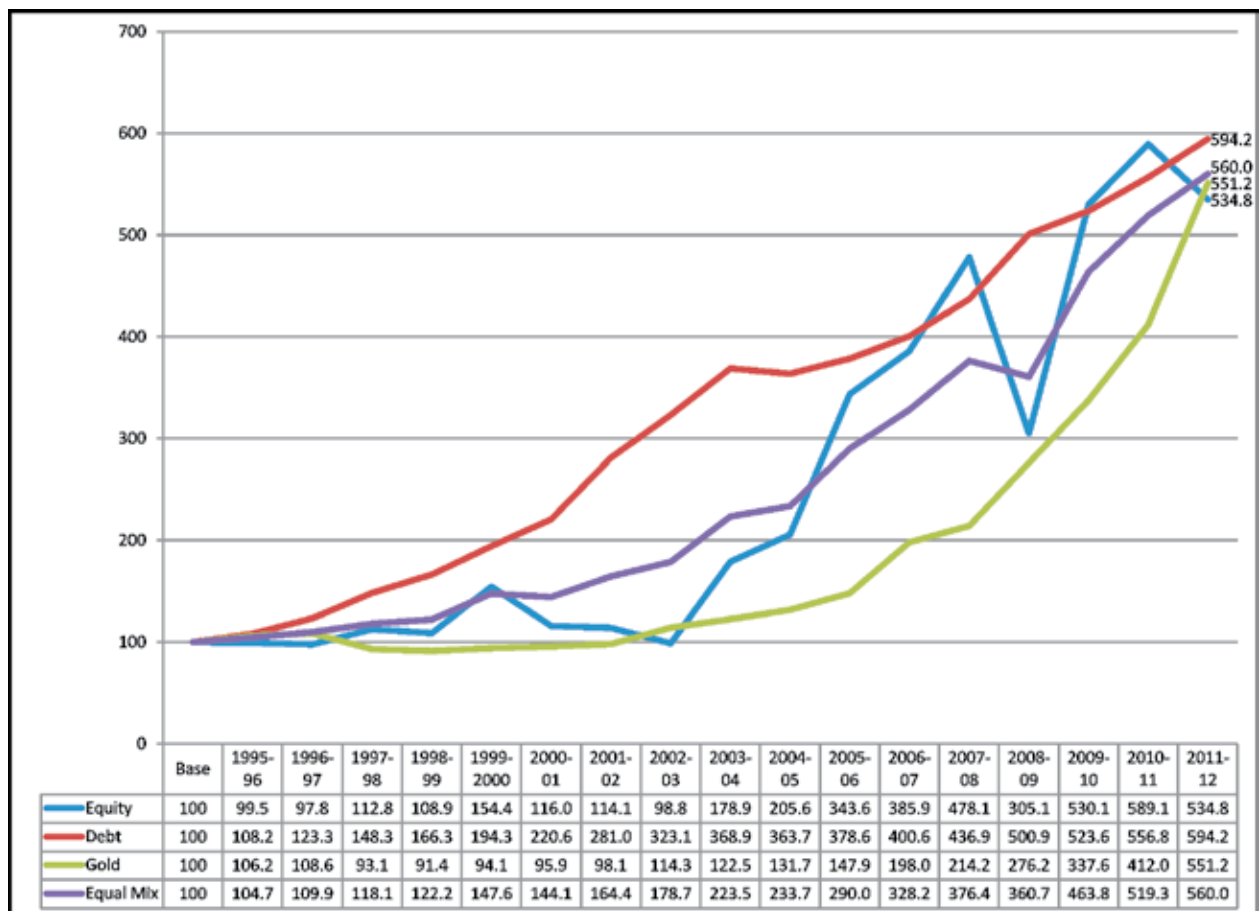
Graph 8.3

#### Fixed Asset Allocation (Equity, Debt&Gold) - Annual Re-balancing



Graph 8.4

### ***Flexible Asset Allocation (Equity, Debt& Gold)***



## ***8.9 Allocation to Speculation***

Speculation is a risky approach to building wealth. It is therefore advisable that investors put limits on the speculative element in their portfolio. Even for risk-oriented investors, speculative investments should not go beyond 10-15% of the portfolio.

## ***8.10 Diversification in Perspective***

Distribution investments between asset classes, is one aspect of diversification in the investor's portfolio.

Within an asset class, one sees further diversification. For instance,

- The equity component would be largely invested in diversified large cap equity funds or a basket of frontline stocks representing multiple industries. The risk oriented investors may choose to invest in some sector funds.

- The debt component is invested in fixed deposits or debt funds. The fixed deposits in turn are invested in a range of banks or companies. Most debt funds invest in companies from a range of sectors.
- Extremely wealthy investors may invest in precious metals beyond gold. Silver, platinum and palladium are possibilities.
- Investors can spread their real estate exposure in more than one city. Some may even have real estate in many countries.

Having decided on the distribution within an asset class, the investor selects specific investment vehicles. For example:

- Direct investment or investment through mutual funds, private equity funds or venture capital funds;
- Within mutual funds, which specific scheme of which mutual fund.

Wealthy investors thus build in several levels of diversification within their portfolio.

Finally, within mutual fund schemes, a decision is taken on the option to select viz. dividend payout, dividend re-investment or growth. Choice of option is not an asset allocation decision. It is discussed in Chapter 11.

## Self-Assessment Questions

- ❖ Risk taking ability goes down as the number of dependents increases.
  - **True**
  - False
  
- ❖ Asset allocation based on risk profile is
  - Tactical asset allocation
  - **Strategic asset allocation**
  - Fixed asset allocation
  - Flexible asset allocation
  
- ❖ Fixed asset allocation does not entail portfolio re-balancing
  - True
  - **False**
  
- ❖ Flexible asset allocation schemes help investors benefit from swings in returns between asset classes.
  - **True**
  - False
  
- ❖ A large percentage of any investor's equity exposure should be to -
  - Sector funds
  - Banking stocks
  - Stocks of food companies
  - **Diversified mix of large cap stocks**
  
- ❖ Choice of option within a MF scheme has a major impact on asset allocation.
  - True
  - **False**

# Chapter 9 Risk Management through Insurance

## 9.1 Risk Assessment

A wealth manager has to assess the risks to which the client is exposed to, and suggest suitable products to mitigate those risks. The following insurance products are available for risk mitigation:

- o Life insurance policies, to protect the family from the financial consequences of demise of the assured
- o Health insurance policies to cover medical expenses that the client may have to incur on self or family
- o General insurance for protection against loss of assets through fire, theft, earth quake, terrorism and such other exigencies.

## 9.2 Life Insurance

While policies are sold under various names, broadly a policy is either a pure insurance plan or a savings-cum-insurance plan. Insurance premium may be payable only one-time (single premium policy) or regularly over the life of the policy.

Pure insurance policies are also called term plans. They cover the life of the assured for a fixed period of 5 to 30 years. In the event of death of the assured, the policy amount is payable by the insurer to the family of the deceased. If the assured survives the term of the policy, then nothing is payable by the insurer.

Term plans offer life insurance cover at the lowest premium. Younger the age at which the assured buys the policy, lower would be the premium.

Savings-cum insurance plans are also called cash value plans. They may be offered as 'with bonus' or 'without bonus'. If the policy is 'with bonus', then the policy-holder's account will be credited with a bonus every year, subject to profitability. The bonus will be paid to the policy-holder if he survives the term of the policy, or to the family if the policy-holder passes away. The premium payable is higher on 'with bonus' plans.

Cash value plans come under different structures with varying mixes of savings and insurance.

- Endowment plans are typically used for covering long term financial planning goals such as child's education or marriage. In the event of death of the assured, the policy amount

is received by the family. If the assured survives the policy period, then an agreed endowment is paid.

- Whole life plans offer cover for the entire life of the assured. Policy amount is payable to the family on death of the assured. Depending on the terms of the policy, the assured has to pay premium for 35 years or until he attains the age of 80, whichever is later.
- Money-back plans offer the assured the benefit of some money being paid back by the insurer at regular intervals during the policy period. For example, 20% of the policy amount may be paid every 5 years in a 20 year policy. In the event of death during the policy period (of say, 20 years), the entire policy amount would be payable by the insurer.
- Mortgage redemption plans are linked to mortgage loans that the assured may have availed. They protect the family of the assured, in the event of death of the assured. The family does not have to repay the loan to retain the property. The policy amount will cover the amount payable by the assured as on the date of demise.

Over the life of the loan, the outstanding amount will reduce with each equated monthly instalment. The cover offered by the mortgage redemption plan also keeps reducing accordingly.

The premium on a mortgage redemption plan can be quite attractive, especially when the mortgage financier works out special arrangements with an insurer.

- Unit linked insurance plans (ULIP) offer the facility to investors to decide how the savings component should be invested. Out of the premium paid, a certain percentage is appropriated by the insurer for the risk cover and expenses. The balance is invested. As in a mutual fund scheme, the policy-holder can choose between portfolios. The insurer announces the NAV from time to time.

These were primarily investment vehicles with some insurance offered. The insurance regulator has however taken steps to enhance the role of insurance in such products.

Insurers assess the need for insurance based on the human life value. For instance, if the client is earning Rs. 10 lakh p.a., the adviser may suggest insurance cover of 20 times that amount viz. Rs. 2 crore.

Using MS Excel spread sheets, it is possible to refine the insurance need calculations by relating it to the cash flow needs of the client.

Term plans are critical in situations where cash flow constraints affect the premium paying ability, and thus limit the cash value plans that the client can buy. Even if affordability is not

an issue, investors are advised to go for a judicious mix of term plans and cash value plans, because the latter can be quite costly.

Professional investors prefer insurance only to the extent it covers risk. The lower cost structure makes them opt for other investment products for their investment needs.

### **9.3      *Health Insurance***

Given the ever increasing medical costs and ever widening range of ailments, every family should have medical insurance. The policy may be cashless or re-imbursment. The cashless policy works better because the individual does not need to pay the hospital. With a re-imbursment policy, the individual needs to pay the hospital and then file a claim for re-imbursment. This takes time, and comes with the risk of the insurer rejecting the claim or reducing it substantially.

A range of medical insurance policies are available with different mixes of ailments covered or not covered. Similarly, there are differences in the extent to which domiciliary treatment or tests are covered. The person should thoroughly understand the policy conditions and keep in mind the family history of ailments before buying a policy.

Some people are covered by medical re-imbursment schemes of their employers. They need to get into details of what is covered and what is not. Some employers limit the number of family members covered. Most employer schemes come with a limit. Medical insurance policies should be taken to get over any limitations of the employer's schemes.

Employer's medical re-imbursment schemes rarely cover medical expenses post-retirement. At that age if medical insurance policy is taken, pre-existing illnesses at that stage would not be covered. There is also the risk of the insurer rejecting claims on grounds of pre-existing illness. Therefore, taking a medical insurance policy early helps. It also takes care of situations when a person is without a job. Some policies can be extended to cover domestic helps and drivers.

### **9.4      *General Insurance***

Exigencies like fire or theft or floods can completely destroy the wealth that the person builds. Insurance against such events offer peace of mind at a nominal cost. It is also possible to get cover against terrorism.

It is important to understand what is not covered, before the policy is taken. Damage arising out of terrorism or riots may not be covered in the policy. Depending on where the person stays, it may be better to buy a rider, which will extend the coverage of the policy to such events.

Motor insurance to cover third parties is mandatory. Motor repair costs arising out of accidents can be quite steep. In some cities, there is also the risk of floods affecting the car. Motor insurance policies can offer effective protection in such situations.

Insurance premia goes down, when the insurance buyer agrees to bear part of the costs in a claim. Such possibilities should be explored to balance the medical insurance premium payable.

## **9.5      *Safeguards in Insurance***

While insurance offers a lot of protection, the insurance buyer should be watchful about the following:

- Choice of insurer

The claims re-imbbursement record of the insurer is available in the websites of the insurer. One can also ask around with insurance advisers, family and friends. It is better to avoid insurers who have a poor claim re-imbbursement track-record.

- Choice of policy

Slick insurance sellers can sell insurance policies that are worthless for the buyer. Therefore, the buyer should make a comprehensive list of the risks against which he wants coverage. He has to ensure that the policy provides the requisite coverage. He should also check that there are no important exclusions or inconvenient conditions attached to the policy.

- Choice of rider

Riders help the buyer extend the coverage of the policy at a cost. But riders come with a cost. The buyer should compare the total cost of the basic policy plus the cost of riders on a policy, with alternate policies where the same risk may be covered by the basic policy, without the need for riders.

- Documentation

At the stage of buying the insurance itself, the buyer should be perfect on documentation. He should retain a copy of the filled application form, rather than leave it in the hands of the adviser.

When the insurance policy is delivered, it is important to go through the important clauses to ensure they are in line with what was purchased. Policies have a free look in period during which they can be returned and the premia will be paid back by the insurer.

Insurers do reject claims on account of minor clerical errors made while filling the application form or even in the insurance policy issued by the insurer.



Similarly, care should be exercised while filling the claims with the insurer. The wording used in the claim form can become a ground for the insurer to reject the claim entirely or significantly. Good insurance advisers help clients through the entire claims process. The insurance buyer should consider buying insurance only through advisers who have a reputation for offering such support.

## Self-Assessment Questions

- ❖ A wealth manager need not look at insurance requirements of the client, because it is not part of the wealth building exercise.
  - True
  - **False**
  
- ❖ Which of the following is a pure insurance product
  - **Term plan**
  - ULIP
  - Cash value plan
  - Money-back policy
  
- ❖ People covered by employer's medical re-imbursement schemes need not buy medical insurance policies.
  - True
  - **False**
  
- ❖ The coverage of an insurance policy can be extended through
  - Extensions
  - Add ons
  - Pluses
  - **Riders**
  
- ❖ General insurance provides protection against
  - Fire
  - Theft
  - Floods
  - **All the above**

# Chapter 10 Elements of Taxation

## **10.1 Previous Year and Assessment Year**

The 12-month period that starts on 1 April each year, and ends on 31 March in the following calendar year is the Assessment Year (AY).

Previous Year (PY) is the year in which the income is earned. It ends on 31 March preceding the assessment year.

For example, Assessment Year 2013-14 is the period between 1 April 2013 and 31 March 2014. Previous Year 2012-13 is the period between 1 April 2012 and 31 March 2013.

Income earned in PY 2012-13 is taxable in AY 2013-14.

## **10.2 Gross Total Income**

Income is taxed under the following heads:

- (a) Salaries
- (b) Income from House Property
- (c) Profits & Gains of Business and Profession
- (d) Capital Gains
- (e) Income from Other Sources

The sum of these heads of income for an assessee in a previous year is the Gross Total Income for that year. It is taxable in the assessment year that follows.

## **10.3 Income Tax Slabs**

The slabs applicable for AY 2013-14 for different types of assessee are shown in Table 10.1.

## **10.4 Advance Tax**

Although income is assessable to tax only in the assessment year, the income tax law provides for payment of estimated tax in advance, where the advance tax payable by an assessee is more than Rs. 10,000. The due dates for advance tax are shown in Table 10.2.

Senior citizens not having income from business or profession do not have to pay advance tax.

The assessee can claim credit for the advance tax paid, while paying tax based on self-

assessment in the assessment year.

Table 10.1

**Income Tax Slabs (AY 2013-14)**

Investor Type	Taxable Income		Basic Rate	Surcharge	Ed. Cess	Sec. & H EC	Marginal Rate
Individuals (Other than Specified Individuals) & HUF, Association of Persons, Body of Individuals, Artificial Juridical Persons	Upto	2,00,000	0%	0%	0%	0%	0.00000%
	2,00,001	5,00,000	10%	0%	2%	1%	10.30000%
	5,00,001	10,00,000	20%	0%	2%	1%	20.60000%
	Over	10,00,000	30%	0%	2%	1%	30.90000%
Specified Individuals - Indian Residents above 60 years of age, but less than 80 years of age at any time during the financial year	Upto	2,50,000	0%	0%	0%	0%	0.00000%
	2,50,001	5,00,000	10%	0%	2%	1%	10.30000%
	5,00,001	10,00,000	20%	0%	2%	1%	20.60000%
	Over	10,00,000	30%	0%	2%	1%	30.90000%
Specified Individuals - Indian Residents above 80 years of age at any time during the financial year	Upto	5,00,000	0%	0%	0%	0%	0.00000%
	5,00,001	10,00,000	20%	0%	2%	1%	20.60000%
	Over	10,00,000	30%	0%	2%	1%	30.90000%
Partnership Firm	Upto	1,00,00,000	30%	0%	2%	1%	30.90000%
	Over	1,00,00,000	30%	5.0%	2%	1%	32.44500%
Co-operative Society	Upto	10,000	10%	0%	2%	1%	10.30000%
	10,001	20,000	20%	0%	2%	1%	20.60000%
	Above	20,001	30%	0%	2%	1%	30.90000%
Domestic Company	Upto	1,00,00,000	30%	0%	2%	1%	30.90000%
	Over	1,00,00,000	30%	5.0%	2%	1%	32.44500%
Foreign Company	Upto	1,00,00,000	40%	0%	2%	1%	41.20000%
	Over	1,00,00,000	40%	2.0%	2%	1%	42.02400%

Table 10.2

**Due Dates for Advance Tax**

	Corporate Assessee	Others
On or before June 15 of previous year	Up to 15% of advance tax payable	-
On or before September 15 of previous year	Up to 45% of advance tax payable	Up to 30% of advance tax payable
On or before December 15 of previous year	Up to 75% of advance tax payable	Up to 60% of advance tax payable
On or before March 15 of previous year	Up to 100% of advance tax payable	Up to 100% of advance tax payable

**10.5 Tax Deducted at Source (TDS)**

TDS is aimed at plugging leakage of income of the government. The person making payments above a specified value has to deduct tax and pay only the net amount to the beneficiary.

The tax deducted has to be deposited with the government, on behalf of the beneficiary. The person making the deduction also has to provide relevant details to the tax authorities, including Permanent Account Number (PAN) of the beneficiary.

The person deducting the tax also provides the requisite TDS details to the beneficiary. Based on this, the beneficiary, while filing tax returns in the assessment year, can claim credit for the TDS already deposited. The beneficiary has to pay only the remaining tax i.e. Amount payable = Tax Payable (based on self-assessment by the beneficiary) minus TDS – Advance Tax.

Non-resident investors might have to bear withholding tax, which will reduce the amount they receive from the scheme as dividend or re-purchase amounts. They can however take the benefit of Double Taxation Avoidance Agreements, if India has signed such an agreement with the country of their residence. In that case, deduction will be at the agreement rate.

In his country of residence, the investor may be able to claim a rebate for the withholding tax.

## **10.6 Exempted Income**

The Income Tax Act has provided that certain incomes are exempt from tax. Accordingly, the assessee does not have to include in Gross Total Income or pay tax on such income. The list of exempted incomes includes:

- Agricultural income
- Interest from Tax-free Bonds
- Gratuity, subject to limits

## **10.7 Deductions from Income**

The Income Tax Act allows certain deductions to be made from Gross Total Income, for the purpose of assessing the tax payable. These include:

### **10.7.1 Section 80C**

Some of the investments that qualify are as follows:

- Life insurance premia (upto 10% of sum assured)
- Contributions to statutory provident fund, recognised provident fund or public provident fund
- Payment for non-commutable deferred annuity
- Subscriptions to National Savings Certificates (including interest which is re-invested each year)
- Subscription to Equity Linked Savings Schemes of mutual funds
- Tuition fees paid to any university, college or educational institution in India for full time education of upto two children

- Payment towards cost of purchase / construction of a residential property.
- Repayment of loan taken for purchase or construction of residential property from government, bank, LIC, National Housing Bank or employer fulfilling specified criteria
- Investment in in specified debentures and equity shares in a public company engaged in infrastructure business, or units of a mutual fund where proceeds are to be used for developing or maintenance of a new infrastructure facility
- Subscription to notified bonds of NABARD
- Amount deposited in Senior Citizens Savings Scheme
- Deposits in specified 5-year deposits of scheduled bank or 5-year time deposit with post office

The deduction is available to individuals and Hindu Undivided Families (HUF), limited to Rs. 1lakh in a previous year (including deduction under Section 80CCC and Section 80CCD

#### **10.7.2 Section 80CCC**

Investments by individuals in specified annuity plans of insurance companies can be claimed as a deduction

#### **10.7.3 Section 80CCD**

Individuals contributing to the National Pension Scheme can claim deduction upto:

- 10% of salary (Basic and DA), in the case of individuals who are employed.
- 10% of Gross Total Income, in the case of the self-employed.

#### **10.7.4 Section 80D**

Deduction up to Rs. 15,000 is available for medical insurance premium paid by individual or HUF. An additional Rs. 5,000 can be deducted if the policy is taken on the health of an Indian resident who is over 60 years of age.

#### **10.7.5 Section 80E**

Interest on specified loans taken for financing the full-time higher education (post-Senior Secondary Examination) of self or spouse or child or any student for whom the individual is legal guardian can be deducted. Starting from the year in which repayment starts, the benefit is available for 8 years or until the loan is fully repaid.

### **10.7.6 Section 80GG**

This deduction covers rent paid by the assessee. The minimum of the following is available as deduction:

- Rs. 2,000 p.m.
- 25% of the Gross Total Income of the tax payer after specified deductions

The deduction is further subject to the following conditions:

- The assessee should be self-employed or salaried and not receive any house rent allowance
- The person or spouse or children should not own any other residence in the place of residence

### **10.8 Long Term and Short Term Capital Gain / Loss**

The tax treatment varies depending on whether capital gains or losses are long term or short term.

Most capital assets need to be held for more than 3 years for the capital gain or loss to qualify as long term. However, a shorter holding period of more than 1 year is specified for shares, debentures and mutual fund units.

### **10.9 Speculation Profit / Loss**

If gains or losses arise out of "speculation business" it is treated as speculation profit / loss.

### **10.10 Capital Gains Tax exemption under Section 54EC**

Long term capital gains of any assessee are exempted if invested in specified bonds. Exemption is available upto Rs. 50 lakh in any previous year.

Investment has to be made within 6 months of booking the capital gain. The bonds will have to be held for 3 years.

### **10.11 Capital Gains Tax exemption under Section 54F**

This exemption is available only for individuals and HUF. Long term capital gains are exempt from tax if the entire sale proceeds are invested in residential house property (new house). In case part of the sale proceeds are invested, then the benefit is proportionately reduced.

The new house has to be purchased within 1 year before or two years after; or constructed within three years after the original asset is transferred. Further, the new house has to be held for at least 3 years.

### ***10.12 Setting Off & Carry Forward***

The Income Tax Act allows certain losses to be set off against gains for the purpose of tax calculations. Further, if in any year the assessee has losses, then these can be carried forward to future years so that they can be set off against future income. The following rules govern this:

- Speculation loss can only be set off against speculation profits.
- Unabsorbed speculation loss can be carried forward for 4 years.
- Capital loss cannot be set off against any other income – only against capital gains.
- Short term capital loss can be set off against short term gain or long term gain.
- Long term capital loss can be set off only against long term capital gain - not against short term capital gain.
- Where long term capital gains are exempt from tax (shares and equity mutual fund schemes), long term capital losses are not available for set off.
- Unabsorbed capital losses can be carried forward for 8 years.



## Self-Assessment Questions

- ❖ Assessment Year is necessarily April to March
  - **True**
  - False
  
- ❖ Advance Tax is payable by corporate assesseees in \_\_\_\_ instalments in a year
  - 2
  - 3
  - **4**
  - 6
  
- ❖ The limit for section 80C deduction is
  - **Rs. 1 lakh**
  - Rs. 70,000
  - Rs. 60,000
  - Rs. 2 lakh
  
- ❖ Person above 80 years of age does not pay tax on income upto
  - Rs. 2 lakh
  - Rs. 2.5 lakh
  - **Rs. 5 lakh**
  - Rs. 10 lakh
  
- ❖ Section 54F exemption is available only to individuals and HUF.
  - **True**
  - False

# Chapter 11 Taxation of Investment Products

## 11.1 Dividend Tax / Tax on Income Distributed by Mutual Fund

Dividend tax is applicable on the dividend that a company distributes at 15% (basic rate). Including surcharge and education cess, the “quoted rate” works out to  $15\% \times 1.05 \times 1.03$  i.e. 16.2225%.

Since the tax is on the amount **distributed**, if Rs. 16.2225 has been paid as tax, then Rs. 100 would have been distributed to the investor. Thus, the dividend tax of Rs. 16.2225 relates to “gross” dividend of Rs. 100 + Rs. 16.2225 i.e. Rs. 116.2225. Thus, the “effective rate” of dividend tax is  $\text{Rs. } 16.2225 \div \text{Rs. } 116.2225$  i.e. 13.958% (rounded to 3 decimals).

The deduction is not in the nature of TDS. Therefore, the investor cannot claim a credit for, or seek refund of the amount, in his income tax returns. However, the dividend received by the investor is not liable to any tax in his hands.

Similarly, tax is applicable on income distributed by debt mutual fund schemes. The rates are given in Table 11.1.

Table 11.1

### **Rates of Tax on Income Distributed by Mutual Funds**

	Basic	Quoted	Effective
Equity Schemes	-	-	-
Debt Schemes – Investors other than individual or HUF	30%	32.445%	24.497%
Liquid Schemes – Investors who are individual or HUF	25%	27.0375%	21.283%
Liquid Schemes – Investors other than individual or HUF	12.5%	13.51875%	11.909%

Note -Effective rates have been rounded off in the table

## 11.2 Securities Transaction Tax (STT)

STT is applicable on transactions in equity shares, equity derivatives and equity mutual fund schemes at the following rates:

Delivery-based purchase of equity shares or units of equity oriented funds in a recognized stock exchange	0.10% of value of shares or units bought
-----------------------------------------------------------------------------------------------------------	------------------------------------------

Delivery-based sale of equity shares or units of equity oriented funds in a recognized stock exchange	0.10% of value of shares or units sold
Non-delivery-based sale of equity shares or units of equity oriented funds in a recognized stock exchange	0.025% of value of shares or units sold
Sale of Derivatives (Futures) in a recognized stock exchange	0.017% of trade value
Sale of Derivatives (Options) in a recognized stock exchange	0.017% of the sum of strike price and premium
If the option is exercised, the purchaser would need to pay	0.125% of value of shares bought
Sale of units of equity oriented fund to the mutual fund	0.25% of value at which units are sold (i.e., re-purchased from investors)

### **11.3 Capital Gains Taxation**

Mutual fund schemes, being a pass-through vehicle, are exempted from capital gains taxation. However, investors in securities (including units of mutual fund scheme) are taxed as follows:

- o Long term capital gain on equity shares and mutual fund equity schemes is exempt, if STT is paid on the sale transaction.

If STT is not paid, then the taxation will be like debt investments.

- o Short term capital gain on equity shares and mutual fund equity schemes is taxed at 15%, if STT is paid on the sale transaction.

Further, if taxable income exceeds Rs. 1 crore, surcharge is applicable at 5% for domestic companies and 2% for non-domestic companies.

In addition, 2% towards education cess and 1% towards secondary and higher education cess are applicable to all investors (including those with taxable income below Rs. 1 crore).

If STT is not paid, then the taxation will be like debt investments.

- o Short term capital gains from debt are added to the income of the investor. Thus, taxation would depend on the slab rate of the investor.
- o In the case of long term capital gains from debt, resident investors have the benefit of indexation. They can choose between the following:
  - 10% plus surcharge plus education cess

For example, if 100 units were bought at Rs20 and sold at Rs25, capital gains tax would be payable on Rs5 X 100 units i.e. Rs500 at 10% plus surcharge plus

education cess. Thus, the capital gains tax, under this method, would be Rs50 plus surcharge plus education cess.

- 20% plus surcharge plus education cess on capital gains that are reduced to the extent of indexation.

Indexation is a facility given to the investor to adjust the acquisition cost of his investment to the extent of inflation. Suppose the government declares an inflation index of 500 for the financial year in which the investment is acquired, and 550 for the financial year in which the investment is sold. This amounts to an inflation of 10%.

In the above example, the adjusted acquisition cost would therefore become Rs20 + 10% i.e. Rs22. Long term capital gains would be Rs25 minus Rs22 i.e. Rs3 per unit.

Capital gains tax would be calculated on Rs3 X 100 units i.e. Rs300 at 20% plus surcharge plus education cess. Thus, the capital gains tax, under this method, would be Rs60 plus surcharge plus education cess.

The investor will opt for the first method, where the tax is lower.

## **11.4 Taxation of Fixed Deposits and Fixed Maturity Plans**

### **11.4.1 Fixed Deposits**

Suppose an investor invested Rs. 10,00,000 in a fixed deposit earning 10% interest p.a. Annual interest will be Rs. 100,000. Net of TDS at 10%, the investor will receive Rs. 90,000.

Depending on the tax rate of the investor, the investor may have to incur further tax as follows:

<i>Slab Rate</i>	<i>Tax + Cess</i>	<i>Tax payable on interest</i>	<i>TDS</i>	<i>Additional Tax payable</i>	<i>Net Income</i>
10%	10.30%	10,300	10,000	300	89,700
20%	20.60%	20,600	10,000	10,600	79,400
30%	30.90%	30,900	10,000	20,900	69,100

### **11.4.2 Fixed Maturity Plans (FMP)**

Fixed maturity plans are close-ended schemes that seek to eliminate market risk by investing in debt securities of the same tenor as the tenor of the scheme.

Suppose an investor invested Rs. 10,00,000 in a FMP which in turn invested in a debt security. If the FMP is of 3 years, then during the 3 years the scheme does not pay a tax on its interest income. By re-investing annual interest on gross basis, the investor can have a higher amount on maturity of the scheme.

If the investor opts for the dividend option, then income distribution tax would be applicable. As seen earlier, the effective rate of income distribution tax for investors who are not individual or HUF is 24.497%, which is much lower than the normal corporate tax rate of 30.9% (if taxable income is below Rs. 1 crore) or 32.445% (if taxable income is above Rs. 1 crore).

For individuals and HUF, the effective rate of income distribution tax for non-liquid schemes is 11.909%. This is much lower than the normal tax rate for investors who are in the 20% or 30% income tax slabs.

Investors may be able to avoid even this levy by avoiding the dividend option. They can opt for growth option, and recover their moneys through re-purchase of units by the scheme. Through indexation, they may be able to avoid income tax completely on the capital gain.

Thus, FMPs are a tax-efficient investment option.

### ***11.5 Dividend and Growth Options in Mutual Fund schemes***

Mutual fund schemes give investors the option to receive or not to receive dividend by selecting the relevant option. This facility is not available for direct investment in a company.

Since there is no income distribution tax on equity schemes, investors can opt for dividend option in such schemes. Every dividend payment reduces the NAV of the scheme, and therefore the capital gains.

Long term capital gains is exempt; but if the investment is sold within a year, the investor needs to incur short term capital gains tax. This is minimised in the dividend option.

Choice of growth option helps investors avoid income distribution tax that is levied on debt schemes. This is particularly attractive for investors in debt schemes who are in the nil or 10% tax bracket (or even 20% tax bracket, for investments in liquid schemes). Short term capital gains will be added to their income and taxed at lower rates. They can benefit from indexation if it becomes long term capital gain.

Investors in the higher tax bracket may choose dividend option and incur income distribution cost, which is lower than their effective slab rates. This is particularly applicable if they are not sure if the investment will be held for the long term, and therefore the indexation benefit is not certain.

### ***11.6 Wealth Tax***

Wealth tax is payable by individuals, HUF and companies on their net wealth that is in excess of Rs. 30 lakh. Net wealth is calculated as assets minus liabilities. The following assets are taxable:

- Guest house, residential house or commercial building (one house or plot of land not

exceeding 500 square metres is exempt for individuals and HUF)

- Motor cars
- Jewellery, bullion, utensils of gold, silver etc.
- Yachts, boats and aircraft
- Urban land
- Cash in hand (uptoRs. 50,000 is exempt for individuals and HUFs)

Indian assesseees, who are resident in India have to pay tax on their wealth in India and abroad. Non-residents and individuals who are foreign nationals are exempt from wealth tax on their net foreign wealth.

Net wealth is to be calculated as on March 31 immediately preceding the assessment year. Assessment year is the period of 12 months starting April 1 each year, immediately following the previous year.

Wealth tax is payable at 1% on the net wealth.

## Self-Assessment Questions

- ❖ When a company distributes dividend to an individual, dividend tax is not applicable.
  - True
  - **False**
  
- ❖ STT on purchase of equity shares in the stock exchange is
  - Nil
  - **0.1%**
  - 0.2%
  - 0.25%
  
- ❖ Minimum holding period for long term capital gains in the case of units of debt mutual fund schemes is
  - **1 year**
  - 2 years
  - 3 years
  - 5 years
  
- ❖ Investors in the lower tax bracket should prefer dividend option in the case of investment in debt schemes
  - **True**
  - False
  
- ❖ FMPs pay tax on their interest income each year
  - True
  - **False**

# Chapter 12 Estate Planning

## **12.1 Background**

The estate of most people will comprise a mix of assets and liabilities. Ensuring orderly transfer of his own estate to the next generation is every person's moral obligation, though not a legal obligation. This is best achieved through an estate plan - a plan for what should be done to the person's estate when he is no more.

The financial adviser, being an independent professional, is in the best position to advise the client to prepare an estate plan. He should attempt the discussion only when a high-trust relationship is established with the client. Such a relationship might take several years to forge.

There are times when the client may approach the financial adviser for an estate plan. On such occasions, the adviser should seek to understand the client's family structure, the financial position of every close family member and the emotional relationship between the client and every such family member.

The client has complete discretion to decide on his estate plan. However, the adviser should point out the need to provide adequately for family members who are minors, women or financially weak. If reasonable provision is not made for adult financially weak family members (especially women), and the client does not document any strong reasons for such an estate plan, courts may change the estate plan in case of litigation.

## **12.2 Assets & Liabilities**

The starting point for any estate plan is a listing of assets and liabilities. The ownership of these assets and the extent of known liabilities should be independently verified with the parties concerned. The ownership pattern viz. self, as compared to spouse or joint ownership is material.

The adviser should check on mortgage of assets and any conditions that limit free marketability or tax considerations that limit complete encashment of value.

It is a good practice to record the source of finance for large assets, and application of funds in the case of liabilities.

Besides the amount borrowed, the lender and the purpose of the borrowing, details of interest rate, repayment date, any EMI and its frequency should be recorded. Any assets charged or guarantees given against the loan or any other conditions should also be recorded.



Such a listing and verification of assets and liabilities is a useful protection against genuine mistakes of the client or fraud that the client may be exposed to.

As part of the exercise, the adviser can also confirm if wealth tax is paid and wealth tax returns filed. The wealth tax return can be a starting point for the preparation of the statement of assets and liabilities.

### **12.3 Nomination**

Nomination is possible for a range of assets – demat accounts, bank accounts, fixed deposits, mutual fund units, flats in co-operative societies etc. This is the most common form of estate planning.

With most assets, the nominee is only a trustee for the beneficiaries of the estate. The bank or the company will pay the nominee when application is made with death certificate. However, close family members are potential beneficiaries of the estate of the deceased. The beneficiaries can claim their share from the nominee who receives the proceeds of the assets. Thus, the nominee has to hold the funds 'in trust' on behalf of the beneficiaries.

The rights of beneficiaries are governed by the inheritance law applicable to the deceased and any valid Will that may have been prepared by the deceased.

### **12.4 Inheritance Law**

If a person passes away without making a valid Will, he is said to have died intestate. In such cases, the personal law of the deceased determines the beneficiaries of the estate and their entitlements.

Hindus are governed by Hindu Succession Act, 1956. The act is also applicable for Buddhists, Sikhs and Jains.

The principles of Shariat govern inheritance in Muslims.

If there is no personal law for the religion of the deceased, the Indian Succession Act, 1925 is applicable. Christians, Jews and Parsis are covered by this law.

### **12.5 Will**

A Will ensures that the person can ensure bequeathing of wealth to his successors as per his wishes. The personal law will come into play only for assets that are not specifically mentioned in the Will.

While the Will is made when a person is alive, it comes into effect on his death. It is viewed as the last declaration of the deceased person.

The person who makes the Will is called 'testater'. A Will can be hand-written or typed. It does not need to be in legal language. Registration of Will is not compulsory, but advisable.

The Will has to be witnessed by two witnesses. There is no need for the witness to know the contents of the Will. They only need to confirm that the Will was signed by the testater in their presence. The witnesses should not be beneficiaries.

Since assets not covered in the Will are distributed as per the applicable inheritance law, the Will should include a clause for distribution of 'all other assets'.

It is advisable that the Will mentions one or more Executors. The job of an executor is to execute the Will on demise of the Testater. The Executor can be a beneficiary. It is not necessary to obtain Executor's signature on the Will, though it is better than his permission is taken. Even if a person's name is mentioned as Executor, he is entitled to refuse to act.

On the death of the testater, the Executor has to apply to court for Probate. The application has to be accompanied by copy of the Will with the confirmation of at least one of the witnesses mentioned in the Will, death certificate and statement of assets and liabilities.

Grant of probate acts as an authorization for the Executor to execute the Will. If no Executor is mentioned, or if the executor is unable or unwilling to act, Court can permit any beneficiary to execute the Will.

The testater can make as many Wills as he wishes. The latest Will prevails over the previous Wills. Minor changes in the Will can be effected by the testater mentioning these changes in a written signed document. Such a document of changes is called 'codicil'.

## **12.6 Trust**

An alternate format is to create a trust in which the assets are held. The trust deed will mention the beneficiaries and the distribution. The trust will have trustees who will act as per the trust deed. They will also be able to handle assets, issues and concerns not specifically covered in the trust deed.

The trust route ensures that inheritance does not go through the court process. This saves cost as well as time. Besides, the inheritance process can be handled with privacy.

Execution of Will comes with the risk of anyone objecting to it on various real or fictitious grounds. The trust structure ensures speedy execution of the Will without such problems.

Creation and maintenance of trusts however entail investment of time and money. Therefore, trusts are normally created only if the wealth of the person justifies the structure.

## Self-Assessment Questions

- ❖ \_\_\_\_\_ is in the best position to advise a person to make a Will
  - Son
  - Daughter
  - Daughter-in-law
  - **Financial Planner**
  
- ❖ Nominee is in the nature of a trustee
  - **True**
  - False
  
- ❖ Buddhists are covered by
  - **Hindu Succession Act, 1956**
  - Indian Succession Act, 1925
  - Shariat
  - Buddhist Succession Act, 1985
  
- ❖ \_\_\_\_\_ operates as the last declaration of the deceased person
  - **Will**
  - Probate
  - Succession certificate
  - Letter of administration
  
- ❖ Trust structures are normally appropriate only for the very wealthy
  - **True**
  - False

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