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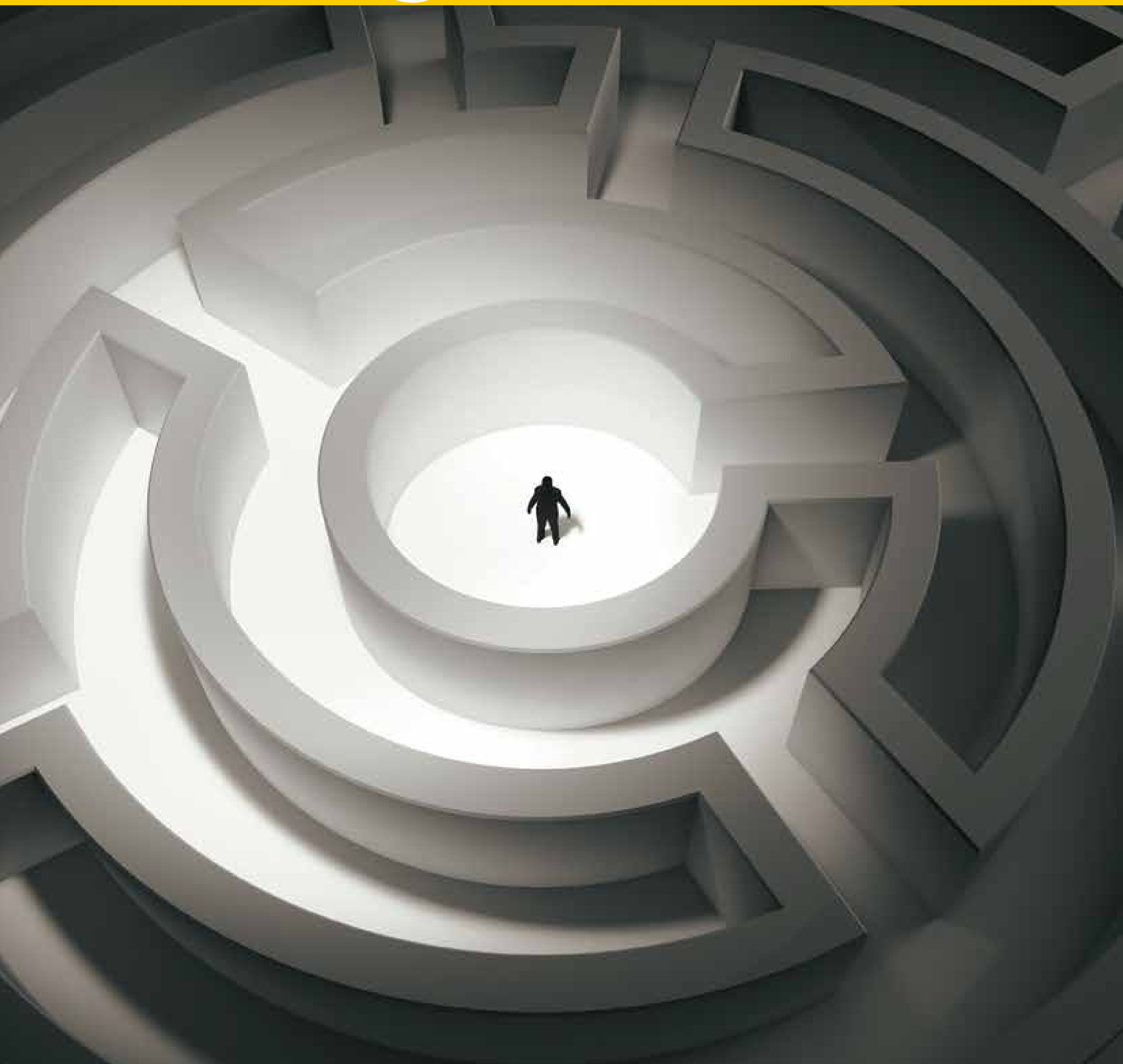
September - October, 2017

INVEST IN INVESTING



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From the
Editor's Desk

In today's complex financial environment, wayfinding may seem like an uphill struggle to most investors. The key to making prudent investment decisions is asking the right questions.

Why – The Purpose

The most important question is Why, which helps determine one's purpose for investing. To earn more money is not a good enough reason. You must understand why having more money is important to you.

How – The Path

The next question is How can you achieve your purpose? Here, I am distinguishing between achieving your purpose and accumulating greater wealth because earning more money doesn't necessarily mean you have achieved your purpose.

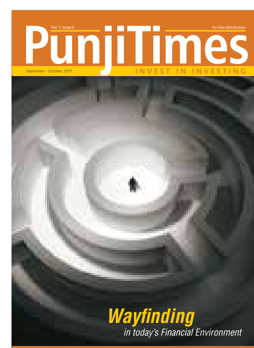
What – The Product

The next step is figuring out which investment product is right for you. Remember, the product is only the means to an end, and not the end itself. Focus on your purpose and the path, and the right product will follow.

This issue aims to educate readers on key topics such as asset allocation, compounding, benefits of investing in debt funds, human life value and hedging portfolio using derivatives. We hope you find this issue as refreshing and informative as the last one.

Best,

Tushar Goyal
Editor-in-Chief



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Snowballing Towards Prosperity

"Tis the stone that will turn all your lead into gold. Remember that money is of a prolific, generating nature. Money can beget money, and its offspring can beget more."

- Benjamin Franklin

A simple yet powerful concept, compounding is the foundation stone for long-term wealth creation. When you invest in a financial asset, compounding allows you to earn interest on not just the principal investment, but also on the interest that is re-invested periodically. It works on the principle of 'multiplier effect' where the interest earned on the initial capital further earns an interest, growing the value of the investment at a geometric (increasing) rate instead of an arithmetic (straight-line) rate.

HOW DOES COMPOUNDING WORK?

Let's say you make an annual investment of Rs. 1 lakh for 20 years. At an annual compound interest rate of 8%, your initial investment will grow to Rs. 50 lakhs over the 20 years. But at a rate of 10%, you would see the same investment grow to Rs. 63 lakhs. We see how a seemingly small 2% makes a difference of Rs. 13 lakhs to the final corpus. Imagine the benefits of compounding over a longer period or with a larger initial investment.

Compounding, a typically long-term investment strategy, is much like a snowball rolling down a slope, gathering more snow with each turn. Thus, when you invest in a mutual fund, compounding will earn interest on both the principal and re-invested earnings. In short, compounding generates a return on your returns, with your money growing faster as the years roll on. As your corpus grows, the magnitude of every incremental interest amount increases. Thus, the power of compounding can be significant over a long period of time.

START EARLY TO LEVERAGE THE POWER OF COMPOUNDING

On the surface, compounding may seem like a boring concept to mull over. You may wonder, "What does an 8% annual growth in a mutual fund matter? Why do I need to start investing now?"

In the short-term, it really doesn't make much of a difference. But the short-term fades in comparison to the bigger picture – how your corpus grows over the course of the next 20-30 years. On the slow, steady path to wealth, a focus on long-term goals is the best strategy an investor can adopt.

Let's understand the power of compounding through another example. Say, you want to make a provision for your infant's higher education overseas. You have about 18 years of time to save for the event. Let's assume the cost of tertiary education would be close to Rs. 2 crore at the time. Assuming an annual expected return of 15%, all you'd need

to save each month is Rs. 20,000. By the end of 18 years, you would have invested Rs. 43.2 lakhs which, due to the power of compounding, would have snow balled into approximately Rs. 2.2 crore!

The idea is, the earlier you start investing, the more money you stand to make. Even a small amount of money invested over a long period can yield a higher return than a larger sum invested over a short period. This is one of the reasons behind the growing popularity of Systematic Investment Plans (SIP).

The secret to long-term financial success is to start saving today and saving regularly, even if all you can afford is a small sum. How much you invest is not nearly as important as starting early. Every year you put off investing makes your financial goals that much difficult to achieve.

HARNESSING THE POWER OF COMPOUNDING

How can you harness the power of compounding to build long-term wealth? You can start with a few simple steps:

1. **Start early:** The earlier you start, the more time you allow compounding to work for you and the more your corpus grows. There is no better time to start saving than today.
2. **Invest regularly:** The second tenet is discipline. Don't make haphazard investments; instead, remain disciplined in your investment approach. Set aside money on a quarterly or monthly basis, thus incorporating discipline in your investment approach.
3. **Patience is key:** Compounding only works if you remain patient and allow your corpus to grow with time. It might seem like a slow, long-drawn-out process at first, but if you remain patient, it will be worth it in the end ■

GET SMART WITH ASSET ALLOCATION

In '4 Steps to Creating a Portfolio', we wrote about the need for asset allocation. It really is not surprising to note that asset allocation grabs the spotlight when designing a portfolio.

Any security-specific selection decision is preceded, either implicitly or explicitly, by an asset allocation decision. Asset allocation is therefore the most fundamental of investment decisions. It establishes the framework for an investor's portfolio and acts as the foundation on which an investment plan is based.

At this juncture, it would be wise to differentiate between asset allocation and diversification. Investors tend to use the terms interchangeably, often mistakenly believing they have achieved both by packing their portfolio with a dozen different funds.

ASSET ALLOCATION VS. DIVERSIFICATION

Asset allocation is the process of determining the right mix of investments one should own i.e. the level of exposure to various asset classes. The most common asset classes are equity, debt, and cash. Investors can further look at other asset classes such as gold, commodities, real estate, art, private equity, and collectibles. Asset allocation is simply the percentage of a portfolio invested in different asset classes. Whatever your situation or stage in life, having the right mix of investments is crucial and can maximize returns and minimize risk.

Diversification, on the other hand, is what you invest in within these asset classes. For instance, you may decide to allocate 65% of your portfolio to equity. Figuring out how to invest your money within this asset class is where diversification comes into play. This would entail deciding on the number of equity mutual funds to hold, the mix between growth, value, infrastructure or other sector funds, number of large and mid-cap funds, and whether an international fund to gain global equity exposure is a good strategy.

If you decide to go with just one equity fund, a 65% exposure to a single fund establishes no diversification at all, despite the fact that you have planned a sensible asset allocation.

It's rather obvious now that the heavy lifting of any financial plan starts well before individual investment selection. In other words, sensible portfolio construction must commence with asset allocation. But do bear in mind that choosing an asset allocation model won't necessarily diversify your portfolio. Whether or not your portfolio is diversified will depend on how you spread the money within each asset class.

> The ultimate use of your portfolio should shape your asset allocation

Of course, the situation may be such that diversification doesn't come into play. A 24-year old on her first job might have the foresight to plan for retirement but not the financial bandwidth. She may be able to save just Rs. 1,500 every month towards her retirement kitty. Her asset allocation could demand pure equity exposure and she may invest the entire amount in one equity mid-cap fund. In such a case, her asset allocation is in place but there is no diversification.

Summing up, while asset allocation maximizes the risk-adjusted return and reduces risk by combining asset classes that have less than perfect correlations, diversification reduces the investment specific risk. Both are necessary to maintain a healthy portfolio.

GETTING ASSET ALLOCATION RIGHT

The decision regarding the mix of assets to hold in one's portfolio is an individual one. A 62-year-old with limited investment assets and poor health who intends to retire the next year will, very likely, need to invest differently than a wealthy entrepreneur with the same expected retirement date. Alternatively, two 45-year-olds with identical income will also have a different asset-mix if one intends on retiring in 20 years and the other in the next 5. Even if two individuals with the same income choose to retire at the same age, sources of in-retirement income, expected monthly expenses, expected length of retirement, and the desire to leave a legacy for their children will play a role in a customized asset allocation.

No pre-determined allocation or tool can possibly address the many variables that factor into an appropriate asset-allocation framework. The asset allocation that works best for you at any given point in your life will depend on numerous factors such as age, time horizon for various goals, risk tolerance and capacity, and earning capability.

Moreover, your asset allocation would change over time. Your retirement portfolio in your 30s will look different from the same retirement portfolio when you are in your 50s.

Some financial experts believe that determining your asset allocation is the most important decision you'll make with respect to your investments - that it's even more important than the individual investments you buy. Spend time figuring it out or consult a financial adviser when doing so ■

Contributed by **Axis Mutual Fund**

Value Creation Through Demergers

In India, old corporate houses have historically had multiple businesses controlled by a single company. This is, in fact, not just an Indian but an Asian phenomenon. We often see such businesses having little or nothing in common except parentage i.e. promoters. Managers at the operational level are often promoter-appointed and in some cases even professionals at senior levels are sponsored by promoters.

HOW CONGLOMERATES CAME INTO EXISTENCE

One of the major reasons for conglomerates emerging was a limited access to capital for new ventures. Therefore, existing corporate houses entered new businesses with the financial strength of their established business backing them.

The second reason was a desire by established corporates to tap into new business opportunities, either through forward integration into new products and geographies or backward integration to secure inputs and raw materials. The business dynamics of the expansion were often different from their core business. As a result, business risks, profitability, cash-flows, return on capital etc. were also quite different, although the businesses were held by the same company.

In both cases, there was often cross-subsidization and a diversion of cash-flows from profitable (cash-cow) businesses to not-so-profitable (often loss-making) businesses. Additionally, there was a lack of transparency in terms of profitability and cash flows of individual businesses, making it difficult to value each business independently. As a result, markets rarely valued conglomerates to their full potential, significantly discounting their sum-of-the-parts value

CREATING VALUE BY DEMERGING BUSINESSES

A trend to demerge businesses into separate companies has emerged in the last decade. The three primary reasons responsible for this are:

- Unlocking value since the conglomerate was valued at a significant discount to the sum-of-its-parts
- Greater management focus driven by professional management teams, with promoters providing strategic direction and making capital allocation decisions across businesses
- Greater opportunities for individual businesses to pursue Mergers and Acquisition (M&A) opportunities on the strength of their own balance sheets

So far, investors have had a hugely rewarding experience in most demerger cases. Let's look at some examples of how demergers have played out recently.

CROMPTION GREAVES DEMERGES ITS CONSUMER ELECTRICALS BUSINESS

The business of Crompton Greaves could be broadly classified as Consumer Electricals and Capital Goods for the power equipment and industrial systems industries. The differences in the two businesses are highlighted in the table below:

	Consumer Electricals	Capital Goods
Nature of business	Business to consumer	Business to business-institutional
Role of branding	High	Low
Geography	Primarily domestic markets	Both domestic and international
Margins	Higher than capital goods	Lower than consumer electricals
Working capital requirement	Low	High to very high
Return on capital/ Equity	RoCE and RoE were high due to high turnover of assets and low working capital	RoCE and RoE were low due to high working capital requirements and low asset turnover

In 2016, the erstwhile Crompton Greaves went in for a demerger of the Consumer Electrical business and listed it separately as Crompton Greaves Consumer Electricals (CGCEL). CG Power and Industrial Solutions (CGPISL) now houses the Capital Goods business.

As can be seen from the table below, from a market price of Rs. 150 per share of the combined entity, there has been significant value creation in both companies, partly on account of improved performance and partly due to overall markets trading at historic highs. However, the key point to be noted is the valuation of CGCEL, which, on account of troubles in the power equipment business, was not at its optimal as part of the consolidated entity.

(Figures in Rs./ share)	Crompton Greaves (pre-demerger)	CGCEL (post-demerger)	CGPISL (post-demerger)	Total / % Gains
At the time of demerger – March 2016	150	130	50	180 / 20%
August 2017	n.a.	225	82	307 / 105%

INFRASTRUCTURE DEVELOPMENT AND FINANCE CORPORATION (IDFC) BANK DEMERGED FROM IDFC

IDFC started off as a financial institution to primarily provide long-term financing to the infrastructure sector. Somewhere along the line, the management felt the need to also obtain a banking license that would enable them to tap into Current Account and Savings Account (CASA) Deposits, which could potentially improve the interest margins of its infrastructure-lending business. A consumer bank would also help IDFC enter the high-growth segments of consumer and working capital lending, higher in terms of profitability and lower in terms of risk as compared to pure infrastructure lending. RBI granted it a banking license and by regulation, the businesses were demerged. IDFC Bank was then separated from IDFC and listed independently.

This is one of those rare examples where a demerger did not result in gains for investors, partly on account of the poor performance of both IDFC and IDFC Bank even after 2 years of the separation, in spite of overall markets trading at all-time highs.

	IDFC (pre-demerger)	IDFC (post-demerger)	IDFC Bank (post-demerger)	Total / % Gains
At the time of demerger – November 2015	140	64	67	131 / -7%
August 2017	n.a.	58	58	116 / -17%

SINTEX INDUSTRIES DEMERGES ITS PLASTIC BUSINESS

Sintex Industries, a well-known name in the plastic water tanks industry, held two businesses - plastic molding and textiles. The plastic business enjoyed better margins, cash-flows, and hence higher returns on both invested capital and equity. However, the textiles business would pull down the overall margins and returns for the company. Thus, the plastics business' performance was never fully reflected in the stock price and Sintex continued to trade at low valuations, similar to most textile companies.

In 2017, the management demerged the plastics business into Sintex Plastic Technologies (SPTL) and listed it separately. Investors in Sintex Industries (SIL) were given shares of SPTL for free while they continued to hold the remaining SIL shares that now purely represented the textile business. As can be seen from the table below, the demerger has been rewarding for investors.

	Sintex Ind. (pre-demerger)	Sintex Ind. (post-demerger)	Sintex Plastics (post-demerger)	Total / % Gains
At the time of demerger – May 2017	105	25	130	155 / 48%
August 2017	n.a.	36	125	161 / 53%

RELIANCE CAPITAL DEMERGES ITS HOUSING FINANCE BUSINESS

Reliance Capital (RCL) is the holding company for the financial services business of the Anil Ambani Group. The financial services business includes investments in subsidiaries for Housing Finance, Life Insurance, General Insurance, Asset Management, Non-Banking Finance Company (NBFC) besides being the holding company for non-core investments (Media etc.). Although the individual operational and financial performances of the businesses were good with consistent growth over the years, the stock price had been a laggard in the markets over the past decade due to a negative sentiment prevailing around the Anil Ambani group.

Just the announcement of value unlocking in RCL due to the listing of the housing finance subsidiary was enough to trigger a massive rally. The stock has moved from Rs. 400 to Rs. 750+ within the last year.

RCL could be a story of multi-year, multiple rounds of value unlocking, since the management has stated its intent to list each of the businesses separately over the next 5 years, with RCL becoming the holding company of the several businesses.

In the next issue, we will look at some more examples of demergers that have been announced and are currently in the process. As is evident, these could prove to be rewarding opportunities for investors ■

Vivek Mavani

Vivek Mavani is a SEBI Registered Investment Advisor based in Mumbai.

Earn a Guaranteed Monthly Income with a Systematic Withdrawal Plan

Unlike the popular and oft-discussed Systematic Investment Plans (SIPs), Systematic Withdrawal Plans (SWPs) are a relatively unknown investment tool. While SIPs have gained massive acceptance in the mutual fund community in recent times, not many are familiar with the concept of SWPs.

WHAT IS A SYSTEMATIC WITHDRAWAL PLAN?

A Systematic Withdrawal Plan (SWP) is an investment tool that allows a mutual fund investor to withdraw a pre-determined sum at fixed intervals. SWPs are often employed by investors to generate a regular flow of income through their investment.

To put it simply, an SWP is the reverse of an SIP. While an SIP requires a fixed, regular investment into a mutual fund, an SWP allows for regular withdrawal from a fund, with the withdrawal amount and frequency set by the investor.

WHO NEEDS AN SWP?

Because SWPs allow account holders to access their investment when they need it the most, they work best for investors that require liquidity at regular intervals. Thus, they are a preferred investment tool for retirees, employees on a sabbatical, and other investors looking for a fixed cash flow every month, making it easier for them to plan their long-term financial objectives and meet goals.

HOW IT WORKS

Selling a mutual fund usually means the investor has two options – sell their units all at once or choose an SWP. An SWP gives them the option to withdraw fixed sums of money at fixed intervals. In accordance with the investor's instructions and the prevailing Net Asset Value (NAV), their fund units are redeemed and the fixed sum returned to them.

Let's take a look at how exactly SWPs work. Say, person X holds 10,000 units in a mutual fund scheme and wants to withdraw Rs. 8,000 each month through an SWP. If, on January 1, the Net Asset Value (NAV) of the scheme is Rs. 50, the investor forfeits 160 units (8,000/50) in lieu of Rs. 8,000. The remaining units in his portfolio would be 9,840 (10,000-160). Now, on February 1, the NAV is Rs. 40, which means the investor lets go of 200 units (8,000/40) in return for Rs. 8,000. Now, 9,640 units (9,840-200) would remain.

Thus, the investor's holding is redeemed in a systematic manner so as to provide them with a regular income.

ADVANTAGES OF INVESTING IN AN SWP

- **Uniformity:** Unlike other monthly income plans that are based on dividend payments, an SWP assures a fixed sum at a pre-determined frequency. It eliminates the risk of erratic monthly income or even worse, no income at all. Thus, it is extremely useful for investors looking for a regular income.
- **Inflation Protection:** Most fixed-income instruments do not offer protection against inflation. This means that while the principal is mostly secure, the income generated is not sufficient to meet future needs. However, an SWP generates enough returns to battle inflation, especially if it is an equity fund.
- **Lower Taxation:** SWP is a wiser choice from the taxation perspective too. While debt fund dividends are subject to a dividend distribution tax (DDT) of 13.5%, SWPs typically see a lower tax burden in the form of either a short-term capital gain (STCG) or a long-term capital gains tax (LTCG). And it only gets better in the case of equity fund SWPs. Since long-term capital gains from equity mutual funds are exempt when held beyond a year, an investor ends up paying no tax on withdrawals. Even when compared to bank and corporate fixed deposits, the tax liability is lower on SWPs, the only caveat being that withdrawals can start only after a year for availing concessions on tax. For instance, an investor who falls in the 30% tax bracket is liable to pay tax at the rate of 30% on bank FDs but only has to pay 10% on the SWP.

Thus, investing in an SWP is a rewarding strategy for generating income on a regular basis, even if you lack a primary source of income. With time, as investors become aware of the advantages of an SWP as a vital income-generating strategy, it will see wider acceptance and reach ■

Achieving Financial Independence for Charitable Organisations

Donations are the primary source of funding for NGOs, but are not immediately available for use. Tax laws mandate accumulation of up to 15% of the income of an NGO for an indefinite period, forming part of its corpus fund. An NGO also receives voluntary contributions for charitable activities, which it can then choose to accumulate, in accordance with tax laws, for a maximum period of 5 years. During this period, the sum must be deposited in the mandated modes to be qualified for Income Tax exemption.

The total of the corpus and accumulated income, called surplus funds, can create a self-sustaining model for an NGO by earning significant and recurring returns. In this manner, an NGO can reduce its dependence on external donations and become financially independent for achieving both long and short-term goals.

While there are several avenues to park funds, not all investments qualify for exemption under the Income Tax Act, 1961. So how can NGOs go about achieving financial independence?

CHOOSING MUTUAL FUNDS FOR BETTER RETURNS AND HIGHER LIQUIDITY

Typically, NGOS invest their capital in bank fixed deposits or other low-risk instruments due to a lack of information and guidance. While these instruments provide safety of capital and risk-free returns, low returns and high taxes make them an inefficient investment option. What NGOs then need is an avenue that provides not just safety of capital but also higher liquidity and better returns than bank deposits.

The law allows NGOs to invest in mutual funds, which combine safety of capital with high liquidity and better returns. Based on the securities they invest in, mutual funds can be equity-oriented (>65% equity), debt-oriented (>65% debt securities) or a combination of the two.

Since the primary investment consideration for an NGO is safety of capital, debt funds are best suited as they are extremely low-risk investments. However, they are a more lucrative investment option than other low-risk investment options due to the higher liquidity and returns they provide. Coupled with lower income taxes, safety of capital and a possibility of capital appreciation, debt funds make the best long-term investment for NGOs.

HOW FUND INVESTMENTS PROMOTE GREATER FINANCIAL INDEPENDENCE

It is also important to choose the right kind of fund depending on individual objectives. For example, an NGO targeting a regular income for its running expenses can opt for a Systematic Withdrawal Plan (SWP) while an NGO targeting an investment in a major project in the future can opt for a growth scheme. The following illustration will aid further understanding of the benefits of debt funds over other low-risk investment options.

An NGO that requires Rs. 10 lakhs to operate annually has Rs. 1 crore in surplus funds. It decides to invest the surplus in a low-risk instrument that earns 10% interest annually. Let us consider two investment scenarios – a bank fixed deposit and a debt fund.

CASE 1: Fixed Deposit

The NGO invests the sum in a fixed deposit paying 10% interest annually. At the end of year 1, it earns Rs. 9 lakhs after a 10% TDS. Tax laws require an NGO to apply 85% of earnings towards its charitable objective. Thus, it will need to set aside Rs. 8.5 lakhs of the Rs. 9 lakhs for its income to be tax-exempt. But, it also needs this money for its daily operations, thus creating a misalignment between its investment and financial objectives.

CASE 2: Debt Fund

The NGO invests the sum in a debt fund (return at 10% p.a.), which earns Rs. 10 lakhs at the end of year 1. Now, it can opt for a SWP where it can withdraw ~Rs. 84,000 for monthly expenses (no tax withholding). By the end of the year, the NGO would have received Rs. 10 lakhs but the entire sum is not considered income in this case. The income part (calculated pro-rata to its capital) amounts to Rs. 90,909 (Rs. 10 lakhs * 10 lakhs/1.10 crore). Thus, it needs to spend only Rs. 90,909 for the entire Rs. 10 lakhs to be tax-exempt. This leaves the NGO with adequate funds to operate for the year, the investment now aligned with financial objectives.

Thus, we see how investing in mutual funds is advantageous not just because of the better returns or higher liquidity, but also because of several other benefits. Besides, the alignment of investments with financial goals can provide financial independence so an NGO can focus on its core charitable objectives ■

What Is Your
Human Life Value
And Why Does It Matter?

You wouldn't think of insuring half of your car, home or other important property, would you? And yet when people look to purchase life insurance, a common misconception they hold is that only a modest multiple of their income is enough for the cover. However, this is often an inaccurate representation of what one's actual earning potential would be over their lifetime – one's **'human life value'**.

Solomon Huebner, Ph.D., an early expert in insurance economics and risk management who is also known as the **'Father of Insurance Education'**, defined human life value as:

"The capitalized monetary worth of the earning capacity resulting from the economic forces that are incorporated within our being: namely, our character and health, our education, training, and experience, our personality and industry, our creative power, and our driving force to realize the economic images of the mind."

OUR MOST IMPORTANT ASSET

In simple terms, our human life value must take into account the financial sum of what we can earn or produce over our lifetime. It is arguably our biggest asset and therefore, the legacy we leave behind for our family, business or charitable interests.

Even though an insurance policy is not a replacement for a person, Huebner's thoughts underline the fact that a life cover is crucial in financially supporting dependants in the event of the insured's death, enabling them to not just sustain but also fund major expenses.

It is estimated that it takes the average family as much as seven years to get its finances back on track after the death of the primary breadwinner.

To assess the financial loss your family would incur, use this Human Life Value Calculator to arrive at your estimated lifetime income.

CALCULATING YOUR HUMAN LIFE VALUE

WHY YOUR HUMAN LIFE VALUE MATTERS

Say, you are 40 years old and make Rs. 6.5 lakhs per year. After assessing your family's budget, you calculate Rs. 4.8 lakhs as the annual sum required to support it. Assuming this income would need to be replaced until retirement at the age of 65, with a 5% discount rate, the present value of your future net salary would be Rs. 68.3 lakhs.

This method yields accurate results in situations where replacing the income foregone in the event of the death of the breadwinner is the primary concern. However, it only factors in the replacement of the income and does not take into account any lump-sum requirements at death.

Providing your family with adequate finances to support them in your absence is naturally imperative. However, different people could have differing financial situations, some requiring more complex analysis than usual. No matter which stage of life you are currently in, and especially if you are the primary breadwinner, life insurance is important to keep your family secure, not just financially, but also emotionally ■

Contributed by
Aviva Life Insurance

HEDGING PORTFOLIO THE SMART WAY WITH Derivatives

Most retail investors are wary of the derivatives market, viewing it as an inherently risky bet. While the underlying risk is an undeniable fact (like any other kind of investment), derivatives can provide an excellent portfolio hedging tool to investors and fund managers alike.

WHAT ARE DERIVATIVES?

In simple terms, any financial security whose value depends on an underlying security is a derivative i.e. it derives its value from that of another asset. Thus, when you trade a derivative on an exchange, you don't trade the underlying asset but the instrument itself, whose value is dependent on the underlying. Indian stock exchanges offer trading in two types of derivatives – Futures and Options.

TYPES OF DERIVATIVES

A futures contract is an agreement between the seller and buyer to exchange an asset at a pre-determined price on a future date. Futures are continuously priced according to the value of the underlying asset i.e. they are marked-to-market. Based on the current value of the futures contract, the buyer or seller can then square off their position.

An options contract grants the buyer the right to either buy or sell the underlying security on expiry of the contract at a pre-determined price, which is called the strike price. Unlike a futures contract, an options contract only grants a right but doesn't place an obligation. There are two kinds of options:

- **Call Option** – This gives the buyer the right to buy the asset at a fixed price
- **Put Option** – Gives the buyer the right to sell the asset at a fixed price

An option also involves a premium, which can be thought of as the price to be paid for exercising the option. While a futures contract holds the potential for unlimited profits and losses, options entail unlimited profits and losses limited to the premium paid.

Just like futures, option premiums are marked-to-market. This means investors, based on the market price of the options, can square off their positions on any given date.

WHY YOU SHOULD HEDGE YOUR PORTFOLIO USING DERIVATIVES

While the equity market is known to be volatile, mutual funds heavily invest in it for the long-term. How can a fund manager mitigate risk in volatile markets?

There are three options available with a fund manager –

- They can liquidate their equity portfolio and sit on the cash to prevent losses. But this means investors suffer a loss if the share price rises, thus hurting their long-term financial objectives
- The manager could halt all activity and hold all positions till the market recovers. But this would mean NAV dropping as volatility continues, thus causing a loss to investors. As the value of investments falls, investors would start redeeming their units, ultimately forcing the fund manager to sell
- A smarter option is for fund managers to hedge their losses through derivatives

For instance, an investor is invested in a diversified equity fund with a majority of large and midcap stocks. Now, say the Nifty falls by around 15%, causing the NAV to fall by around 10% with an additional 10-15% loss in value expected. If the fund manager were to sell Nifty futures, and the index were to fall by another 10%, the fund would make a neat 10% profit in the futures market, thus limiting the impact on the NAV. Not only would this reduce notional losses for investors, it would also allow the fund manager to remain invested in high-conviction equity bets which would create long-term wealth for investors.

What is more, hedging using derivatives also offers a tax-efficient solution to investors with a low risk appetite. Many investors are interested in investing in equities but are averse to volatility and will accept lower profits in return. The usual solution for such investors is to choose an asset-mix of debt and equity that offers a balance between risk and return. But, equity and fixed income taxations are different in India which means that capital gains on equity funds are tax-free if held for more than 1 year and those on debt funds are taxed if held for less than 3 years. Hybrid funds make use of derivatives to balance portfolio risk and also take advantage of equity taxation.

CONCLUSION

There really isn't a reason for investors to stay away from derivatives. With adequate education, most of which is freely available over the web, investors can learn to hedge their risks with derivatives. Eventually, investors can come to understand fund schemes, using them to either manage risk or generate returns through arbitrage opportunities ■

Expert Speak

"Protecting capital from mistakes is as important as making it grow. It is therefore important that risk-appropriate asset allocation is followed and self-discipline is enforced in the present market."

Dear Friends,

The rally of hope is upon us. In such scenarios, the upbeat momentum takes over disciplined behaviour. More and more investors see their direct investments outperform well-established benchmarks and funds. At this point, there is a spike in gains from IPOs and low float counters. Thus, the chase for higher and faster returns sends investors scurrying for riskier assets, which ultimately leads them to the penny stocks segment. This makes them lose focus on potential risks. Till the going is good, retail investors are blocked from buying due to constant upper circuits. But when the market turns, they are locked in at lower circuits.

Therefore, don't choose stocks on the basis of past returns. Instead, choose them on the basis of proven management, effective business model, and a positive outlook. The market has reached maturity level for most part where governance gets a premium. However, a small pocket of the market, especially in the penny and low floating stocks segment, is driven by momentum.

It is important that investors begin to measure the long-term potential cost of their short-term investments. It is the long-term view on earnings, value and scalability that creates wealth in equities. **The temperament of an equity investor should be that of a bamboo farmer.** A bamboo can remain a seedling for years and then suddenly, in just a few weeks, it will shoot so rapidly that it will outgrow the farmer. Likewise, a good stock may remain dormant for years before shooting with a velocity that would confound many.

For example, had you invested in Kotak Mahindra Finance's IPO (later Kotak Bank), you would have made a significant amount of money on listing. But if you'd purchased the stock post-listing, you would have had to wait for years (till 2004) to see a sustainable return on your holding.

In the present market, where buoyant sentiment has pushed prices up into the fair-value-plus zone, the rally is being driven by hope rather than greed for the most part. At current levels, some pockets of value remain, especially in the IT and Pharma sectors; but these are contra plays. The breakout in these sectors will depend on defining events and regulatory changes, neither of which seem to be the case right now.

Our funds are currently betting big on the shift in savings from physical to financial assets. Moreover, a confluence of major regulatory changes like GST, declining inflation, and reducing interest rates is paving the way for sustainable long-term growth. We continue to believe that long-term SIP and opportune allocation would create wealth for the investors.

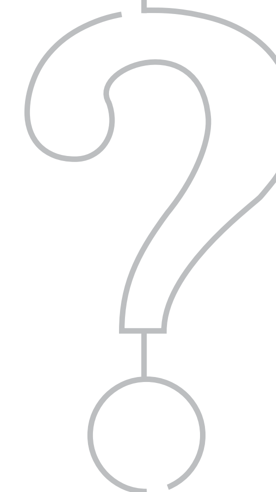
In conclusion, protecting capital from mistakes is as important as making it grow. It is therefore important that risk-appropriate asset allocation is made and self-discipline is enforced in the present market because wealth creation is not a function of luck but of enterprise, value, and expertise ■

GROWING THROUGH ASSET ALLOCATION

Particulars	Nifty Level	Net Assets in Rs.	Debt	Equity
Start in Kotak MIP with ~ 20% equity exposure	10,000	10.00	8.50	1.50
Equity markets drop by 15% (represented by Nifty 50)	8,500	9.78	8.50	1.28
Shift to Kotak Equity Savings Fund which has ~ 25% unhedged equity	8,500	9.78	8.31	1.47
Equity markets drop by ~15% (represented by Nifty 50)	7,225	9.56	8.31	1.25
Shift to Kotak balance with ~65% equity	7,225	9.56	3.34	6.21
Equity markets drop by 15% (represented by Nifty 50)	6,141	8.62	3.34	5.28
Shift to Equity Fund with ~ 100% equity such as Kotak Select Focus	6,141	8.62	-	8.62
Equity markets go up by 20% (represented by Nifty 50)	7,370	-	-	10.35
Shift Back to Kotak MIP with ~ 20% equity exposure	7,370	10.00	7.93	2.07

Nilesh Shah,
Managing Director,
Kotak Mutual Fund

FAQs
FOREIGN ACCOUNT TAX COMPLIANCE ACT



Q1. WHAT IS FATCA?

The **Foreign Account Tax Compliance Act** (FATCA) is a 2010 United States (US) federal law to enforce the requirement for US persons including those living outside the US to file yearly reports on their non-US financial accounts to the Financial Crimes Enforcement Network (FINCEN).

Q2. WHAT DOES THIS MEAN FOR INDIA?

Since India has now signed the deal, it will be the responsibility of the Indian government to furnish this information. Under FATCA, financial institutions have to report accounts of US nationals to the US Inland Revenue Service (IRS) either directly or indirectly. The IRS, on its part, will also share with India, financial information of its citizens holding assets in the US. India will start receiving information from other countries under the automatic exchange of information (AEOI) route from 2017 onwards.

Q3. WHAT INFORMATION IS REQUIRED TO BE FURNISHED AS PART OF FATCA?

The basic information that will be certainly required includes

1. Country of birth / incorporation
2. Place of birth / incorporation
3. Address Type [Residential or Business, Registered Office] for the KYC registered address
4. Occupation
5. Applicant Income details
6. Net Worth details
7. Details of PEP [Politically Exposed Person]
8. Information on specific corporate services [applicable for non-individuals]
9. Information about Ultimate Beneficiary Owner(s)/Controlling Person(s) [applicable for select category of Non-Individuals]
10. If you are a tax resident in a country other than India, then the following information is required for all countries you are tax resident of:
    - Country of Tax Residency
    - Tax Identification Number
    - Identification Type

Q4. WHICH INSTITUTIONS FALL UNDER THE PURVIEW OF FATCA?

- Mutual Funds
- Broking Houses for Demat
- Banks
- Other financial organisations

iProbono
Enabling Justice

WHAT WE DO

iProbono is a non-profit working to provide access to quality pro bono legal assistance to civil society and disadvantaged individuals, while building a culture of pro bono in the legal profession.

iProbono's global reach enables the legal professionals registered on its network to get involved in projects for organisations working on a wide range of development and rights-based issues.

HOW IT WORKS

Civil Society Organisation (CSO) in need of legal assistance reaches out to us.

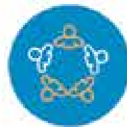
Our Programs Team, comprising of lawyers analyses the CSO's legal requirement.

Our Team identifies a suitable professional from our network of lawyers, policy-experts and law students.

We match the requirement & manage the project, ensuring the CSO gets the best pro bono assistance.

BE PART OF THE CHANGE

Reach out to us if you are an NGO or social enterprise in need of pro bono legal assistance.



Join our network if you are a legal professional looking to provide pro bono legal services.

Donate to us if you want to support our work and help us get more people access to justice.

Contact Us

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ARE YOU ON THE SAME PAGE AS YOUR KIDS ABOUT THEIR FUTURE?

#DoYourHomework

Your kids may be cooking up a different dream than what you had in mind. With innumerable career options, kids today can choose to become whatever they want to, while you do your homework and be financially prepared for their future.

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Invest in Investing

Every individual is unique and so are his or her investment needs. Investment planning must always be aligned with one's goals. Hence, our approach is to help you chalk out an investment strategy that is best fit for 'you'.

We see ourselves as educators rather than advisors. Our endeavor is to build awareness about the various kinds of investment products in the market. After all, an informed decision is always a better decision.

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