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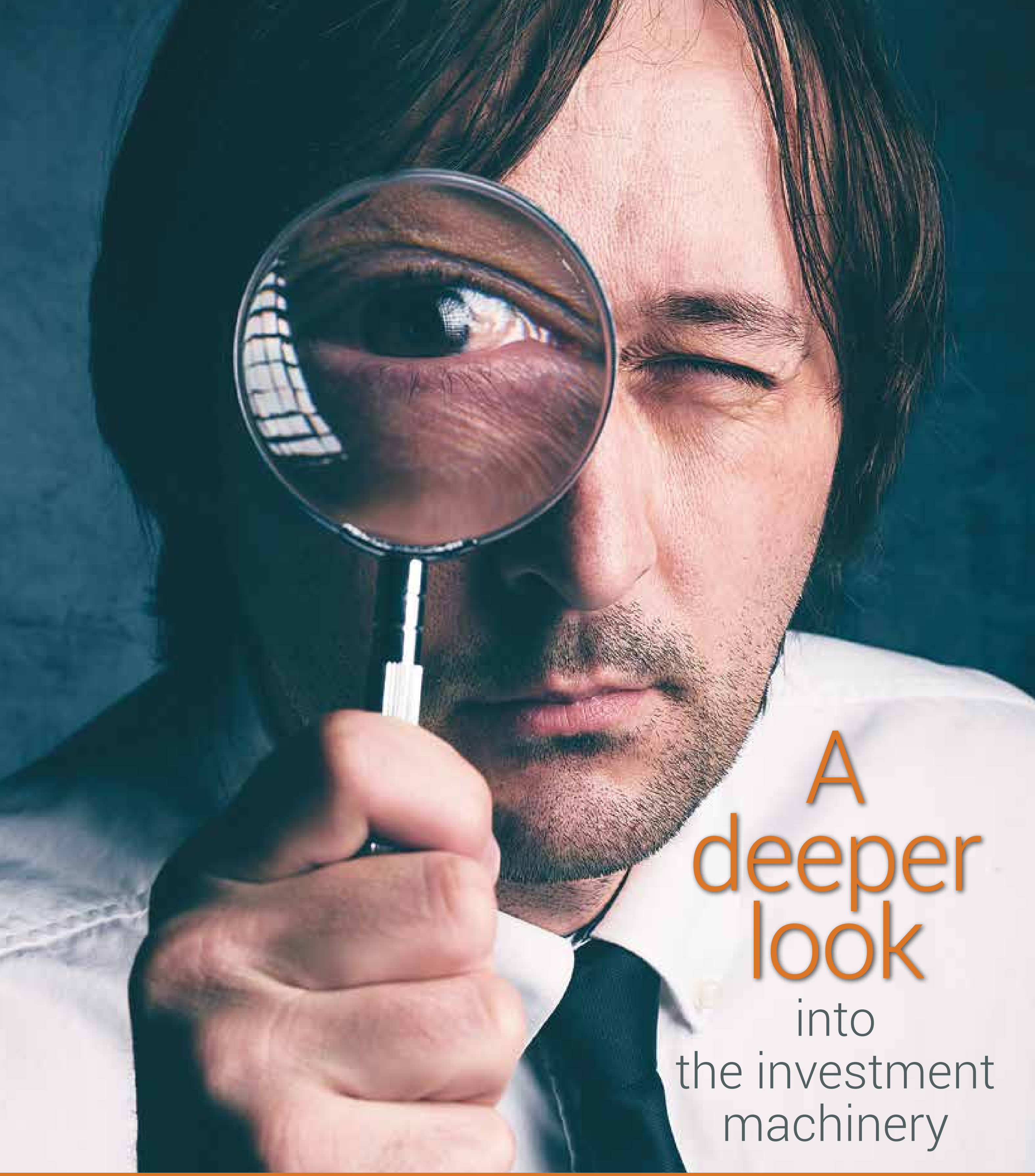
INVEST IN INVESTING

September-October, 2019



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About Us

Financial Sketchers (India), registered under: IRDA (Insurance Regulatory Development Authority) comprises of a team of experienced & certified advisors. The company has over 20 years of diverse experience in: Wealth Management and managing investment portfolio for their clients in domestic and international space.

We prefer and are happy to provide door-step-service to our clients to build trust and long term relationship.

Our current countries of work include: India, Hong Kong, Singapore, UK/ UAE and now extending to Kenya as well starting Dec 2017. We could carve out a neat investment portfolio for Indian individuals/ businessmen to spreads across their investments in the stated countries.

India, as a country, currently stands as a 'favorite' of all Indians across the globe for its formidable growth trajectory that it is poised to acquire. There is a heavy inflow of investments in India from across companies and individuals from Kenya itself.

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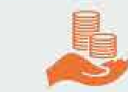
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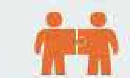
Collaborative Portfolio

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ADVANTAGES OF FILING TAX RETURNS

Filing returns makes you a responsible citizen of your nation.

This can boost your chances of getting a suitable home loan if you apply for one in the future.

Some credit card companies demand proof of tax returns before issuing a card.

As income is recorded by the tax department, it is easier for individuals to enter into future transactions with minimal complications.

In cases when you want to claim adjustment against past losses, a return is compulsory.

Varun Anand (Area Manager)**: +91-9313204369**

From the Editor's Desk

Given the present state of economic slowdown coupled with the blow hot - blow cold trade war between China & USA, would surely have the investors worried and nervous.

The BSE Sensex from an all-time high of 40267 points is down by nearly 8.5 in just 3 months. History is replete with events where anxiety of recession came to fore again and again.

Nobody, in the wildest of dreams would have ever imagined that senex would reach this level after 9/11 WTC attack in 2001 or Sub-prime mortgage & Lehman Brother crisis in 2008. The growth rate of Indian GDP over last 30 years has been a yo-yo curve. It is not for the first time that the Indian GDP has slumped after showing robust growth in the preceding years. In 2008 it steeply declined from nearly 10.5% to 3.3% and then again in 2013 it again declined to 5%. Inspite all these issues the Sensex has given a CAGR of more than 16% since 1988.

Negative stories always weigh down heavily and so we tend to agree more on any bearish argument. History says one will always find reasons why not to invest but no one can stop the Market in the long run. “One can create Money by investing in Bull Market but one can create a Fortune by investing in Bear Market”. Investor should have patience and a high level of conviction in the fundamentals and a belief that this setback is temporary.

Best,

Team Meri Punji

Punji (*noun / Hindi*) - **Capital** *meaning, wealth in the form of money or other assets owned by a person or organization or available for a purpose such as starting a company or investing.*

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HACKING YOUR MIND

TO MAKE BETTER INVESTMENT DECISIONS

It isn't uncommon for investors to make bad decisions. From sacrificing long-term goals at the altar of short-term volatility to putting all eggs in one basket, our cognitive biases often keep us from making prudent investment decisions. Because it's all in the head, it is possible to hack our minds to become better investors that don't give in to heuristics. Let's see how.

1. MAP YOUR GOALS

Instead of approaching investments in an abstract fashion, look at them in terms of intelligible objectives. For example, the difference between a 3000 mAh and a 6000 mAh battery becomes comprehensible when explained in terms of the charge life. Meaning, a 3000 mAh battery can survive up to 14 hours of rigorous gaming whereas a 6000 mAh battery can survive up to 26-28 hours of the same. Similarly, the difference between a Rs. 10,000 monthly SIP and a Rs. 20,000 monthly SIP is clear only when you think in terms of tangible goals. For example, the first one will make it possible to buy a 1 BHK home in 10 years whereas the second one will make it possible to buy a 2 BHK home in 10 years. However, if you think of investing Rs. 10,000 in an SIP per month with no perspective, you're on the road to making a poor decision. When you map your investment to actual financial goals, you get a more realistic outlook. Ultimately, this helps you make better investment decisions.

2. CHOOSE THE DEFAULT WELL

Opting for the default option is the most basic of human tendencies. We enjoy, seek, even crave recommendations, especially during bouts of tough decision-making. Whether it be a chef-recommended dish at a restaurant or the 'recommended' option on a software package, the default is our go-to. When it comes to investments, use the default to your advantage. Some good options are perpetual SIPs. An automated SIP top-up with a rise in your annual income also serves as a valuable default option.

3. MINIMIZE ERRORS

Human beings are prone to making errors. But you can, however, minimize predictable errors. For example, inadequate funds in the bank account when the SIP trigger hits or redeeming on exit loans are some common errors you can simply do away with. You can engage a professional advisor to put mechanisms in place that can fix errors and stop their recurrence or even instruct your bank to automate certain processes.

4. STRUCTURING COMPLEXITY

Imagine you had to look for a home in a city as big as, say, Bengaluru or Delhi or Chennai. Daunting as it may sound, your first line of thought would be to break down the whole into achievable parts such as budget constraints, house size preferences or even the preferred locality; some boundaries and structures within which decisions can be confined. This narrowing down of options makes decision-making easier.

There is no denying that the investment landscape is complex. Instead of taking it all on, narrow down your options to make decision-making easier. Making accurate investment decisions with the innumerable types of funds, market, events, and news floating around, can be intimidating. But on breaking down the complexity of investment into goals that can be accomplished by certain categories of funds will help you make faster and better investment choices. In a nutshell, always know your goals and work towards them, else it can seem daunting to navigate the investment landscape. Relate back to investing decisions – choose time frame of investing, acceptable risk, expected rate of return, etc

5. SEEKING FEEDBACK

We all love the digital camera and one of the prime reasons for doing so is the instant photo retrieval feature that it offers unlike its antecedent – the analogue camera. Investments can often feel like the analogue camera, with no clear feedback on the outcome. As an investor, you can ask your advisors for feedback on what investing at the bottom of the cycle vs. what investing at the top of the cycle means for your goals. This will give you a more personalised, real, and meaningful picture of the impact of your investment decisions.

When the above-mentioned 'nudges', as mentioned in the book 'Nudges' by Richard Thaler and Cass Sunstein, are put to use, you will realize improved investment decision-making. Remember, personal finance is a long-term game. You will not see huge benefits immediately, but hacking your mind to do away with biases and exercising prudence is incredibly rewarding in the long run ■

Share valuation
from a regulatory perspective

The Central Board of Direct Taxes (CBDT) issued a notification No. 23/2018, dated 24 May 2018, to amend the Rule 11U and 11UA of Income Tax Rules, 1962 to allow only merchant bankers to determine the fair value of securities, effective 24 May 2018.

In addition to the regular issuances of share to existing or new investors, following are some other circumstances where the need for valuation of shares arises:

- When companies amalgamate through a share swap or are similarly reconstructed
- For buying / selling of unlisted securities between shareholders
- For valuation share while giving loans against such securities
- When shares of a company are given as gift
- During the conversion of preference shares or convertible debentures
- When equity shareholders are compensated for the acquisition of their shares, including those bought back

An appropriate valuation method is one which incorporates relevant factors having a material effect on the fair value of the investment. The appropriate valuation method is dependent on the availability of data, stage of development of the target, the ability of the target to generate positive cash flows in the future, and the quality and reliability of data used. Some commonly used valuation methods include:

1. Discounted Cash Flow (DCF)

This method values the projected cash flows by discounting them with the opportunity cost of capital. The net present value however is often significantly influenced by the terminal value growth rate, an entirely subjective assumption (it is usually assumed at lower than projected GDP growth). For start-ups in new age businesses, DCF is not an entirely relevant method given the early phase losses and difficulty in estimating the time horizon for a business to make regular profits. However, DCF still is the most preferred method for valuers and regulators as the method allows estimation of revenues and profits over a foreseeable future and a time-tested basis for arriving at a per share value.

2. Comparable Company Market Multiple Method (CCM)

This involves comparing the operating metrics and valuations of listed companies with that of the target company. It usually involves comparing the Enterprise Value or Market Capitalisation of listed companies with that of the target company, on the basis with their Revenues, EBIDTA or PAT. The necessary condition for using this method is the availability of comparable businesses in the public domain of similar size or scale, without significant volatility in their share prices.

3. Comparable Company Transaction Multiples Method (Transaction Multiples)

This method works well in M&A situations or even otherwise, as long as there are comparable companies (either private or public) with reliable data on their transaction values. The valuation method considers Enterprise Value or Market Capitalisation paid for similar companies in similar circumstances by strategic buyers or investors. Most of the time this information is private, making it difficult to draw conclusions.

4. Asset-Based Valuation Model

This works well for businesses that derive revenues from the ownership of an asset, license, contract, or intellectual property. This method can be used for arriving at liquidation value for certain types of business.

5. Sum of Parts Valuation Model

For diversified businesses, each business can be valued using one or more of the above methods (from 1 to 4) and added up to reflect the per-share equity value ■

Amol Dhariya, Director
HPMG Shares & Sec Pvt Ltd

LIFE INSURANCE AND TAXATION

A common assumption taxpayers make is that any amount received from a life insurance company is completely tax-free. This is not entirely true. The amount received from life insurance companies (including bonus) is tax-free u/s 10(10D) of the Income Tax Act-1961, except following receipt:

(a) any sum received u/s 80DD(3) or u/s 80DDA(3); or

(b) any sum received under a Keyman insurance policy; or

(c) Any sum received in respect of any policy issued,

(i) between 01.04.2003 to 31.03.2012, if the premium in any years exceeds 20% of the actual capital sum assured

(ii) After 01.04.2012, if the premium in any years exceeds 10% of the actual capital sum assured. However, if the policy is issued for the life of a person with a specified disability or one suffering from a specified disease, 10% needs to be replaced by 15%. [No tax impact would be there if such amount is received on the death of a person].

There is no escaping from tax on insurance proceeds if the premium paid exceeds 20% or 10% or 15% of the sum assured. Similar conditions are applicable for deduction u/s 80C as the deduction is admissible only if the premium is within the limit of 20% or 10% or 15% as referred above.

To track the taxability of such transactions, section 194DA provides for deduction of tax @ 1% (20% if no PAN) of sum paid under a life insurance policy which is not eligible for exemption u/s 10(10D) if aggregate sum paid in a financial year is Rs. 1 lakh or more. In short, if the TDS credit statement (Form 26AS) of the taxpayers reflects TDS U/s 194DA, one can be sure that amount is taxable. However, one needs to carefully note that Rs.1 lakh limit is applicable for TDS u/s 194DA & not for 10(10D).

An important issue that emerges is with regards to the computation of taxable income, if the amount is not exempt u/s 10(10D) - whether the entire amount received is taxable or only the difference i.e., amounts received less amount invested. The issue is all the more relevant as the TDS is for the entire amount and not the difference. The long-standing dispute has been put to an end by an amendment to section 194DA in the recent Union Budget – 2019 w.e.f. 01.09.2019, which now mandates TDS on the differential amount only, though at a higher rate of 5% (as against 1% earlier).

Relevant part of the explanatory memorandum associated with the amendment reads as under:

Several concerns have been expressed that deducting tax on gross amount creates difficulties to an assessee who otherwise has to pay tax on net income (i.e., after deducting the amount of insurance premium paid by him from the total sum received). From the point of views of tax administration as well, it is preferable to deduct tax on net income so that the income as per TDS return of the deductor can be matched automatically with the return of income filed by the assessee. Hence, it is proposed to provide for tax deduction at source @ 5% on income component of the sum paid by the person.

Above amendment in section 194DA has made it absolutely clear that the entire amount cannot be treated as 'income' and it's only the differential amount that would be taxable as income. However, even after above amendment, one issue still remain unresolved i.e., whether income would be taxable- whether as "Income from Capital Gain" or "Income from Other source"? Issue is controversial as above amendment treats the differential amount as income for TDS @5%. From taxpayer perspective, Income is obviously arising from the investment activity of the taxpayer and so should form the part of the "Capital gain income" & if the period of investment exceeds 3 Years then the benefit of indexation can also be enjoyed by the taxpayers. However, if taxpayer offers income as capital gain then the amount may not match with the TDS statement in Form No. 26AS.

A suitable clarification by the CBDT would be in the interest of the taxpayers as well as revenue ■

Alok Goyal,
Anil K Goyal and Associates

Change in Valuation Norms for Liquid Funds

Know the True Value of Your Investment

Combining high returns with the safety of capital, liquid mutual funds have been a favourite with investors looking to park their corpus for short periods. Despite the safety and stability such funds offer, rising instances of defaults and rating downgrades have dented investor confidence in the recent past. Stray as these instances were, they were enough to draw the attention of the market regulator. SEBI stepped in to safeguard the interests of the investors by making a key change in valuation norms.

THE CHANGE IN VALUATION EXERCISE

In its board meeting held on the 27 June 2019, SEBI introduced a number of measures aimed at improving the safety and liquidity of liquid funds. Inter alia, the most defining change that has been proposed has to do with the valuation of underlying securities. All debt instruments with 30 days or more to maturity will now be valued on a 'mark to market' (M2M) basis. Meaning, all securities will now be valued at the prevailing market price. Up until this change, all debt instruments with up to 60 days to maturity were valued on the basis of amortisation, where the difference between the purchase and the maturity value of the instrument was 'amortised' or distributed over the tenor of the instrument. This meant that the Net Asset Value (NAV) moved daily in a linear manner and saw no volatility based on rating downgrades, market movements, and defaults. Hence, short-term investors in such funds could be certain that their capital invested would be safe. Then, why the change?

THE PROBLEM WITH AMORTISATION

The NAV based on amortisation reflected merely the accounting value and not the realisable value. Meaning, if the fund were to liquidate the instrument in the market, the realisable NAV would likely be much lower, leading to a subsequent fall in returns. While low volatility is certainly desirable, amortisation ignores the deterioration in the financial situation of the issuer and its ability to actually pay the maturity value. If an issuer's credit rating is downgraded, investors will remain in the dark about the true value of their investment; they will be seeing steady growth in NAV on a daily basis.

But, the introduction of M2M will now improve the transparency of liquid funds. With amortisation taken away, the NAV of liquid funds will now reflect the actual worth of the portfolio on any given day.

IMPACT ON INVESTORS

Despite the higher volatility this change introduces in liquid mutual funds, investors benefit at the end of the day. Why? Because on any given day, they will know exactly the true value of their investment in the scheme. No longer will they be misled with a steadily increasing NAV or take a mark down from the artificially inflated NAV. As a result, more transparency will be introduced in daily NAVs, and investors will be in a position to make an informed decision as to redeeming or switching schemes. The resultant increase in volatility is likely to be quite small.

Another change proposed by the watchdog requires liquid funds to hold at least 20% in liquid assets such as cash or cash equivalents (treasury bills, legal tenders, etc.). This change is aimed at maintaining adequate liquidity at all times, but especially during crises periods in the bond market when redemptions are high. As of the end of May, liquid funds, on an average held only 10% in liquid assets.

Moreover, investors who exit liquid funds within a span of seven days will be charged a graded exit load. This new norm is directed towards minimising irregularities in inflows and outflows. The propensity of institutional investors to invest their surpluses in liquid funds and then exit shortly in favour of better opportunities had left smaller investors vulnerable. The graded exit load will ensure equity at all levels. As a result, much of this corporate hot money will shift to overnight funds. But both liquid and overnight funds will not be allowed to invest in short-term deposits, debt and other instruments having structured obligations.

Furthermore, the sectoral limit in liquid funds is to be capped at 20% in lieu of 25%. SEBI's circular said, "The additional exposure of 15% to HFCs shall be restructured to 10% in HFCs and 5% in securitized debt based on retail housing loan and affordable housing portfolios."

SEBI's regulatory changes have certainly paved the way for introducing transparency and safety in liquid funds, for the average investor. Liquid funds, in any case, continue to be a safe investment option for short-term investment needs. Consult your financial advisor if you're looking to park your funds in liquid instruments ■

Some thoughts on the Market

Most of the small and midcap are 50-70% down from their peak. Do you think it's a good time to buy?

Should people, at least continue their sips in small and midcap?

1) Continue SIP in small/mid-cap funds. This is the worst time to discontinue SIPs simply because the NAVs/returns are negative across most time periods, 1m, 3m, 6m, 1 year, 2 years, 3 years. Nobody really will know the bottom either in terms of levels or timing. SIP is the only way to go through the bottoming out process.

2) For bottom-up stock pickers, it's a good time to accumulate good quality stocks but caution should be maintained to avoid stocks that have management/ governance issues. This includes promoters who have leveraged their personal holdings and raised debt. The market will be absolutely unforgiving and those stocks could see sharp, sudden downsides. Either they may never recover or may take a long time to do so.

3) Although valuations of many stocks look attractive, they could still go lower. The market overshoots on both sides. If stocks can be driven to overvaluation in a bull market, they can/will be driven down during a Bear market, before they bottom out and start a new up cycle. Hence, have patience and the conviction to invest regularly.

4) Whatever be the approach, MF or direct stocks, don't expect multiplier returns in the short term. Take a 3-5 year view and be realistic in your returns expectations. Again, have patience and conviction. Returns will be much better over the longer term than the short term.

5) Do not get carried away with negativity surrounding the government, economic policies, FII selling, macro-economic issues, increased taxes, etc. This country, in the past 30 years, has seen much worse governments, financial crises, scams, currency crises etc. Not only did this country eventually do better but all of us are financially better off today than we were anytime in the past. So avoid negativity from clouding your judgement and decision-making. This a passing phase.

6) Managing investments (and business) is all about being optimistic about the future. Otherwise, one can never invest and make money/returns. So avoid the company of negative/ pessimistic people. They neither help themselves nor you. Constantly ranting about how useless this government is, how bad the policies are, etc. doesn't help anybody. It is not a profitable business/trading/ investment strategy either.

   Since the results of the General Elections came out in May 2019, the markets have been sliding down, with the slide having accelerated in July 2019, post the budget on 5th July. The government has come in for a lot of criticism surrounding increased taxes and economy slowdown.

In my opinion, irrespective of what the government would have done or not done, the markets would have corrected anyway. The 2013-18 period witnessed a strong bull market, where valuations multiples of all stocks had been driven up sharply. However, the growth in earnings of the Indian corporate sector has remained muted by and large, and the high valuation multiples are difficult to justify. Which is why valuation multiples have to correct significantly, unless growth momentum accelerates.

Few points of view, related to the government taking the criticism and the market cycles.

1) As recently as 2013, good quality stocks were available at 5-15X earnings. These were companies with 20% Return on Equity, had healthy balance sheets, with little or no debt. Why should the cycle not go back to those levels before bottoming out?

2) Why can't we accept this correction as a cyclical thing? Every few years we have an upcycle and a down cycle. We had a 5 year upcycle during 2013-18, now if we have a couple of years of down cycle, it is normal market behaviour, why blame the government for it? It's not there weren't sharp corrections during other/ previous regimes.

3) I have studied/analysed data over 25 years, expansion (rerating) and contraction (derating) of multiples. They are part of the market cycles driven by global and domestic liquidity, growth rates, inflation, interest rates, etc. Again, a normal thing that governments can actually do little about.

4) Currently, if we are going through a period of derating (contraction of valuation multiples), why are we so upset about economic principles playing out? These play out across every asset class, every geography, at different points in time.

5) It is human tendency to ascribe a cause and effect relationship to everything or create a correlation between different sets of data even when no relationships exist. It's psychological to blame somebody all the time; the government is always an easy target for the market to fall/ correct.

6) It is individual stocks which we invest in that create wealth for us. Why not focus on finding those wealth enhancing companies/ stocks rather than debate about the government and how useless the bureaucracy is.

7) A large number of stocks went up anywhere from 5X-100X over the last 10 years. Can anybody ascribe reasons for their going up, to anything to do with any government? These companies grew consistently, compounded their earnings year after year and markets acknowledged that and investors were rewarded. Now if those stocks correct, that is also part of the market cycle. Why blame the government? They hadn't gone up because of the government either.

8) I may personally be a BJP supporter, have friends within the ruling party, but I will certainly not be foolish to hope/expect the government to make money for me.

9) Lastly, about politicians and taxes, the sore point for most of us since taxes have gone up. Politicians across the world, across party lines and across time frames, are all the same. They will tax wherever and whenever they find an opportunity to get some extra revenue to cover the deficits. When one accepts this fundamental truth in life, a lot of things become easier. This is my personal experience ■

Vivek Mavani
A SEBI Registered Investment Advisor based in Mumbai

CHOOSING THE RIGHT DEBT FUND

Know All About Modified Duration and Volatility

This is a common 'accrual' strategy wherein the fund invests in fixed income instruments and holds them until maturity, thus earning interest over its tenure.

For those looking for regular income with low-moderate risk, debt funds serve as one of the best investment options. Understanding the workings of debt funds is crucial to making rewarding investments. Once you develop a basic understanding of fixed income (debt) investments, it's time to level up and look at more advanced concepts.

There are two main strategies that are employed for fixed income investing:

- **Hold Till Maturity:** This is a common 'accrual' strategy wherein the fund invests in fixed income instruments and holds them until maturity, thus earning interest over its tenure. Let us understand this through a bond investment illustration.

Say, a fund invests ₹ 1 lakh in a bond with the face value of ₹ 100 and coupon rate of 8%, due in 6 months and maturing in 2 years. If the bond was purchased for ₹ 101, a total of 990 units were bought. Suppose interest rates shoot up after the bond is purchased and bond price rises to ₹ 98 after a month (since interest rates and bond prices are inversely related). The book value of the investment thus drops to ₹ 97,030, resulting in a loss of ₹ 2,970 for the investor. Post six months, the investor receives a coupon interest of ₹ 7,920 (8% of ₹ 100 multiplied by the total number of bond units - 990). Next year, there is a coupon payment of the same amount. When the bond matures after 2 years from purchase, the investor receives the face value. Hence, the maturity amount will be ₹ 99,010 plus the additional coupon interest of ₹ 15,840. Therefore, the investment of ₹ 1 lakh has generated ₹ 114,940.

Thus, despite making a loss of ₹ 2,970 in the first month, the investor still makes an overall profit of ₹14,850 on the initial investment, by holding the bond until maturity, irrespective of the price fluctuation that happened in the interim. This exemplifies the hold till maturity strategy, the objective of which is to generate a stable income. Some examples of funds which hold till maturity include short-term debt funds, fixed maturity plans, liquid funds, credit opportunities funds, ultra-short-term debt funds etc.

- **Duration Calls:** This strategy involves the fund manager observing the trajectory of interest rates. Here is the rationale behind the inverse relationship between bond price and

interest rates, which forms the basis for a duration call strategy. Suppose you purchased a 20-year bond with a coupon of 9% on a face value of ₹ 100 one year back. If interest rates went down by 1% during the year, the bond yield would decline, prompting new issuers to offer a lower coupon rate. Because your 20-year bond yields a higher interest than the one currently being offered, investors who are keen on earning a higher interest would be willing to pay an amount greater than the original ₹ 100. Thus, you could sell the bond at a higher price and thus earn a profit, over and above the coupon payment received already. Also note that if interest rates were to rise, the effect on the bond price would be the opposite.

Additionally, the price sensitivity of a bond to a change in interest rate relates directly to its maturity period. Compare an investor who holds a bond with 9% coupon for 10 years with another who holds a bond of 9% coupon for 1 year. If interest rates decline, the first one earns a higher interest rate for a longer period of time compared to the second. Thus, investors would be willing to pay a higher price for longer maturity bonds compared to shorter maturity bonds when interest rates fall. However, if interest rates rise, the price of bonds with longer maturity will fall more than that of shorter maturity bonds.

So, if you are looking for capital appreciation along with the income, employ a duration call strategy i.e. invest in longer maturity bonds when the interest rates are expected to fall. Examples of debt funds that take duration calls based on interest rates are long-term gilt funds, dynamic bond funds, income funds etc.

When it comes to fixed income investment, the two most important concepts are Yield to Maturity and Modified Duration. Understanding them will help you make superior investment decisions.

YIELD TO MATURITY

Yield to Maturity (or YTM) is the return an investor earns on holding a bond until maturity. In the case of a debt fund, it is the return the fund earns by holding securities in its portfolio till maturity.

For instance, consider a debt fund's portfolio with a YTM of 10% and a duration of 2 years. If there is no fluctuation in the portfolio, the fund will earn a return of 10% (before expenses), as long as it holds the securities in its portfolio for the entire duration of 2 years. If the expense ratio of the fund is 1%, the investor earns 9% interest.

An investor can see the YTM of a debt mutual fund scheme in its monthly factsheet. If it reflects a high YTM, the investor will gain high returns for accrual-based debt funds. However, it is also possible for fund managers to achieve a higher YTM by investing in lower rated papers. Hence, it is advisable investors ensure they understand and are comfortable with the credit risk of the fund before investing.

MODIFIED DURATION

Simply put, modified duration is the price sensitivity of a bond to changes in either yield or interest rates. Therefore, if interest rates decrease by 1% and the modified duration of the bond of 10 years, the bond price will increase by 1%.

If you invest in a low modified duration (2 years or less) bond, you minimise interest rate risk. Subsequently, if you wish for capital appreciation and expect declining interest rates, then choose funds with a higher modified duration. For those with a moderate risk appetite, a modified duration of 3 to 5 years is suitable, while those with a higher risk appetite can choose funds with a modified duration of over 5 years.

Say, an investor chooses a fund with a modified duration of 5 years and YTM of 9% with an expense ratio as 1%. The investor predicts the interest rate to increase by 50 bps during the year.

Thus, his expected return would be = YTM + Interest Rate Change* Modified Duration – Expense ratio

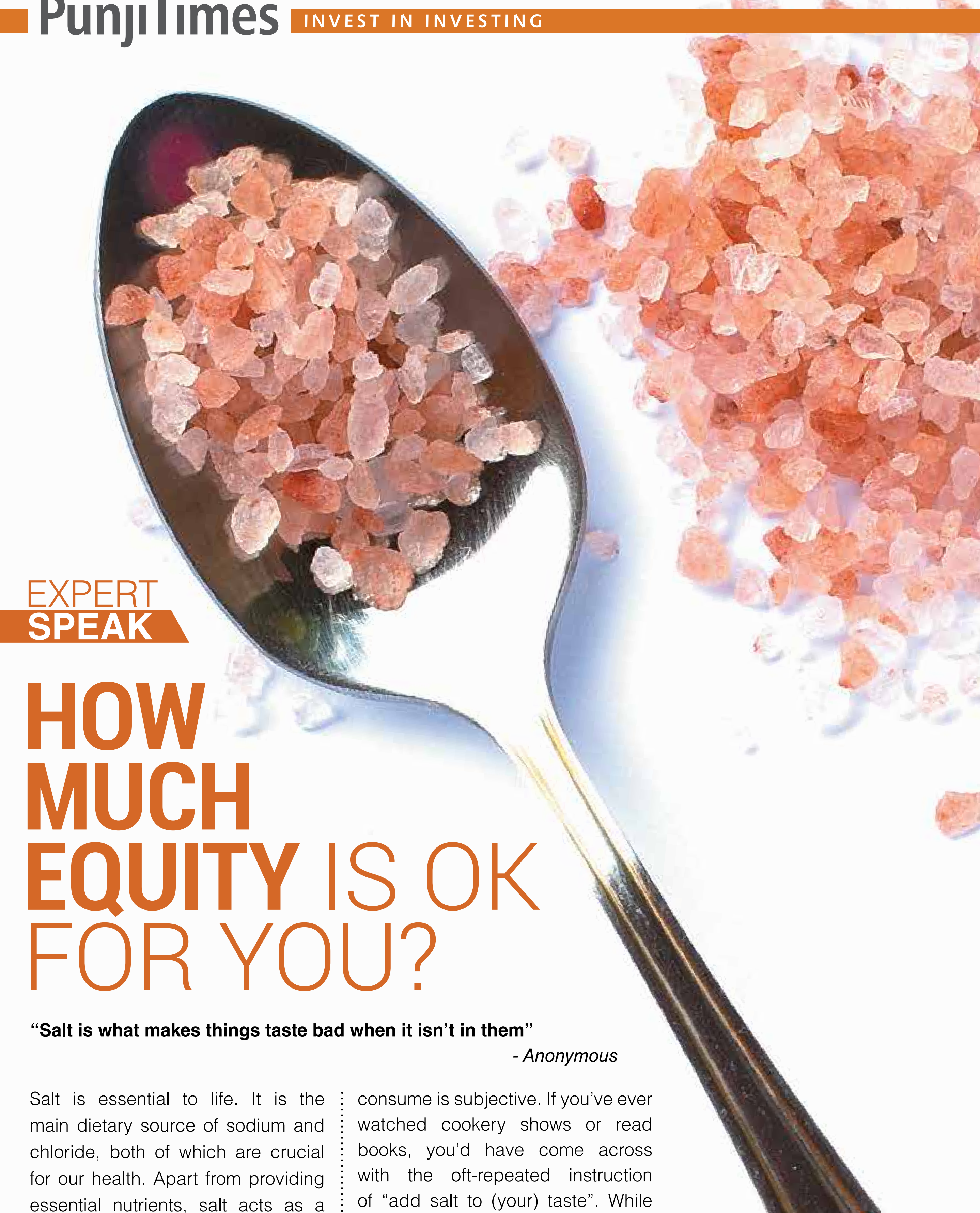
= 9% + 2.5% - 1%

= 10.5%

It is also prudent to understand risk when forming a return expectation. Assuming that interest rates go up by 50 bps during the year, the return is = 9% - 2.5% - 1% = 5.5%

Thus, investors should thoroughly consider the risk-return trade-off when making decisions. It is important to keep in mind that risk is a function of probabilities. If the probability of a favourable event (interest rates declining, in this case) is high, investors must also consider their gain.

Understanding how debt funds work is the first step towards making an informed investment choice. By internalising and applying both basic and advanced concepts, investors stand to earn superior returns on their fixed income investments ■



EXPERT SPEAK

HOW MUCH EQUITY IS OK FOR YOU?

"Salt is what makes things taste bad when it isn't in them"

- Anonymous

Salt is essential to life. It is the main dietary source of sodium and chloride, both of which are crucial for our health. Apart from providing essential nutrients, salt acts as a flavour enhancer, negating bitter tastes in food items.

While the fact that salt is an essential part of one's diet is objective, the right amount of salt one should consume is subjective. If you've ever watched cookery shows or read books, you'd have come across with the oft-repeated instruction of "add salt to (your) taste". While the proportion of other ingredients is measured and defined, when it comes to salt, no recipe defines a concrete measurement and dishes out the confusing "namak swaad anusar".

Ever wondered why? The primary reason is that everyone has a different preference and palate for salt. Moreover, there is a fine balance to maintain with salt. Too little of it and the food may lose its flavour; too much of it and food may end up being unpalatable.

The role of equities in wealth creation is similar to that of salt in cooking. Much like how salt, in the right proportion, acts a flavour enhancer, equities, in the right proportion, ensure long-term wealth creation. Allocating some part of your portfolio to equities is important for beating inflation, creating wealth, and maintaining your financial health over time. While most investors have begun to realize the importance of equities for wealth creation, what puzzles many is the right percentage to add in one's portfolio. Just like with salt, there is no standard measure of equity allocation that will suit everyone.

While equities are certainly more volatile than other asset classes over the short term, equity returns track/mirror the economic growth of the country in the long term, which in a way explains the SENSEX returns of ~ 16% over the last 4 decades vis-à-vis nominal GDP growth of ~ 14%.

The following table brings forth the impact of equities on wealth creation over the long term.

Equity (% of portfolio)	Debt (% of portfolio)	Value after 5 Years	Value after 10 Years
100	0	201	405
80	20	190	367
60	40	179	329
50	50	174	310
40	60	169	291
20	80	158	254
0	100	147	216

Assumed Investment: Rs. 100,
Assumed Rate of Return: Equity 15%, Debt 8%

As seen above, inverting a 20:80 Equity:Debt ratio to 80:20 results in a 21% increase (from 158 to 190) and 45% increase (from 254 to 367) in investment value over 5 and 10 years, respectively.

The above table is for illustrative purposes only and should not be construed as a promise of minimum returns and safeguard of capital. Equity, as an asset class, is riskier than debt. Past performance may or may not be sustained in the future.

The "as per taste" dictum for salt translates to "as per risk appetite" (willingness and ability) for equities. Optimal equity allocation is a function of one's risk tolerance, financial goals, time horizon, and existing wealth. Investors with a longer time horizon, income stability, and relatively lower financial obligations can have a higher equity allocation and vice versa. More often than not, investors do not invest or invest too little in equities by confusing volatility with capital erosion and end up missing out on their financial goals in the long run.

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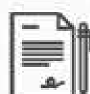

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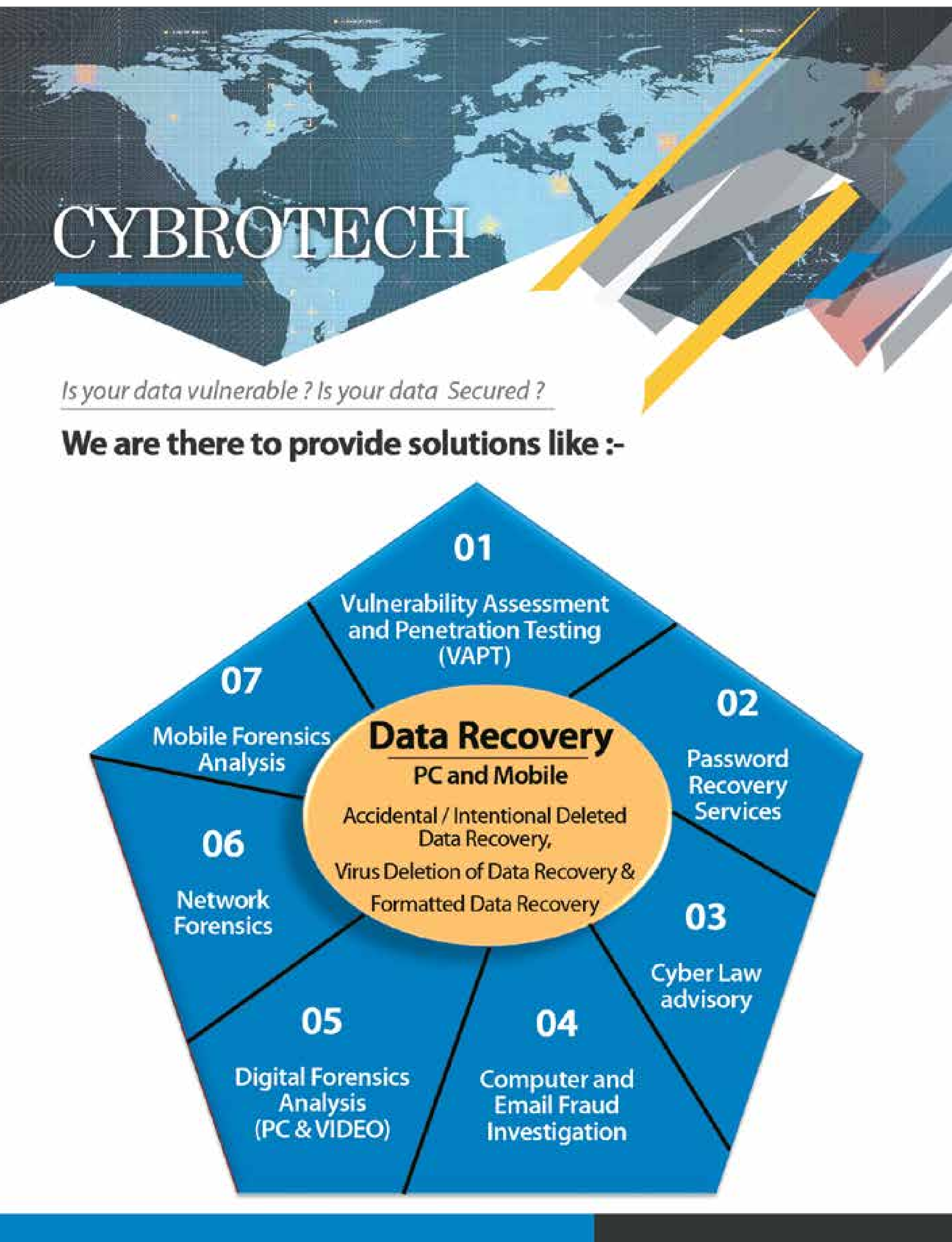

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