LOVELY PROFESSIONAL UNIVERSITY

PERSONAL FINANCIAL PLANNING

Edited By

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SYLLABUS

Personal Financial Planning

Objectives: To enable the students to understand the various components of financial planning and how to get more rewards using risk return trade-off.

Sr. No.	Description
1.	**Basics of Personal Financial Planning:** Definition, Importance and process of financial planning, Concept of time value of money in single and series.
2.	**Managing Investment Risk:** types of risks, measurement and management of risks and financial statements.
3.	**Measuring Investment Returns:** Risk and Return trade-off, Short term and long term capital Gains. Choosing the various source of credit and credit alternatives.
4.	**Investment Vehicles:** Investment concerns, Small saving schemes, Fixed income Instruments, Mutual funds and other investment schemes and Asset classes.
5.	**Investment Strategies:** Various Strategies and asset allocation. Evaluating investment in various stocks and Various Loans and their usage.
6.	**Investment Strategies:** Investing in stocks, bonds and commodities and concept of Futures and options. Insurance Planning;-Personal risk management, Nature and function of Insurance, Need analysis and Various Insurance products. Concept of Health Insurance.
7.	**Retirement Planning:** Process, Annuities and its types, Asset allocation & diversification and concept of mortgage and its types.
8.	**Tax and Estate Planning:** Various heads of incomes, Exemptions in Income tax applicable to various categories. Concept of wealth Tax. Estate Planning need and creation of Will and various formats.
9.	**Strategies of putting together a Complete Financial Plan:** Benefits, Essential components of comprehensive financial plan. Implementing Personal Financial Plan.
10.	**Regulatory Environment:** Government regulations and various regulators like SEBI, IRDA, and ethical issues involved in Financial Planning.

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Unit 1: Basics of Personal Financial Planning

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Objectives

After studying this unit, you will be able to:

- Explain issues and concepts related to overall financial planning process;
- Understand the goals and objectives of personal financial planning.

Introduction

As one of the most rapidly developing service industries in India and aided by a world of economic, technological and social change, the role of financial planning is increasingly important in the Indian community. In India, we have endured major economic and regulatory change, including widespread changes in the banking system and, through the late '1990s, a reducing inflation rate in stark contrast to the double-digit inflation earlier. We have seen turbulent times in the stock market and adoption of the depository system, a transition to rolling settlement and the introduction of derivatives. A well-developed debt market still remains a distant dream forcing investors to hold on to illiquid instruments. Senior citizens are facing the brunt of the impact of these changes and as the average age of our population climbs, there is increasing pressure on an early introduction of a social security system for financial support.

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Shadowing and, at times, pre-empting this environment has been an expansion in the type and style of investment products available in the market. Indians, by and large, have increasingly embraced the new investment environment and, the rising popularity of managed funds show an increasing sophistication in the consumer's approach towards their investments. The openings up of the insurance sector and the imminent arrival of broad ranging pension reforms have primed both the economy and society for the development of the personal financial planning.

India is not alone in witnessing the emergence of the financial planning profession, as several other countries have adopted the' Certified Financial Planner', CFP, marks from the US-based CFM Board of Standards. In recent years we have seen Australia, United Kingdom, Germany, France, Japan, Canada, South Africa, New Zealand, Switzerland, Singapore, Malaysia, South Korea, and Hong Kong securing the right to use the CFP mark as a means of designating the standing of a financial planner. The CFP designation is based on the education and experience of the practitioner.

Your enrolment in the CFP Professional Education Program is one major step toward achieving CFP status. In India today, advice on financial needs of individuals is being given by bank managers, accountants, share brokers, real estate and life insurance agents. With the growth in the professional recognition of financial planning continuing unabated the world over, people are increasingly turning to the financial planner for comprehensive financial advice. For example, a recent study done in April 2000 in Australia showed that 31.3% of the 1200 adults surveyed would approach a financial planner/adviser, up from 27.1% in the survey of June 1997.

Internationally, it is not just the wealthy and those about to retire who are turning to financial planners for advice. For example, families with young children, a loan and other financial commitments are increasingly seeking professional advice on managing their current finances and building a sound financial future. Financial planners are in a unique position to assist all Indians who are willing to put a value to sound financial advice because of the range of services they can offer. An increasing community awareness of such services is no doubt linked to the growth in the profession.

A career in financial planning offers the potential to gain both personal satisfaction from assisting clients meet their financial objectives and personal financial security for the successful practitioner. While it is a rewarding career, it is a career which requires an ongoing commitment from the practitioner to continuing education and professional development.

In this section, the first topic of this unit, we will introduce you to the professional world of the financial planner. We address the nature and scope of services offered in comprehensive financial planning, the professional environment of the financial planner, including the Financial Planning Standards Board, India (FPSB, India) Code of Ethics and Rules of Professional Conduct and the relationship between the client, financial planner and employer.

At the end of this topic, we will outline the way in which financial planning is a continually evolving and changing profession and, importantly, we will identify the professional attributes that define a successful financial planner.

1.1 Meaning and Definition of Personal Financial Planning

Financial planning is the process of meeting your life goals through the proper management of your finances. Life goals can include buying a home, saving for your child's education or planning for retirement.

The financial planning process consists of six steps that help you take a "big picture" look at where you are financially. Using these six steps, you can work out where you are now, what you may need in the future and what you must do to reach your goals.

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The process involves gathering relevant financial information, setting life goals, examining your current financial status and coming up with a strategy or plan for how you can meet your goals given your current situation and future plans.

Personal financial planning is the process of managing your money to achieve personal economic satisfaction. This planning process allows you to control your financial situation. Every person, family, or household has a unique financial position, and any financial activity therefore must also be carefully planned to meet specific needs and goals.

Personal Financial Planning also refers to short- and long-term financial planning by somebody, either independently or with the assistance of a professional adviser. It will include the use of tax-efficient plans such as Individual Retirement Accounts, ensuring adequate provisions are being made for retirement, and examining short- and long-term borrowing requirements such as overdrafts and mortgages.

What is Personal Financial planning?

Financial planning is the process of developing a personal roadmap for your financial well being. The inputs to the financial planning process are: (a) your finances, i.e., your income, assets, and liabilities, (b) your goals, i.e., your current and future financial needs and (c) your appetite for risk. The output of the financial planning process is a personal financial plan that tells you how to use your money to achieve your goals, keeping in mind inflation, real returns, and taxes. In short, financial planning is the process of systematically planning your finances towards achieving your short-term and long-term life goals.

Self Assessment

Fill in the blanks:

1. CFP stands for ……..
2. Personal financial planning is the process of managing your money to achieve personal ……...
3. The output of the financial planning process is a ……
4. The inputs to the financial planning process are finances, your goals and your …….
5. ……..is the process of developing a personal roadmap for your financial well being.

1.2 The Benefits of Financial Planning

Financial planning provides direction and meaning to your financial decisions. It allows you to understand how each financial decision you make affects other areas of your finances. For example, buying a particular investment product might help you pay off your mortgage faster or it might delay your retirement significantly. By viewing each financial decision as part of a whole, you can consider its short and long-term effects on your life goals. You can also adapt more easily to life changes and feel more secure that your goals are on track.

One of the commonly asked questions is "can you do your own financial planning?"

Some personal finance software packages, magazines or self-help books can help you do your own financial planning. However, you may decide to seek help from a professional financial planner if:

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- you need expertise you don't possess in certain areas of your finances. For example, a planner can help you evaluate the level of risk in your investment portfolio or adjust your retirement plan due to changing family circumstances.
- you want to get a professional opinion about the financial plan you developed for yourself.
- you don't feel you have the time to spare to do your own financial planning.
- you have an immediate need or unexpected life event such as a birth, inheritance or major illness.
- you feel that a professional adviser could help you improve on how you are currently managing your finances.
- you know that you need to improve your current financial situation but don't know where to start.

Here's a list of the benefits that a well chalked out financial plan can bring about:

- Helps monitor cash flows and reduces unnecessary expenditure.
- Enables maintenance of an optimum balance between income and expenses.
- Helps boost savings and create wealth.
- Helps reduce tax liability.
- Maximizes returns from investments.
- Creates wealth and ensures better wealth management to achieve life goals.
- Financially secures retirement life.
- Reviews insurance needs and therefore also ensures that dependents are financially secure in the unfortunate event of death or disability.
- Lastly, it also ensures that a will is made.

1.3 Importance of Personal Financial Planning

Can you manage without financial planning? Many people do, but they may find—often when it's too late—that they don't have the means to achieve their life goals.

For example, people today realize the importance of living life to the fullest. Consequently, many opt for early retirement from full time jobs, as compared to a few decades ago, when most people worked until the maximum retirement age of 58-60 years.

The average person can, today, expect to live a healthy life well into his or her seventies or eighties, which means that retirement life is almost as long as working life. Financially, it implies that savings (after taking into account inflation) should be enough, not just to maintain the same lifestyle for almost 25-30 years, with no new income, but also to take care of medical expenses, which are usually high the older a person gets. Planning for all this is a tall order for anyone. That's why it's critical for everyone to plan their finances from an early age.

Over the last few years, terms like financial planning and personal finance have emerged as buzzwords of sorts. Newspapers, magazines, television channels and just about every one under the sun seem to be talking about the importance of financial planning. So what is financial planning; more importantly, does it merit the attention that it is being given?

Financial planning is a process through which an individual can chart a roadmap to meet expected and unforeseen needs in life. Simply put, the intention is to take necessary steps to

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ensure that the individual is equipped to accomplish what he has set out to achieve and is prepared to deal with contingencies as well.

And yes, the importance of financial planning (especially in the present scenario) cannot be overstated. Among others, two factors are responsible for the same i.e. inflation and changing lifestyles.

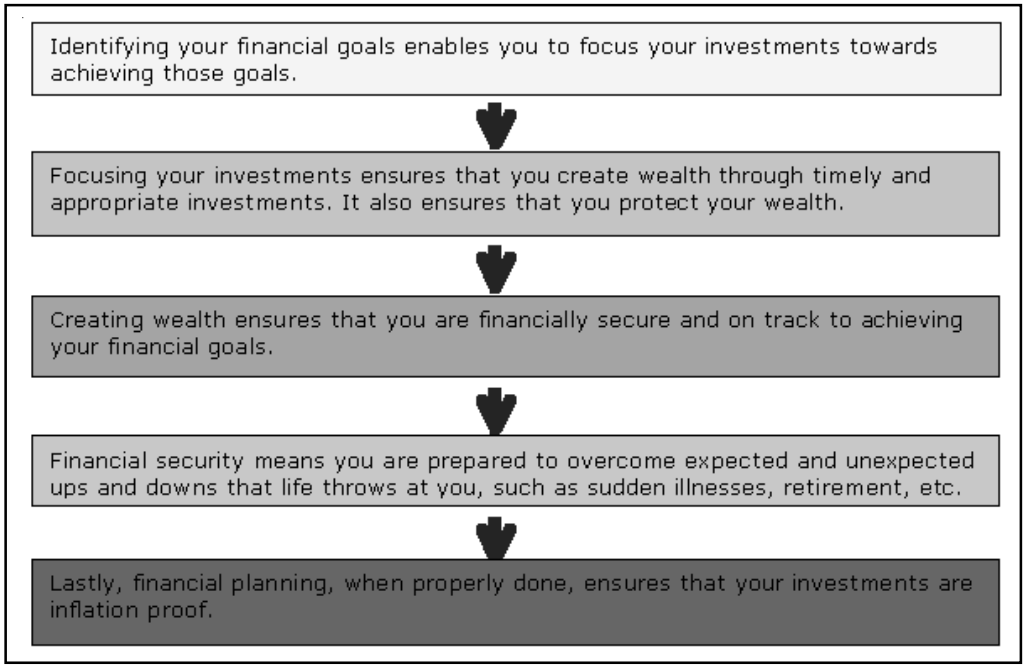
Inflation is a situation where too much money chases a limited number of goods. This leads to a fall in the value of money. It is also expressed as a rise in the general price level. For example, a product that costs ₹ 100 at present would cost ₹ 105 a year from today, assuming that prices rise at 5 per cent. This is the impact of rising prices over one year; over a 30-Yr period, assuming that inflation continues to rise at 5 per cent, the same product will be available at ₹ 432!

Financial planning can ensure that one is equipped to deal with the impact of inflation, especially in phases like retirement when expenses continue but income streams dry up.

The second factor is changing lifestyles. With higher disposable incomes, it is common for individuals to upgrade their standard of living. For example, objects like cars that were considered luxuries not too long ago, have become necessities today. Financial planning has a role to play in helping individuals both upgrade and maintain their lifestyle as well.

Finally, there are contingencies like medical emergencies or unplanned expenditures that an individual might have to cope with. Sound financial planning can enable him to easily mitigate such situations, without straining his finances.

Financial planning can help you achieve peace of mind since:



Self Assessment

State True or False:

6. Financial planning is a process through which an individual can chart a roadmap to meet expected and unforeseen needs in life.

7. Financial planning cannot ensure that one is equipped to deal with the impact of inflation.

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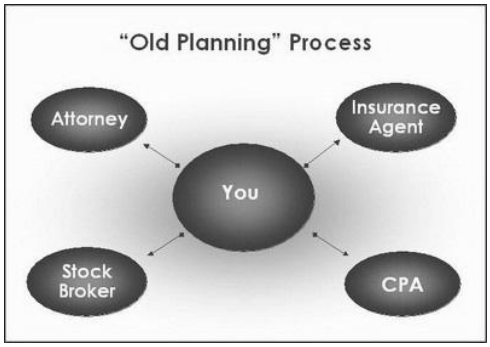
8. Financial planning has no role to play in helping individuals both upgrade and maintain their lifestyle as well.

1.4 Process of Financial Planning

1.4.1 Old Personal Financial Planning



Earlier the people used various financial advisors such as an insurance agent to manage their insurance policies, a stock broker for managing their equities and stocks, an attorney and a CPA for managing their taxation etc.

This method of financial planning led to more complexity and difficulty because of following reasons:

1. The person or the client has to reveal his financial soundness to all the financial advisors
2. Each financial advisor may give different suggestions for financial planning and many times conflict each other resulting in confusion(for client) as to which advice to follow
3. The client has to pay service charges or fees to all the advisors separately resulting in increased cost of management.

1.4.2 New Method of Personal Financial Planning

Most people want to handle their finances so that they get full satisfaction from each available dollar. Typical financial goals include such things as a new car, a larger home, advanced career training, extended travel, and self-sufficiency during working and retirement years. To achieve these and other goals, people need to identify and set priorities. Financial and personal satisfaction is the result of an organized process that is commonly referred to as personal money management or personal financial planning.

The specific advantages of personal financial planning include:

- Increased effectiveness in obtaining, using, and protecting your financial resources throughout your lifetime.
- Increased control of your financial affairs by avoiding excessive debt, bankruptcy, and dependence on others for economic security.
- Improved personal relationships resulting from well-planned and effectively communicated financial decisions.
- A sense of freedom from financial worries obtained by looking to the future, anticipating expenses, and achieving your personal economic goals.

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We all make hundreds of decisions each day. Most of these decisions are quite simple and have few consequences. Some are complex and have long-term effects on our personal and financial situations.

The personal financial planning process is according to ISO 22222:2005 six-step processes which are as follows:

(1) Determining your current financial situation

(2) Developing financial goals

(3) Identifying alternative courses of action

(4) Evaluating alternatives

(5) Creating and implementing a financial action plan, and

(6) Reevaluating and revising the plan.

Step 1: Determine Your Current Financial Situation

In this first step of the financial planning process, you will determine your current financial situation with regard to income, savings, living expenses, and debts. Preparing a list of current asset and debt balances and amounts spent for various items gives you a foundation for financial planning activities.

Step 2: Develop Financial Goals

You should periodically analyze your financial values and goals. This involves identifying how you feel about money and why you feel that way. The purpose of this analysis is to differentiate your needs from your wants.

Specific financial goals are vital to financial planning. Others can suggest financial goals for you; however, you must decide which goals to pursue. Your financial goals can range from spending all of your current income to developing an extensive savings and investment program for your

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future financial security. Such objectives may include short term goals including savings for a deposit on a house or car, or savings for a holiday, and may be for periods of up to three to four years. Longer term goals of beyond four years include mortgage reduction, superannuation savings for retirement and general wealth accumulation.

Caution Financial goals must be defined as specifically as possible. Saying that you need to save money next year is not a specific goal. But instead you must clearly define your financial goal as how much money you need to save and for what purpose.

Example: I need to save ₹ 20,000 each month from my salary so as to buy a luxury car of ₹ 8 Lac by next year is a specific financial goal.

Life Goals

Most people nurture dreams of owning a bigger house or car, exploring the world, giving their children the best possible education, a blissful retirement, etc. Basically, these dreams are life goals. Consider this example.

Example: Mr and Mrs Bhanot, 35 and 32 respectively, have a three year old daughter. Both work in private sector companies. Mr Bhanot plans to retire when he's 50. From their current one bedroom rented suburban Mumbai apartment, the Bhanots hope to move to their own two bedroom apartment costing around ₹ 25 lakh within the next five years. They own a small car, for which they have availed of a loan. Mr Bhanot reckons that he will need ₹ 15 lakh for his daughter's higher education 15 years later. He also wants to build a corpus of ₹ 75 lakh for his retirement.

While distinguishing short-term goals from long-term goals, you must keep in mind that, as a general rule, any life goal that needs to be met within five years can be considered as short-term. Beyond that, any other goal can be classified as long term. By this classification, the Bhanots' goals can be classified as follows:

Short-term Goals	Long-term Goals
2BHK apartment	Daughter's higher education
	Retirement corpus

Using a similar yardstick, you may classify your own life goals. Each of them needs financing. How you plan your finances, to have the right amount at your disposal at the right time, is what financial planning is about.

Task List down your own five short-term and long-term financial goals.

Step 3: Identify Alternative Courses of Action

Developing alternatives is crucial for making good decisions. Although many factors will influence the available alternatives, possible courses of action usually fall into these categories:

- Continue the same course of action.
- Expand the current situation.

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- Change the current situation.
- Take a new course of action.

Not all of these categories will apply to every decision situation; however, they do represent possible courses of action.

Creativity in decision making is vital to effective choices. Considering all of the possible alternatives will help you make more effective and satisfying decisions.

Step 4: Evaluate Alternatives

- You need to evaluate possible courses of action, taking into consideration your life situation, personal values, and current economic conditions.
- Consequences of Choices. Every decision closes off alternatives. For example, a decision to invest in stock may mean you cannot take a vacation. A decision to go to school full time may mean you cannot work full time. **Opportunity cost** is what you give up by making a choice. This cost, commonly referred to as the trade-off of a decision, cannot always be measured in dollars.
- Decision making will be an ongoing part of your personal and financial situation. Thus, you will need to consider the lost opportunities that will result from your decisions.
- Evaluating Risk
- Uncertainty is a part of every decision. Selecting a college major and choosing a career field involve risk. What if you don't like working in this field or cannot obtain employment in it?
- Other decisions involve a very low degree of risk, such as putting money in a savings account or purchasing items that cost only a few dollars. Your chances of losing something of great value are low in these situations.
- In many financial decisions, identifying and evaluating risk is difficult. The best way to consider risk is to gather information based on your experience and the experiences of others and to use financial planning information sources.

Financial Planning Information Sources

Relevant information is required at each stage of the decision-making process. Changing personal, social, and economic conditions will require that you continually supplement and update your knowledge.

Step 5: Create and Implement a Financial Action Plan

In this step of the financial planning process, you develop an action plan. This requires choosing ways to achieve your goals. As you achieve your immediate or short-term goals, the goals next in priority will come into focus.

To implement your financial action plan, you may need assistance from others. For example, you may use the services of an insurance agent to purchase property insurance or the services of an investment broker to purchase stocks, bonds, or mutual funds.

Step 6: Re-evaluate and Revise Your Plan

Financial planning is a dynamic process that does not end when you take a particular action. You need to regularly assess your financial decisions. Changing personal, social, and economic factors may require more frequent assessments.

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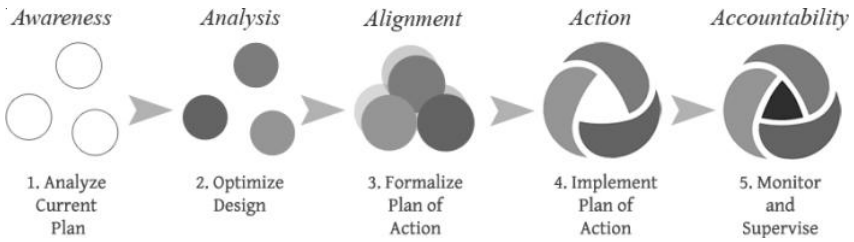
When life events affect your financial needs, this financial planning process will provide a vehicle for adapting to those changes. Regularly reviewing this decision-making process will help you make priority adjustments that will bring your financial goals and activities in line with your current life situation.

Notes There are Five A's of Personal Financial Planning. These are:

- Awareness
- Analysis
- Alignment
- Action
- Accountability



1.4.3 Tips for making the most of the Financial Planning Process

1. Start now. Even if you are in your mid thirties or forties, it's better to start now than dawdle for another five years. Every day counts.
2. Be honest with yourself. Seek help when needed.
3. Set sensible, measurable goals for yourself. Be realistic in your expectations of the results of financial planning.
4. Review your plan and financial situation periodically and adjust as needed.
5. Always review the performance of your investments; pull out if needed and reinvest the money elsewhere.
6. Be hands-on. It's your money and no one else will do your work for you.

1.4.4 Features of a Good Financial Plan

How do you evaluate the quality and effectiveness of your financial plan? Well, here's a checklist you can use.

- Does it indicate your current financial situation?
- Does it list out all your goals in measurable terms?
- Does it lay out an investment strategy?

If professional help is sought, your financial planner will ensure that your financial plan also contains the following:

- List of possible risks and a risk management plan.
- Expected returns from each investment.

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- A mapping between the investments and goals, i.e., how each investment helps you achieve your goals.
- Details of one time and recurring fees charged by him.

1.5 Scope of Personal Financial Planning

Personal financial planning covers all areas of an individual's financial needs and should result in the achievement of each of the financial goals. The scope of personal financial planning would usually include the following:

1. ***Risk Management and Insurance Planning:*** Managing cash flow risks through sound risk management and insurance techniques
2. ***Investment and Planning Issues:*** Planning, creating and managing capital accumulation to generate future capital and cash flows for reinvestment and spending
3. ***Retirement Planning:*** Planning to ensure financial independence at retirement including 401Ks, IRAs etc.
4. ***Tax Planning:*** Planning for the reduction of tax liabilities and the freeing-up of cash flows for other purposes
5. ***Estate Planning:*** Planning for the creation, accumulation, conservation and distribution of assets
6. ***Cash Flow and Liability Management:*** Maintaining and enhancing personal cash flows through debt and lifestyle management
7. ***Relationship Management:*** Moving beyond pure product selling to understand and service the core needs of the client
8. Education Planning for kids and the family members.

1.6 Financial Planner

A financial planner or personal financial planner is a practicing professional who helps people deal with various personal financial issues through proper planning, which includes: cash flow management, education planning, retirement planning, investment planning, risk management and insurance planning, tax planning, estate planning and business succession planning (for business owners).

The work engaged in by this professional is commonly known as personal financial planning. In carrying out the planning function, he is guided by the financial planning process to create a financial plan; a detailed strategy tailored to a client's specific situation, for meeting a client's specific goals. The key defining aspect of what the financial planner does is that he considers all questions, information and advice as it impacts and is impacted by the entire situation of the client.

1.6.1 Reasons for hiring a Financial Planner

People enlist the help of a financial planner because of the complexity of performing the following:

- Finding direction and meaning in one's financial decisions;
- Understanding how each financial decision affects other areas of finance; and
- Adapting to life changes to feel more financially secure.

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The best results of working with a comprehensive financial planner, from an individual client or family's perspective are:

- To create the greatest probability that all financial goals (anything requiring both money and planning to achieve) are accomplished by the target date, and
- To have a frequently-updated sensible plan that is proactive enough to accommodate any major unexpected financial event that could negatively affect the plan, and
- To make intelligent financial choices along the way (whether to "buy or lease" whether to "refinance or pay-off" etc.).

Before working with a comprehensive financial planner, a client should establish that the planner is competent and worthy of trust, and will act in the client's interests rather than being primarily interested in selling the client financial products for his own benefit. As the relationship unfolds, an individual financial planning client's objective in working with a comprehensive financial planner is to clearly understand what needs to be done to implement the financial plan created for them. So, in many ways, a financial planner's step-by-step written implementation plan of action items, created after the plan is completed, has more value to many clients than the plan itself. The comprehensive written lifetime financial plan is a technical document utilized by the financial planner, the written implementation plan of action is just a few pages of action items required to implement the plan; a much more "usable" document to the client.

1.6.2 Functions of a Financial Planner

A financial planner specializes in the planning aspects of finance, in particular personal finance, as contrasted with a stock broker who is generally concerned with the investments, or with a life insurance intermediary who advises on risk products.

Financial planning is usually a multi-step process, and involves considering the client's situation from all relevant angles to produce integrated solutions. The six-step financial planning process has been adopted by the International Organization for Standardization (ISO). Financial planners are also known by the title financial adviser in some countries, although these two terms are technically not synonymous, and their roles have some functional differences.

Although there are many types of 'financial planners,' the term is used largely to describe those who consider the entire financial picture of a client and then provide a comprehensive solution. To differentiate from the other types of financial planners, some planners may be called 'comprehensive' or 'holistic' financial planners.

Other financial planners may specialize in one or more areas, such as insurance planning (risk management) or retirement planning.

Financial planning is a growing industry with projected faster than average job growth through 2014.

Case Study

Financial Planning isn't just for the Rich

A lot of people feel that financial planning is only for the rich and it isn't at the top of mind of many first jobbers. After all, if one does not have a lot of money what is there to plan? But eventually you may want to buy that first house, get married, travel the world or retire early. Where will that money come from if you did not plan?

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Financial planning does not have to be complicated but neither is it a monthly budget plan. Although a monthly budget is a component of the bigger picture. Start by thinking how you can save. An investor must remember the line, 'it's not how much you earn but how much you safe that matters.' Then how you can protect that wealth, think of yourself as a wealth making machine hence, insurance – medical, life and general insurance is important – to protect your capability to continue to build wealth. Start thinking and understanding about building wealth via investments be it real estate, mutual funds or shares.

What are the keys to financial planning a newbie at work should know? Do not squander away your hard earned money. Do not think you are young hence you have a lot of time to save for your retirement and that dream home.

Money does not work that way. It has its own set of rules and if you do not obey it, you will pay for it in double. What are some of the keys to good financial planning?

1. ***Pay Yourself First:*** It basically means when you get your pay, put some aside for yourself immediately. Better yet, siphon it to an account where withdrawing is tough. Almost always you will still have money to take care of other bills when you pay yourself first. This money is for a rainy day, emergency cash and cash for investment opportunities that may crop up.

2. ***Living Expenses:*** You can then start to pay off all your living expenses bills. There are the cell phone, rent, student loan, car loans, utilities bill, etc. to pay off. Of course the grocery bills and transportation costs. I like to keep leisure out of these living expenses because to me these are priorities, if these aren't taken care of, it can lead to debt accumulation. Especially paying off loan installments where interest can compound one month after another.

3. ***Save for the Future:*** Under save for the future, lump the desired lifestyle you want for your family in here. It means taking into account what you want for your future. Is it a house, paying for your children's education, etc?. Financial freedom starts when you know how to manage your money. Think about investments in this category. You do not just save this money in the bank, you use it to invest in order to hedge against inflation and also to grow your money. This is an important part of keys to financial planning as it helps grow the money. Inflation is a money virus that will shrink the value of your money. Use investment as an antidote for this.

4. ***Personal Development:*** You need to continually improve yourself. I know at a young age you may not think about this too much. Start this habit early and allocate, even if it is a small sum for personal development. For example, something as simple as reading about managing money and investments. What about work related books to help you improve your work quality? All these go a long way in making you a better person.

5. ***Leisure:*** Of course, you must reward yourself. There is no sense in working so hard for the money but not being able to enjoy it. Use this pool of money in moderation though. Allocate some money for leisure - weekend breaks, movies, or even the yearly traveling.

6. ***Charity:*** You do not exist in this world alone. You need to know you are truly blessed and one way to show gratitude is to contribute the money you have earned. Rich are those who can give, for one who is poor has nothing to give. Of course, for the purpose of this article I am talking about giving money, but you can go beyond that like giving your time and energy.

Contd...

Notes

The keys to financial planning aren't all about investments and saving, it includes fun and taking care of others as well. Do not be afraid to ask questions and read more about financial planning. The earlier you plan the better it will be for you.

Questions

1. What are the keys to financial planning a newbie at work should know?
2. What is the importance of personal financial planning?

1.7 Summary

Personal financial planning is the process of managing your money to achieve personal economic satisfaction. This planning process allows you to control your financial situation. Every person, family, or household has a unique financial position, and any financial activity therefore must also be carefully planned to meet specific needs and goals. A comprehensive financial plan can enhance the quality of your life and increase your satisfaction by reducing uncertainty about your future needs and resources.

The personal financial planning process is according to ISO 22222:2005 six-step processes which are as follows:

(1) Determining your current financial situation

(2) Developing financial goals

(3) Identifying alternative courses of action

(4) Evaluating alternatives

(5) Creating and implementing a financial action plan, and

(6) Reevaluating and revising the plan.

A financial planner or personal financial planner is a practicing professional who helps people deal with various personal financial issues through proper planning, which includes: cash flow management, education planning, retirement planning, investment planning, risk management and insurance planning, tax planning, estate planning and business succession planning (for business owners).

1.8 Keywords

Financial Planner: A financial planner or personal financial planner is a practicing professional who helps people deal with various personal financial management issues.

Financial Planning: Financial planning is the process of meeting your life goals through the proper management of your finances.

Personal Financial Planning: Personal financial planning is broadly defined as "a process of determining an individual's financial goals, purposes in life and life's priorities, and after considering his resources, risk profile and current lifestyle, to detail a balanced and realistic plan to meet those goals."

1.9 Review Questions

1. What is Personal Financial Planning?
2. Why should everyone do personal financial planning?

Notes

3. Discuss the benefits of personal financial planning.
4. List down the major advantages of personal financial planning.
5. What are the various steps involved in personal financial planning?
6. Define "Financial Planner". What are the functions of a financial planner?
7. What is a Financial Plan? Who can formulate a financial plan?
8. What are the inputs and output of a financial planning process?
9. "It is always better to hire a financial planner or advisor for managing your finances." Discuss.
10. What are the objectives behind hiring a financial planner?
11. What are the characteristics of good financial plan?

Answers: Self Assessment

1.	Certified Financial Planner	2.	Economic satisfaction
3.	Personal financial plan	4.	your appetite for risk.
5.	Financial planning	6.	True
7.	False	8.	False

1.10 Further Readings

Books

Chandra, P. *Financial Management - Theory and Practice*, New Delhi, Tata McGraw-Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management,* New Delhi, Excel Books, 2008

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management,* New Delhi, Prentice Hall of India Pvt. Ltd., 1996. p. 2.

Online link

http://www.fei.org/

Notes

Unit 2: Time Value of Money

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Objectives

After studying this unit, you will be able to:

- Learn about the concept of time value of money
- Discuss various techniques of calculating the time value of money
- Calculate the time value of money in single
- Calculate the value of money in series

Introduction

Like any business enterprise, every individual wants to maximize his wealth and money. This requires him to take appropriate decisions on financing, investment and dividends. While taking these decisions, the individual must keep the "Time factor" in mind.

For example,

(i) When interest on funds raised will have to be paid.

(ii) When return on investment will be received.

(iii) Whether it will be received on a consistent basis or otherwise etc.

All this requires that the person should know about the various valuation concepts, viz., Compound Value Concept, Annuity Concept, Present Value Concept etc. All these concepts are basically based upon the fact that, money has time value.

2.1 Meaning of Time Value of Money

"Money has time value" means that the value of money changes over a period of time. The value of a rupee, today is different from what it will be, say, after one year.

Money has a time value because of the following reasons:

(i) Individuals generally prefer current consumption to future consumption.

(ii) An investor can profitably employ a rupee received today, to give him a higher value to be received tomorrow or after a certain period of time.

(iii) In an inflationary economy, the money received today, has more purchasing power than money to be received in future.

(iv) 'A bird in hand is worth two in the bush' : This statement implies that, people consider a rupee today, worth more than a rupee in the future, say, after a year. This is because of the uncertainty connected with the future.

Thus, the fundamental principle behind the concept of time value of money is that, a sum of money received today, is worth more than if the same is received after some time.

Example: If an individual is given an alternative either to receive ₹ 10,000 now or after six months; he will prefer ₹ 10,000 now. This may be because, today, he may be in a position to purchase more goods with this money than what he is going to get for the same amount after six months.

Time value of money or time preference of money is one of the central ideas in finance. It becomes important and is of vital consideration in decision making. This will be clear with the following example.

Notes

Example: A project needs an initial investment of ₹ 1,00,000. It is expected to give a return of ₹ 20,000 p.a. At the end of each year, for six years. The project thus involves a cash outflow of ₹ 1,00,000 in the 'zero year' and cash inflows of ₹ 20,000 per year, for six years. In order to decide, whether to accept or reject the project, it is necessary, that the present value of cash inflows received annually for six years is ascertained and compared with the initial investment of ₹ 1,00,000. The firm will accept the project only when the present value of the cash inflows at the desired rate of interest is at least equal to the initial investment of ₹ 1,00,000.

2.2 Valuation Concepts or Techniques

The Time value of money implies:

(i) that a person will have to pay in future more, for a rupee received today and

(ii) a person may accept less today, for a rupee to be received in the future.

The above statements relate to two different concepts:

(i) Compound Value Concept

(ii) Discounting or Present Value Concept

2.3 Compound Value Concept

In this concept, the interest earned on the initial principal amount becomes a part of the principal at the end of a compounding period.

Illustration 1

₹ 1,000 invested at 10% is compounded annually for three years, Calculate the Compounded value after three years.

Solution:

Amount at the end of 1st year will be: 1,100

[1000 × 110/100 = 1,100]

Amount at the end of 2nd year will be: 1,210

[1100 × 110/100 = 1,210]

Amount at the end of 3rd year will be: 1,331

[1210 × 110/100 = 1,331]

This compounding process will continue for an indefinite time period.

Compounding of Interest over 'N' years: The compounding of Interest can be calculated by the following equation.

$$A = P (1 + i)^n$$

In which,

A = amount at the end of period 'n'.

P = Principal at the beginning of the period.

i = Interest rate.

n = Number of years.

Notes

By taking into consideration, the above illustration we get,

$A = P(1+i)^n$

$A = 1000(1 + .10)^3$

$A = 1{,}331$

Notes Computation by this formula can also become very time consuming if the number of years increase, say 10, 20 or more. In such cases to save upon the computational efforts, **Compound Value table*** can be used. The table gives the compound value of ₹ 1, after 'n' years for a wide range of combination of 'I' and 'n'.

For instance, the above illustration gives the compound value of ₹ 1 at 10% p.a. at the end of 3 years as 1.331, hence, the compound value of ₹ 1000 will amount to :

1000 × 1.331 = ₹ 1331

Self Assessment

Fill in the blanks:

1. Simple interest (SI) = Po (I) (.....).
2. According to dividend capitalization approach dividend is paid .....
3. An annuity is a stream of ..... annual flows.
4. ..... is repayment of loan over a period of time.
5. The nominal rate of interest and ..... per year is equal.

2.3.1 Multiple Compounding Periods

Interest can be compounded, even more than once a year. For calculating the multiple value above, logic can be extended. For instance, in case of Semi-annual compounding, interest is paid twice a year but at half the annual rate. Similarly in case of quarterly compounding, interest rate effectively is 1/4th of the annual rate and there are four quarter years.

Formula:

$$A = P\left[1+\frac{i}{m}\right]^{m\times n}$$

Where,

A = Amount after a period.

P = Amount in the beginning of the period.

i = Interest rate.

m = Number of times per year compounding is made.

n = Number of years for which compounding is to be done.

Illustration 2

An amount of ₹ 1500.00 is deposited in a bank paying an annual interest rate of 4.3%, compounded quarterly. Find the balance after 6 years.

Notes

Solution:

Using the formula above, with P = 1500, r = 4.3/100 = 0.043, n = 4, and t = 6:

$$A = 1500\left(1 + \frac{0.043}{4}\right)^{4\times 6} = 1938.84$$

So, the balance after 6 years is approximately ₹ 1,938.84.

2.3.2 Future Value of Series of Cash Flows

So far we have considered only the future value of a single payment made at time zero. The transactions in real life are not limited to one. An investor investing money in installments may wish to know the value of his savings after 'n' years.

$$\text{FV of Annuity} = P\left[\frac{(1+r)^n - 1}{r}\right]$$

P = Periodic Payment

r = rate per period

n = number of periods

The future value of an annuity formula is used to calculate what the value at a future date would be for a series of periodic payments.

The future value of an annuity formula assumes that:

1. The rate does not change
2. The first payment is one period away
3. The periodic payment does not change

If the rate or periodic payment does change, then the sum of the future value of each individual cash flow would need to be calculated to determine the future value of the annuity. If the first cash flow, or payment, is made immediately, the future value of annuity due formula would be used.

Illustration 3

Mr. Manoj invests ₹ 500, ₹ 1,000, ₹ 1,500, ₹ 2,000 and ₹ 2,500 at the end of each year. Calculate the compound value at the end of 5 years, compounded annually, when the interest charged is 5% p.a.

Solution:

Statement of the Compound Value

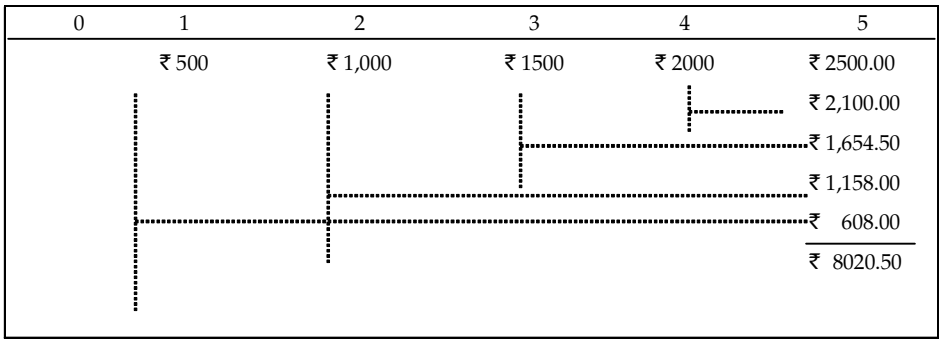
End of year	Amount deposited	Number of years compounded	Compounded Interest factor from Table A – 1	Future Value (2) X (4)
1	2	3	4	5
1	₹ 500	4	1.216	₹ 608.00
2	1,000	3	1.158	1158.00
3	1,500	2	1.103	1,654.50
4	2,000	1	1.050	2,100.00
5	2,500	0	1.000	2,500.00

Amount at the end of the 5th Year ₹ 8020.50

Notes

It may be noted here, that we are making use of the Compound interest formula for each payment separately. For instance, ₹ 500 put at the end of the first year, compounds for four years, and has a future value of ₹ 608 at 5% interest [₹ 500 $(1 + 0.05)^4$]. Similarly, ₹ 1,000 deposited at n = 2 compounds for 3 years, amounts to ₹ 1,158 [₹ $1000(1+0.05)^3$] and so on.

Figure 2.1: Graphic illustration of Compounding Values



2.3.3 Compound Sum of an Annuity

An annuity is a stream of equal annual cash flows. Annuities involve calculations based upon the regular periodic contribution or receipt of a fixed sum of money.

An annuity is a method of accumulating a lump sum of money through a series of regular and equal payments and the reverse, being the liquidation of a lump sum through a series of regular and equal payments.

To annuitize a sum of money means to convert the sum to a series of monthly incomes such as the creation of a monthly retirement income flow.

To understand the math involved in the calculation, one should understand the basics of simple and compound interest. The process involves the interaction of value and time and the interest rate.

Illustration 4

Mr Ramesh deposits ₹ 2,000 at the end of every year for 45 years in his saving account, paying 5% interest compounded annually. Determine the sum of money, he will have at the end of the 5th year.

Solution:

End of Year	Amount Deposited	Number of Years compounded	Compounded Interest factor From Table 3	Future Sum
1	2	3	4	5
1	₹ 2,000	4	1.216	8 2,432
2	2,000	3	1.158	2,316
3	2,000	2	1.103	2,206
4	2,000	1	1.050	2,100
5	2,000	0	1.000	2,000

Amount at the end of 5th Year ₹ 11,054

Notes

Finding the common factor of ₹ 2,000

= ₹ 2,000 (1.216+1.158+1.103+1.050+1.000)

= ₹ 2,000(5.527)

= ₹ 11,054

The above illustration depicts that in order to find the sum of the annuity, the annual amount must be multiplied by the sum of the appropriate compound interest factors. Such calculations are available for a wide range of I and n. To find the answer to the annuity question of illustration 3 we are required to look for the 5% column and the row for the five years and multiply the factor y annuity amount of ₹ 2000. From the table we find that the sum of annuity of Re. 1 deposited at the of each year for 5 years is 5.526(IF). Thus, when multiplied by ₹ 2,000 annuity (A) we find the total sum as ₹ 11,052.

Symbolically $S_n = IF \times A$

Where,

A = is the value of annuity.

IF = represents the appropriate factor for the sum of the annuity of Re.1.

S_n = represents the compound sum of annuity.

Annuity tables are great innovations in the field of investment banking as they guide the depositors and investors as to what sum amount (X) paid for number of years, n, will accumulate to, at a stated rate of compound interest.

Illustration 5

Find the compound value of annuity, when three equal yearly payments of ₹ 25,000 are deposited into an account, that yields 7% compound interest.

Solution:

The Annuity Table gives the compound value as 3,215, when Re.1 is paid every year for 3 years at 7%. Thus, the compounded value of annuity of ₹ 2,000 is :

$S_n = IF \times A$

$S_n = 3.215 \times 2000$

$S_n = 6{,}430$

2.4 Discounting or Present Value Concept

The concept of present value is the exact opposite of that of a sum of money or series of payments, while in case of present value concept, we estimate the present worth or a future payment/ installment or series of payment adjusted for the time value of money.

The basis of present value approach is that, the opportunity cost exist for money lying idle. That is to say, that interest can be earned on the money. This return is termed as 'discounting rate'.

Caution Given a positive rate of interest, the present value of the future Rupee will always be lower. The technique for finding the present value is termed as 'discounting'.

Notes

Present value after 'n' Years:

Formula:

$$PV = \frac{A}{(1+i)^n}$$

Where,

PV = principal amount the investor is willing to forego at present

i = Interest rate.

A = amount at the end of the period 'n'.

n = Number of years.

With this formula, we can directly calculate the amount; any depositor would be willing to sacrifice at present, with a time preference rate or discount rate of x%.

Example: If Mr. X, depositor, expects to get ₹ 100 after one year, at the rate of 10%, the amount he will have to forego at present can be calculated as follows :

$$PV = \frac{A}{(1+i)^n}$$

$$PV = \frac{100}{(1+.10)} = ₹\ 90.90$$

Similarly, the present value of an amount of inflow at the end of 'n' years can be computed.

2.4.1 Present Value of a Series of Cash Flows

In a business situation, it is very natural that returns received by a firm are spread over a number of years. An investment made now may fetch returns a certain time period. Every businessman will like to know whether it is worthwhile to invest or forego a certain sum now, in anticipating of returns he expects to earn over a number of years. In order to take this decision he needs to equate the total anticipated future returns, to the present sum he is going to sacrifice. The estimate of the present value of future series of returns, the present value of each expected inflow will be calculated.

The present value of series of cash flows can be represented by the following:

$$PV = \frac{C_1}{(1+i)^1} + \frac{C_2}{(1+i)^2} + \frac{C_3}{(1+i)^3} + \frac{C_n}{(1+i)^n}$$

$$PV = \sum_{T=1}^{n} \frac{C_t}{(1+i)^n}$$

Where,

PV = sum of individual present values of each cash flow : C_1, C_2, C_3.....

C_n = Cash flows after period 1,2,3……n.

i = Discounting rate.

However, a project may involve a series of cash inflows and outflows. The computation of the present value of inflows by the above equation is a tedious problem. Hence, present value Table is used.

Notes

Illustration 6

Given the time value of money as 10% (i.e. the discounting factor), you are required to find out the present value of future cash inflows that will be received over the next four years.

Year	Cash flows (₹)
1	1,000
2	2,000
3	3,000
4	4,000

Solution:

Present Value of Cash flows

1 Year	2 Cash flows	3 Present Value Factor at 10%	4(2x3) Present Value
1	1,000	0.909	909
2	2,000	0.826	1,652
3	3,000	0.751	2.253
4	4,000	0.683	2,732
Present value of series of Cash flows 7,546			

2.4.2 Present Value of an Annuity

In the above case there was a mixed stream of cash inflows. An individual or depositor may receive only constant returns over a number of years. This implies that, the cash flows are equal in amount. To find out the present value of annuity either, we can find the present value of each cash flow or use the annuity table. The annuity table gives the present value of an annuity of Re. 1 for interest rate 'r' over number of years 'n'.

Illustration 7

Calculate the present value of annuity of ₹ 500 received annually for four years, when the discounting factor is 10%.

Solution:

Present value of annuity of ₹ 500

1 Year	2 Cash flows	3 Present Value Factor at 10%	4(2x3) Present Value
1	500	0.909	454.50
2	500	0.827	413.50
3	500	0.751	375.50
4	500	0.683	341.50
		3.170	
Present value of series of Cash flows ₹ 500			1,585.00

This basically means to add up the Present Value Factors and multiply with ₹ 500.

i.e. 3.170 × 500 = **₹ 1,585.**

Notes

Formula for calculation of the present value of an annuity can be derived from the formula for calculating the present value of a series of cash flows :

$$PVA_n = \frac{C_1}{(1+i)^1} + \frac{C_2}{(1+i)^2} + \frac{C_3}{(1+i)^3} + \frac{C_n}{(1+i)^n}$$

$$= C\left(\frac{1}{(1+i)^1} + \frac{1}{(1+i)^2} + \frac{1}{(1+i)^3} + \frac{1}{(1+i)^n}\right)$$

$$= C\left(\sum_{t=1}^{n} \frac{Ct}{(1+i)^n}\right)$$

Where,

PVA_n = Present value of an annuity having a duration of 'n' periods.

A = value of single instalment.

i = Rate of interest.

However, as stated earlier, a more practical method of computing the present value would be to multiply the annual instalment with the present value factor.

$PVA_n = A \times ADF$

Where ADF denotes Annuity Discount Factor. The PVA_n in the above example can be calculated as 500 × 3.170 = ₹ 1,585.

The figure of 3,170 has been picked up directly from the Annuity Table for present value.

Illustration 8

Find out the present value of an annuity of ₹ 5,000 over 3 years when discounted at 5%.

Solution:

$PVA_n = A \times ADF$

$= 5000 \times 2.773$

$= 13,865$

Present Value of a Perpetual Annuity

A person may like to find out the present value of his investment, in case he is going to get a constant return year after year. An annuity of this kind which goes on for ever is called a 'perpetuity'.

The present value of a perpetual annuity can be ascertained by simply dividing 'A' by interest or discount rate 'i', symbolically represented as A/i.

Illustration 9

Mr. Bharat, principal, wishes to institute a scholarship of ₹ 5,000 for an outstanding student every year. He wants to know the present value of investment which would yield ₹ 5,000 in perpetuity, discounted at 10%.

Solution:

$$P = \frac{A}{1} = \frac{5000}{.10} = 50,000$$

Notes

Illustration 10

Mr. Nandan intends to have a return of ₹ 10,000 p.a. for perpetuity, Incase the discount rate is 20%, calculate the present value of this perpetuity.

Solution:

$$P = \frac{A}{i} = \frac{10,000}{.20} = 50,000$$

This means that, Mr. Nandan should invest ₹ 50,000 at 20% to get an annual return of ₹ 10,000 for perpetuity.

2.5 Valuation of Bonds or Debentures

Meaning: A bond or debenture is an instrument of long-term debt issued by a borrower.

Technique of Valuation of Bonds or Debentures: The value of bonds or debentures is, generally, determined through the technique known as the Capitalization technique.

The process of determination of the present value of a bond or debenture can be considered under two headings viz.,

1. When a bond or debenture is redeemable (i.e. definite maturity period).
2. When a bond or debenture is irredeemable (i.e. as no specified definite maturity period).

Present Value of a Redeemable Bond or Debenture

When a bond or debenture is redeemable, its present value can be determined by estimating its future cash flows, and then, discounting the estimated future cash flows at an appropriate capitalisation rate or discount rate.

The estimated cash flows from the bond or debenture consists of the stream of future interest payments plus the principal repayment.

The appropriate capitalization rate or discount rate to be applied to discount the cash flows from the bond or debenture will depend upon the risk associated with the bond or debenture. If the risk is low, a lower discount rate will be applied. On the other hand, if the risk is high, a higher discount rate would be applied.

The following formula may be used to find out the present value of the bond or debenture (assuming that the bond has a maturity period of 4 years):

$$V = \frac{I_1}{(1+K_d)^1} + \frac{I_2}{(1+K_d)^2} + \frac{I_3}{(1+K_d)^3} + \frac{I_4 + M}{(1+K_d)^4}$$

Where,

V = the present value of the bond or debenture.

I = annual interest payment.

K_d = the capitalization rate or the discount rate.

M = The maturity value of the bond or debenture.

Notes

Self Assessment

State True or False:

6. Current consumption is one of the reasons for time preference of money.
7. Compound value and future value both, are same.
8. There are two rules available to find out double period.
9. Effective rate of interest is more than the nominal rate of interest in single period compounding.
10. Rule 73 is one of the rules of doubling period.
11. Cost of capital interest rate requires rate of return and discounting rate factor, all are used for calculating of PV of cash flows.
12. Compound growth rate formula is Vo (1 + r) = Vn.
13. A series of unequal cash flows are called Annuity.
14. 0.35 + 69/I is the formula used to calculate present value of perpetuity.
15. Cash flows are divided with interest (per cent) rate to calculate future value of perpetuity.

2.6 Practical Implications of Compounding and Discounting Value Concepts

Illustration 11

Suppose you have ₹ 10,00,000 today, and you deposit it in a financial institute, which pays you 8 per cent compound interest annually for a period of 5 years. Show how the deposit would grow.

Solution:

$C_{vn} = P_o (1 + I)^8$

$FV_5 = 10,00,000(1+0.08)^5 = 10,00,000\ (1.469)$

$FV_5 =$ ₹ 14,69,000

Notes See the compound value for one rupee Table for 5 years at 8 per cent rate of interest.

2.6.1 Variable Compounding Periods

Illustration 12 (Semi annual compounding)

How much does a deposit of ₹ 40,000 grow in 10 years at the rate of 6 per cent interest and compounding is done semi-annually. Determine the amount at the end of 10 years.

Solution:

$$CV_{10y} = ₹\ 40,000\left(1+\frac{0.06}{2}\right)^{2\times 10}$$

$$= ₹\ 40,000\ [1.806] = ₹\ 72,240$$

Notes

Notes See the compound value for one rupee Table for year 20 and at 3 per cent interest rate.

Illustration 13 (Quarterly compounding)

Suppose a firm deposits ₹ 50 lakhs at the end of each year, for 4 years at the rate of 6 per cent interest and compounding is done on a quarterly basis. What is the compound value at the end of the 4th year.

Solution:

$$FV_4 = ₹\ 50{,}000{,}000 \left(1 + \frac{0.06}{4}\right)^{4\times4}$$

$$= ₹\ 50{,}00{,}000\ [FV1F_{3y....8y}]$$

$$= ₹\ 50{,}00{,}000 \times 1.267 = ₹\ 63{,}35{,}000$$

2.6.2 Calculation of the Compound Growth Rate

Compound growth rate can be calculated with the following formula :

$$g_r = V_o(1 + r)^n = V_n$$

where,

g_r = Growth rate in percentage.

V_o = Variable for which the growth rate is needed (i.e., sales, revenue, dividend at the end of year '0').

V_n = Variable value (amount) at the end of year 'n'.

$(1 + r)^n$ = Growth rate.

Illustration 14

From the following dividend data of a company, calculate compound rate of growth for period (1998 – 2003).

Year	1998	1999	2000	2001	2002	2003
Dividend per share (₹)	21	22	25	26	28	31

Solution:

$$21\ (1 + r)^5 = 31$$

$$(1 + r)^5 = 31 / 21 = 1.476$$

Notes See the compound value one rupee Table for 5 years (total years – one year) till you find the closest value to the compound factor, after finding the closest value, see first above it to get the growth rate.

Notes

2.6.3 Compounded/Future Value of Series of Cash Flows [Annuity]

Illustration 15

Mr. Bhat deposits each year ₹ 5000, ₹ 10000, ₹ 15000, ₹ 20000 and ₹ 25000 in his savings bank account for 5 years at the interest rate of 6 per cent. He wants to know his future value of deposits at the end of 5 years.

Solution:

$CV_n = 5000(1+0.06)^4+10000(1+0.06)^3+15000(1+0.06)^2+20000(1+0.06)^1 +25000(1+0.06)^0$

$CV_5 = 5000(1.262)+10000(1.191)+15000(1.124)+20000(1.050)+25000(1.00)$

$= 6310 + 11910 + 16860 + 21000 + 25000 =$ ₹ 81,080/-

CV can also be calculated in the following ways.

Year	Amount paid ₹	No. of years compounded	Compound interest factor	Future value ₹
(1)	(2)	(3)	(4)	(5) = (2) x (4)
1	5000	4	1.262	6,310
2	10,000	3	1.191	11,910
3	15,000	2	1.124	16,860
4	20,000	1	1.05	21,000
5	25,000	0	1.00	25,000
TOTAL				**81,080**

2.6.4 Compound Value of Annuity (Even Cash Flows)

Illustration 16

Mr. Ram deposits ₹ 500 at the end of every year, for 6 years at 6 per cent interest. Determine Ram's money value at end of 6 years.

Solution:

$FV_n = P_1 (1+I)^{n-1} + P_2 (1+I)^{n-2} + ... +P_{n-1}(1+I)+P^{n-n}$

$FV_6 = 500(1+0.06)^5+500(1+0.06)^4+500(1+0.06)^3+500(1+0.06)^2+500(1+0.06)^1 + 500(1+0.06)^0$

$= 500(1.338) + 500(1.262) + 500(1.19) + 500(1.124) + 500(1.060) + 500(1.00)$

$= 669 + 631 + 595.5 + 562 + 530 + 500 =$ ₹ 3487.5

By using table format,

Year	Amount Paid ₹	No. of years compounded	Compound interest factor	Future value ₹
1	500	5	1.338	669.00
2	500	4	1.262	631.00
3	500	3	1.191	595.50
4	500	2	1.124	562.00
5	500	1	1.06	530.00
6	500	0	1.00	500.00
TOTAL				**3,487.50**

Notes

Short-cut formula

$$CV_n = P\left[\frac{(1 + I)^n - 1}{I}\right]$$

Where,

P = Fixed periodic cash flow.

I = Interest rate.

n = Duration of the amount.

$$\frac{(1+I)^n - 1}{1} = (FVIFA_{I.n})$$

$(FVIFA_{I.n})$ = Future value for interest factor annuity at 'I' interest and for 'n' years.

Illustration 17

Take the above example.

$$CV_6 = 500\left(\frac{(1+0.06)^6 - 1}{0.06}\right)$$

= 500 [6.975] = ₹ 3487 = 50

Notes See the compound value of annuity table of one rate for 6 years at 6 per cent interest.

2.6.5 Compound Value of Annuity Due

Illustration 18

Suppose you deposit ₹ 2500 at the beginning of every year for 6 years in a saving bank account at 6 per cent compound interest. What is your money value at the end of the 6 years?

Solution:

$$CV_6 = 2500\left(\frac{(1+0.06)^6 - 1}{0.06}\right)(1 + 0.06)$$

= 2500 (6.975) (1 + 0.06) = ₹ 18,483.75

Through the Table format

Year	Cash outflow ₹	No. of times compounded	Compound factor	Compound value (₹)
1	2500	6	1.419	3,547.50
2	2500	5	1.338	3,345.00
3	2500	4	1.262	3,155.00
4	2500	3	1.191	2,977.50
5	2500	2	1.124	2,810.00
6	2500	1	1.06	2,650.00
	TOTAL			**18,485.00**

Notes

2.7 Doubling Period

Doubling period is the time required, to double the amount invested at a given rate of interest. For example, if you deposit ₹ 10,000 at 6 per cent interest, and it takes 12 years to double the amount. (see compound value for one rupee table at 6 per cent till you find the closest value to 2).

Doubling period can be computed by adopting two rules, namely:

1. ***Rule of 72 :*** To get doubling period 72 is divided by interest rate.

   Doubling period (D_p) = 72 ÷ I

   Where,

   I = Interest rate.

   D_p = Doubling period in years.

Illustration 19

If you deposit ₹ 500 today at 10 per cent rate of interest, in how many years will this amount double?

Solution:

D_p = 72 ÷ I = 72 ÷ 10 = 7.2 years (approx.)

2. ***Rule of 69:*** Rule of 72 may not give the exact doubling period, but rule of 69 gives a more accurate doubling period. The formula to calculate the doubling period is:

   D_p = 0.35 + 69 / I

Illustration 20

Take the above problem as it is and calculate doubling period.

Solution:

D_p = 0.35 + 69 / 10 = 7.25 years.

2.8 Effective Rate of Interest in Case of Doubling Period

Sometimes investors may have doubts as to what is the effective interest rate applicable, if a financial institute pays double amount at the end of a given number of years.

Effective rate of interest can be defined by using the following formula:

(a) In case of rule of 72

ERI = 72 per cent Doubling period (D_p)

where,

ERI = Effective rate of interest.

D_p = Doubling period.

Illustration 21

A financial institute has come with an offer to the public, where the institute pays double the amount invested in the institute by the end of 8 years. Mr. A, who is interested to make a deposit, wants to know the affective rate of interest that will be given by the institute. Calculate.

Notes

Solution:

ERI = 72 ÷ D_p = 72 ÷ 8 years = 9 per cent

(b) In case of rule of 69

$$ERI = \frac{69}{D_p} + 0.35$$

Illustration 22

Take the above example:

$$ERI = \frac{69}{8 \text{ years}} + 0.35$$

= 8.98 per cent or 9 per cent

2.9 Present Value

Illustration 23

An investor wants to find the present value of ₹ 40,000, due 3 years. His interest rate is 10 per cent.

Solution:

$$P_v = FV_3\left(\frac{1}{1+I}\right)^3$$

$$= ₹\ 40{,}000\left(\frac{1}{(1+0.10)}\right)^3$$

= ₹ 40,000 [0.751] = ₹ 30,040

Notes Present value of one rupee table at 3 years for the rate of 10 per cent.

2.9.1 Present Value of a Series of Cash Flows

Illustration 24

From the following information, calculate the present value at 10 per cent interest rate.

Year	0	1	2	3	4	5
Cash inflow (₹)	2,000	3,000	4,000	5,000	4,500	5,500

Solution:

$$P_v = \frac{2000}{(1+0.10)^0} + \frac{3000}{(1+0.10)^1} + \frac{4000}{(1+0.10)^2} + \frac{5000}{(1+0.10)^3} + \frac{4500}{(1+0.10)^4} + \frac{5500}{(1+0.10)^5}$$

= 2000 + 2727 + 3304 + 3755 + 3073.5 + 3415.5 = ₹ 18.275

Notes

Present value can also be calculated by the following way:

Years	Cash inflow (₹)	PV Factor 10 per cent	Present value (₹)
0	2000	1.00	2000.0
1	3000	0.909	2727.0
2	4000	0.826	3304.0
3	5000	0.751	3755.0
4	4500	0.683	3073.5
5	5500	0.621	3415.5
Total present value			**18275.0**

Present Value of Even Cash Flows (Annuity)

Present Value of Deferred Annuity

$$PVA_n = \frac{CIF_1}{(1+I)^1} + \frac{CIF_2}{(1+I)^2} + ------ \frac{CIF_n}{(1+I)^{n-1}} + \frac{CIF}{(1+I)^n}$$

or

$$CIF\left(\frac{(1+I)^n - 1}{I(1+I)^n}\right) = CIF(PVIFA_{1.n})$$

Where,

PVA = Present value of annuity.

I = Discounting factor or interest rate.

CIF = Cash inflows.

n = Duration of the annuity.

Illustration 25

Mr. Bhat wishes to determine the PV of the annuity consisting of cash flows of ₹ 40,000 per annum for 6 years. The rate of interest he can earn from this investment is 10 per cent.

Solution:

$$= ₹\ 40{,}000 \times PVIFA_{I.n}$$

$$= ₹\ 4000 \times 4.355 = ₹\ 17{,}420$$

Notes See present value of annuity table for 6 year at 10 per cent.

Alternate Way to Find Present Value

Years	Cash inflow (₹)	PV Factor 10 per cent	Present value (₹)
1	4000	0.91	3640
2	4000	0.826	3304.0
3	4000	0.751	3004.0
4	4000	0.683	2732.0
5	4000	0.621	2484.0
6	4000	0.564	2256.0
PV of Annuity			**17420**

Alternate Way

Years	Cash inflow (₹)	PV factor at 10 per cent	PV (₹)
1 to 6	4000	4.355	17,420

Notes

2.9.2 Present Value of Annuity Due

$PVA_n = CIF\ (FVIF_{I.n})\ (1 + I)$ **or**

$$PVA_n = CIF\left(\frac{1-(1+I)^{-n}}{I}\right)(1+I)$$

Illustration 26

Mr. Bhat has to receive ₹ 500 at the beginning of each year, for 4 years. Calculate personal value of annuity due, assuming 10 per cent rate of interest.

Solution:

PVA_4 = ₹ 500 (3.170) × (1.10) = ₹ 1743.5

Alternatively

Years	Cash inflow (₹)	PV Factor at 10 per cent	Present value (₹)
1	500	1.00	500.0
2	500	0.909	454.5
3	500	0.826	413.0
4	500	0.751	375.5
PV of Annuity			**1743.0**

2.10 Effective vs Nominal Rate

The nominal rate of interest or rate of interest per year is equal. Effective and nominal rate are equal only when the compounding is done yearly once, but there will be a difference, that is, effective rate is greater than the nominal rate for shorter compounding periods. Effective rate of interest can be calculated with the following formula.

$$ERI = \left(1+\frac{I}{m}\right)^m - 1$$

Where,

I = Nominal rate of interest.

m = Frequency of compounding per year.

Illustration 27

Mr. X deposited ₹ 1000 in a bank at 10 per cent of the rate of interest with quarterly compounding. He wants to know the effective rate of interest.

Solution:

$$ERI = \left(1+\frac{0.10}{4}\right)^4 - 1$$

= 1.1038 – 1 = 0.1038 or 10.38 per cent.

2.11 Sinking Fund Factor

The financial manager may need to estimate the amount of annual payments so as to accumulate a predetermined amount after a future date, to purchase assets or to pay a liability. The following formula is useful to calculate the annual payment.

Notes

$$A_p = FVA_n\left(\frac{I}{(1+I)^n - 1}\right)$$

Where,

A_p = Annual payment.

VA_n = Future value after 'n' years.

I = Interest rate.

$$\left(\frac{I}{(1+I)^n - 1}\right) = FVIFA_{I.n}$$

Illustration 28

The finance manager of a company wants to buy an asset costing ₹ 1,00,000 at the end of 10 years. He requests to find out the annual payment required, if his savings earn an interest rate of 12 per cent per annum.

Solution:

$$A_p = 1,00,000\left(\frac{0.12}{(1+0.12)^{10} - 1}\right)$$

= 1,00,000 (0.12 or 2 / 2.1058) = ₹ 5698.5

$$A_p = 1,00,000 \times \frac{1}{FVIFA_{12\%.10y}}$$

$$= 1,00,000 \times \frac{1}{17.548}$$

= ₹ 5698.65

2.11.1 Present Value of Perpetuity

Perpetuity is an annuity of infinite duration. It may be expressed as:

$PV_\mu = CIF \times PVIFA_{I.\mu}$

Where,

PV_μ = Present value of a perpetuity.

CIF = Constant annual cash inflow.

$PVIFA_{I.\mu}$ = PV interest factor for a perpetuity.

PV_μ = CIF / I

Illustration 29

Mr. Bhat an investor, expects a perpetual amount of ₹ 1000 annually from his investment. What is his present value of this perpetuity if the interest rate is 8 per cent?

Solution:

PV_μ = CIF/I = 1000/0.08 = ₹ 12,500

Notes

2.12 Loan Amortisation

Loan is an amount raised from outsiders at an interest and repayable at a specified period (lumpsum) or in installments. The repayment of loan is known as amortisation. A financial manager may take a loan and he may interested to know the amount of equal instalment to be paid every year to repay the complete loan amount including interest. Instalment can be calculated with the following formula:

$$L_I = P_A \left(\frac{I(1+I)^n}{(1+I)^n - 1} \right)$$

or

$$L_I = P_A \div PVIFA_{n.I}$$

Where,

L_I = Loan installment.

P_A = Principal amount.

I = Interest rate.

n = Loan repayment period.

$PVIFA_{n.I}$ = PV interest factors at loan repayment period at a specified interest rate.

Illustration 30

ABC Company took a loan of ₹ 10,00,000 lakh for an expansion program from IDBI at 7 per cent interest per year. The amount has to be repaid in 6 equal annual installments. Calculate the per instalment amount.

Solution:

$$L_I = 10,00,000 \left(\frac{0.06(1+0.06)^6}{(1+0.06)^6 - 1} \right)$$

or

$$L_I = 10,00,000 \div PVIFA_{7\%.\,6y}$$

$$= 10,00,000 \div 4.769 = ₹\ 2,09,687.56$$

2.12.1 Present Value of Growing Annuity

Growing annuity means the cash flow that grows at a constant rate for a specified period of time. In others, the cash flow grows at a component rate.

Steps involved in calculation:

1. Calculate the series of cash flows.
2. Convert the series of cash flows into present values at a given discount factor.
3. Add all the present values, of series of cash flows to get total PV of a growing annuity.

Formula

$$PVG_A = \frac{CIF}{(1+g)} \left(\frac{1 - \frac{(1+g)^n}{(1+I)^n}}{(1-g)} \right)$$

Notes

Where,

PVG_A = PV of growing annuity.

CIF = Cash inflows.

g = Growth rate.

I = Discount factor.

n = Duration of the annuity.

Illustration 31

XYZ real estate agency has rented one of their apartment for 5 years at an annual rent of ₹ 6,00,000 with the stipulation that, rent will increase by 5 per cent every year. If the agency's required rate at return is 14 per cent. What is the PV of expected (annuity) rent?

Solution:

Step 1 : Calculate on series of annual rent

Year	Amount of rent (₹)
1	6,00,000
2	6,00,000 × (1 + 0.05) = 6,30,000
3	6,30,000 × (1 + 0.05) = 6,61,500
4	6,61,500 × (1 + 0.05) = 6,94,575
5	6,94,575 × (1 + 0.05) = 7,29,303.75

Step 2 : Calculate present values

Year	Cash inflow (₹)	Discounting Rate 14 per cent	Present value (₹)
1	600,000	0.877	526200.0
2	630,000	0.769	484470.0
3	661,500	0.675	446512.5
4	694,575	0.592	411188.4
5	729,303.75	0.519	378508.6
Total PV of Annuity			**22,46,879.55**

2.12.2 Shorter Discounting Periods

Generally cash flows are discounted once a year, but sometimes cash flows have to be discounted less than one (year) time, like, semi-annually, quarterly, monthly or daily. The general formula used for calculating the PV in the case of shorter discounting period is:

$$PV = CIF_n \left(\frac{1}{1 + I/m} \right)^{m \times n}$$

Where,

PV = Present value.

CIF_n = Cash inflow after 'n' year.

m = No. of times per year discounting is done.

I = Discount rate (annual).

Notes

Illustration 32

Mr. A expected to receive ₹ 1,00,000 at the end of 4 years. His required rate of return is 12 per cent and he wants to know PV of ₹ 1,00,000 with quarterly discounting.

Solution:

$$PV = 1,00,000 \left(\frac{1}{1+0.12/4}\right)^{4\times4}$$

$$= 1,00,000 \times PVIF_{3\text{per cent } 4y}$$

$$= 1,00,000 \times 0.623 \qquad = ₹\ 62,300$$

Task Calculate the following:

1. Mr. A deposits at the end of each year ₹ 2000, ₹ 3000, ₹ 4000, ₹ 5000 and ₹ 6000 for the consequent 5 years respectively. He wants to know his series of deposits value at the end of 5 years with 6 per cent rate of compound interest.
2. A borrower offers 16 per cent rate of interest with quarterly compounding. Determine the effective rate of income.
3. What is the present value of ₹ 1,00,000, which is receivable after 60 years. If the investor required rate of interest is 10 per cent.

Case Study

Time Value of Money

The application of the time value of money principles can help you make decisions on loan alternatives. This exercise requires you to compare three mortgage alternatives using various combinations and points. Points on a mortgage refer to a payment that is made upfront to secure the loan. A single point is a payment of one per cent of the amount of the total mortgage loan. If you were borrowing ₹ 200,000 a single point would require an upfront payment of ₹ 2,000.

When you are evaluating alternative mortgages, you may be able to obtain a lower rate by making an upfront payment. This comparison will not include an after-tax comparison. When taxes are considered, the effective costs are affected by interest paid and the amortization of points on the loan. This analysis will require you to compare only before-tax costs.

Zeal.com allows you to compare the effective costs on alternative mortgages. You are considering three alternatives for a ₹ 250,000 mortgage. Assume that the mortgage will start in December, 2006. The mortgage company is offering you a 6% rate on a 30-year mortgage with no points. If you pay 1.25 points, they are willing to offer you the mortgage at 5.875%. If you pay 2 points, they are willing to offer you the mortgage at 5.75%.

Questions

1. What are the mortgage payments under the three alternatives?
2. Which alternative has the lowest effective cost?
3. Can you explain how the effective rate is being calculated?

Notes

2.13 Summary

- Time value of money means that the value of money changes over a time.
- It is the sum of money received today is worth more than if the same is received after some time.
- In compound value concept, the interest earned on the initial principal amount becomes a part of the principal at the end of a compounding period.
- Interest can be compounded even more than once a year.
- An investor investing money in installments may wish to know the value of his savings after 'n' years. This is called future value of series of cash flows.
- In case of present value concept, we estimate the present worth adjusted for the time value of money.

2.14 Keywords

Annuity: It is a stream of equal annual cash flows.

Cash Flow: It is the movement of cash into or out of a business, a project, or a financial product. It is usually measured during a specified, finite period of time

Compound Interest: When interest is added to the principal, so that from that moment on, the interest that has been added *also itself* earns interest.

Compound Value: The interest earned on the initial principal becomes a part of the principal at the end of a compounding period.

Present Value: In case of present value concept, we estimate the present worth of a future payment/instalment or series of payment adjusted for the time value of money.

Time Value of Money: Time value of money is that the value of money changes over a period of time.

2.15 Review Questions

1. Mr. X deposited ₹ 1,00,000 in a savings bank account today, at 5 per cent simple interest for a period of 5 years. What is his accumulated interest?
2. Mr. X invested ₹ 40,000 today, for a period of 5 years. Calculate the future value if his required rate of returns is 10 per cent.
3. Suppose you deposit ₹ 1,00,000 with an investment company, which pays 10 per cent interest with semiannual compounding. What is the total deposit amount at the end of 5 years?
4. Mr. A deposits at the end of each year ₹ 2000, ₹ 3000, ₹ 4000, ₹ 5000 and ₹ 6000 for the consequent 5 years respectively. How he can know his series of deposits value at the end of 5 years with 6 per cent rate of compound interest?
5. Assume you have been depositing each year for 5 years, the deposit amount of ₹ 100, ₹ 200, ₹ 300, ₹ 400 and ₹ 500 respectively. Calculate your deposits value if you get 7 per cent compound interest and assume you have deposited in the beginning of each year.
6. If you invest ₹ 500 today, at a compound interest of 9 per cent, what will be its future value after 60 years?

Notes

7. Explain the meaning and importance of valuation concept. How does valuation concept help in decision making?
8. Explain the rule of 69. How does it compare with the rule of 72?
9. "A bird in hand is more preferable than two birds in the bush". Explain.
10. A borrower offers 16 per cent rate of interest with quarterly compounding. Determine the effective rate of income.
11. A finance company has advertised saying that, it will pay a lumpsum of ₹ 44,650 at the end of 5 years to anyone who deposits ₹ 6000 per annum. Mr. A is interested, but he wants to know the implicit rate of interest. Calculate it.
12. What is the present value of ₹ 1,00,000, which is receivable after 60 years. If the investor required rate of interest is 10 per cent.

Answers: Self Assessment

1.	n	2.	Annually
3.	Equal	4.	Amortization
5.	Rate of interest	6.	True
7.	True	8.	True
9.	False	10.	False
11.	True	12.	False
13.	False	14.	False
15.	False		

2.16 Further Readings

Books

Chandra, P. *Financial Management - Theory and Practice*, New Delhi, Tata McGraw-Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management,* New Delhi, Excel Books, 2008

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management,* New Delhi, Prentice Hall of India Pvt. Ltd., 1996. p. 2.

Online link

http://www.fei.org/

Notes

Unit 3: Managing Investment Risks

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Objectives

After studying this unit, you will be able to:

- Identify the various types of risks;
- Understand the method of measuring and handling risks;
- Learn about the management of risks;
- Discuss the use and importance of financial statements in financial planning.

Introduction

The whole gamut of financial decision making centers around the trade-off between risk and return. Decision making of any kind involves both positive and negative aspects. A Farmer tills

Notes

the land, sows the seeds with an expectation of better yield. Till the crop is ripe and he actually reaps the harvest, he rarely knows whether his expectations have come true. In between expectation and reality, there is the interplay of many variables. Continuing the example of the farmer, there are key variables such as weather, seeds, fertilizers, farm management techniques that make the expectations turn into reality. There is the possibility of adverse happening in any of the variables widening the gap between the expectation and reality. The analogy applies equally to a company, to an investment manager and every individual or institution that is faced with a decision making situation.

3.1 Meaning and Definitions of Risk

Risk is a concept that denotes a potential negative impact to some characteristic of value that may arise from a future event. Exposure to the consequences of uncertainty constitutes a risk. In everyday usage, risk is often used synonymously with the probability of a known loss.

Risk communication and risk perception are essential factors for all human decision making.

There are many definitions of risk that vary by specific application and situational context. Risk is described both qualitatively and quantitatively. Qualitatively, risk is proportional to both the expected losses which may be caused by an event and to the probability of this event. Greater loss and greater event likelihood result in a greater overall risk.

Frequently in the subject matter literature, risk is defined in pseudo-formal forms where the components of the definition are vague and ill-defined, for example, risk is considered as an indicator of threat, or depends on threats, vulnerability, impact and uncertainty.

In engineering, the definition of risk is Measuring engineering risk is often difficult, especially in potentially dangerous industries such as nuclear energy. Often, the probability of a negative event is estimated by using the frequency of past similar events or by event-tree methods, but probabilities for rare failures may be difficult to estimate if an event tree cannot be formulated. Methods to calculate the cost of the loss of human life vary depending on the purpose of the calculation. Specific methods include what people are willing to pay to insure against death, and radiological release (e.g., GBq of radio-iodine). There are many formal methods used to assess or to "measure" risk, considered as one of the critical indicators important for human decision making.

Financial risk is often defined as the unexpected variability or volatility of returns and thus includes both potential worse-than-expected as well as better-than-expected returns. References to negative risk below should be read as applying to positive impacts or opportunity (e.g., for "loss" read "loss or gain") unless the context precludes.

In statistics, risk is often mapped to the probability of some event which is seen as undesirable. Usually, the probability of that event and some assessment of its expected harm must be combined into a believable scenario (an outcome), which combines the set of risk, regret and reward probabilities into an expected value for that outcome.

Thus, in statistical decision theory, the risk function of an estimator $\delta(x)$ for a parameter θ, calculated from some observables x, is defined as the expectation value of the loss function L,

In information security, a risk is defined as a function of three variables:

- The probability that there is a threat
- The probability that there are any vulnerabilities
- The potential impact.

If any of these variables approaches zero, the overall risk approaches zero.

Notes

Notes The management of actuarial risk is called risk management.

3.2 Types of Investment Risk

There are many different types of investment risk. The two general types of risk are:

- Losing money, which you can identify as investment risk
- Losing buying power, which is inflation risk

It probably comes as no surprise that there are several different ways you might lose money on an investment. To manage these risks, you need to know what they are.

Most investment risk is described as either systematic or non-systematic. While those terms seem intimidating, what they refer to is actually straightforward.

Systematic risk: The systematic risk affects the entire market. Often we hear that stock market is bear hug or in bull grip. This indicates that the entire market is moving in particular direction either downward or upward. The economic conditions, political situations and the sociological changes affect the security market. There are factors which are beyond the control of corporate and investor. They cannot be entirely avoided by the investor. It drives home the point that the systematic risk is unavoidable. The systematic risk is further sub divided into:

- Market risk
- Interest rate risk
- Purchasing power risk
- ***Market risk:*** It is defined as that portion of total variability of return caused by the alternating forces of bull and bear market. When the security index moves upward haltingly for a significant period of time it is known as bull market. In bull market the index moves from a low level to the peak. Bear market is just a reverse to the bull market.

  The forces that affect the stock market are tangible and intangible events. The tangible events are real events such as earthquake, war, political uncertainty and fall in the value of currency.

  Intangible events are related to market psychology. The market psychology is affected by the real events. But reactions to the tangible events become over reactions and they push the market in a particular direction.

  Any untoward political or economic event would lead to a fall in the price of the security which would be further accentuated by the over reactions and the herd like behavior of the investors. If some institutions start disposing stocks the fear grips in and spreads to other investors. This results in a rush to sell the stocks. This type of over reaction affects the market adversely and the prices of the scrip fall below their intrinsic values. This is beyond the control of the corporate.
- ***Purchasing power risk*:** Variations in the returns are caused also by the loss of purchasing power of currency. Inflation is reason behind the loss of purchasing power. The level of inflation proceeds faster than the increase in capital value. Purchasing power risk is the probable loss in purchasing power of the returns to be received. The rise in rice penalizes the returns to the investor, and every potential rise in price is a risk to the investor.

Notes

- ***Inflation Rate Risk*:** Inflation may be demand pull or cost push inflation. In ***demand pull inflation*** the demand for goods and services are in excess of their supply. At full employment level of factors of production, the economy would not be able to supply more goods in the short run and the demand for products pushes the price upward.

  The ***cost push inflation*** as the name itself indicates that the inflation or the rise in price is caused by the increase in the cost. The increase in the cost of raw material, labor and equipment makes the cost of production high and ends in high price level. The cost push inflation has a spiraling effect on price level.

Unsystematic Risk: It is unique and peculiar to a firm or an industry. Unsystematic risk stems from managerial inefficiency, technological change in the production process, availability of raw material, changes in the consumer preference, and labor problems. The nature and magnitude of the above mentioned factors fifer from industry to industry, and company to company. They have to be analyzed separately for each industry and firm. The changes in the consumer preference affect the consumer products like TV, washing machines, refrigerators more than that of consumer product industry. The nature and mode of raising finance and paying back the loans, involve a risk element. Unsystematic risk can be classified into

- Business risk
- Financial risk
- ***Business Risk:*** It is that portion of unsystematic risk caused by the operating environment of the business risk arises from the inability of a firm to maintain its competitive edge and the growth or stability of earnings. Variation that occurs in the operating environment is reflected on the operating income and expected dividends. The variation in expected operating income indicates the business risk. Business risk is further divided into external business risk and internal business risk.

  - *Internal business Risk:* It is associated with the operational efficiency of the firm. The operational efficiency of operation is reflected on the company's achievement of its pre set goals and the fulfillment of the promises to its investors.

    Fluctuations in the sales: The sales level has to be maintained. It is common in business to lose customers abruptly because of competition. Loss of customers will lead to a loss in operational income. Hence the company has to build a wide customer base through various distribution channels. Diversified sales force any help to tide over this problem.

    Research and Development: Sometimes the product may go out of style or become obsolescent. It is the management, who has to overcome the problem of obsolescence by concentrating on the in house research and development program.

    Personnel Management: The personnel management of the company also contributes to the operational efficiency of the firm. Frequent strikes and lock outs result in loss of production and high fixed capital cost. The labor productivity also would suffer. The risk of labor management is present in all the firms. It is up to the company to solve the problems at the table level and provide adequate incentives to encourage the increase in labor productivity. Encouragement given to the laborers at the floor level would boost morale of the labor force and leads to higher productivity and less wastage of raw materials and time.

    Fixed Cost: The cost components also generate internal risk if the fixed cost is higher in the cost component. During the period of recession or low demand for product the company cannot reduce the fixed cost. At the same time in the boom period also the fixed factor cannot vary immediately. The high fixed cost component in a firm

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would become a burden to the firm. The fixed cost component has to be kept always in a reasonable size so that it may not affect the profitability of the company.

Single Product: The internal business risk is higher in case of firm producing a single product. The fall in demand for a single product would be fatal for the firm. Hence the company has to diversify the products if it has to face the competition and the business cycle successfully.

- *External Risk:* It is the result of operating conditions imposed on the firm by circumstances beyond its control. The external environments in which it operates exert some pressure on the firm. The external factors are:
  - Social and regulatory factors
  - Monetary and fiscal policies of the government
  - Business cycle and general economic environment within which a firm operates.

  Social and regulatory factors: Harsh regulatory climate and legislation against the environmental degradation may impair the profitability of the industry. Price control, volume control, import export control and environment control reduce the profitability of the firm. This risk is more in industries related to public utility sectors such as telecom, banking and transportation.

  Political risk: It arises out of the change in government policy. With a change in the ruling party, the policy also changes. Political risk arises mainly in the case of foreign investment. The host government may change its rules and regulations regarding the foreign investment.

  Business cycle: The fluctuations of the business cycle lead to fluctuations in the earnings of the company. Recession in the economy leads to a drop in the output of many industries. Steel and white consumer goods industries tend to move in tandem with the business cycle. During the boom period there would be hectic demand for steel products ad white consumer goods. But at the same time, they would be hit much during recession period. This risk factor is external to the corporate bodies and they may not be able to control it.

- ***Financial Risk:*** It refers to the variability of the income to the equity capital due to the debt capital. Financial risk in a company is associated with the capital structure of the company. Capital structure of the company consists of equity funds and borrowed funds. The presence of debt and preference capital results in a commitment of paying interest or prefixed rate of dividend. The residual income alone would be available to the equity holders. The interest payment affects the payments that are due to the equity investors. The debt financing increases the variability of the returns to the common stock holders and affects their expectations regarding the return. The use of debt with the owned funds to increase the return to the shareholders is known as financial leverage.

  - *Equity Risk:* Equity risk is the risk that one's investments will depreciate because of stock market dynamics causing one to lose money.

    The measure of risk used in the equity markets is typically the standard deviation of a security's price over a number of periods. The standard deviation will delineate the normal fluctuations one can expect in that particular security above and below the mean, or average. However, since most investors would not consider fluctuations above the average return as "risk", some economists prefer other means of measuring it.

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3.3 Pure Risk

A pure risk is one in which there are only the possibilities of loss or no loss (earthquake).

A category of risk in which loss is the only possible outcome; there is no beneficial result. Pure risk is related to events that are beyond the risk-taker's control and, therefore, a person cannot consciously take on pure risk. This is the opposite of speculative risk.

For example, the possibility that a person's house will be destroyed due to a natural disaster is pure risk. In this example, it is unlikely that there would be any potential benefit to this risk.

There are products that can be purchased to mitigate pure risk. For example, home insurance can be used to protect homeowners from the risk that their homes will be destroyed.

Other examples of pure risk events include premature death, identity theft and career-ending disabilities.

Situation where there is a *chance* of either *loss* or no loss, but no chance of *gain*; for example either a *building* will burn down or it won't. Only pure risks are insurable because otherwise (where the chance of the occurrence of a loss is determinable) *insurance* is akin to betting and the *insured* may stand to gain from it—a situation contrary to the most fundamental *concept* of insurance. Also called absolute risk.

3.3.1 Types of Pure Risks

- Personal risks involve the possibility of a loss or reduction in income, extra expenses or depletion of financial assets:
  - Premature death of family head
  - Insufficient income during retirement
  - Most workers are not saving enough for a comfortable retirement
  - Poor health (catastrophic medical bills and loss of earned income)
  - Involuntary unemployment
- Property risks involve the possibility of losses associated with the destruction or theft of property:
  - Physical damage to home and personal property from fire, tornado, vandalism, or other causes
- Direct loss vs. indirect loss:
  - A direct loss is a financial loss that results from the physical damage, destruction, or theft of the property, such as fire damage to a restaurant
  - An indirect loss results indirectly from the occurrence of a direct physical damage or theft loss, such as lost profits due to inability to operate after a fire
- Liability risks involve the possibility of being held liable for bodily injury or property damage to someone else:

  There is no maximum upper limit with respect to the amount of the loss
  - A lien can be placed on your income and financial assets
  - Defence costs can be enormous

3.4 Measurement of Risk

Notes

Risk measurement must provide answers to following two basic questions:

1. How does the target figure change when the risk factors change?
2. What changes in the risk factor must be reckoned with in the future?

Since risk is variability in the expectations, there are many statistical tools that can be employed to measure risk. The following are the usual statistical techniques that are relied upon.

1. Standard Deviation (SD)
2. Variance (V)
3. Coefficient of Variation (CV)
4. Skewness (Sk)
5. Probability Distribution

1. ***Standard deviation (σ):*** SD provides a measure of the spread of the probability distribution. The larger the SD, the greater would be the dispersion of the distribution. This is denoted by the symbol (σ) sigma. This is commonly used to measure variability in a given distribution. The following equation is used to find out the value of SD.

$$\sigma = \frac{\sqrt{\Sigma(x-\bar{x})^2}}{N}\text{; or}$$

$$\sigma = \sqrt{\frac{\Sigma fx^2}{N} - \left(\frac{\Sigma fx}{N}\right)^2}$$

Where x is the variable under consideration

$(x-\bar{x})^2$ is the square of deviation from the mean of x

'f' is the frequency distribution

In order to understand the significance of SD, let us take a simple example. Let us assume that we have invested in two stocks, A & B. The following are the returns generated by them in a period of five years:

Years	1	2	3	4	5
A(%)	30	28	34	32	31
B(%)	26	13	48	11	57

The average return produced by the above two investments is 31%. Whereas the SD of returns is quite significant. SD for A is 2% and SD for B is 18.5%. This implies that investment on stock A is less riskier than investment in stock B. Perhaps, we may also tend to conclude that investment in B is nine times riskier than investment in A.

2. ***Variance (σ^2):*** The square of SD is called variance. This measures the dispersion around the mean.

3. ***Co-efficient of Variation (CV):*** This is yet another frequently used measure of variation.

$$CV = \frac{\sigma}{\bar{x}} x100$$

The interpretation of this measure is that the lesser the variation in data, the more consistent it is.

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4. ***Skewness (Sk):*** Skewness tells us about the symmetry of the data. Sometimes, a given data of two distributions may produce same mean and the same standard deviation. But the data may differ in terms of the shape of distribution. If a given data are not symmetrical, it is called asymmetrical or skewed. Higher skewness implies higher dispersion. In skewness, there are two possibilities, of data being: (i) positively skewed and; (ii) negatively skewed. Positive skewness implies that there is less likelihood of returns being lower than the mean. Whereas, negative skewness implies higher deviations from the mean. Therefore, positive skewness is considered less risky.

5. ***Probability Distribution:*** Probability distribution is a measure of someone's opinion about the likelihood that an event will occur. In other words, a probability distribution is a statement of the different potential outcomes for an uncertain variable together with the probability of each potential outcome. Typically, probability distributions of returns are estimated using actual historical data. By studying the behavior of stock returns over the recent past, it is possible to come up with a subjective probability assessment for future returns. While assessing risks and returns related to an investment, the expected return from an investment is taken as the average of return from the investment and is calculated as the probability weighted sum of all potential returns. Thus:

   $E(R)=\Sigma\ [P(r) \times r]$

   Where:

   E (R) = Expected return

   P (r) = Probability of a particular value of return

   r = return

   S = sum of all possible outcomes

As per the above equation, each potential return be multiplied by its probability occurrence and then all these products are to be added together.

Example: Computation of Expected Return of Stock 'X'.

Return (%)	Probability	Return X Probability (%)
40	0.3	12
0	0.5	0
-20	0.2	-4
Expected Return=		+ 8

Expected return = $40 \times 0.3 + 0 \times 0.5 + -20 \times .2 = +8$

3.5 Methods of Handling Risk

Because risk is the possibility of a loss, people, organizations, and society usually try to avoid risk, or, if not avoidable, then to manage it somehow. There are five major methods of handling risk: avoidance, loss control, retention, non-insurance transfers, and insurance.

3.5.1 Avoidance

Avoidance is the elimination of risk. You can avoid the risk of a loss in the stock market by not buying or shorting stocks; the risk of a venereal disease can be avoided by not having sex, or the risk of divorce, by not marrying; the risk of having car trouble by not having a car. Many manufacturers avoid legal risk by not manufacturing particular products.

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Of course, not all risks can be avoided. Notable in this category is the risk of death. But even where it can be avoided, it is often not desirable. By avoiding risk, you may be avoiding many pleasures of life, or the potential profits that result from taking risks. Those who minimize risks by avoiding activities are usually bored with their life and don't make much money. Virtually any activity involves some risk. Where avoidance is not possible or desirable, loss control is the next best thing.

3.5.2 Loss Control

Loss control works by either loss prevention, which involves reducing the probability of risk, or loss reduction, which minimizes the loss.

Losses can be prevented by identifying the factors that increase the likelihood of a loss, then either eliminating the factor or minimizing its effect. For instance, speed and driving drunk greatly increase auto accidents. Not driving after drinking alcohol is a method of loss prevention that reduces the probability of an accident. Driving slower is an example of both loss prevention and loss reduction, since it both reduces the probability of an accident and, if an accident does occur, it reduces the magnitude of the losses, since slower speeds yield less damage.

Most businesses actively control losses because it is a cost-effective way to prevent losses from accidents and damage to property, and generally becomes more effective the longer the business has been operating.

3.5.3 Retention

Risk retention, as active retention or risk assumption, is handling the unavoidable or unavoided risk internally, either because insurance cannot be purchased for the risk, because it costs too much, or because it is much more cost-effective.

Usually, retained risks occur with greater frequency, but have a low severity.

Example: An insurance deductible is a common example of risk retention to save money, since a deductible is a limited risk that can save money on insurance premiums for larger risks.

Businesses actively retain many risks—self-insurance—because of the cost or unavailability of commercial insurance.

Passive risk retention is retaining risk because the risk is unknown or because the risk taker either does not know the risk or considers it a lesser risk than it actually is.

Example: Smoking cigarettes can be considered a form of passive risk retention, since many people smoke without knowing the many risks of disease, and, of the risks they do know, they don't think it will happen to them. Another example is speeding. Many people think they can handle speed, and that, therefore, there is no risk.

However, there is always greater risk to speeding, since it always takes longer to stop, and, in a collision, higher speeds will always result in more damage or risk of serious injury or death, because higher speeds have greater kinetic energy that will be transferred in a collision as damage or injury. Since no driver can possibly foresee every possible event, there will be events that will happen that will be much easier to handle at slower speeds than at higher speeds. For instance, if someone fails to stop at an intersection just as you are driving through, then, at slower speeds, there is obviously a greater chance of avoiding a collision, or, if there is a collision, there will be less damage or injury than would result from a higher speed collision.

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3.5.4 Non-insurance Transfers

Risk can also be managed by non-insurance transfers of risk. The three major forms of non-insurance risk transfer are by ***contract, hedging,*** and, for business risks, by ***incorporating***. A common way to transfer risk by contract is by purchasing the warranty extension that many retailers sell for the items that they sell. The warranty itself transfers the risk of manufacturing defects from the buyer to the manufacturer. Transfers of risk through contract is often accomplished or prevented by a hold-harmless clause, which may limit liability for the party to which the clause applies.

Hedging is a method of reducing portfolio risk or some business risks involving future transactions. Thus, the possible decline of a stock price can be hedged by buying a put for the stock. A business can hedge a foreign exchange transaction by purchasing a forward contract that guarantees the exchange rate for a future date.

Investors can reduce their liability risk in a business by forming a corporation or a limited liability company. This prevents the extension of the company's liabilities to its investors.

3.5.5 Insurance

Insurance is another major method that most people, businesses, and other organizations can use to transfer pure risks by paying a premium to an insurance company in exchange for a payment of a possible large loss. By using the law of large numbers, an insurance company can estimate fairly reliably the amount of loss for a given number of customers within a specific time. An insurance company can pay for losses because it pools and invests the premiums of many subscribers to pay the few who will have significant losses.

Notes Not every pure risk is insurable by private insurance companies. Events which are unpredictable and that could cause extensive damage, such as earthquakes, are not insured by private insurers. Nor are most speculative risks—risks taken in the hope of making a profit.

Self Assessment

Fill in the blanks:

1. Risk is a concept that denotes a potential ..... impact to some characteristic of value that may arise from a future event.
2. Risk communication and risk perception are essential factors for all human .....
3. ..... is defined as that portion of total variability of return caused by the alternating forces of bull and bear market.
4. Risk can also be managed by ..... transfers of risk.
5. Events which are ..... and that could cause extensive damage, such as earthquakes, are not insured by private insurers.

3.6 Assessing Risk

It's one thing to know that there are risks in investing. But how do you figure out ahead of time what those risks might be, which ones you are willing to take, and which ones may never be

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worth taking? There are three basic steps to assessing risk:

- Understanding the risk posed by certain categories of investments
- Determining the kind of risk you are comfortable taking
- Evaluating specific investments

You can follow this path on your own or with the help of one or more investment professionals, including stockbrokers, registered investment advisers, and financial planners with expertise in these areas.

Step 1: Determining the Risk of an Asset Class

The first step in assessing investment risk is to understand the types of risk a particular category or group of investments—called an asset class—might expose you to. For example, stock, bonds, and cash are considered separate asset classes because each of them puts your money to work in different ways. As a result, each asset class poses particular risks that may not be characteristic of the other classes. If you understand what those risks are, you can generally take steps to offset those risks.

Stock Investment-wise Risk Levels

Now that we have discussed risk from the perspective of the investor, let us look at investment risk. This is necessary because different investments carry different levels of risk.

Equities and Mutual Funds

Equities and related investments, such as mutual funds, carry a high level of risk. More importantly, they help you beat inflation and create wealth.

The risk in equities is significantly higher in the short term, when the value of your portfolio depends completely upon the whims of the capital market.

The only way you can avoid this risk completely is by avoiding investing in equities. Hence, investing in equities is essentially an exercise in risk management and risk reduction to a certain extent rather than risk avoidance. Financial products like mutual funds and derivatives are aimed at exactly that.

Debt Instruments

This class of investments includes relatively low risk instruments such as government bonds, money market funds, bank fixed deposits, liquid or gilt funds, and so on.

However, seldom are phenomenal results expected from these investments; in fact, many debt instruments offer a fixed rate of return, which often fails to outrun inflation.

Asset Allocation

Creating an optimal investment mix, bearing in mind risk profile and return objectives, is what asset allocation is all about.

When done properly, asset allocation ensures that a portfolio diversifies or spreads the overall risk across investments. A balanced portfolio should include a mix of equities, debt investments, commodities (such as gold), and real estate. How much capital you invest in each investment class depends upon your risk profile.

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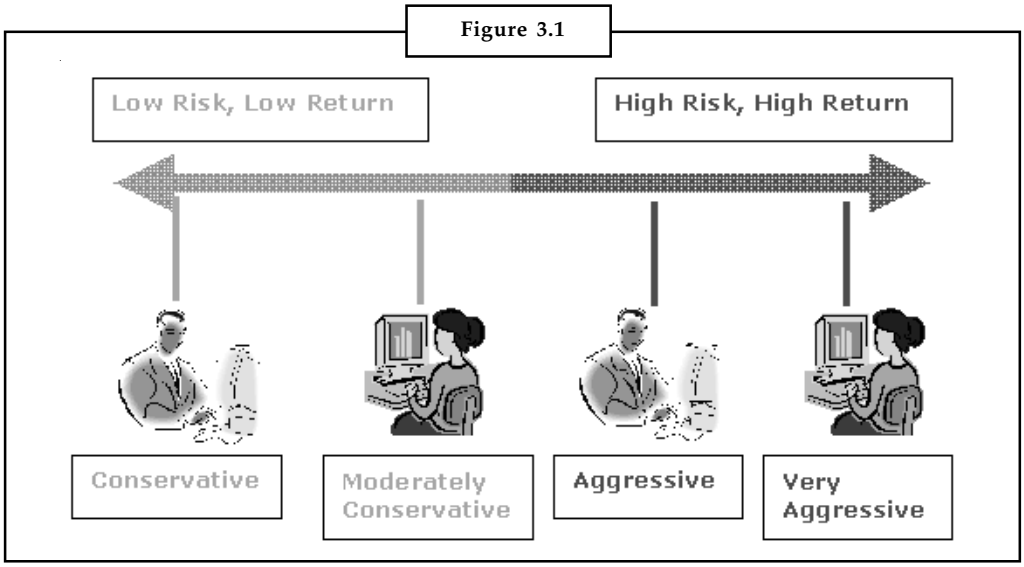
Financial advisors generally classify investors into the following categories based on investor risk:

- Conservative
- Moderately conservative
- Aggressive
- Very aggressive

The following diagram shows how each category of investors would invest. On the green side are the safer, low risk, low return investments, whereas on the red side are the high risk, high return investments.

Figure 3.1



Other asset classes, including real estate, pose their own risks, while investment products, such as annuities or mutual funds that invest in a specific asset class, tend to share the risks of that class. That means that the risk you face with a stock mutual fund is very much like the risk you face with individual stock, although most mutual funds are diversified, which helps to offset non-systematic risk.

Step 2: Selecting Risk

The second step is to determine the kinds of risk you are comfortable taking at a particular point in time. Since it's rarely possible to avoid investment risk entirely, the goal of this step is to determine the level of risk that is appropriate for you and your situation. This decision will be driven in large part by:

- Your age
- Your goals and your timeline for meeting them
- Your financial responsibilities
- Your other financial resources

Age is one of the most important issues in managing investment risk. In general, the younger you are, the more investment risk you can afford to take. The reason is simple: You have more time to make up for any losses you might suffer in the short term.

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Example: Suppose two people, one 30 and the other 60, had been similarly invested in October 2007 in portfolios overloaded with stocks. By March 2009, both would almost certainly have lost substantial amounts of money. But while the younger person has perhaps 35 years to recover and accumulate investment assets, the older person may be forced to delay retirement.

Task Choose any five people of different age groups (between 25-60 years) and analyze the difference in their investment risk appetite. Also find out the reasons behind their investment choices.

On the other hand, having a long time to recover from losses doesn't mean you can ignore the importance of managing risk and choosing investments carefully and selling them when appropriate. The younger you are, the more stock and stock funds—both mutual funds and exchange traded funds—you might consider buying. But stock in a poorly run company, a company with massive debt and noncompetitive products, or a company whose stock is wildly overpriced, probably isn't a good investment from a risk-management perspective, no matter how old you are.

As you get closer to retirement, managing investment risk generally means moving at least some of your assets out of more volatile stock and stock funds into income-producing equities and bonds. Determine what percentage of your assets you want to transfer, and when. That way you won't have more exposure to a potential downturn than you've prepared for. The consensus, though, is to include at least some investments with growth potential (and therefore greater risk to principal) after you retire since you'll need more money if you live longer than expected. Without growth potential, you're vulnerable to inflation.

Keep in mind that your attitude toward investment risk may—and probably should—change over time. If you are the primary source of support for a number of people, you may be willing to take less investment risk than you did when you were responsible for just yourself.

In contrast, the larger your investment base, the more willing you may be to take added risk with a portion of your total portfolio. In a worst-case scenario, you could manage without the money you lost. And if your calculated risk pays off, you may have even more financial security than you had before.

Many people also find that the more clearly they understand how investments work, the more comfortable they feel about taking risk.

Figure 3.1 can be effectively used as a general guideline for identifying how your investments should be allocated. For example, if you fall in the red side, you'll invest a higher slice of the pie in equities. On the other hand, if you're playing it safe, you'll invest more in debt instruments.

As aforesaid, risk taking capacity is determined by investment horizon. Hence how long you plan to stay invested for determines the right investment for you. This is mainly because equities are fairly volatile, and you don't want to chance your investment value dipping just when you need it the most.

However, regardless of your investment horizon, make sure your portfolio has an equity component to create wealth, and a debt component to protect your capital. Depending on your risk profile it is only the proportion of equity: debt that would vary.

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Step 3: Evaluating Specific Investments

The third step is evaluating specific investments that you are considering within an asset class. There are tools you can use to evaluate the risk of a particular investment—a process that makes a lot of sense to follow both before you make a new purchase and as part of a regular reassessment of your portfolio. It's important to remember that part of managing investment risk is not only deciding what to buy and when to buy it, but also what to sell and when to sell it.

For stocks and bonds, the place to start is with information about the issuer, since the value of the investment is directly linked to the strength of the company—or in the case of certain bonds, the government or government agency—behind them.

Company Documents—Each public company in India must be registered under section 3(1)(iv) of the Companies Act, 1956 and provide updated information on a periodic basis. The annual report of the company contains audited financial statements as well as a wealth of detailed information about the company, the people who run it, the risks of investing in the company, and much more.

Caution When you're reading a company's financial statements, don't skip over the footnotes. They often contain red flags that can alert you to pending lawsuits, regulatory investigations, or other issues that could have a negative impact on the company's bottom line.

The company's prospectus, especially the risk factors section, is another reliable tool to help you evaluate the investment risk of a newly issued stock, an individual mutual fund or exchange-traded fund, or a REIT (real estate investment trust). The investment company offering the mutual fund, ETF, or REIT must update its prospectus every year, including an evaluation of the level of risk you are taking by owning that particular investment. You'll also want to look at how the fund, ETF, or REIT has done in the past, especially if it has been around long enough to have weathered a full economic cycle of market ups and downs—which might be as long as 10 years. Keep in mind, however, that past results cannot predict future performance. Also verify that mutual fund managers have not changed. In actively managed funds, it is the managers' picks that determine returns and the level of risk the fund assumes. Past returns would not reflect a new manager's performance.

- ***Rating Service:*** It's important to check what one or more of the independent rating services has to say about specific corporate and municipal bonds that you may own or may be considering. The ratings are provided by agencies such as Morningstar, Standard & Poor's, and Moody's Corporation. All banks and financial institutions have their financial services and products evaluated and rated by such companies, and many investors put their trust in the ratings.' The higher the letter grade a rating company assigns, the lower the risk you are taking. But remember that ratings aren't perfect and can't tell you whether or not your investment will go up or down in value.

Notes Also remember that managing investment risk doesn't mean avoiding risk altogether. There might be times when you include a lower-rated bond or bond fund in your portfolio to take advantage of the higher yield it can provide.

Research companies also rate or rank stocks and mutual funds based on specific sets of criteria. Brokerage firms that sell investments similarly provide their assessments of the probable performance of specific equity investments. Before you rely on ratings to select

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your investments, learn about the methodologies and criteria the research company uses in its ratings. You might find some research companies' methods more useful than others'.

Take a Broad View

While the past performance of an investment never guarantees what will happen in the future, it is still an important tool. For example, a historical perspective can alert you to the kinds of losses you should be prepared for—an awareness that's essential to managing your risk. A sense of the past can also tell you which asset class or classes have provided the strongest return over time and what their average returns are.

Another way to assess investment risk is to stay tuned to what's happening in the world around you. For example, investment professionals who learn that a company is being investigated by its regulator may decide it's time to unload any of its securities that their clients own or that they hold in their own accounts. Similarly, political turmoil in a particular area of the world might increase the risk of investing in that region. While you don't want to overreact, you don't want to take more risk than you are comfortable with.

3.7 Investing to Minimize Risk

While some investors assume a high level of risk by going for the gold or looking for winners most people are interested in minimizing risk while realizing a satisfactory return. If that's your approach, you might consider two basic investment strategies: asset allocation and diversification.

3.7.1 Using Asset Allocation

When you allocate your assets, you decide—usually on a percentage basis—what portion of your total portfolio to invest in different asset classes, usually stock, bonds, and cash or cash equivalents. You can make these investments either directly by purchasing individual securities or indirectly by choosing funds that invest in those securities.

As you build a more extensive portfolio, you may also include other asset classes, such as real estate, which can also help to spread out your investment risk and so moderate it.

Asset allocation is a useful tool in managing systematic risk because different categories of investments respond to changing economic and political conditions in different ways. By including different asset classes in your portfolio, you increase the probability that some of your investments will provide satisfactory returns even if others are flat or losing value. Put another way, you're reducing the risk of major losses that can result from over-emphasizing a single asset class, however resilient you might expect that class to be.

For example, in periods of strong corporate earnings and relative stability, many investors choose to own stock or stock mutual funds. The effect of this demand is to drive stock prices up, increasing their total return, which is the sum of the dividends they pay plus any change in value. If investors find the money to invest in stock by selling some of their bond holdings or by simply not putting any new money into bonds, then bond prices will tend to fall because there is a greater supply of bonds than of investors competing for them. Falling prices reduce the bonds' total return. In contrast, in periods of rising interest rates and economic uncertainty, many investors prefer to own bonds or keep a substantial percentage of their portfolio in cash. That can depress the total return that stock provides while increasing the return from bonds.

While you can recognize historical patterns that seem to indicate a strong period for a particular asset class or classes, the length and intensity of these cyclical patterns are not predictable. That's

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why it's important to have money in multiple asset classes at all times. You can always adjust your portfolio allocation if economic signs seem to favor one asset class over another.

Financial services companies make adjustments to the asset mix they recommend for portfolios on a regular basis, based on their assessment of the current market environment. For example, a firm might suggest that you increase your cash allocation by a certain percentage and reduce your equity holdings by a similar percentage in a period of rising interest rates and increasing international tension. Companies frequently display their recommended portfolio mix as a pie chart, showing the percentage allocated to each asset class.

Modifying your asset allocation modestly from time to time is not the same thing as market timing, which typically involves making frequent shifts in your portfolio holdings in anticipation of which way the markets will turn. Because no one knows what will happen, this technique rarely produces positive long-term results.

3.7.2 Using Diversification

When you diversify, you divide the money you've allocated to a particular asset class, such as stocks, among various categories of investments that belong to that asset class. These smaller groups are called subclasses. For example, within the stock category you might choose subclasses based on different market capitalizations: some large companies or funds that invest in large companies, some mid-sized companies or funds that invest in them, and some small companies or funds that invest in them. You might also include securities issued by companies that represent different sectors of the economy, such as technology companies, manufacturing companies, pharmaceutical companies, and utility companies.

Similarly, if you're buying bonds, you might choose bonds from different issuers—the federal government, state and local governments, and corporations—as well as those with different terms and different credit ratings.

Diversification, with its emphasis on variety, allows you to manage non-systematic risk by tapping into the potential strength of different subclasses, which, like the larger asset classes, tend to do better in some periods than in others. For example, there are times when the performance of small company stock outpaces the performance of larger, more stable companies. And there are times when small company stock falters.

Similarly, there are periods when intermediate-term bonds—Treasury notes are a good example—provide a stronger return than short- or long-term bonds from the same issuer. Rather than trying to determine which bonds to buy at which time, there are different strategies you can use.

For example, you can buy bonds with different terms, or maturity dates. This approach, called a barbell strategy, involves investing roughly equivalent amounts in short-term and long-term bonds, weighting your portfolio at either end. That way, you can limit risk by having at least a portion of your total bond portfolio in whichever of those two subclasses is providing the stronger return.

Alternatively, you can buy bonds with the same term but different maturity dates. Using this strategy, called laddering, you invest roughly equivalent amounts in a series of fixed-income securities that mature in a rolling pattern, perhaps every two years. Instead of investing a lump sum in one note that will mature in 10 years, you can invest small sum of money in a note maturing in two years, another smaller amount of money in a note maturing in four years, and so on. This approach helps you manage risk in two ways:

- If rates drop just before the first note matures, you'll have to invest only small amount at the new lower rate rather than the full bigger amount. If rates behave in traditional fashion, they will typically go up again at some point in the ten-year span covered by your ladder.

Notes

- If you need money in the short term for either a planned or unplanned expense, you could use the amount of the maturing bond to meet that need without having to sell a larger bond in the secondary market.

How much Diversification?

In contrast to a limited number of asset classes, the universe of individual investments is huge. Which raises the question: How many different investments should you own to diversify your portfolio broadly enough to manage investment risk? Unfortunately, there is no simple or single answer that is right for everyone. Whether your stock portfolio includes six securities, 20 securities, or more is a decision you have to make in consultation with your investment professional or based on your own research and judgment.

In general, however, the decision will depend on how closely the investments track one another's returns—a concept called correlation. For example, if Stock A always goes up and down the same amount as Stock B, they are said to be perfectly correlated. If Stock A always goes up the same amount that Stock B goes down, they are said to be negatively correlated. In the real world, securities often are positively correlated with one another to varying degrees. The less positively correlated your investments are with one another, the better diversified you are.

Building a diversified portfolio is one of the reasons many investors turn to pooled investments—including mutual funds, exchange traded funds, and the investment portfolios of variable annuities. Pooled investments typically include a larger number and variety of underlying investments than you are likely to assemble on your own, so they help spread out your risk. You do have to make sure, however, that even the pooled investments you own are diversified—for example, owning two mutual funds that invest in the same subclass of stocks won't help you to diversify.

With any investment strategy, it's important that you not only choose an asset allocation and diversify your holdings when you establish your portfolio, but also stay actively attuned to the results of your choices. A critical step in managing investment risk is keeping track of whether or not your investments, both individually and as a group, are meeting reasonable expectations. Be prepared to make adjustments when the situation calls for it.

3.8 Modern Portfolio Theory

In big-picture terms, managing risk is about the allocation and diversification of holdings in your portfolio. So when you choose new investments, you do it with an eye to what you already own and how the new investment helps you achieve greater balance. For example, you might include some investments that may be volatile because they have the potential to increase dramatically in value, which other investments in your portfolio are unlikely to do.

Whether you're aware of it or not, by approaching risk in this way—rather than always buying the safest investments—you're being influenced by what's called modern portfolio theory, or sometimes simply portfolio theory. While it's standard practice today, the concept of minimizing risk by combining volatile and price-stable investments in a single portfolio was a significant departure from traditional investing practices.

Did u know? In fact, modern portfolio theory, for which economists Harry Markowitz, William Sharpe, and Merton Miller shared the Nobel Prize in 1990, employs a scientific approach to measuring risk, and by extension, to choosing investments. It involves calculating projected returns of various portfolio combinations to identify those that are likely to provide the best returns at different levels of risk.

Notes

Self Assessment

State True or False:

6. The primary risk you face with cash investments, including treasury bills and money market mutual funds, is losing ground to inflation.
7. Morningstar, Standard & Poor's, and Moody's Corporation are examples of rating companies in India.
8. Political turmoil in a particular area of the world does not play any significant role in investing decision in that region.
9. Asset allocation is a useful tool in managing systematic risk because different categories of investments respond to changing economic and political conditions in different ways.
10. Buying bonds with different terms, or maturity dates is a way to minimize risk in investment by asset allocation.

Case Study

Evaluating Investment Banking and Market Risks

Understanding and being able to evaluate the investment banking market and its risks is important for all investors. Investment banking helps companies find the capital needed to expand their business, bring new products to the market and grow the economy. The investment banking system is important to the country's economic well-being and provides a tremendous value for all investors.

One element of investment banking involves the proper management of risk. Risks are always present when investing and can never be eliminated. There are techniques that investment bankers use to manage the risks associated with investing and to help investors and the company's they represent maximize their potential profits.

Elements of Investment Banking

Investment banking involves bringing market companies that seek to sell their stock to the public. Investment bankers evaluate a company's financial information, management team and business to determine how best to introduce the company's stock to the market and provide the best price for that stock.

Investment banking involves both the initial and subsequent offer of a company's stock. The initial offering, which is known as the initial public offering or IPO, sets the initial pricing for a company and provides it with the capital necessary to meet its business objective. The investment banker, as the underwriter, will maintain an interest in the company's stock to sell to the public as part of the exchange market.

Nature and Types of Risk

The work of the investment banker to properly time the offer of an IPO, or secondary offering, of a company's stock is based on their evaluation of the market conditions. A company's stock is less likely to do well when investor's expectations are lower due to an economic hardship or concerns about inflation. The investment banker studies the economy carefully to determine the best time to offer a company's stock.

Risks associated with investing and bringing a company to market includes market risk, credit risk, inflation or purchasing power risk and regulatory risk. Each of these risks is

Contd...

Notes

specific to certain types of companies and is always present. It is the job of investment banker to understand the nature of risk and help companies and investors mange risk properly.

Methods for Handling Risk

Risk can be managed through different strategies design to reduce exposure. An investment banker may recommend that a stock not be sold during a certain period when interest rates are high in order to maximize the price that the company's share can get. Investors use techniques such as diversification and dollar cost averaging as a way to reduce their risk exposure.

Questions

1. What is the role of an investment banker in guiding people about investment?
2. What do you understand by the term: Investment Banking? Name few investment banking companies in India.

3.9 Summary

- Risk is a concept that denotes a potential negative impact to some characteristic of value that may arise from a future event. Exposure to the consequences of uncertainty constitutes a risk.
- Financial risk is often defined as the unexpected variability or volatility of returns and thus includes both potential worse-than-expected as well as better-than-expected returns.
- Modern investment analysis categorizes the traditional sources of risk causing variability in returns into two general types: systematic risk and non-systematic risk.
- Systematic Risk, also referred to as market risk, is the part of total risk that cannot be eliminated or reduced, no matter how well an investor diversifies his or her portfolio.
- Non-systematic Risk, or non-market risk, is the risk that is unique to a particular security or asset class and can be associated with such risks as business, financial, country, exchange rate, and liquidity.
- A pure risk is one in which there are only the possibilities of loss or no loss (earthquake).
- There are mainly five statistical techniques for measurement of risk: standard deviation (sd), variance (v), coefficient of variation (cv), skewness (sk) and probability distribution.
- There are five major methods of handling risk: avoidance, loss control, retention, non-insurance transfers, and insurance.
- The 3 major forms of non-insurance risk transfer are by contract, hedging, and, for business risks, by incorporating.
- Loss control works by either loss prevention, which involves reducing the probability of risk, or loss reduction, which minimizes the loss.
- Insurance is another major method that most people, businesses, and other organizations can use to transfer pure risks by paying a premium to an insurance company in exchange for a payment of a possible large loss.
- There are three basic steps to assessing risk: Understanding the risk posed by certain categories of investments, determining the kind of risk you are comfortable taking and evaluating specific investments.

Notes

- The three major forms of non-insurance risk transfer are by contract, hedging, and, for business risks, by incorporating.

3.10 Keywords

Avoidance: Avoidance is the elimination of risk.

Equity Risk: Equity risk is the risk that one's investments will depreciate because of stock market dynamics causing one to lose money.

Financial Risk: Financial risk is often defined as the unexpected variability or volatility of returns and thus includes both potential worse-than-expected as well as better-than-expected returns.

Hedging: Hedging is a method of reducing portfolio risk or any business risks involving future transactions.

Investment: It refers to a commitment of funds to one or more assets that will be held over some future time period.

Investment Risk: Investment risk is deviation from an expected outcome.

Investor: A person who buys or sells securities for his or her own account or the account of others.

Passive Risk Retention: Passive risk retention is retaining risk because the risk is unknown or because the risk taker either does not know the risk or considers it a lesser risk than it actually is.

Portfolio: A collection or combination of financial assets (or securities) for investment purpose.

Pure Risk: A pure risk is one in which there are only the possibilities of loss or no loss (earthquake).

Risk Retention: Risk retention, as active retention or risk assumption, is handling the unavoidable or unavoided risk internally, either because insurance cannot be purchased for the risk, because it costs too much, or because it is much more cost-effective.

3.11 Review Questions

1. Briefly explain the concept of risk with definitions.
2. What are the different types of risk?
3. Distinguish between Risk and Un-certainty.
4. What are the various statistical available for measurement of risk?
5. Explain in detail the five major methods of risk handling.
6. What is Pure Risk? What are its types?
7. What is the difference between internal risk and external risk?
8. How is insurance an investment tool? Discuss.
9. What are the techniques available to minimize risks in investments? Explain with examples.
10. What is the difference between systematic and unsystematic risk?
11. Explain Modern Portfolio theory with the help of suitable examples.

Notes

Answers: Self Assessment

1.	Negative	2.	Decision making
3.	Market risk	4.	non-insurance
5.	Unpredictable	6.	True
7.	True	8.	False
9.	True	10.	True

3.12 Further Readings

Books

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Online link

http://www.fei.org/

Notes

Unit 4: Measuring Investment Return

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Objectives

After studying this unit, you will be able to:

- Explain the meaning of investment;
- State the different types of investments;
- Explain the concept of risk and return;
- Determine the expected return of an asset;
- Describe the risk free and risky assets.

Introduction

Investment involves making of a sacrifice in the present with the hope of deriving future benefits. Investment has many meanings and facets. The two most important features of an investment are current sacrifice and future benefit. We can identify a variety of activities which display the two features of investment. For example, a portfolio manager buys 10,000 shares of ITC Ltd. for his mutual fund; your relative may have subscribed to the 6-year Post Office Monthly Income Scheme. A corporate firm may spend ₹ 5 crores for expansion programmers; a middle-aged man with a family decides to spend ₹ 10 lakhs to buy an apartment in a city and so on. All these constitute investment activities because they involve current sacrifice of consumption and hope of future gain. Perhaps, an investment in an apartment for the purpose of living in it may involve, partially at least, certain current consumption but because the family will continue to

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live in the house for a very long period of time, the act of purchasing a house or apartment may be taken as an investment activity.

4.1 Risk and Return Trade-off

Return expresses the amount which an investor actually earned on an investment during a certain period. Return includes the interest, dividend and capital gains; while risk represents the uncertainty associated with a particular task. In financial terms, risk is the chance or probability that a certain investment may or may not deliver the actual/expected returns.

The risk and return trade off says that the potential return rises with an increase in risk. It is important for an investor to decide on a balance between the desire for the lowest possible risk and highest possible return.

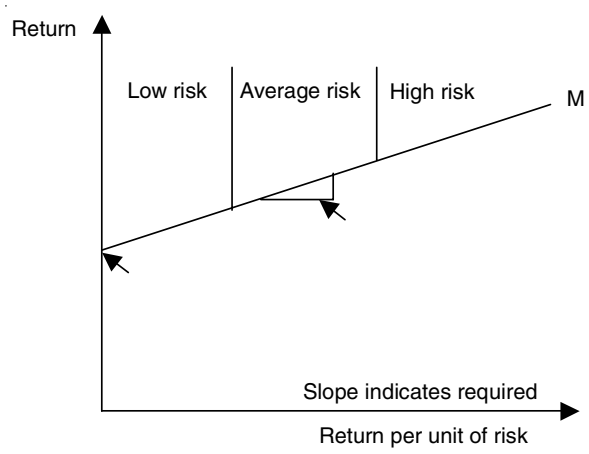
The most fundamental tenet of finance literature is that there is a trade-off between risk and return. The risk-return relationship requires that the return on a security should be commensurate with its riskiness. If the capital markets are operationally efficient, then all investment assets should provide a rate or return that is consistent with the risks associated with them. The risk and return are directly variable, i.e., an investment with higher risk should produce higher return.

The risk/return trade-off could easily be called the "ability-to-sleep-at-night test." While some people can handle the equivalent of financial skydiving without batting an eye, others are terrified to climb the financial ladder without a secure harness. Deciding what amount of risk you can take while remaining comfortable with your investments is very important.

In the investing world, the dictionary definition of risk is the possibility that an investment's actual return will be different than expected. Technically, this is measured in statistics by standard deviation. Risk means you have the possibility of losing some, or even all, of your original investment.

Low levels of uncertainty (low risk) are associated with low potential returns. High levels of uncertainty (high risk) are associated with high potential returns. The risk/return trade-off is the balance between the desire for the lowest possible risk and the highest possible return. This is demonstrated graphically in the figure below. A higher standard deviation means a higher risk and higher possible return. The figure below represents the relationship between risk and return.

Figure 4.1: Risk and Return Relationship



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4.2 Types of Investment

The term "investment" is used differently in economics and in finance. Economists refer to a real investment (such as a machine or a house), while financial economists refer to a financial asset, such as money that is put into a bank or the market, which may then be used to buy a real asset.

In business management the investment decision (also known as capital budgeting) is one of the fundamental decisions of business management: managers determine the assets that the business enterprise obtains. These assets may be physical (such as buildings or machinery), intangible (such as patents, software, goodwill), or financial. The manager must assess whether the net present value of the investment to the enterprise is positive; the net present value is calculated using the enterprise's marginal cost of capital.

A business might invest with the goal of making profit. These are marketable securities or passive investment. It might also invest with the goal of controlling or influencing the operation of the second company, the investee. These are called intercorporate, long-term and strategic investments. Hence, a company can have none, some or total control over the investee's strategic, operating, investing and financing decisions. One can control a company by owning over 50% ownership, or have the ability to elect a majority of the Board of Directors.

In economics, investment is the production per unit time of goods which are not consumed but are to be used for future production. Examples include tangibles (such as building a railroad or factory) and intangibles (such as a year of schooling or on-the-job training). In measures of national income and output, gross investment I is also a component of Gross Domestic Product (GDP), given in the formula GDP = C + I + G + NX, where C is consumption, G is government spending, and NX is net exports. Thus investment is everything that remains of production after consumption, government spending, and exports are subtracted I is divided into non-residential investment (such as factories) and residential investment (new houses). Net investment deducts depreciation from gross investment. It is the value of the net increase in the capital stock per year.

In finance, investment = cost of capital, like buying securities or other monetary or paper (financial) assets in the money markets or capital markets, or in fairly liquid real assets, such as gold, real estate, or collectibles. Valuation is the method for assessing whether a potential investment is worth its price. Returns on investments will follow the risk-return spectrum.

The important options available for investment are as follows:

Cash investments: These include savings bank accounts, certificates of deposit (CDs) and treasury bills. These investments pay a low rate of interest and are risky options in periods of inflation.

Debt securities: This form of investment provides returns in the form of fixed periodic payments and possible capital appreciation at maturity. It is a safer and more 'risk-free' investment tool than equities. However, the returns are also generally lower than other securities.

Stocks: Buying stocks (also called equities) makes you a part-owner of the business and entitles you to a share of the profits generated by the company. Stocks are more volatile and riskier than bonds.

Mutual funds: This is a collection of stocks and bonds and involves paying a professional manager to select specific securities for you. The prime advantage of this investment is that you do not have to bother with tracking the investment. There may be bond, stock- or index-based mutual funds.

Derivatives: These are financial contracts the values of which are derived from the value of the underlying assets, such as equities, commodities and bonds, on which they are based. Derivatives can be in the form of futures, options and swaps. Derivatives are used to minimize the risk of loss resulting from fluctuations in the value of the underlying assets (hedging).

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Commodities: The items that are traded on the commodities market are agricultural and industrial commodities. These items need to be standardized and must be in a basic, raw and unprocessed state. The trading of commodities is associated with high risk and high reward. Trading in commodity futures requires specialized knowledge and in-depth analysis.

Real estate: This investment involves a long-term commitment of funds and gains that are generated through rental or lease income as well as capital appreciation. This includes investments into residential or commercial properties.

4.3 Expected Return of an Asset

Risk and expected return are the two key determinants of an investment decision. Risk, in simple terms, is associated with the variability of the rates of return from an investment; how much do individual outcomes deviate from the expected value? Statistically, risk is measured by any one of the measures of dispersion such as co-efficient of range, variance, standard deviation etc.

The risk involved in investment depends on various factors such as:

- The length of the maturity period – longer maturity periods impart greater risk to investments.
- The credit-worthiness of the issuer of securities – the ability of the borrower to make periodical interest payments and pay back the principal amount will impart safety to the investment and this reduces risk.
- The nature of the instrument or security also determines the risk. Generally, government securities and fixed deposits with banks tend to be riskless or least risky; corporate debt instruments like debentures tend to be riskier than government bonds and ownership instruments like equity shares tend to be the riskiest. The relative ranking of instruments by risk is once again connected to the safety of the investment.
- Equity shares are considered to be the most risky investment on account of the variability of the rates of returns and also because the residual risk of bankruptcy has to be borne by the equity holders.
- The liquidity of an investment also determines the risk involved in that investment. Liquidity of an asset refers to its quick salability without a loss or with a minimum of loss.
- In addition to the aforesaid factors, there are also various others such as the economic, industry and firm specific factors that affect the risk an investment.

Another major factor determining the investment decision is the rate of return expected by the investor. The rate of return expected by the investor consists of the yield and capital appreciation.

Real and Nominal Rate of Return

We have noted earlier that an investment is a postponed consumption. Postponement of consumption is synonymous with the concept of 'time preference for money'. Other things remaining the same, individuals prefer current consumption to future consumption. Therefore, in order to induce individuals to postpone current consumption they have to be paid certain compensation, which is the time preference for consumption. The compensation paid should be a positive real rate of return. The real rate of return is generally equal to the rate of return expected by an investor from a risk-free capital asset assuming a world without inflation. However, in real life, inflation is a common feature of a capitalist economy. If the investor is not compensated for the effects of inflation, the real rate of return may turn out to be either zero or

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negative. Therefore, the investors, generally, add expected inflation rate to the real rate of return to arrive at the nominal rate of return.

For example, assume that the present value of an investment is ₹ 100; the investor expects a real time rate of 3% per annum and the expected inflation rate is 3% per annum. If the investor was to receive only the real time rate, he would get back ₹ 103 at the end of one year. The real rate of return received by the investor would be equal to zero because the time preference rate of 3% per annum is matched by the inflation of 3% per annum. If the actual inflation rate is greater than 3% per annum, the investor would suffer negative returns.

Thus, nominal rate of return on a risk-free asset is equal to the time preference real rate plus expected inflation rate.

If the investment is in capital assets other than government obligations, such assets would be associated with a degree of risk that is idiosyncratic to the investment. For an individual to invest in such assets, an additional compensation, called the risk premium will have to be paid over and above the nominal rate of return.

Determinants of the Rate of Return

Therefore, three major determinants of the rate of return expected by the investor are:

(i) The time preference risk-free real rate

(ii) The expected rate of inflation

(iii) The risk associated with the investment, which is unique to the investment.

Hence,

Required return = Risk-free real rate + Inflation premium + Risk premium

Self Assessment

Fill in the blanks:

1. Return includes the interest, dividend and……; while risk represents the uncertainty associated with a particular task.
2. Risk and expected return are the two key determinants of an …….decision.
3. The risk and return are ……..variable.
4. …….rate of return on a risk-free asset is equal to the time preference real rate plus expected inflation rate.
5. ……are more volatile and riskier than bonds.

4.4 Risk Free and Risky Assets

Two basic investment avenues are:

(i) Financial assets

(ii) Physical assets (real assets)

Investment in financial assets consists of:

(a) Securitized (i.e., security forms of) investments

(b) Non-securitized investments.

Notes

The term 'securities' is used in the broadest sense, consisting of those papers that are quoted and are transferable. Under Section 2(h) of the Securities Contract (Regulation) Act, 1956 (SCRA) 'securities' include:

(i) Shares, scripts, stocks, bonds, debentures, debenture stock or other marketable securities of alike nature in or of any incorporated company or other body corporate.

(ii) Government securities.

(iii) Such other instruments as may be declared by the Central Government to be securities, and

(iv) Rights or interest in securities.

Therefore, in the above context, security forms of investments include equity shares, preference shares, debentures, government bonds, units of UTI and other mutual funds, and equity shares and bonds of Public Sector Undertakings (PSUs).

Non-security forms of investment include all those investments, which are not quoted in any stock market and are not freely marketable, viz., bank deposits, corporate deposits, post office deposits, national savings and other small savings certificates and schemes, provident funds, and insurance policies. The above investments are essentially forms of savings and should be treated as such. In India, nearly 33% of the household savings go into such savings schemes as Post office savings schemes, life insurance, provident funds, etc.

Another popular investment avenue is the investment in physical assets such as gold, silver, diamonds, real estate, antiques etc. Indian investors have always considered physical assets to be attractive investments and, particularly for hedging against inflation. India has a very long tradition in arts and crafts in jewellery, made of gold/silver and precious stones. Moreover, it has been observed that in times of high inflation, investors move away from financial assets into physical assets more particularly, real estate.

On the bases of risk assets can be classified as risk free and risky assets. Although a truly risk free assets is only in theory but they are so safe that the return on risk-free assets is very close to the current interest rate. Government securities are considered as the risk free assets.

The following are the key options which are considered as risky and risk free assets:

4.4.1 Risk Free Assets

The following are the assets which are considered as risk free assets:

1. Government Securities
2. Treasury bills

We will study about these two in detail now.

Government Securities

Government securities (G-secs) or gilts are sovereign securities, which are issued by the Reserve Bank of India (RBI) on behalf of the Government of India (GOI). The GOI uses these funds to meet its expenditure commitments.

Different Types of Government Securities

Following are the different types of government securities:

(a) ***Dated Securities:*** These securities generally carry a fixed coupon (interest) rate and have a fixed maturity period. e.g. an 11.40% GOI 2008 G-sec. In this case, 11.40% is the coupon rate and it is maturing in the year 2008. The salient features of dated securities are:

Notes

(i) These are issued at the face value.

(ii) The rate of interest and tenure of the security is fixed at the time of issuance and does not change till maturity.

(iii) The interest payment is made on half yearly rest.

(iv) On maturity the security is redeemed at face value.

(b) ***Zero coupon bonds:*** These securities are issued at a discount to the face value and redeemed at par i.e. they are issued at below face value and redeemed at face value. The salient features of zero coupon bonds are:

(i) The tenure of these securities is fixed.

(ii) No interest is paid on these securities.

(iii) The return on these securities is a function of time and the discount to face value.

(c) ***Partly paid stock:*** In these securities, the payment of principal is made in installments over a given period of time. The salient features of Partly Paid Stock are:

(i) These types of securities are issued at face value and the principal amount is paid in installments over a period of time.

(ii) The rate of interest and tenure of the security is fixed at the time of issuance and does not change till maturity.

(iii) The interest payment is made on half yearly rest.

(iv) These are redeemed at par on maturity.

(d) ***Floating rate bonds:*** These types of securities have a variable interest rate, which is calculated as a fixed percentage over a benchmark rate. The interest rate on these securities changes in sync with the benchmark rate. The salient features of Floating Rate Bonds are:

(i) These are issued at the face value.

(ii) The interest rate is fixed as a percentage over a predefined benchmark rate. The benchmark rate may be a bank rate, Treasury bill rate etc.

(iii) The interest payment is made on half yearly rests.

(iv) The security is redeemed at par on maturity, which is fixed.

(e) ***Capital indexed bonds:*** These securities carry an interest rate, which is calculated as a fixed percentage over the wholesale price index. The salient features of Capital Indexed Bonds are:

(i) These securities are issued at face value.

(ii) The interest rate changes according to the change in the wholesale price index, as the interest rate is fixed as a percentage over the wholesale price index.

(iii) The maturity of these securities is fixed and the interest is payable on half yearly rates.

(iv) The principal redemption is linked to the wholesale price index.

Invest in Government Securities

Entities registered in India including banks, financial institutions, primary dealers, partnership firms, institutions, mutual funds, Foreign Institutional Investors (FIIs), State Governments,

provident funds, trusts, research organizations, Nepal Rashtra Bank and individuals can invest in government securities.

Advantages and Disadvantages of Investing in Gilts

Advantages

1. The main advantage of investing in G-secs is that there is a minimal default risk, as the instrument is issued by the GOI.
2. G-secs, especially dated securities, offer investors the opportunity to invest in very long-term debt (at times with maturity over 20 years), which is usually not available from the private sector.
3. Although some issues of G-secs tend to be illiquid, there is adequate liquidity in most other issues. In fact, buying and selling from/to a primary dealer can take care of the liquidity risk.

Disadvantages

The main disadvantage of investing in G-secs is the same as in the case of investing in any other debt instrument i.e. possibility of higher interest rates and inflation. While higher interest rates will lead to erosion in value of the bond, a rise in inflation will eat into the real return (though this can be taken care of by buying capital indexed bonds, for example).

Treasury Bills

Treasury bills are short-term money market instruments, which are issued by the RBI on behalf of the GOI. The GOI uses these funds to meet its short-term financial requirements of the government. The salient features on T-Bills are:

(a) These are zero coupon bonds, which are issued at discount to face value and are redeemed at par.

(b) No tax is deducted at source and there is minimal default risk.

(c) The maximum tenure of these securities is one year.

4.4.2 Risky Assets

Investment under all the assets other than the government securities are considered as more risky assets. The given below are the key assets which have higher risk:

1. ***Equity Shares:*** Equity shares represent equity capital, which is the ownership capital because equity shareholders collectively own the company. The ownership of equity shares or stocks confers upon the shareholders the benefits of such ownership, which is a residuary claim on the profits and assets of the company after the claims of others have been satisfied. The shareholders are the last category of those with claims on the company to receive any of its earnings and if the company is dissolved, the last to receive any assets. Equity shareholders also enjoy the right to control the company through the board of directors and have the right to vote on 1 every resolution placed before the general body. Yet another right enjoyed by the equity shareholders is the pre-emptive right that obliges the company to give the existing equity shareholders the first opportunity to purchase, proportionately, additional equity shares called the 'right shares'.

   Equity shares are the first security to be issued by a corporation and, in the event of bankruptcy, the last to be retired. Equity shares, also called common stock, represent a

Notes

share in the ownership of a firm; they have the lowest-priority claim on earnings and assets of all securities issued.

2. ***Money Market Securities:*** Highly liquid debt securities that have short-term maturity periods and involve little or no risk of default are known as money market securities. All money market securities are debts that mature within 364 days or less. Money market securities are frequently issued instead of longer-term debt securities in order to avoid long and costly formalities.

   Money market securities pay continuously fluctuating rate of interest that over somewhere between the rate of inflation and the rate paid by the long-term debt instruments.

   Money market securities typically pay interest to their investors, as a discount from their face (or maturity) values. Indian Government Treasury Bills, for instance, with a face value of ₹ 1 cr. and a maturity of 90 days can be sold for ₹ 97 lacs, when issued by the Treasury Department. The buyer can either hold the security for 90 days or sell it in the active secondary market before it matures. Upon maturity, whosoever owns the T-bill can redeem it for its face value of ₹ 1 cr. The ₹ 3 lac difference between the discounted purchase price of ₹ 97 lac and the maturity value of ₹ 1 cr. is the interest paid to the T-bill's investor (or series of investors).

   (i) *Certificates of Deposit (CD):* One of the money market securities, CD's were innovated by Citibank, New York in 1961. A CD is a receipt from a commercial bank for a deposit of ₹ 10 lakh or more, with certain provisions attached. One of the provisions is that the deposit will not be withdrawn from the bank before a specific maturity date.

   (ii) *Banker's Acceptances:* Securities that are written when a bank inserts itself between the borrower and the investor and accepts the responsibility for paying the loan, thereby shielding the investor from the risk of default.

   (iii) *Commercial Paper (CP):* Refers to the short term promissory notes issued by "blue-chip" corporations - large, old, safe, well known, national companies like TISCO, ONGC, SAIL, etc. The maturities vary from 5 to 270 days, and the denominations are for ₹ 10 lakh or more - usually more. These notes are backed only by the high credit ratings of the issuing corporations.

   (iv) *Bonds Issued by Corporations:* A bond is a marketable legal contract that promises to pay its investors a stated rate of interest and to repay the principal amount at the maturity date. Bonds differ according to their provisions for repayment, security pledged and other technical aspects. Bonds are the senior securities of a corporation in the respect that in the case of bankruptcy of the corporation, the law requires that the bondholders should be paid off before their stock investors.

3. ***Hybrid Instruments:*** A warrant is a long-term call option issued along with a bond or on a stand-alone basis. Warrants are generally detachable from the bond, and they trade separately. When warrants are exercised, the firms receive additional equity capital and the original bonds remain outstanding. Warrants are 'sweeteners' that are used to make the underlying debt or preferred share issue more attractive to investors.

   Fully Convertible Debentures (FCDs) are bonds issued by corporations which are convertible into common stock not too far in to the future. In order to avoid the credit rating process, these bonds are normally converted into common stock in less than 18 months with 6, 12 and 18 months being the normal converse periods. Rate of conversion is usually decided at the time of the issue but a price band can also be specified.

   Partly convertible debentures are a combination of non-convertible debentures and fully convertible debentures.

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Optionally convertible debentures provide an option to the debenture holder, to convert or not to convert. They usually carry an interest rate that they keep on paying if the investor decides not to convert these into equity shares because the market price of the shares is less than the conversion price.

Foreign Currency Convertible Bonds (FCCBs) are exactly like optionally convertible debentures with the difference that these are offered only to overseas investors.

4. ***Social Security Funds:*** Household sector savings in the form of social security funds, which include savings in insurance and in provident and pension funds, constitute the second major category of financial savings next only to deposits.

   Household sector savings in the form of insurance comprise of the life funds of Life Insurance Corporation of India (LIC), Postal Insurance, State Insurance Fund and Central Government Group Insurance Funds.

   Various National Savings Schemes have been introduced from time to time to mobilise public savings for financing the economic development plans. These schemes have been very popular in view of tax benefits enjoyed by them. Unlike commercial bank schemes, these schemes are uniform all over the country. Again, the interest is paid on completed years, no payment being admissible for broken periods of a year. Premature encashment is discouraged. Some of the schemes are offered through the State Bank of India/nationalised banks. The national savings certificates sold through the SBI are designated as "Bank Series". Unlike commercial banks schemes, nomination facility is available for all the National Savings Schemes. Accounts can also be transferred from one post office to another. Further, many of these savings certificates can be pledged as security, towards loan guarantee.

5. ***Fixed Income Securities:*** Fixed income securities consist of government securities, corporate securities and PSU bonds. Securities issued by the Central Government, State Governments, semi-government authorities, autonomous institutions like part trusts, electricity boards, public sector financial institutions and other public sector units are broadly known as gilt-edged securities. Gilt-edged securities include treasury bills and dated securities.

6. ***Bullion/Gold, Silver, and Platinum:*** From times immemorial gold and silver have constituted important media for investment from the points of view of both capital appreciation and liquidity. But these precious metals do not yield any current return. In fact, there is a cost, even if modest, in holding bullion; capital appreciation could also be on some equity shares besides a current return.

   (i) *Gold:* The monthly average price of gold in the Mumbai market recorded a sharp rise of ₹ 9,200 per 10 grams in March 2007 as compared to 27 years ago. Presently, investment on gold (not in jewellery) is a good investment. The rally in gold prices during the second half of 2006-07 in the national and international markets could be largely attributed to supply-demand imbalances. On the supply side, a deceleration in gold production in major gold producing countries and a virtual stoppage of sale of official gold holding by central banks reduced the supply in the market. On the demand side, investors' disappointment with global equity markets and apprehension regarding future inflation following the Federal Reserve's lowering of the short-term lending rate led to a sharp increase in demand for the yellow metal.

   (ii) *Silver/Platinum:* Silver prices in the domestic market in Mumbai fluctuated in a narrow range during April-December 2006, but soared during January through early April 2007. It increased thereafter and this trend continued till May 2007. Silver and Platinum became major investment avenues in our country.

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7. ***Real Estate Investment:*** Real estate has historically been useful in a portfolio for both income and capital gains. Home ownership, in itself, is a form of equity investment, as is the ownership of a second or vacation home, since these properties generally appreciate in value. Other types of real estate, such as residential and commercial rental property, can create income streams as well as potential long-term capital gains.

   Real estate investments can be made directly, with a purchase in your own name or through investments in limited partnerships, mutual funds, or Real Estate Investment Trusts (REIT). REIT is a company organized to invest in real estate. Shares are generally traded in the organized exchanges.

Advantages

1. The potential for high return in real estate exists due, in part to the frequent use of financial leverage.
2. There are potential tax advantages in real estate, as well. First, for personal use residential property, there is the opportunity to deduct interest paid (first and second homes, within limitations)
3. Some consider real estate a good hedge against inflation.
4. Good quality carefully selected income property will generally produce a positive cash flow.
5. As a real estate owner, you may be in a position to take your gains from real estate through refinancing the property without having to sell the property, therein triggering a taxable capital gain. Real estate is advantageous in this respect, because good quality properties can be used to secure mortgage loans up to a relatively high percentage of current value.

Disadvantages

1. There is generally limited marketability in real estate (depending on the nature and location of the property).
2. There is also a lack of liquidity, in that there is no guarantee that the property can be disposed of at its original value, especially if it must be done within a short period of time.
3. A relatively large initial investment often is required to buy real estate.
4. If ownership in investment property is held directly by the investor, there are many "hands-on" management duties that must be performed.

Self Assessment

State True or False:

6. Non-security forms of investment include all those investments, which are not quoted in any stock market and are not freely marketable.
7. In India, nearly 60% of the household savings go into such savings schemes as Post office savings schemes, life insurance, provident funds, etc.
8. Floating rate bonds have a fixed interest rate.
9. Money market securities pay continuously fluctuating rate of interest that over somewhere between the rate of inflation and the rate paid by the long-term debt instruments.
10. Warrants are generally non-detachable from the bond but they trade separately.

Notes

4.5 Long-term and Short-term Capital Gains

We often hear the term "Capital Gains". What is capital gain or loss? How is it classified into long term and short term? Let's understand what capital gains is, how it is classified into long term and short term, and how it is taxed.

Capital gain (or loss) is a profit (or loss) made while selling a capital asset. Therefore, let's start by understanding what capital asset is.

Capital Asset

Capital asset roughly means property – a house, an apartment, office space, factory, godown or a plot of land.

Did u know? Agricultural land is not considered as a capital asset, unless it is situated within the limits of, or within 8 kilometers of a municipality. Investments such as shares and bonds are also considered as capital assets.

When does a Capital Gain or Loss arise?

When the sale price of a capital asset is more than its purchase price, you incur a capital gain. Similarly, when the sale price of a capital asset is less than its purchase price, you incur a capital loss.

Classification of Capital Gains

Capital gain is classified into two types, depending on the period of holding of the capital asset.

1. Short-term Capital Gain (STCG)
2. Long-term Capital Gain (LTCG)

This classification also varies depending on the type of the capital asset. So, let's understand this classification based on the type of the capital asset.

Shares/Stocks/Equities and Equity Mutual Funds (MFs)

Short-term Capital Gain (STCG): If shares or equity MFs are held for less than 12 months before selling, the gain arising is classified as Short Term Capital Gain. The only condition here is that the shares/equities should be sold on a recognized stock exchange (for example, BSE or NSE), and a securities transaction tax (STT) should be paid on it. If the sale of shares is off-market (that is, if the sale is not on a stock exchange), the gain would be classified like that for other capital assets. A short term capital loss arising from sale of shares can be offset against a short term capital gain from sale of other shares, as long as both the sales occur in the same financial year.

Long-term Capital Gain (LTCG): If shares or equity MFs are held for more than 12 months before selling, the gain arising is classified as Long Term Capital Gain. In the case of long term capital gain arising out of the sale of shares or equity mutual funds, there is no income tax. The long term capital gain in this case is tax free.

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All Other Capital Assets

Short-term Capital Gain (STCG)

If the capital asset is held for less than 36 months before selling, the gain arising from it is classified as Short Term Capital Gain. This short term capital gain is clubbed with your income for the year, and is taxed at a rate as per the applicable tax slabs/brackets.

Short Term Capital Gain = Sale Price – Purchase Price

This is true even for shares or equity mutual funds sold off market.

Example: When a company comes out with a buyback offer, or when a company taking over another company comes up with an open offer, and you tender your shares to the company directly, any gain arising out of this would be taxed as if the sale was of "other capital asset", and would be clubbed with your income for the year of sale for the purpose of calculation of income tax.

Long-term Capital Gain (LTCG)

If the capital asset is held for more than 36 months before selling, the gain arising from the sale is classified as Long Term Capital Gain.

In case of assets other than equity shares or equity MFs, the long term capital gain is taxed at 20%. In other words, 20% of the long term capital gain has to be paid as income tax. (In case of debt mutual funds, the capital gain tax is 10% if the cost of acquisition is not indexed, and it is 20% if the cost of acquisition is indexed). We know that the cost of money decreases over a period due to the effect of inflation. Thus, an amount some years back can't be compared directly with an amount today – ₹ 100 were worth a lot more in 1985 than today!

So, we first need to make the purchase price comparable to today's price. For doing this, we need to use the inflation figures from both these years.

But the Reserve Bank of India (RBI) has made our task easy here – for every year (starting in 1980), they have come up with a number. This is called the Cost Inflation Index.

The Cost Inflation Index in itself doesn't convey anything – but the increase in the number from one year to another is a representative of the change in prices (and therefore, inflation) between these years.

The purchase price that needs to be used for calculating the long term capital gains is thus called the Indexed Cost of Acquisition.

Indexed Cost of Acquisition = Actual Purchase Price × (Cost Inflation Index during the year of sale/Cost Inflation Index during the year of purchase)

And,

Long Term Capital Gain = Sale Price – Indexed Cost of Acquisition

Also, in case of a house, you can add the cost of improvement (incurred during your ownership of the house) in the cost price of the house. Again, this cost can be indexed (and therefore, increased!).

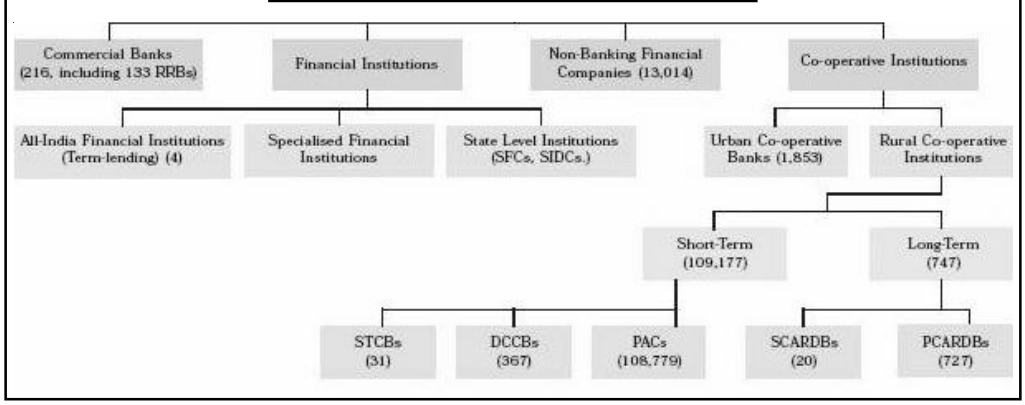
4.6 Sources of Credit and Credit Alternatives

The credit market structure in India has evolved over the years. A wide range of financial institutions exist in the country to provide credit to various sectors of the economy. These

Notes

include commercial banks, Regional Rural Banks (RRBs), Cooperatives [comprising urban Cooperative Banks (UCBs), State Co-operative Banks (STCBs), District Central Co-operative Banks (DCCBs), Primary Agricultural Credit Societies (PACS), State Co-operative and Agricultural Rural Development Banks (SCARDBs) and Primary Co-operative and Agricultural Rural Development Banks (PCARDBs)], Financial Institutions (FI) (term-lending institutions, both at the Centre and State level, and refinance institutions) and Non-banking Financial Companies (NBFCs).

Figure 4.2: Credit Market Structure



Note: Figures in parentheses represent number of institutions in the respective category. Numbers relate to end-March 2005 in respect of rural co-operatives and end-June 2006 in respect on NBFCs.

Source: Report on Trend and Progress of Banking in India, 2005-06, Reserve Bank of India.

Scheduled commercial banks constitute the predominant segment of the credit market in India. In all, 83 scheduled commercial banks were in operation at end-March 2006. The commercial banking sector is undergoing a phase of consolidation. There have been 12 mergers/ amalgamations since 1999. The RRBs, which were set up in the 1970s to provide agricultural and rural credit, are being restructured at the initiative of the Government of India. Till October 31, 2006, 137 RRBs were amalgamated to form 43 new RRBs, bringing down the total number of RRBs in the country to 102 from 196 at end-March 2005.

The co-operative banking system, with two broad segments of urban and rural co-operatives, forms an integral part of the Indian financial system. Urban cooperative banks, also referred to as primary cooperative banks, play an important role in meeting the growing credit needs of urban and semi-urban areas of the country. The UCBs, which grew rapidly in the early 1990s, showed certain weaknesses arising out of lack of sound corporate governance, unethical lending, comparatively high levels of non-performing loans and their inability to operate in a liberalised environment. Accordingly, some of the weak UCBs have been either liquidated or merged with other banks. As a result, the number of UCBs declined from 1,942 at end-March 2001 to 1,853 by end-March 2006.

Historically, rural co-operative credit institutions have played an important role in providing institutional credit to the agricultural and rural sectors. These credit institutions, based on the nature of their lending operations, have typically been pided into two distinct segments, commonly known as the Short-term Cooperative Credit Structure (STCCS) and the Long-term Co-operative Credit Structure (LTCCS). The STCCS, comprising PACS at the village level, DCCBs at the intermediate level, and the STCBs at the apex level, provide crop and other working capital loans to farmers and rural artisans primarily for short-term purposes. The LTCCS, comprising SCARDBs at the State level and PCARDBs at the district or block level, provide typically medium and long-term loans for making investments in agriculture, rural industries and, in the recent period, housing. However, the structure of rural co-operative banks is not

Notes

uniform across all the States of the country. Some States have a unitary structure with the State level banks operating through their own branches, while others have a mixed structure incorporating both unitary and federal systems.

Financial institutions owed their origin to the objective of state driven planned economic development, when the capital markets were relatively underdeveloped and judged to be incapable of meeting adequately the long-term requirements of the economy. Over the years, a wide range of FIs, mostly Government owned, came into existence to cater to the medium to long-term financing requirements of different sectors of the economy. FIs played a key role in extending development finance in India and for this purpose they were given access to concessional finance in the form of Government guaranteed bonds and Long-term Operations (LTO) Fund of the Reserve Bank. However, the government's fiscal imperatives and market dynamics forced a reappraisal of the policies and strategy with regard to the role of FIs in the economy and the concessional finance was phased out by the mid-1990s. A major restructuring in the financial sector occurred when two major FIs, *viz*., ICICI and IDBI converted into banks. Thus, this particular segment of the credit market has shrunk significantly in recent years.

NBFCs encompass a heterogeneous group of intermediaries and provide a whole range of financial services. Though heterogeneous, NBFCs can be broadly classified into three categories, *viz.*, asset finance companies (such as equipment leasing and hire purchase), loan companies and investment companies. A separate category of NBFCs, called the Residuary Non-banking Companies (RNBCs), also exists as it has not been categorised into any one of the above referred three categories. Besides, there are miscellaneous non-banking companies (Chit Fund), mutual benefit financial companies (*Nidhis* and unnotified *Nidhis*) and housing finance companies. The number of NBFCs operating in the country was 51,929 in 1996. Following the amendments to the provisions contained in Chapter III-B and Chapter III-C of the Reserve Bank of India Act, NBFCs both, deposit taking and non-deposit taking, are required to compulsorily register with the Reserve Bank. One of the conditions for registration for NBFCs was a minimum net owned fund (NOF) of ₹ 25 lakh at the entry point. This limit was subsequently enhanced to ₹ 2 crore for new NBFCs seeking grant of Certificate of Registration on or after April 21, 1999. The Reserve Bank received 38,244 applications for grant of certificate of registration (CoR) as NBFCs till end-March 2006. Of these, the Reserve Bank approved 13,141 applications, including 423 applications of companies authorised to accept/hold public deposits. Due to consolidation in the sector, the number of NBFCs declined to 13,014 by end-June 2006.

Of all institutions, in terms of assets, commercial banks constitute the largest category, followed by rural co-operatives.

4.6.1 Credit Information Bureaus

Credit bureaus (or credit reference agencies) are useful as they help lenders to assess credit worthiness of individual borrowers and their ability to pay back a loan. As credit bureaus collect and collate personal financial data on individuals from financial institutions, a form of price discrimination can be modelled taking into account credit rating and past behaviour of borrowers. The information is generally aggregated and made available on request to contributing companies for the purposes of credit assessment and credit scoring. Establishment of credit information bureaus can facilitate in obtaining the credit history of the borrowers and, thus, help the banks in correctly assessing the creditworthiness.

The CIBIL provides a vital service, which allows its members to make informed, objective and faster credit decisions. CIBIL's aim is to fulfill the need of credit granting institutions for comprehensive credit information by collecting, collating and disseminating credit information pertaining to both commercial and consumer borrowers, to a closed user group of members.

Notes

Banks, financial institutions, non-banking financial companies, housing finance companies and credit card companies use CIBIL's services. Data sharing is based on the principle of reciprocity, which means that only members who have submitted all their credit data, may access Credit Information Reports from CIBIL.

With a view to strengthening the legal mechanism and facilitating credit information companies to collect, process and share credit information on borrowers of banks/FIs, a draft Credit Information Companies (Regulation) Bill was passed in May 2005 and notified in June 2005. The Government and the Reserve Bank have framed rules and regulations for implementation of the Act, with specific provisions for protecting individual borrower's rights and obligations. The rules and regulations were notified on December 14, 2006. In terms of the provisions of the Act, after obtaining the certificate of registration from the Reserve Bank to commence/carry on business of credit information companies will be able to collect all types of credit information (positive as well as negative) from their member credit institutions and disseminate the same in the form of credit reports to the specified users/individuals.

The risk management architecture of banks in India has strengthened and they are on the way to becoming Basel II compliant, providing adequate comfort level for the introduction of credit derivatives. Accordingly, the Reserve Bank, as part of the gradual process of financial sector liberalisation in India, permitted banks and primary dealers to begin transacting in single-entity credit default swaps (CDS) in its Annual Policy Statement for 2007-08 released on April 24, 2007.

Case Study

The Reality of Investment Diversification

Investment diversification, simply said, is "don't put all your eggs in one basket." This is the traditional approach to investing that you'll see promoted by many financial advisors and popular personal finance magazines and investment books.

Here's the idea behind investment diversification. Suppose you invest $10,000 in five different investments for twenty years. The results are below:

1. $2,000 in a high risk investment becomes worthless
2. $2,000 in a risk level four investment earns 10% and grows to $13,455
3. $2,000 in a risk level four earns 8% and grows to $9,322
4. $2,000in a risk level three earns 6% and grows to $6,414
5. $2,000 in a risk level one investment earns 2% and grows to $2,972

You invested $10,000 which grew to $32,163, which means, on average your investments earned a 6% annualized return. Not bad.

Investment diversification is important. I advise you do it. I also advise you understand its limitations.

The premise behind choosing to diversify your investments is that if you do it properly, you will earn an average return of let's say six to seven percent a year. Financial planners will run a retirement plan projection for you using a rate of return based on this assumption. They often neglect to account for a margin of error.

Contd...

Notes

The impact of a margin of error is best explained with this excerpt from the book The Black Swan:

"You would take a different set of clothes on your trip to some remote destination if I told you that the temperature was expected to be seventy degrees Fahrenheit, with an expected error rate of forty degrees than if I told you that my margin of error was only five degrees."

Diversification does help reduce investment risk, but you must remember that the long term results of a diversified set of investments are far from certain.

Adding additional investment risk management techniques to diversification can improve the odds that your investments will achieve the results you need them to achieve so you can reach your financial goals.

Questions

1. What do you mean by investment diversification? Why is it advisable to diversify your assets?
2. How can an investor diversify his assets?

4.7 Summary

- The risk and return trade off says that the potential return rises with an increase in risk. It is important for an investor to decide on a balance between the desire for the lowest possible risk and highest possible return.
- The important options available for investment are cash incentives, stocks, bonds, mutual funds, derivatives, commodities, real estate.
- Risk and expected return are the two key determinants of an investment decision. The rate of return expected by the investor consists of the yield and capital appreciation.
- There are three major determinants of the rate of return expected by the investor are:
  - (i) The time preference risk-free real rate
  - (ii) The expected rate of inflation
  - (iii) The risk associated with the investment, which is unique to the investment.
- Two basic investment avenues are:
  - (i) Financial assets
  - (ii) Physical assets (real assets)
- Non-security forms of investment include all those investments, which are not quoted in any stock market and are not freely marketable, viz., bank deposits, corporate deposits, post office deposits, national savings and other small savings certificates and schemes, provident funds, and insurance policies.
- Capital gain (or loss) is a profit (or loss) made while selling a capital asset.
- If shares or equity MFs are held for less than 12 months before selling, the gain arising is classified as Short Term Capital Gain. If shares or equity MFs are held for more than 12 months before selling, the gain arising is classified as Long Term Capital Gain.
- If the capital asset is held for less than 36 months before selling, the gain arising from it is classified as Short Term Capital Gain. If the capital asset is held for more than 36 months before selling, the gain arising from the sale is classified as Long Term Capital Gain.

Notes

- There are many sources of credit in India. These can be broadly classified into institutional (commercial banks, cooperative credit banks etc) and non institutional/informal (such as relatives, friends and money lenders).

4.8 Keywords

Capital Gain (or loss): Capital gain (or loss) is a profit (or loss) made while selling a capital asset.

Investment: Investment involves making of a sacrifice in the present with the hope of deriving future benefits.

Real Rate of Return: The real rate of return is generally equal to the rate of return expected by an investor from a risk-free capital asset assuming a world without inflation.

Return: Return expresses the amount which an investor actually earned on an investment during a certain period.

Risk: In financial terms, risk is the chance or probability that a certain investment may or may not deliver the actual/expected returns.

Risk-return Trade-off: The risk and return trade off says that the potential return rises with an increase in risk.

Securities: The term 'securities' is used in the broadest sense, consisting of those papers that are quoted and are transferable.

Valuation: Valuation is the method for assessing whether a potential investment is worth its price.

4.9 Review Questions

1. Explain the relation between Risk and Return with the help of graph.
2. What do you understand by the term: Return of an asset? Explain in detail.
3. What are the various types of investment options available in Indian market?
4. What are three major determinants of the rate of return expected by the investor. Explain briefly.
5. Explain the two basic investment avenues available in Indian financial market. Also give examples of each.
6. What do you understand by non-security forms of investment? Discuss using suitable examples.
7. Explain the concept of capital gains/loss. How does it play a vital role in investment decision?
8. What is the difference between real and nominal rate of return? Which is important from the perspective of calculating the investment return and why?
9. What are government securities? Explain the different types of government securities.
10. Explain the treasury bills. How do you view them as an investment option?
11. What are risk free and risky assets? Explain.
12. What are the various sources of credit? Explain in detail.

Notes

Answers: Self Assessment

1.	Capital Gains	2.	Investment
3.	Directly	4.	Nominal
5.	Stocks	6.	True
7.	False	8.	False
9.	True	10.	False

4.10 Further Readings

Books

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Unit 5: Investment Vehicles

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Objectives

After studying this unit, you will be able to:

- Describe the various types of investment vehicles in India;
- Understand the significance of investment vehicles in personal financial planning;
- Know about the various types of small savings scheme operating in India;
- Explain the various types of fixed income instruments;
- Learn about the concept of mutual funds and various other investment schemes.

Introduction

Investors generally have three broad concerns when an investment is made. They care about how much money the investment will earn over time, they care about how risky the investment is, and they care about how liquid, or convertible, the asset is.

5.1 Investment Concerns

Rate of Return: The percentage change in the value of an asset over some period of time. Investors purchase assets as a way of saving for the future. Anytime an asset is purchased the purchaser is forgoing current consumption for future consumption. In order to make such a transaction worthwhile the investors hopes (sometimes expects) to have more money for future consumption than the amount they give up in the present. Thus investors would like to have as high a rate of return on their investments as possible.

Example: Suppose a Picasso painting is purchased in 1996 for ₹ 500,000. One year later the painting is resold for ₹ 600,000. The rate of return is calculated as,

$$\frac{(600,000-500,000)}{500,000}\times 100=\frac{100,000}{500,000}\times 100=0.20\times 100=20\%$$

Notes

Example: ₹ 1000 is placed is a savings account for 1 year at an annual interest rate of 10%. The interest earned after one year is ₹ 1000 x 0.10 = $100. Thus the value of the account after 1 year is $1100. The rate of return is,

$$\frac{(1100-1000)}{1000}\times 100 = \frac{100}{1000}\times 100 = 0.10\times 100 = 10\%$$

This means that the rate of return on a domestic interest bearing account is merely the interest rate.

Risk: The second primary concern of an investor is the riskiness of the assets. Generally, the greater the expected rate of return, the greater the risk. Invest in an oil wildcat endeavor and you might get a 1000% return on your investment ... if you strike oil. The chances of doing so are likely to be very low however. Thus, a key concern of investors is how to manage the trade-off between risk and return.

Liquidity: Liquidity essentially means the speed with which assets can be converted to cash. Insurance companies need to have assets which are fairly liquid in the event that they need to pay out a large number of claims. Banks have to stand ready to make payout to depositors etc.

5.2 Small Savings Scheme

There are different kinds of Small Savings Schemes suitable for various segments of the population.

Objective: Small savings schemes are designed to provide safe & attractive investment options to the public and at the same time to mobilise resources for development.

Operating Agencies

1. These schemes are operated through about 1.54 Lakh post offices throughout the country.
2. Public Provident Fund Scheme is also operated through about 8000 branches of public sector banks in addition to the post offices.
3. Deposit Schemes for Retiring Employees are operated through selected branches of public sector banks only.

Promotion

1. National Savings Organisation (NSO) is responsible for national level promotion of these schemes through publicity campaigns and advertisements in audio, video as well as print media.
2. Through a large network of over 5 lakh small savings agents working under different categories viz:
   a. Standardised Agency System (SAS),
   b. Mahila Pradhan Kshetriya Bachat Yojana (MPKBY),
   c. Public Provident Fund Agency Scheme,
   d. Payroll Savings Groups,
   e. School Savings Banks (Sanchayikas)
3. In addition, the **Extra Departmental Branch Postmasters (EDBPMs)** also help in mobilising savings, especially in rural and remote/far flung areas.

Notes

Institutional Investment in Small Savings Schemes

These schemes being primarily meant for small urban and rural investors; institutions are not eligible to invest in major small savings schemes.

N.R.Is' Investment in Small Savings Schemes

The Non-Resident Indians (NRIs.) are not eligible to invest in small savings schemes including Public Provident Fund (PPF) and Deposit Schemes for Retiring Employees.

Current Small Savings Scheme

1. ***Post Office Savings Account***

Who can Open?

(i) A single adult or two-three adults jointly,

(ii) A pensioner to receive/credit his monthly pension,

(iii) Group Accounts by Provident Fund, Superannuation Fund or Gratuity Fund, Public Account by a local authority/body,

(iv) An employee, contractor, or agent of a government or of a government company or of a university for depositing security amounts,

(v) A Gazetted Officer or an officer of a government company or corporation or Reserve Bank of India or of a local authority in his official capacity.

(vi) A cooperative society or a cooperative bank for payment of pay, leave salary, pension contribution of government servants on deputation with such society or bank.

Where can it be opened?

At any post office.

Deposits

Account can be opened with a minimum of ₹ 200with no maximum limit.

Maturity Period/Withdrawl

Withdrawals: The deposited amount is repayable after expiry of the period for which it is made viz: 1 year, 2 years, 3 years or 5 years.

Interest

Interest, 'calculated on quarterly compounding basis', is payable annually.

Interest rates applicable w.e.f. the **1st day of March, 2003** are:

Period of deposit Rate of Interest per cent/ per annum

1 YEAR	6.25
2 YEARS	6.50
3 YEARS	7.25
5 YEARS	7.50

Pass Book

Depositor is provided with a pass book with entries of all transactions duly stamped by the post Office.

Notes

Tax Treatment

Income tax relief is available on the amount of interest under the provisions of section 80L of Income Tax Act.

Premature Withdrawal

Premature withdrawals from all types of Post Office Time Deposit accounts are permissible after expiry of 6 months with certain conditions.

Post Maturity Interest

Post maturity interest "at the rate applicable to the post office savings accounts from time to time", is payable for a maximum period of 2 years.

2. ***Post Office Recurring Deposit accounts***

Who can open?

(i) A single adult or two adults jointly,

(ii) A guardian on behalf of a minor or a person of unsound mind; or

(iii) A minor who has attained the age of ten year, in his own name.

Where can be opened?

At any post office.

Maturity

Period of maturity of an account is five years.

Deposits

Sixty equal monthly deposits shall be made in an account in multiples of ₹ five subject to a minimum of ten rupees.

Defaults in Deposits

(i) Accounts with not more than four defaults in deposits can be regularized within a period of two months on payment of a default fee.

(ii) Account becomes discontinued after more than four defaults.

Interest & Repayment on Maturity

(i) On maturity of the accounts opened on or after 1st March, 2003, an amount (inclusive of interest) of ₹ *728.90* is payable to a subscriber of *Rupees: Ten denomination account.*

(ii) Amount repayable, inclusive of interest, on an account of any other denomination shall be proportionate to the amount specified above.

Pass Book

Depositor is provided with a pass book with entries of the deposited amount and other particulars duly stamped by the post Office.

Premature Closure

Premature closure of accounts is permissible after expiry of three years provided that interest at the rate applicable to post office savings account shall be payable on such premature closure of account.

Notes

Continuation after Maturity

Permissible for a maximum period of five years.

3. ***Post Office Monthly Income Accounts***

Who can open?

(i) A single adult or 2-3 adults jointly.

(ii) More than one account can be opened subject to maximum deposit limits.

Where can be opened?

At any post office.

Maturity

Period of maturity of an account is s**ix** years.

Deposits

Only one deposit shall be made in an account.

Deposit Limits

(i) ***Minimum:*** rupees one thousand.

(ii) ***Maximum:*** rupees *three lakhs* in case of single and rupees *six lakhs* in case of joint account. Deposits in all accounts taken together shall not exceed ₹ three lakhs in single account and ₹ six lakhs in joint account. The depositor's shares in the balances of joint accounts shall be taken as one half or one third of such balance according as the account is held by 2 or 3 adults.

Interest

(i) Interest @ *8 per cent/* per annum, *payable monthly* in respect of the accounts opened on or after the 1st March, 2003.

(ii) In addition, *bonus* equal to *ten per cent* of the deposited amount is payable at the time repayment *on maturity.*

Pass Book

Depositor is provided with a pass book with entries of the deposited amount and other particulars duly stamped by the post Office.

Premature Closure

(i) Premature closure facility is available after one year subject to condition closure of account.

(ii) Account shall be closed after expiry of 6 years, bonus equal to ten per cent of deposits shall be paid along with principle amount.

Income Tax Relief

Income tax relief is available on the interest earned as per limits fixed vide section 80L of Income Tax, as amended from time to time.

4. ***National Savings Certificate (VIII Issue)***

Who can purchase?

(i) An adult in his own name or on behalf of a minor,

(ii) A minor,

Notes

(iii) A trust,

(iv) Two adults jointly,

(v) Hindu Undivided Family.

Where available?

Available for purchase/issue at Post Offices.

Maturity

Period of maturity of a certificate is **six** Years.

Nomination/Transferability

(i) Nomination facility is available.

(ii) Certificates can be transferred from one post office to any other post office.

(iii) Transfer from one person to another person permissible in certain conditions.

Denomination/Deposit Limits

Certificates are available in denominations (face value) of ₹ 100, ₹ 500, ₹ 1000, ₹ 5000 & ₹ 10,000. There is no maximum limit for purchase of the certificates.

Interest/maturity value

(i) With effect from 1st March, 2003, *Maturity value* a certificate of ₹ 100 denomination is *₹ 160.10.*

(ii) Maturity value of a certificate of any other denomination shall be at proportionate rate.

(iii) Interest accrued on the certificates every year is liable to income tax but deemed to have been reinvested.

Premature Encashment

Premature encashment of the certificate is not permissible except at a discount in the case of death of the holder(s), forfeiture by a pledgee and when ordered by a court of law.

Place of Encashment/Discharge on Maturity

Can be encashed/discharged at the post office where it is registered or any other post office.

Income Tax Relief

(i) *Income Tax rebate* is available on the amount invested and interest accruing every year under Section 88 of Income tax Act, as amended from time to time.

(ii) Income tax relief is also available on the interest earned as per limits fixed vide section 80L of Income Tax, as amended from time to time.

5. ***Kisan Vikas Patra***

Who can purchase?

(i) An adult in his own name or on behalf of a minor,

(ii) A minor,

(iii) A Trust,

(iv) Two adults jointly.

Notes

Where available?

Available for purchase/issue at Post Offices.

Maturity Amount/Period

With effect from 1st March, 2003, invested amount *doubles* on *maturity* after **E***ight Years and Seven months.*

Nomination

Nomination facility is available.

Denomination/Deposit limits

Certificates are available in denominations (face value) of ₹ 100, ₹ 500, ₹ 1000, ₹ 5000, ₹ 10,000 & ₹ 50,000.

There is no maximum limit for purchase of the certificates.

Tax Benefits

No income tax benefit is available under the scheme. However the deposits are exempt from Tax Deduction at Source (TDS) at the time of withdrawal.

Premature Encashment

Premature encashment of the certificate is not permissible except at a discount in the case of death of the holder(s), forfeiture by a pledgee and when ordered by a court of law.

Place of Encashment/Discharge on Maturity

Can be encashed/discharged at the post office where it is registered or any other post office.

6. ***Public Provident Fund Scheme***

Who can open account under the scheme?

(i) An individual: in his own name, on behalf of a minor of whom he is a guardian,

(ii) a Hindu Undivided Family.

Where to open an account?

(i) at designated post offices throughout the country and

(ii) at designated branches of Public Sector Banks throughout the country.

Maturity Period

(i) The account matures for closure after 15 years.

(ii) Account can be continued with or without subscriptions after maturity for block periods of five years.

Nomination

Nomination facility is available.

Deposit Limits

(i) Minimum deposit required is ₹ 500 in a financial year.

(ii) Maximum deposit limit is ₹ 70,000 in a financial year.

(iii) Maximum number of deposits is twelve in a financial year.

Notes

Loans

Loans from the amount at credit in PPF account can be taken after completion of one year from the end of the financial year of opening of the account and before completion of the 5th year. The amount of withdrawal cannot exceed 40% of the amount that stood to credit at the end of fourth year preceding the year of withdrawal or at the end of preceding year whichever is lower.

Withdrawal

Premature withdrawal is permissible every year after completion of 5 years from the end of the year of opening the account.

Transferability

Account can be transferred from one post office to another post office, from a bank to another bank; and from a bank to post office and vice-versa.

Pass Book

Depositor is provided with a pass book with entries of the deposited amounts, interest credited every year and other particulars duly stamped by the post Office.

Interest

Interest at the rate, notified by the Central Government from time to time, is calculated an credited to the accounts at the end of each financial year.

Income Tax relief

(i) **Income Tax rebate** is available 'on the deposits made', under Section 88 of Income tax Act, as amended from time to time.

(ii) Interest credited every year is tax-free.

7. ***Deposit Scheme for Retiring Government Employees***

Who can open an account?

(i) Retired Central and State Governments' employees.

(ii) Retired Judges of the Supreme Court and High Courts.

Where to open an account?

At designated branches of Public Sector Banks throughout the country.

Maturity Period

(i) The account matures for closure after 3 years.

(ii) Account can be continued with the whole or a part of the deposits after maturity.

Nomination

(i) The account can be opened individually or jointly with his/her spouse.

(ii) Nomination facility is available in respect of individual accounts.

Deposit Limits

One time deposit with a minimum of ₹ 1000 to the maximum of the total retirement benefits in multiple of one thousand rupees.

Retirement Benefits Means

(i) Balance at the credit of employee in any of the Government Provident Funds.

(ii) Retirement/Superannuation gratuity.

Notes

(iii) Commuted value of pension.

(iv) Cash equivalent of leave,

(v) Savings element of Government insurance scheme payable to the employee on retirement, and

(vi) Arrears of retirement benefits, as defined in (i) to (v) above on implementation of Fifth Pay Commission's recommendations.

Withdrawals

Whole or a part of the deposits can be withdrawn at any time after expiry of the normal maturity period of 3 years.

Premature Withdrawal

(i) Not permissible before completion of one year.

(ii) Permissible after completion of one year and before completion of three years on reduced interest rate.

Interest

(i) Interest at the rate, notified by the Central Government from time to time, is credited and payable on half yearly basis at any time after 30th June and 31st December every year.

(ii) Present rate of interest is Seven per cent/per annum since: 1st March, 2003.

Transferability

Account can be transferred from one public sector bank to another public sector bank operating the scheme due to change of residence.

Pass Book

Depositor is provided with a pass book with entries of the deposited amount, interest etc. and other particulars by the bank.

Income Tax Relief

(i) Interest accrued/credited/paid is fully tax-free.

(ii) Amount deposited under the scheme is free from wealth tax.

Banks Authorised to Accept Deposits

Selected branches of the following banks are authorized to accept deposits under the scheme.

8. ***Deposit Scheme for Retiring Employees of Public Sector Companies***

Who can open an account?

Retired/retiring employees of Public Sector Undertakings, Institutions, Corporations, viz:

(i) Public Sector Banks,

(ii) Life Insurance Corporation of India,

(iii) General Insurance Corporation,

(iv) Public Sector Companies, etc.

Notes

Where to open an account?

At designated branches of Public Sector Banks throughout the country.

Maturity Period

(i) The account matures for closure after 3 years.

(ii) Account can be continued with the whole or a part of the deposits after maturity.

Nomination

(i) The account can be opened individually or jointly with his/her spouse.

(ii) Nomination facility is available in respect of individual accounts.

Deposit Limits

One time deposit with a minimum of ₹ 1000 to the maximum of the total retirement benefits in multiple of one thousand rupees.

Retirement Benefits Means

(i) Balance at the credit of employee in any of the Government Provident Funds.

(ii) Retirement/Superannuation gratuity.

(iii) Commuted value of pension.

(iv) Cash equivalent of leave.

(v) Savings element of Government insurance scheme payable to the employee on retirement, and Arrears of retirement benefits, as defined in (i) to (v) above on implementation of Fifth Pay Commission's recommendations.

Withdrawals

Whole or a part of the deposits can be withdrawn at any time after expiry of the normal maturity period of 3 years.

Premature Withdrawal

(i) Not permissible before completion of one year.

(ii) Permissible after completion of one year and before completion of three years on reduced interest rate.

Interest

Interest at the rate, notified by the Central Government from time to time, is credited and payable on half yearly basis at any time after 30th June and 31st December every year.

Present rate of interest is Seven per cent / per annum since: 1st March, 2003.

Transferability

Account can be transferred from one public sector bank to another public sector bank operating the scheme due to change of residence.

Pass Book

Depositor is provided with a pass book with entries of the deposited amount, interest etc. and other particulars by the bank.

Notes

Income Tax Relief

(i) Interest accrued/credited/paid is fully tax-free.

(ii) Amount deposited under the scheme is free from wealth tax.

Banks Authorised to Accept Deposits

Selected branches of the following banks are authorized to accept deposits under the scheme.

Self Assessment

State True or False:

1. Investors would like to have as high a rate of return on their investments as possible.
2. Generally, the greater the expected rate of return, the smaller the risk.
3. Liquidity essentially means the speed with which assets can be converted to Gold.
4. Small savings schemes are designed to provide safe & attractive investment options to the public and at the same time to mobilise resources for development.
5. BSE is responsible for national level promotion of the small savings schemes through publicity campaigns and advertisements in audio, video as well as print media.

5.3 Fixed Income Instruments

Step1: Why Invest in Fixed Income

Fixed-income instruments in India typically include company bonds, fixed deposits and government schemes.

- Low risk tolerance one of the key benefits of fixed-income instruments is low risk i.e. the relative safety of principal and a predictable rate of return (yield). If your risk tolerance level is low, fixed-income investments might suit your investment needs better.
- Need for returns in the short-term Investment in equity shares is recommended only for that portion of your wealth for which you are unlikely to have a need in the short-term, at least five-years. Consequently, the money that you are likely to need in the short-term (for capital or other expenses), should be invested in fixed-income instruments.
- Predictable versus Uncertain Returns: Returns from fixed-income instruments are predictable i.e. they offer a fixed rate of return. In comparison, returns from shares are uncertain. If you need a certain predictable stream of income, fixed-income instruments are recommended.

Step 2: Evaluate Options to meet your needs

Before you decide to invest in fixed-income instruments, evaluate your needs from three key perspectives - risk, returns and liquidity. Match the investment options with your financial needs.

1. ***Evaluate credit risk:*** Credit risk refers to the possibility that the issuer fails to pay what is owed (principal and/or interest). Evaluate the credit ratings assigned by rating agencies like CRISIL, ICRA and CARE to find corporate bonds/fixed deposits that match your risk tolerance level.

Notes

Please note that it is not mandatory for non-finance companies to get a credit rating for their fixed deposit schemes. Hence, it is advisable to see if the company has a credit rating for any other debt instrument while evaluating fixed deposit schemes.

2. ***Diversify***: Diversification across issuers of fixed-income instruments is a recommended approach to reducing credit risk.

Notes Returns Return calculations should consider effective yield, interest rate expectations and taxes.

(i) ***Calculate effective yield*:** Calculate the post-tax effective yield for each instrument for comparison. Effective yield is the IRR (Internal Rate of Return) of the fixed-income instrument.

For example for an instrument that pays 14% monthly interest, the effective annual yield works out to 14.93%. This is definitely more attractive than an instrument that pays 14% annually.

(ii) ***Consider interest rate (and inflation) expectations*:** Once you invest in a fixed-income instrument, your investment is committed, more often than not, for the specified period of time.

During this period, if interest rates increase, you will not benefit from this rise. Hence your effective return from this investment will be lower than if you had the flexibility to invest at a higher interest rate.

So, if you expect interest rates to increase, invest only in short-term instruments, and vice versa.

(iii) ***Don't forget taxes:*** While calculating your interest yield remember to include post-tax interest receipts. For investors in high-tax brackets, tax-free government bonds/ schemes might be more attractive.

Did u know? Mutual funds present an alternative avenue to invest in fixed income instruments at zero tax liability on the income received.

Liquidity Fixed-income instruments are normally illiquid as the secondary market for these instruments is not yet developed in India. Make sure you carefully evaluate the potential liquidity, exit route and penalties of the instrument before you invest.

Step 3: How to buy

Since the secondary market for fixed-income instruments is not yet developed in India, we discuss below only the primary market options available for retail investors.

Company bonds/debentures: Companies issue bonds and debentures through public issues that are open only for a limited period of time. Application forms for these issues are available with primary market brokers.

Company fixed deposits: Fixed deposit schemes from companies are typically open round the year, unless they have exceeded their collection limits. Even in such cases, companies accept renewal from existing fixed deposit holders.

Notes

Government schemes: You can invest in RBI bonds directly through the Reserve Bank of India or through a broker. Investments in other government schemes can normally be made through nationalised banks and post offices.

For more details on specific government schemes, visit Government Schemes Directory.

Fixed income mutual funds: Fixed-income and money market mutual funds offer investors an exposure to fixed-income instruments. Open-ended mutual funds are available round the year and can be easily purchased/sold on any business day.

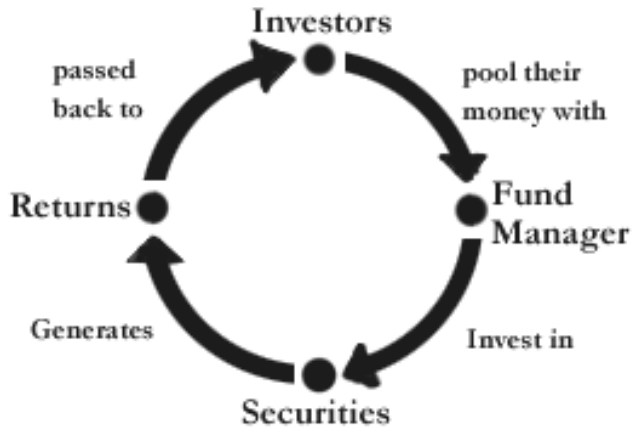
Most Asset Management Companies (AMCs) have service centres/authorised agents/brokers across the country through whom you can invest in mutual funds.

5.4 Mutual Funds

Various authors have defined a mutual fund in different ways. According to Pierce, James L, it is a non-depository or non-banking financial intermediary which acts as an "important vehicle for bringing wealth holders and deficit units together directly."

Weston, J. Fred and Brigham, Eugene F, in their book Essentials of Managerial Finance state that mutual funds are corporations that accept dollars from savers and then use these dollars to buy stock, long-term bonds, short-term debt instruments issued by business or government. These corporations pool funds and thus reduce risk by diversification.

Figure 5.1: Mutual Fund Operation Flow Chart



A mutual fund is essentially a mechanism of pooling together the savings of a large number of small investors for collective investment, with an avowed objective of attractive yields and capital appreciation, holding the safety and liquidity as prime parameters.

According to the author: Mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. The money, thus, collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them. Thus, a mutual fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

Notes

Important Aspects of Mutual Funds

(i) ***Net Asset Value (NAV)***

NAV is calculated as follows:

$$\text{NAV} = \frac{\text{Fair market value of Scheme's Investments + Receivables + Accrued income + Other assets – Accrued expenses – Payables – Other liabilities}}{\text{Number of units outstanding}}$$

(ii) ***Entry Load and Exit Load***

A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses.

Calculation of Front-end Load of Entry Load

$$\text{Public Offer Price} = \frac{\text{Net Asset Value}}{1 - \text{Front-end Load}}$$

Calculation of Back-end Load or Exit Load

$$\text{Redemption Price} = \frac{\text{Net Asset Value}}{(1 - \text{Back-end Load})}$$

(iii) ***Return on Investment***

The investor who invests in mutual fund units can receive returns in the following two ways:

Capital Appreciation – Profit earned on sale of units at a higher NAV than the original cost.

Income Distribution – When a fund makes a profit on its investment, this profit will be given to investor as a dividend which can be re-invested in the fund or retain it in the form of cash.

Return on Mutual Fund

$$r = \frac{(NAV_t - NAV_{t-1}) + 1_t + G_t}{NAV_{t-1}}$$

Where

r = Return on mutual fund

NAV_t = Net asset value at the time period 't'

NAV_{t-1} = Net asset value at time period "t-1"

1_t = Income at time period 't'

G_t = Capital gain distribution at time period 't'

Required Return on Mutual Fund Investment (as a percentage)

$$R_2 = \left[\frac{1}{1 - \text{Initial expenses}(\%)} \times R_1\right] + \text{Recurring expenses } (\%)$$

Notes

Where,

R_1 = Personal Return of investor

R_2 = Mutual Fund earnings

Effective Yield on Mutual Fund Investment

$$= \frac{Dividend + Capital\ Appreciation}{Initial\ Investment} \times \frac{365}{No.\ of\ days} \times 100$$

Self Assessment

Fill in the blanks:

6. A ..... is a trust that pools the savings of a number of investors who share a common financial goal.
7. A Mutual fund is the most suitable investment for the common man as it offers an opportunity to invest in a ..... basket of securities at a relatively low cost.
8. A ……..is one that charges a percentage of NAV for entry or exit.
9. Most ……have service centres/authorised agents/brokers across the country through whom you can invest in mutual funds.
10. ……..instruments in India typically include company bonds, fixed deposits and government schemes.

5.5 Other Types of Investment Vehicles

The investment options before you are many. Pick the right investment tool based on the risk profile, circumstance, time zone available etc. If you feel market volatility is something which you can live with then buy stocks. If you do not want to risk the volatility and simply desire some income, then you should consider fixed income securities. However, remember that risk and returns are directly proportional to each other. Higher the risk, higher the returns. A brief preview of different investment options is given below:

Equities: Investment in shares of companies is investing in equities. Stocks can be bought/sold from the exchanges (secondary market) or via IPOs – Initial Public Offerings (primary market). Stocks are the best long-term investment options wherein the market volatility and the resultant risk of losses, if given enough time, is mitigated by the general upward momentum of the economy. There are two streams of revenue generation from this form of investment.

1. ***Dividend:*** Periodic payments made out of the company's profits are termed as dividends.
2. ***Growth:*** The price of a stock appreciates commensurate to the growth posted by the company resulting in capital appreciation.

On an average an investment in equities in India has a return of 25%. Good portfolio management, precise timing may ensure a return of 40% or more. Picking the right stock at the right time would guarantee that your capital gains i.e. growth in market value of your stock possessions, will rise.

Bonds: It is a fixed income (debt) instrument issued for a period of more than one year with the purpose of raising capital. The central or state government, corporations and similar institutions sell bonds. A bond is generally a promise to repay the principal along with fixed rate of interest on a specified date, called as the maturity date. Other fixed income instruments include bank fixed deposits, debentures, preference shares etc.

Notes

The average rate of return on bonds and securities in India has been around 10 - 12 % p.a.

Certificate of Deposits : These are short-to-medium-term interest bearing, debt instruments offered by banks. These are low-risk, low-return instruments. There is usually an early withdrawal penalty. Savings account, fixed deposits, recurring deposits etc are some of them. Average rate of return is usually between 4-8 %, depending on which instrument you park your funds in. Minimum required investment is ₹ 1,00,000.

Mutual Funds: A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. The money, thus, collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them. Thus, a mutual fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

Mutual funds are open-ended funds operated by investment companies which raise money from shareholders and invest it in a group of assets, in accordance with a stated set of objectives.

Example:

(i) AIG World Gold Fund

(ii) Franklin InfoTech Fund

(iii) Birla Sun Life Commodity Equities Fund

(iv) ICICI Prudential Technology Fund

Cash Equivalents: These are highly liquid and safe instruments which can be easily converted into cash, treasury bills and money market funds are a couple of examples for cash equivalents.

Others: There are also other saving and investment vehicles such as gold, real estate, commodities, art and crafts, antiques, foreign currency etc. However, holding assets in foreign currency are considered more of an hedging tool (risk management) rather than an investment.

Task Name the major companies providing following financial products in India:

1. Mutual Fund services
2. CD's
3. Credit Advice

Case Study

Selecting the Right Investment Vehicles

Selection of Investment vehicles is most important. Young Turks buy investments with long and short term goals like purchase of home, fine car, education of their siblings and finally for their retirement etc. Some short term goals can also be like buying i-phone for spouse, LED TV for house, etc, but whether your goals are long term or short term, you need to select your investment vehicle to perfection. In this new year 2011

Contd...

Notes

let's see which investment vehicle is going to perform best and shall be preferred over others.

Lets take an example, suppose David has decided to take a home loan for which he is required to pay ₹ 15,000 as monthly EMI. His objective is that he should invest sufficient money is a suitable investment vehicle that should give him a return equal to his EMI. This way the load of paying EMI's will not come on his salary. Here the selection of a suitable and reliable investment vehicle is very important. Suppose David decides to invest in Index ETF then the annual return should be equal to ₹ 15,000×12= ₹ 1,80,000. On an average, Index ETF can give your returns at the rate of 12% per annum. It means to generate a return of ₹ 1,80,000 per year you shall have investing fund equal to ₹ 1,80,000/ 12*100 = ₹ 15,00,000.

It is critical to list down and schedule investment goals before your start investing your money. The reason for this is that longer will be your goals you are likely to get better average results over time as you have options of investing in equity. For short term goals, you have option of investing only in debt linked schemes which gives low returns. Debt linked investment vehicles has a comparatively lower level of risk as compared to equity (shares). But if one can invest for long-term in equity, the level of risk can be drastically reduced. Hence it is always best to select equity as your investment vehicle when investing for long term (more than three to five years). Where an equity linked investment vehicle can give you a return of 12%, a debt linked plans can give 7%-8% at its best.

Questions

1. Discuss the importance of scheduling investment goals before selecting an investment option.
2. Comment: It is always best to select equity as your investment vehicle when investing for long term (more than three to five years).

5.6 Summary

- Investors generally have three broad concerns when an investment is made. They care about how much money the investment will earn over time, they care about how risky the investment is, and they care about how liquid, or convertible, the asset is.
- Liquidity essentially means the speed with which assets can be converted to cash. Insurance companies need to have assets which are fairly liquid in the event that they need to pay out a large number of claims. Banks have to stand ready to make payout to depositors etc.
- There are different kinds of Small Savings Schemes suitable for various segments of the population.
- The objective of small savings schemes are designed to provide safe & attractive investment options to the public and at the same time to mobilise resources for development.
- The Non-Resident Indians (NRIs.) are not eligible to invest in small savings schemes including Public Provident Fund (PPF) and Deposit Schemes For Retiring Employees.
- There are many types of Current Small savings scheme in India such as Post Office Savings Account, Post office recurring deposit accounts, post office monthly income account, national savings certificate, kisan vikas patra, deposit scheme for retiring government employees, deposit scheme for retiring employees of public sector companies etc.
- A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. The money, thus, collected is then invested in capital market

Notes

instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them. Thus, a mutual fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

- Mutual funds have proved to be an attractive investment for many investors, the world over, since they provide them a mixture of liquidity, return and safety in accordance with their performance. Further, the investor obtains these benefits without having to directly a diversified portfolio, which is handled by specialists. The interests of various investors are generally protected through mutual funds. As individual investors, they may not hold much clout in companies whose shares they hold, but by being part of institutional investors like mutual funds, their bargaining power is enhanced.

5.7 Keyword

Mutual Funds: A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal.

5.8 Review Questions

1. Describe various types of investment vehicles in India.
2. Explain the significance of investment vehicles in personal financial planning.
3. What are the various types of small savings scheme operating in India?
4. Explain the various types of fixed income instruments operating in Indian financial market.
5. Discuss the concept of mutual funds.
6. Which investment vehicles will you perceive consider for your retirement? Explain using reasons.
7. Explain the use/purpose of following:
   a. PPF
   b. NSC
   c. Kisan Vikas Patra
   d. Post Office monthly savings scheme

Answers: Self Assessment

1.	True	2.	False
3.	False	4.	True
5.	False	6.	mutual fund
7.	diversified, professionally managed	8.	Load Fund
9.	Asset Management Companies (AMCs)	10.	Fixed-income

5.9 Further Readings

Notes

Books

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Unit 6: Investment Strategies-I

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Objectives

After studying this unit, you will be able to:

- Explain the issues and concepts related to overall financial planning process
- Understand the goals and objectives of personal financial planning

Introduction

In today's complex financial markets, you can select from an impressive array of investment vehicles. Each investment also carries some risks, making it important to choose wisely if you are selecting just one. The good news is that there's no rule that says you must stick with only a single type of investment. In fact, you can potentially lower your investment risk and help increase your chances of meeting your investment goals by practicing "asset allocation."

In the later part of the unit you will also learn about the sources of personal financing through loans. Loans from banks are an important part of personal financial planning in a developing country like India where majority of people have inadequate self finances to meet out their requirements.

6.1 Asset Allocation

What does Asset Allocation Mean?

An investment strategy that aims to balance risk and reward by designing a portfolio's assets according to an individual's goals, risk tolerance and investment horizon.

Notes

6.1.1 Asset Classes

There are three main types of asset classes – equities, fixed-income, and cash and equivalents. The three asset classes have different levels of risk and return, so each will behave differently over time.

Asset allocation refers to the way in which an investor weighs investments in their portfolio in order to try to meet a specific objective.

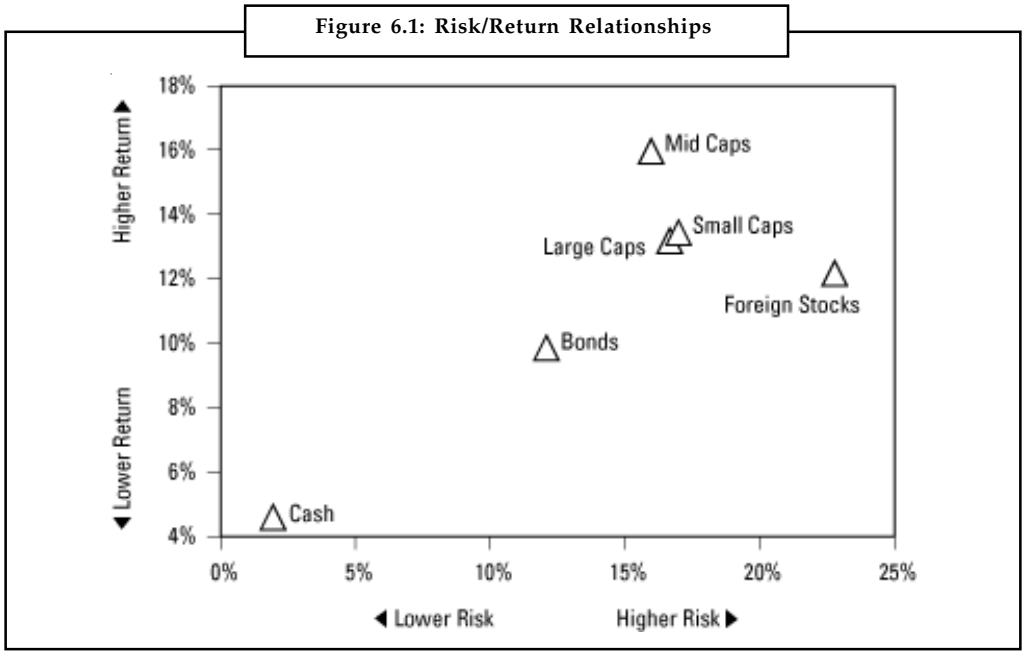
Example: If your goal is to pursue growth (and you're willing to take on market risk in order to do so), you may decide to place 20% of your assets in bonds and 80% in stocks.

The asset classes you choose, and how you weight your investment in each, will probably hinge on your investment time frame and how that matches with the risks and rewards of each asset class.

Risks and Rewards associated with Three Primary Asset Classes

Here's a closer look at the risk and reward levels of the major asset classes: Stocks**.** Well known for fluctuating frequently in value, stocks carry a high level of market risk (the risk that your investments' value will decrease after you purchase them) over the short term. However, stocks have historically earned higher returns than other asset classes by a wide margin, although past performance is no predictor of future results. Stocks have also outpaced inflation — the rising prices of goods and services — at the highest rate through the years, and therefore carry very low inflation risk. Bonds**.** In general, these securities have less severe short-term price fluctuations than stocks, and therefore offer lower market risk. On the other hand, their overall inflation risk tends to be higher than that of stocks, as their long-term return potential is also lower. Money **market instruments** Among the most stable of all asset classes in terms of returns, money market instruments carry relatively low market risk. At the same time, these securities lack the potential to outpace inflation by as wide a margin through the years as stocks.

Figure 6.1: Risk/Return Relationships



Source: Standard & Poor's; Center for Research and Security Prices

Notes

Different investments offer different levels of potential return and market risk. Unlike stocks and corporate bonds, government T-bills are guaranteed as to principal and interest, although money market funds that invest in them are not. Past performance is not indicative of future results.

6.1.2 Diversification: The Basis of Asset Allocation

Before exploring just how you can put an asset allocation strategy to work to help you meet your investment goals, you should first understand how diversification — the process of helping reduce risk by investing in several different types of individual funds or securities — works hand in hand with asset allocation. When you diversify your investments among more than one security, you help reduce what is known as "single-security risk," or the risk that your investment will fluctuate widely in value with the price of one holding. Diversifying among several asset classes may increase the chance that, if and when the return of one investment is falling, the potential return of another in your portfolio may be rising (though there are no guarantees and the total value of your portfolio may decline).

Portfolio Risk Level						
	Low		Moderate		Aggressive	
% Treasury Bills	30	30	20	10	0	10
% Bonds	40	30	30	40	30	20
% Growth Stocks	30	30	40	30	50	70
% Small Caps	0	0	0	10	10	0
% International	0	10	10	10	10	0

Chart illustrates sample portfolio asset allocations: Low Risk (those nearing or in retirement); Moderate Risk (middle-aged investors); Aggressive Risk (younger investors).

Allocations are presented only as examples and are not intended as investment advice. Please consult a financial professional if you have any questions about how these examples may apply to your situation.

Sources: Standard & Poor's; Center for Research and Security Prices; Morgan Stanley; For the 20-year period ended 12/31/05.

Importance of Asset Allocation

The chart above can help you select an appropriate allocation for your investment portfolio based on your life stage. For instance, at age 25 you may decide to invest with the goal of retiring in comfort within 40 years. Most likely, your investment goal is to achieve as much growth as possible — growth that will outpace inflation substantially. In aiming to reach this goal, depending on your individual risk tolerance, you may allocate 70% of your assets into aggressive growth stocks, 20% into bonds, and 10% into money market instruments. You have years to ride out the wide fluctuations that come with stocks, but at the same time, you help manage your risk with your bond and money market holdings. Because your goals and circumstances are unique, you should talk with a financial professional who can help you tailor an allocation strategy for your needs. Generally, your asset allocation will change with your life, your lifestyle, and your investment goals. If you have been investing aggressively for retirement for more than 20 years and are now less than 10 years from retiring, protecting what your investment may have earned from market ups and downs may become more important. In this case you may want to gradually shift some of your stock allocation into your bond and money market holdings. Keep in mind, however, that many financial experts recommend that stocks be considered for every suitable portfolio to maintain growth potential.

Notes

6.1.3 Asset Allocation Strategy

Asset allocation is a simple concept, yet vital to long-term investment success. In fact, a landmark study cited in *Financial Analysts Journal* showed that 91.5% of the average total returns earned by pension plans over a 10-year period (from 1977-1987) was the result of the plans' asset allocation decisions. For many individual investors, the asset allocation decision amounts to choosing what types of mutual funds to invest in and the amount to invest in each type of fund. Others may want to add individual securities to this mix after exploring their investment options.

Caution Regardless of the asset allocation strategy you choose and the investments you select, keep in mind that a well-crafted plan of action over the long term can help you weather all sorts of changing market conditions as you aim to meet your investment goal(s). Please note, however, that asset allocation does not guarantee a profit or protect against a loss.

Points to Remember

1. Asset allocation is the way in which you spread your investment portfolio among different asset classes, such as stocks and stock mutual funds, bonds, and bond mutual funds.
2. When prices of different types of assets do not move in tandem, combining these investments in a portfolio can help manage the variability of returns, commonly referred to as "market risk."
3. Mutual funds are pools of securities, usually offering diversification within a single asset class. Some mutual funds may include several asset classes.
4. The asset allocation that is right for you depends on your investment time frame, goals, and tolerance for risk.
5. As your investment time frame and goals change, so might your asset allocation. Many financial experts suggest re-evaluating your asset allocation periodically or whenever you experience a milestone event in your life such as marriage, the birth of a child, or retirement.

Asset Allocation is a method of diversification which positions assets among major investment categories. This tool may be used in an effort to manage risk and enhance returns. However, it does not guarantee a profit or protect against a loss.

Self Assessment

Fill in the blanks:

1. ……is the way in which you spread your investment portfolio among different asset classes, such as stocks and stock mutual funds, bonds, and bond mutual funds.
2. ……. Strategy can help reduce what is known as "single-security risk".
3. ……carry a high level of market risk.
4. …….. are the most stable of all asset classes in terms of returns.
5. Asset allocation refers to the way in which an investor weighs investments in their ……

Notes

6.2 Evaluating Investment in various Stocks

Investors have access to a wealth of information about stocks, but making sense of it may seem like a daunting task. Evaluating stocks isn't that difficult if you follow some basic steps.

In assessing investments such as stock, investors consider the stock's valuation, strategy, plans for diversification and appetite for risk. Stocks are evaluated in many ways, and most of the common measuring sticks are easily available online or in the print and online versions of The Wall Street Journal.

The most basic measure of a stock's worth involves that company's earnings. When you buy a stock, you're acquiring a piece of the company, so profitability is an important consideration. Imagine buying a store. Before deciding how much to spend, you want to know how much money that store makes. If it makes a lot, you'll have to pay more to acquire it. Now imagine dividing the store into a thousand ownership pieces. These pieces are similar to stock shares, in the sense that you are acquiring a piece of the business, rather than the whole thing.

The business can pay you for your ownership stake in several ways. It can give you a portion of the profits, which for shareholders comes in the form of a periodic dividend. It can continue to expand the business, reinvesting money earned to increase profitability and raise the overall value of the business. In such cases, a more valuable business makes each piece, or share, of the business more valuable. In such a scenario, the more valuable share merits a higher price, giving the share's owner capital appreciation, also known as a rising stock price.

Not every company pays a dividend. In fact, many fast-growing companies prefer to reinvest their cash rather than pay a dividend. Large, steadier companies are more likely to pay a dividend than are their smaller, more volatile counterparts.

The most common measure for stocks is the price to earnings ratio, known as the P/E. This measure, available in stock tables, takes the share price and divides it by a company's annual net income. So a stock trading for $20 and boasting annual net income of $2 a share would have a price/earnings ratio, or P/E, of 10. Market experts disagree about what constitutes a cheap or expensive stock. Historically, stocks have averaged a P/E in the mid teens, though in recent years, the market P/E has been higher, often nearer to 20. As a general rule of thumb, stocks with P/Es higher than the broader market P/E are considered expensive, while stocks with a below-market P/E are considered cheaper.

But P/Es aren't a perfect measure. A company that is small and growing fast may have a very high P/E, because it may earns little but has a high stock price. If the company can maintain a strong growth rate and rapidly increase its earnings, a stock that looks expensive on a P/E basis can quickly seem like a bargain. Conversely, a company may have a low P/E because its stock has been slammed in anticipation of poor future earnings. Thus, what looks like a "cheap" stock may be cheap because most people have decided that it's a bad investment. Such a temptingly low P/E related to a bad company is called a "value trap."

Other popular measures include the dividend yield, price-to-book and, sometimes, price-to-sales. These are simple ratios that examine the stock price against the second figure, and these measures can also be easily found by studying stock tables.

Investors seeking better value seek out stocks paying higher yields than the overall market, but that's just one consideration for an investor when deciding whether or not to purchase a stock.

Picking stocks is much like evaluating any business or company you might consider buying. After all, when you buy a stock, you're essentially purchasing a stake in a business.

Tips

Notes

1. The most common measure of a stock is the price/earnings, or P/E ratio, which takes the share price and divides it by a company's annual net income.
2. Generally, stocks with P/Es higher than the broader market P/E are considered expensive, while lower-P/E stocks are considered not so expensive.
3. Don't automatically go for stocks with low P/Es simply because they are cheaper. Cheap stocks aren't always good stocks.

6.2.1 Steps of Investing in Stocks

Step 1: Picking Stocks

Picking winning stocks involves understanding what makes one stock great and another stock ho-hum. It involves in-depth knowledge of the financial ratios and close monitoring of markets, but finding good investments is not as hard as perceived by investors. All you need to do is to be careful while investing by formulating the right investment strategy.

One of the most important things you need to know is that ROA is leading measure of company's efficiency. Investors often look for the magic number or metric that will identify a great stock out of the universe of all stock but magic number doesn't exist in reality. However, when you are considering stocks to buy, there are certain metrics and numbers that are more important than others.

They can't be used as the sole qualifier to determine great stocks, but you can use them to eliminate poor performers. An investor must always look at the big picture when considering a stock and that means considering a number of metrics.

Return on Assets

Return on Assets is one of the most important metrics every investor should know. Return on Assets (ROA) tells how efficiently (or inefficiently) a company turns assets into net income. It is a way to tell at a glance how profitable a company is.

Consider that companies take capital from investors and turn it into profits, which are in turn returned to the investor in one form or another.

ROA measures how efficiently the company does this. Obviously, the more efficient a company is in converting assets (capital) into profits, the more attractive it will be to investors. ROA is made up of two components: net margin and asset turnover. When used together, these two metrics are very important tools for financial analysis of a company.

Picking Stocks begins with Assessment of Need: Stocks should be Appropriate for your Age and Risk Tolerance

Picking stocks has never been easy if done correctly. Some investors thought they had the talent during the dot.com boom, but that popping bubble revealed lucky guesses instead of investor insight.

If you apply yourself, it is possible to improve the odds that the stock you pick will be a winner, at least for a reasonable period. Some stocks fall into the category of "buy it and forget it" category earlier. But now the world and the market are changing too fast for investors to become too comfortable.

Notes

Therefore your first step in selecting a stock for your portfolio is to see where there are gaps (if you're just beginning, then pick a stock that is appropriate for your age and risk tolerance).

Understanding What Affects Stock Prices: Some Market-Moving Trends More Important to Stock Prices than Others

When a person buy's a company's stock, he/she is investing in the future growth of the company. Yet, the stock's price may float up or down based on some broad market or economic factors that may only indirectly affect the company.

For example, the possibility (not certainty) of increased inflation will send the overall market into a slump, especially if the Reserve Bank of India expresses its concern.

That concern is seen as translating into higher interest rates to head off any rise in inflation before it gets started. Increased interest rates are bad news for most businesses. Likewise, pronouncements that the economy is expected to grow at a robust rate is usually a bad sign for the market because it means the Central Bank-RBI will probably be less inclined to cut interest rates, to avoid overheating the economy and fueling inflation.

The trick for investors is to understand which market-moving factors may also directly affect the company and its stock. Major demographic changes may have a much more permanent effect on a company than temporary fluctuations in interest rates, for example. Aging baby boomers will create opportunities for some companies and problems for others. Knowing the difference will mean investment mistakes avoided.

How do you know what is a major problem or opportunity for a company you own or are considering buying?

In order to get an answer to this question you need to study the company, its products and markets with the help of the company Web site and its annual report. And it is the future growth of the company that will generate the earnings to benefit shareholders.

Step 2: Analysing the Financial Ratios

Investors can use financial ratios to evaluate a company, especially as it compares to others in the same industry. This type of analysis will help you understand where the company ranks among its peer and if it is properly priced by the market as reflected in its stock's price.

Tools of Fundamental Analysis

Fundamental analysis is the process of looking at a business at the basic or fundamental financial level. This type of analysis examines key ratios of a business to determine its financial health and gives you an idea of the value its stock.

Many investors use fundamental analysis alone or in combination with other tools to evaluate stocks for investment purposes. The goal is to determine the current worth and, more importantly, how the market values the stock.

This topic focuses on the key tools of fundamental analysis and what they tell you. Even if an investor doesn't plan to do in-depth fundamental analysis themselves, it will help them follow stocks more closely if they understand the key ratios and terms.

Fundamental Analysis Tools

These are the most popular tools of fundamental analysis. They focus on earnings, growth, and value in the market.

Notes

Some important ratios:

a. EPS

b. P/E Ratio

c. Projected Earnings Growth (PEG)

d. P/S (Price to Sales)

No single number from this list is a magic bullet that will give you a buy or sell recommendation by itself, however as you begin developing a picture of what you want in a stock, these numbers will become benchmarks to measure the worth of potential investments.

Task Select any three stocks from a similar industry and calculate their important financial ratios. Note the reasons behind the differences in their stock prices and market performance for the last 1 year. Also find out how their financial ratios play a vital role in stock performance.

Step 3: Try to Figure out Earnings

Earnings are profits. It may be complicated to calculate, but that's what buying a company is about. Increasing earnings generally leads to a higher stock price and, in some cases, a regular dividend.

When earnings fall short, the market may hammer the stock. Every quarter, companies report earnings. Analysts follow major companies closely and if they fall short of projected earnings, sound the alarm. For more information on earnings, see my article: It's the Earnings.

While earnings are important, by themselves they don't tell you anything about how the market values the stock. To begin building a picture of how the stock is valued you need to use some fundamental analysis tools. These ratios are easy to calculate, but you can find most of them already done on sites like cnn.money.com or MSN MoneyCentral.com.

Step 4: What to Look for in Stocks?

There are many factors to consider when analysing a company. Here are some of the factors you should consider along with others such as financial ratios and the economy.

1. Look for stocks with earnings growth
2. Size matters in investing
3. Three main influences on stock prices

Step 5: Figuring your Return

If you can't measure your return, how will you know if you're making money? Here are some tips on tallying up your profits.

Step 6: Stocks and the Economy

The economy can have a dramatic affect on stock prices. Factors such as interest rates and retail sales play an important role in what happens in the stock market.

Notes

Step 7: Market News Sources

There are many sources for market news on the Internet. Here are some of the best.

1. Market News Sources
2. CNN
3. Bloomberg
4. Moneycontrol.com
5. Yahoo Finance
6. MSN Money

6.3 Various Loans and their Usage

6.3.1 Meaning of Loan

A loan is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower.

In a loan, the borrower initially receives or borrows an amount of money, called the principal, from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. Typically, the money is paid back in regular instalments, or partial repayments; in an annuity, each instalment is the same amount.

The loan is generally provided at a cost, referred to as interest on the debt, which provides an incentive for the lender to engage in the loan. In a legal loan, each of these obligations and restrictions is enforced by contract, which can also place the borrower under additional restrictions known as loan covenants.

6.3.2 Types of Loans

Following are some of the popular loan schemes offered by Indian banks:

1. ***Housing Loans:*** Finance is provided for purchase of a new House. Loan is also given for the purchase of land and constructions of house on the same. The rates of interest to be charged depends on two factors firstly the amount of loan and secondly the time period for which the loan is required. The rate of interest may be fixed or fluctuating. In case of fixed rate of interest the interest rate remain the fixed throughout the period of loan in spite of the fact that the current rate of interest may be different the rate at which the loan was obtained. In case of fluctuating rate of interest the rate of interest changes according to the current rate in the market.

   How to choose your home loan lender?

   Buying a home is dream for everyone but most of us are not able to achieve the dream due to many reasons. The escalating real estate prices have made buying a property a dream for most of us. It may happen that you have been thinking for quite sometime to buy a property but your bank balance is not allowing you to do so. If that is the case, you can go ahead and take a home loan that you can pay over a period of time and also own your dream home.

Notes

Caution The foremost thing to be kept in mind is that one should never finalize a lender on the basis of interest rates. Most of us choose home loan lender on the basis of interest rates, cheapest the best. But actually, there are various other things that should be kept in mind when you decide of taking a home loan.

Check your loan eligibility with various banks

Various banks have their own methods ad standards for calculating eligibility. You should do some shopping to check which bank is offering you higher loan eligibility. Adding up your spouse income may also be a good option to increase your loan eligibility.

Type of interest rate: Fixed or Floating interest rate

A fixed interest rate means that you will have to pay same EMI over a period of time (it may be fixed for entire tenure or it may be reset at fixed interval). Floating interest rates may change at any given point of time, which may result increase or decrease in either your EMI or your tenure.

Processing fees

This fee is charged by the bank for processing the loan and is not refundable. In case you decide not to take the loan from the bank, then the entire amount you have paid towards processing fees is lost. This generally varies in the range of 0.5 to 1% of the total loan amount. Also payment of processing fees doesn't means that your loan is passed. It may happen that you pay the processing fees but still your loan is not sanctioned due to various other reasons. Thus before paying the processing fees, you should bargain on the same and get it confirmed from the bank in writing.

Prepayment fees

Prepayment fees come in to picture in case one wants to prepay his home loan from various sources. It may be from his personal savings or if he is planning to switch the loan to a different lender. Few of the banks offer no prepayment charges in case the prepayment is done from own sources. But in case the person is shifting the loan to a different lender then most of the banks ask to pay a fee in the range of 1% to 2% of the outstanding loan amount.

All the charges should be always be taken down in written from the bank and the written document should be preserved in case the bank asks the person to pay up some different amount after sometime.

Once you are satisfied with the above clauses and the interest rate offered by the particular lender, you should go ahead and buy your dream home.

Along with that it is always said that you can get the best home loan deal only after your property is finalized. So before you start with your loan hunting, it is advisable to finalize the property.

2. ***Personal Loan:*** Finance is provided to meet out all personal needs like renovating the house, purchasing a computer, marriage or medical expenses etc.

   Personal loans are loans provided without any security. Before you hurry to take this magical loan pause a bit. Personal loans are tricky they are far more expensive than a loan given against security. They also require that you have a good credit report and that you can prove that you have a regular income of at least ₹ 3 lakhs per annum.

Notes

You may be eligible for a personal loan even below this income level but the interest rate is likely to be very high.

These loans are likely to be more reasonably priced if you work for a top notch corporate and have large provable income in double digit lakhs per annum.

A better and more convenient option is to take a gold loan. You need to provide jewellery as security but the loan is significantly cheaper (and quick as well since it is available across the counter or in a matter of hours) and your age and repayment history will not matter.

If you have no jewellery you can look at getting a loan against your financial securities such as shares, bonds, life insurance policies with high surrender values, mutual fund units, etc.

But a personal loan is in any case better than borrowing on a credit card which is extremely expensive.

Compare personal loan offers from various lenders across the country right from interest rates to aspects of loans such as repayment options, charges applicable, documentation before making a decision.

Current Personal Loan Interest Rates in India

Interest rates charged on personal loans vary across various banks. There are primarily 3 kinds of interest rates, most commonly offered by banks are:

(i) Fixed interest rate

(ii) Floating interest rate

(iii) Flat rate

Of the rates offered, flat rates can be considered the most expensive as in other cases, the reducing balance method is used for calculation.

Personal Loan: Eligibility Criteria: Overview

You are eligible for a personal loan if you are a salaried individual, self-employed individual (own business), or a self-employed professional (doctor, lawyer, etc.). Other factors such as your income, age, residence, work experience, repayment capacity, past obligations and place of work are also taken into account. A personal loan can be used for any purpose provided it is legitimate; you need not mention the end use to the lender. Compare various personal loan providers and decide for yourself the best option.

3. ***Car Loan/Vehicle Loan:*** Finance is provided for purchase of car or other vehicles either for personal or business purposes.

Current Car Loan Interest Rates

Whether you want to buy a new car or an old one, you can get a car loan. Banks offer loan on fixed as well as floating interest rates for a tenure ranging from 3 to 5 years. While fixed rates have been in the market for a while, floating rates were introduced around September 2007.

Car Loan: Eligibility Criteria

If you have sufficient income and the wish to own a swanky car, new or old – you can get a loan. Auto loans can be about 2.5–3 times the annual salary for salaried professionals or 6 times the annual income for self-employed professionals. For more details you need to contact the concerned bank directly.

Notes

4. ***Travel Loan:*** Finance is provided to meet out the travel cost of the customers either domestic or for international visits.

5. ***Education Loan:*** Finance is provided to meet out the education cost of children of the customers.

Education Loan: Eligibility Criteria

Banks have set eligibility criteria for education loans. Some of the important pre-requisites are mentioned in brief. A loan applicant has to be:

(i) An Indian national

(ii) Aged 16-26 years of age or any other range specified by the bank.

(iii) Have a good academic track record.

(iv) Have parents or guardians with stable source of income.

(v) Should have applied to a recognized university in India or abroad.

(vi) Should not be a minor.

Current Education Loan Interest Rates

For several education loan applicants, the bank offers a holiday period on repayment while the student is doing the course either on the principal or on the interest or both. But the interest rate at which you borrow is certainly going to become very important as soon as your studies are over. The interest rate on an education loan depends on whether you are studying in India or abroad, the course that you are applying for, your loan amount and the tenure. Special concessions on interest rates are available if the student is a female.

Lending loans for educational purposes is a part of the priority sector lending activity for Indian banks. The interest rates offered by banks are:

(i) Fixed interest rate

(ii) Floating interest rate

Banks will charge interest on a daily or monthly reducing balance. Usually, nationalised banks offer variable interest rates for student loans, while private and foreign banks offer fixed interest rates. Some banks also offer a choice between the two.

Task Visit a nearby bank in your area and find out about the various types of loan they offer to their customers. Also enquire about the eligibility criteria, interest rates , documents required and EMI calculation method.

Did u know? Income tax deductions are always welcome, even if the loan was taken to fulfill academic ambitions of your children. Tax deductions are available only on the principal of the education loan. The interest paid on these is not eligible for deductions.

6. ***Other types of loans:***

Festival Loans: Finance is also given to meet out the festival expenses.

Loan Against Property (LAP): A loan against property is a loan against your house or even a plot. If all the land titles are in place, you have an income and you are eligible then this

Notes

is the cheaper loan option for you. Though the interest rates on this loan are higher than that of a home loan, it's cheaper than that a personal loan or a loan against security.

Gold Loans: Loans which are given against gold of the borrower. It is a relatively new concept in Indian financial system.

Self Assessment

State True or False:

6. Lending loans for educational purposes is a part of the priority sector lending activity for Indian banks.
7. For several education loan applicants, the bank offers a holiday period on repayment while the student is doing the course either on the principal or on the interest or both.
8. A credit card payment is in any case better than borrowing on a personal loan.
9. In case the person is shifting the loan to a different lender then most of the banks ask to pay a fee in the range of 4% to 8% of the outstanding loan amount.
10. In case of fluctuating rate of interest the rate of interest changes according to the current rate in the market.

Case Study

Gold Loans-Personal Loan against Gold: A Financing Option for Short-term Needs

For Indians, gold is considered as an essential investment from a cultural, emotional and safety perspective. One bought, is a dead investment. It tends to lie in the locker not earning you any money. Why not make use of it in your time of need? You can monetise this idle asset to help you tide over your financial need. So if ever you find yourself in need of money, consider gold loans as an option. Gold loans also know as gold deposits are loans given by banks/ NBFCs by taking gold as a security.

Gold loans are not new to the Indian market. It existed but in the unorganised sector where money lenders used gold as a security for providing loans. Now banks have entered this space in a big way because the market is very large considering the fact that most Indians tend to have sufficient investment in gold. More importantly, with more and more women working in the family, people have become broadminded. So the social stigma that was once attached to taking a loan on gold is gradually being eliminated.

Off late, this product has become popular because of the substantial rise in gold prices. The quantum of loan that one can get by giving gold as security has increased tremendously making it an attractive loan proposition.

What is the process to be followed to obtain a gold loan?

You offer your jewellery to the lender who can be a bank or an NBFC. The lender will evaluate the purity of the jewellery. The charge for evaluation is generally borne by the borrower. Once the evaluation is done, the paper work for the mortgage is done. Banks will ask you to produce personal documents such as Pan Card, address proof among other things. The lender will give you a loan which in most cases can be up to a maximum of 80% of the value of the jewellery. After having repaid the loan, you get your gold back from the lender.

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Features

1. ***Secured Loan:*** Gold loan is essentially borrowings against the security i.e. gold. Thus this loan should be taken only if you're absolutely sure that you will be able to repay the loan else you may end up losing your gold.
2. ***Tenure:*** Gold loans are typically for duration of 3 to 12 months. They are thus best used to fund short term monetary requirements.
3. ***No end use restrictions:*** The loan can be taken for any purpose so long as the money is not being used for speculative purposes.
4. ***Loan amount:*** In most cases, the maximum loan value is not more than 80% of the value of gold. Most banks deal in relatively higher loan amounts. NBFCs on the other hand, deal in small value loans.
5. ***Interest Rate:*** The interest rate charged by banks can be in the range of 11.5% and 15%. Banks usually charge a processing fee while NBFCs may not charge the same. The rate of interest charged by NBFCs is much higher as compared to banks.
6. ***Repayment:*** The loan can be foreclosed at any time without any penalty. In case of irregular payment of EMIs, a penal interest of up to 2% is charged by banks.
7. ***Market risk:*** The lender retains the exposure to the market risk arising from movements in the market price of gold.

Advantages

1. ***Quick processing:*** Gold loans require minimum documentation and hence it can be resorted to in times of urgent need. Banks maintain that it takes a few hours to get a gold loan and some NBFCs state that it takes only a few minutes.
2. ***More attractive than a personal loan:*** The rate of interest charged on gold loans tends to be much lower than that of a personal loan. Therefore, it may be worthwhile putting you asset to work and thus reducing your cost of loan.
3. ***Emotional attachment will ensure timely payment:*** Most families have an emotional attachment to gold and that will make you morally responsible to repay the loan in time so that you can get back the gold that you had placed as a security.
4. ***Cash flow management:*** In a typical loan against gold transaction, only interest needs to be paid during the tenure of the loan and the principal amount has to be repaid at the end of the tenure. This allows customers the borrower to manage cash flows better.

In times of need of money for a short duration, you can resort to gold loans. Let your asset that you have built over years; be of use to you when you are undergoing a financial strain. Note that you should take a gold loan if and only if you are sure of repaying the loan in time. Else you may end up losing your most treasured asset.

Questions

1. How do you view Gold loan as sources of personal finance? Support your explanation with relevant reasons.
2. Name the various banks providing the customers "Loans against Gold or Gold Loans". Which bank was the first to introduce this service in India?
3. Which finance option will you prefer: Gold Loan or Personal Loan? Give reasons.

Source: http://www.rupeetalk.com/

Notes

6.4 Summary

- An investment strategy that aims to balance risk and reward by designing a portfolio's assets according to an individual's goals, risk tolerance and investment horizon.
- There are three main types of asset classes – equities, fixed-income, and cash and equivalents. The three asset classes have different levels of risk and return, so each will behave differently over time.
- When prices of different types of assets do not move in tandem, combining these investments in a portfolio can help manage the variability of returns, commonly referred to as "market risk."
- When you diversify your investments among more than one security, you help reduce what is known as "single-security risk," or the risk that your investment will fluctuate widely in value with the price of one holding. Diversifying among several asset classes may increase the chance that, if and when the return of one investment is falling, the potential return of another in your portfolio may be rising.
- Fundamental analysis is the process of looking at a business at the basic or fundamental financial level.
- Return on Assets is one of the most important metrics every investor should know. Return on Assets (ROA) tells how efficiently (or inefficiently) a company turns assets into net income. It is a way to tell at a glance how profitable a company is.
- A loan is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower.
- There are various types of loans such as home loan, car loan, personal loan, education loan etc to meet out varied financing needs of individuals.

6.5 Keywords

Asset Allocation : Asset Allocation is a method of diversification which positions assets among major investment categories. This tool may be used in an effort to manage risk and enhance returns. However, it does not guarantee a profit or protect against a loss.

Asset Classes: There are three main types of asset classes - equities, fixed-income, and cash and equivalents. The three asset classes have different levels of risk and return, so each will behave differently over time.

Loan: A loan is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower.

6.6 Review Questions

1. What do you mean by the term investment strategies?
2. What are asset classes? Name the various types of asset classes.
3. What are the various types of primary asset classes? Explain.
4. What do you mean by the term "asset allocation"? Explain its significance while making a investment decision.
5. What is the role of diversification strategy in asset allocation?
6. What are the various types of loan options available in India?

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7. Explain the eligibility criteria for following types of loans:
   a. Home Loan
   b. Car Loan
   c. Personal Loan
8. What point should be kept in mind while choosing a home loan?
9. Which is better loan from the point of view of a borrower: Loan with fixed rate of interest or a loan with floating rate of interest? Give reasons for your answers.
10. How will you compare the loan options available from different types of banks?
11. Why do people take personal loans? What is the rate of interest charged by banks for personal loans?
12. Which factors play a significant role when a person makes an investment decision? Discuss using examples.

Answers: Self Assessment

1.	Asset Allocation	2.	Diversification
3.	Stocks	4.	Money market instruments
5.	Portfolio	6.	True
7.	True	8.	False
9.	False	10.	True

6.7 Further Readings

Books

Cohen, Jerome, B.: Zinbarg, Edward D., and Zeikel, Arthur: *Investment Analysis and Portfolio Management,* Homewood, Ill.: Richard D. Irwin, 2006.

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Unit 7: Investment Strategies-II

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Objectives

After studying this unit, you will be able to:

- Learn about the various types of investment options;
- Understand the process of investing in stocks and bonds;
- Know about the basics of commodity market in India;
- Describe the concept of future and options.

Introduction

A well-planned **investment strategy** is essential before having any investment decisions. A business strategy is generally based upon long run period. Formation of business strategy is largely dependent upon the factors such as long-term goals and risk on the investment.

As the return on investment is not always clear, so the investors prepare the strategy so as to face the ongoing challenges in investment. A balanced **investment strategy** is generally required in the process of investment, which possesses long time period and some risk tolerance.

In the case, when a strategy is aggressive the chance of attaining a higher goal is higher. An efficient strategy can be obtained from portfolio theory, which shows good estimates on risk and return.

7.1 Meaning of Investment Strategy

Investment Strategy is usually considered to be more of a branch of finance than economics. It is defined as set of rules, a definite behaviour or procedure guiding an investor to choose his

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investment portfolio. For example, investing in mutual funds has recently emerged as a very favourable investment strategy.

An **investment strategy** is cantered on risk-return trade-offs for a potential investor. High return investment instruments such as real estate and mutual funds usually have more risks associated with it than low return-low risk investment opportunities. Return on investment can be calculated on past or current investment or on the estimated return on future investment.

Symbolically, it can be expressed as:

$$Vf/Vi - 1$$

Where,

Vf denotes final investment value and

Vi is the initial investment value. ("F" and "I" should be noted as subscripts)

Return on investment (ROI) is profitable when Vf/Vi-1>0 and the investment is deemed to be unprofitable when the value of final investment is less than that of the initial investment. ROI is calculated to be 1 or 100% when the value of the final investment is twice the value of the initial investment.

7.2 Types of Investment Strategies

1. ***Active and Passive Investment Strategies:*** An investment strategy can be either active or passive. A passive investment strategy attempted to minimize transaction costs. An active **investment strategy guide** is used to maximize returns based on moves such as proper market timing. This usually mean, "Buying in the lows and selling in the highs" or buying investment instruments when they are cheap and selling them off when their price appreciates. This strategy, however, is not very beneficial for small time investors.
2. ***Buy and Hold Investment Strategy:*** Small time investors can adopt the buy and hold **investment strategy** to invest in equities, which although volatile in nature, give favourable long run returns. Investing in equity markets for small time investors is associated with the investors holding on for very long periods. In the case of real estate, the holding period extends the life-span of the mortgage. Notably, in case of this strategy, indexing or buying a small proportion of all the shares in market index or a mutual fund is a purely passive variant of the above strategy.
3. ***Strategy of Value Investing:*** The strategy of value investing, a classic investment strategy propagated by Benjamin Graham simply concentrates on the strategy that an investor buys shares of a company as if he was buying off the whole company without paying any attention to the stock market scenario or any exterior conditions such as the political climate. At the end of the day, if he can buy the stock at less than that its actual future worth to the buyer, the person is said to have discovered a "value investment."

Investment strategies can also denote the investment strategies a national or central government should follow to bring about economic growth in a country. This can only be achieved by domestic investment as well as significant FDI (Foreign Direct Investment) flows to particular sectors of countries, especially the less developed ones of Asia and Africa.

In case of India, infrastructural problems, excessive government intervention, rigid labour laws and corruption are stifling the flow of FDI in the critical sectors. Less developed countries such as those in the Asia- Pacific region and Africa can bring about much needed development in these economies.

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An investment strategy in mutual funds is probably the best bet for a profitable investment. Mutual funds is defined as a pool of money supplied by different investors and in turn used by the mutual fund company to invest in various assets such as stocks and bonds. However, a detailed research has to be conducted for choosing the mutual fund companies and only those should be considered which have a professional investment manager. This will ensure that the funds get channelled towards the right investments. This also applies for investing in stock markets where a decision to invest should follow a thorough research about the past and current trends of the stock prices and their Net Asset Values (NAV). Analyses from market researchers about the predicted future trends should also be considered otherwise gains from capital appreciation; capital gain distribution (in case of mutual funds) and dividends might not be realized.

Lastly, investment strategies leading to green investments or investments in renewable sources of energy will be the next big thing in the investment spectrum.

7.3 Investment Strategy Considerations

As you create your investment portfolio of bonds, there are various techniques you and your investment advisor can use to help you match your investment goals with your risk tolerance.

Active vs. Passive

One important consideration is how a portfolio is managed day to day. A portfolio can be actively managed, which means the composition of the portfolio and how often it is traded depend, largely, on the investment decisions made by you or your investment manager. A passively managed portfolio tends to invest in a basket of stocks or bonds (usually mimicking an index) and, generally, employs a buy and hold strategy, where purchases are made for the long term.

Diversification

Diversification is the allocation of assets to several categories in order to spread, and therefore possibly mitigate, risk. Regardless of your investment objectives, diversification is an important consideration in building any portfolio. Diversification can be achieved in any number of ways, including by:

a. ***Bond Type:*** Diversification by bond type may provide some protection for a portfolio, so if one sector or asset class experiences a downturn, the performance of other parts of the portfolio may help offset the negative impact. For example, a bond portfolio might consist of a variety of high-yield and investment-grade bonds in order to balance risk and return.

b. ***Laddering:*** Another diversification strategy is to purchase securities of various maturities in a technique called laddering. When you buy bonds with a range of maturities, a technique called laddering, you are reducing your portfolio's sensitivity to interest rate risk. If, for example, you invested only in short-term bonds, which are the least sensitive to changing interest rates, you would have a high degree of stability but low returns. Conversely, investing only in long-term bonds may result in greater returns, but prices will be more volatile, exposing you to potential losses. Assuming a normal yield curve, laddering allows returns that would be higher than if you bought only short-term issues, but with less risk than if you bought only long-term issues. In addition, you would be better protected against interest rate changes than with bonds of one maturity.

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Example: you might invest equal amounts in bonds maturing in 2, 4, 6, 8 and ten years. In two years, when the first bonds mature, you would reinvest the money in a 10-year maturity, maintaining the ladder.

c. ***Barbells:*** Barbells are a bond investment strategy similar to laddering, except that purchases are concentrated in the short-term and long-term maturities. This allows the investor to capture high yields from longer maturities in one portion of their portfolio, while using the lower maturities to minimize risk.

d. ***Bond Swap:*** *Bond swapping* is the sale of a block of bond swaps and the purchase of another block of similar market value. Swaps may be made to achieve many goals, including establishing a tax loss, upgrading credit quality, extending or shortening maturity, etc. The most common swap is done to achieve tax savings by converting a paper loss into an actual loss that could partially or fully offset other capital gains or income. We strongly recommend that you speak with your financial advisor to learn more about this investment strategy.

Selecting the Right Investment Vehicle

It has been already mentioned that there are many ways to invest your money. Of course, to decide which investment vehicles are suitable, an investor needs to know their characteristics and why they may be suitable for a particular investing objective.

Self Assessment

Fill in the blanks:

1. ……..is the allocation of assets to several categories in order to spread, and therefore possibly mitigate, risk.
2. Another diversification strategy is to purchase securities of various maturities in a technique called……... .
3. ……..are a bond investment strategy similar to laddering, except that purchases are concentrated in the short-term and long-term maturities.
4. …….is the sale of a block of bond swaps and the purchase of another block of similar market value.
5. The strategy of value investing, a classic investment strategy propagated by ……. .

7.4 Investment in Bonds

Grouped under the general category called fixed-income securities, the term bond is commonly used to refer to any securities that are founded on debt. When you purchase a bond, you are lending out your money to a company or government. In return, they agree to give you interest on your money and eventually pay you back the amount you lent out.

The main attraction of bonds is their relative safety. If you are buying bonds from a stable government, your investment is virtually guaranteed, or risk-free. The safety and stability, however, come at a cost. Because there is little risk, there is little potential return. As a result, the rate of return on bonds is generally lower than other securities.

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Bond Investment Strategies

The way you invest in bonds for the short-term or the long-term depends on your investment goals and time frames, the amount of risk you are willing to take and your tax status.

When considering a bond investment strategy, remember the importance of diversification. As a general rule, it's never a good idea to put all your assets and all your risk in a single asset class or investment. You will want to diversify the risks within your bond investments by creating a portfolio of several bonds, each with different characteristics. Choosing bonds from different issuers protects you from the possibility that any one issuer will be unable to meet its obligations to pay interest and principal. Choosing bonds of different types (government, agency, corporate, municipal, mortgage-backed securities, etc.) creates protection from the possibility of losses in any particular market sector. Choosing bonds of different maturities helps you manage interest rate risk.

With that in mind, consider these various objectives and strategies for achieving them.

Preserving Principal and Earning Interest

If keeping your money intact and earning interest is your goal, consider a "buy and hold" strategy. When you invest in a bond and hold it to maturity, you will get interest payments, usually twice a year, and receive the face value of the bond at maturity. If the bond you choose is selling at a premium because its coupon is higher than the prevailing interest rates, keep in mind that the amount you receive at maturity will be less than the amount you pay for the bond.

When you buy and hold, you need not be too concerned about the impact of interest rates on a bond's price or market value. If interest rates rise, and the market value of your bond falls, you will not feel any effect unless you change your strategy and try to sell the bond. Holding on to the bond means you will not be able to invest that principal at the higher market rates, however.

If the bond you choose is callable, you have taken the risk of having your principal returned to you before maturity. Bonds are typically "called," or redeemed early by their issuer, when interest rates are falling, which means you will be forced to invest your returned principal at lower prevailing rates.

Notes When investing to buy and hold, be sure to consider:

1. The coupon interest rate of the bond (multiply this by the par or face value of the bond to determine the dollar amount of your annual interest payments)
2. The yield-to-maturity or yield-to-call. Higher yields can mean higher risks.
3. The credit quality of the issuer. A bond with a lower credit rating might offer a higher yield, but it also carries a greater risk that the issuer will not be able to keep its promises.

Maximizing Income

If your goal is to maximize your interest income, you will usually get higher coupons on longer-term bonds. With more time to maturity, longer-term bonds are more vulnerable to changes in interest rates. If you are a buy-and-hold investor, however, these changes will not affect you unless you change your strategy and decide to sell your bonds.

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You will also find higher coupon rates on corporate bonds than on Government treasury bonds with comparable maturities. In the corporate market, bonds with lower credit ratings typically pay higher income than higher credits with comparable maturities.

High-yield bonds (sometimes referred to as junk bonds) typically offer above-market coupon rates and yields because their issuers have credit ratings that are below investment grade: BB or lower from Standard & Poor's; Ba or lower from Moody's. The lower the credit rating, the greater the risk that the issuer could default on its obligations, or be unable to pay interest or repay principal when due.

If you are thinking about investing in high-yield bonds, you will also want to diversify your bond investments among several different issuers to minimize the possible impact of any single issuer's default. High yield bond prices are also more vulnerable than other bond prices to economic downturns, when the risk of default is perceived to be higher.

Managing Interest Rate Risk: Ladders and Barbells

Buy-and-hold investors can manage interest rate risk by creating a "laddered" portfolio of bonds with different maturities, for example: one, three, five and ten years. A laddered portfolio has principal being returned at defined intervals. When one bond matures, you have the opportunity to reinvest the proceeds at the longer-term end of the ladder if you want to keep it going. If rates are rising, that maturing principal can be invested at higher rates. If they are falling, your portfolio is still earning higher interest on the longer-term holdings.

With a barbell strategy, you invest only in short-term and long-term bonds, not intermediates. The long-term holdings should deliver attractive coupon rates. Having some principal maturing in the near term creates the opportunity to invest the money elsewhere if the bond market takes a downturn.

Smoothing Out the Performance of Stock Investments

Because stock market returns are usually more volatile or changeable than bond market returns, combining the two asset classes can help create an overall investment portfolio that generates more stable performance over time. Often but not always, the stock and bond markets move in different directions: the bond market rises when the stock market falls and vice versa. Therefore in years when the stock market is down, the performance of bond investments can sometimes help compensate for any losses. The right mix of stocks and bonds depends on several factors.

Saving for a Definite Future Goal

If you have a three-year-old child, you may face your first college tuition bill 15 years from now. Perhaps you know that in 22 years you will need a down payment for your retirement home. Because bonds have a defined maturity date, they can help you make sure the money is there when you need it.

Zero coupon bonds are sold at a steep discount from the face value amount that is returned at maturity. Interest is attributed to the bond during its lifetime. Rather than being paid out to the bondholder, it is factored into the difference between the purchase price and the face value at maturity.

You can invest in zero coupon bonds with maturity dates timed to your needs. To fund a four-year college education, you could invest in a laddered portfolio of four zeros, each maturing in one of the four consecutive years the payments will be due. The value of zero coupon bonds is

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more sensitive to changes in interest rates however, so there is some risk if you need to sell them before their maturity date. It is also best to buy taxable (as opposed to municipal) zeros in a tax-deferred retirement or college savings account because the interest that accumulates on the bond is taxable each year even though you do not receive it until maturity.

A bullet strategy can also help you invest for a defined future date. If you are 50 years old and you want to save toward a retirement age of 65, in a bullet strategy you would buy a 15-year bond now, a 10 year bond five years from now, and a five-year bond 10 years from now. Staggering the investments this way may help you benefit from different interest rate cycles.

Reasons you might Sell a Bond before Maturity

Investors following a buy-and-hold strategy can encounter circumstances that might compel them to sell a bond prior to maturity for the following reasons:

1. They need the principal. While buy-and-hold is generally best used as a longer-term strategy, life does not always work out as planned. When you sell a bond before maturity, you may get more or less than you paid for it. If interest rates have risen since the bond was purchased, its value will have declined. If rates have declined, the bond's value will have increased.
2. They want to realize a capital gain. If rates have declined and a bond has appreciated in value, the investor may decide that it's better to sell before maturity and take the gain rather than continue to collect the interest. This decision should be made carefully, as the proceeds of the transaction may have to be reinvested at lower interest rates.
3. They need to realize a loss for tax purposes. Selling an investment at a loss can be a strategy for offsetting the tax impact of investment gains. Bond swapping can help achieve a tax goal without changing the basic profile of your portfolio.
4. They have achieved their return objective. Some investors invest in bonds with the objective of total return, or income plus capital appreciation or growth. Achieving capital appreciation requires an investor to sell an investment for more than its purchase price when the market presents the opportunity.

Total Return

Using bonds to invest for total return, or a combination of capital appreciation (growth) and income, requires a more active trading strategy and a view on the direction of the economy and interest rates. Total return investors want to buy a bond when its price is low and sell it when the price has risen, rather than holding the bond to maturity.

Bond prices fall when interest rates are rising, usually as the economy accelerates. They typically rise when interest rates fall, usually when the RBI Reserve is trying to stimulate economic growth after a recession. Within different sectors of the bond market, differences in supply and demand can create short-term trading opportunities.

Various futures, options and derivatives can also be used to implement different market views or to hedge the risk in different bond investments. Investors should take care to understand the cost and risks of these strategies before committing funds.

Some bond funds have total return as their investment objective, offering investors the opportunity to benefit from bond market movements while leaving the day-to-day investment decisions to professional portfolio managers.

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Diversifying Risk by Investing in Bond Funds

Investors who want to achieve automatic diversification of their bond investments for less than it would cost to construct a portfolio of individual bonds can consider investing in bond mutual funds, unit investment trusts or exchange-traded funds. These vehicles each have specific investment objectives and characteristics to match individual needs.

Swapping for Other Objectives

A tax loss is not the only reason to swap a bond. Investors can also swap to improve credit quality, increase yield or improve call protection. Remember to factor the sell and buy transaction costs into your estimations of return.

Where to Hold your Bond Investments: Taxable or Tax-deferred Accounts?

In a taxable investment account, your capital gains and investment income are subject to taxation in the year they are earned. In a qualified tax-deferred account such as an IRA or some college savings account, income and capital gains are not taxed until you start taking withdrawals, presumably at a future date.

Bonds and bond funds can be held in either type of account, but some investors will have a reason to choose one account type over the other. Municipal investments, for example, are best held in a taxable account, where they can serve to reduce the taxable returns. Taxable zero coupon bonds are best held in a tax-deferred account because their annual interest credits are taxable when earned, even though the investor does not actually receive them until the bond matures.

Since the maximum tax on capital gains was reduced to 15% in 2003, total return investors in a high income tax bracket may find advantages to holding their bonds in a taxable account. Others may prefer to invest for maximum income in their tax deferred accounts. The best solution depends on your individual circumstances and tax situation. Your tax or investment advisor can help you analyze the alternatives and reach the best solution.

Task Prepare a project report on various types of bonds in Indian Financial market and study their performance for the last six months.

7.5 Investment in Stocks

Fundamentals of Stock

Plain and simple, stock is a share in the ownership of a company. Stock represents a claim on the company's assets and earnings. As you acquire more stock, your ownership stake in the company becomes greater. Whether you say shares, equity, or stock, it all means the same thing.

Being an Owner

Holding a company's stock means that you are one of the many owners (shareholders) of a company and, as such, you have a claim (albeit usually very small) to everything the company owns. Yes, this means that technically you own a tiny sliver of every piece of furniture, every trademark, and every contract of the company. As an owner, you are entitled to your share of the company's earnings as well as any voting rights attached to the stock.

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Stock Certificate

A stock is represented by a stock certificate. This is a fancy piece of paper that is proof of your ownership. In today's computer age, you won't actually get to see this document because your brokerage keeps these records electronically, which is also known as holding shares "in street name". This is done to make the shares easier to trade. In the past, when a person wanted to sell his or her shares, that person physically took the certificates down to the brokerage. Now, trading with a click of the mouse or a phone call makes life easier for everybody.

Limited Liability

Another extremely important feature of stock is its limited liability, which means that, as an owner of a stock, you are not personally liable if the company is not able to pay its debts. Other companies such as partnerships are set up so that if the partnership goes bankrupt the creditors can come after the partners (shareholders) personally and sell off their house, car, furniture, etc. Owning stock means that, no matter what, the maximum value you can lose is the value of your investment. Even if a company of which you are a shareholder goes bankrupt, you can never lose your personal assets.

Risk

It must be emphasized that there are no guarantees when it comes to individual stocks. Some companies pay out dividends, but many others do not. And there is no obligation to pay out dividends even for those firms that have traditionally given them. Without dividends, an investor can make money on a stock only through its appreciation in the open market. On the downside, any stock may go bankrupt, in which case your investment is worth nothing.

Although risk might sound all negative, there is also a bright side. Taking on greater risk demands a greater return on your investment. This is the reason why stocks have historically outperformed other investments such as bonds or savings accounts. Over the long term, an investment in stocks has historically had an average return of around 10-12%.

How stocks trade?

Most stocks are traded on exchanges, which are places where buyers and sellers meet and decide on a price. Some exchanges are physical locations where transactions are carried out on a trading floor.

The purpose of a stock market is to facilitate the exchange of securities between buyers and sellers, reducing the risks of investing. Just imagine how difficult it would be to sell shares if you had to call around the neighborhood trying to find a buyer. Really, a stock market is nothing more than a super-sophisticated farmers' market linking buyers and sellers.

Before we go on, we should distinguish between the primary market and the secondary market. The primary market is where securities are created (by means of an IPO) while, in the secondary market, investors trade previously-issued securities without the involvement of the issuing-companies. The secondary market is what people are referring to when they talk about the stock market. It is important to understand that the trading of a company's stock does not directly involve that company.

Some common stock markets of the world are as follows:

1. The New York Stock Exchange: The most prestigious exchange in the world is the New York Stock Exchange (NYSE).

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2. The Nasdaq: The second type of exchange is the virtual sort called an over-the-counter (OTC) market, of which the Nasdaq is the most popular.
3. Bombay Stock Exchange (BSE)
4. National Stock Exchange (NSE)

Technical Analysis of Stocks

In the stock market there is no rule without an exception, there are some principles that are tough to dispute. Still there are some fundamental concept every investor should know before investing in stocks.

1. Carefully study the financial ratios such as EPS, P/E ratio, P/S etc of the stock
2. Try to figure out the earnings of the stock
3. Try to figure out your return
4. Synchronize the flow of economy with the stock process
5. Carefully read the various market news sources on television and internet such as moneycontrol.com, Bloomberg, CNN etc.

When you purchase stocks, or equities, as your advisor might put it, you become a part owner of the business. This entitles you to vote at the shareholders' meeting and allows you to receive any profits that the company allocates to its owners. These profits are referred to as dividends.

While bonds provide a steady stream of income, stocks are volatile. That is, they fluctuate in value on a daily basis. When you buy a stock, you aren't guaranteed anything. Many stocks don't even pay dividends, in which case, the only way that you can make money is if the stock increases in value - which might not happen.

Compared to bonds, stocks provide relatively high potential returns. Of course, there is a price for this potential: you must assume the risk of losing some or all of your investment.

7.6 Investment in Mutual Funds

A mutual fund is a collection of stocks and bonds. When you buy a mutual fund, you are pooling your money with a number of other investors, which enables you (as part of a group) to pay a professional manager to select specific securities for you. Mutual funds are all set up with a specific strategy in mind, and their distinct focus can be nearly anything: large stocks, small stocks, bonds from governments, bonds from companies, stocks and bonds, stocks in certain industries, stocks in certain countries, etc.

The primary advantage of a mutual fund is that you can invest your money without the time or the experience that are often needed to choose a sound investment. Theoretically, you should get a better return by giving your money to a professional than you would if you were to choose investments yourself. In reality, there are some aspects about mutual funds that you should be aware of before choosing them.

Organisation of Mutual Funds

A mutual fund can be constituted either as a corporate entity or as a trust. In India, UTI was set up as a corporation under an Act of Parliament in 1964. Indian banks when permitted to operate mutual funds, were asked to create trusts to run these funds. The basic difference between a corporation and a trust is that in the case of the former, the liability is limited whereas in case of

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the latter, it is unlimited. Also, a corporation enjoys the status of separate legal entity that can act on its own behalf. A trust has to work on behalf of its trustees. Indian banks operating mutual funds had made a convincing plea before the government to allow their mutual funds to constitute them as 'Asset Management Companies.'

Advantages of Investing in Mutual Funds

1. Investment variety and spread in different industries.
2. Capital appreciation without having to watch the upward or downward performance curves of different scrips.
3. No impulsive decision making regarding purchase or sale of share/securities, since the funds are managed by expert, professional fund managers who have access to the latest detailed information regarding the stock market and individual scrips.
4. Liquidity through buyback arrangements of the mutual fund or listing on some stock exchanges after a certain lock-in period.
5. Even the smallest dividend or capital gain gets reinvested, thus enhancing the effective return.
6. Freedom from paperwork.
7. Tax benefits on invested amounts/returns or dividends/capital gains.

Drawbacks of Mutual Funds

Mutual funds have their drawbacks and may not be for everyone:

1. ***No guarantees:*** No investment is risk-free. If the entire stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio.
2. ***Fees and commissions:*** All funds charge administrative fees to cover their day-to-day expenses. Some funds also charge sales commissions or 'loads' to compensate brokers, financial consultants, or financial planners. Even if you don't use a broker or other financial adviser, you will pay a sales commission if you buy shares in a Load Fund.
3. ***Taxes:*** During a typical year, most actively managed mutual funds sell anywhere from 20 to 70% of the securities in their portfolios. If your fund makes a profit on its sales, you will pay taxes on the income you receive, even if you reinvest the money you made.
4. ***Management risk:*** When you invest in a mutual fund, you depend on the fund's manager to make the right decisions regarding the fund's portfolio. If the manager does not perform as well as you had hoped, you might not make as much money on your investment as you expected. Of course, if you invest in index funds, you forego management risk, because these funds do not employ managers.

Types of Mutual Fund Schemes

A wide variety of mutual fund schemes exist to cater to the needs such as financial position, risk tolerance and return expectations etc. The following gives an overview into the existing types of schemes in the industry.

1. **By Structure**
   - (i) Open-ended schemes
   - (ii) Close-ended schemes
   - (iii) Interval schemes

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2. **By Investment Objective**
   - (i) Growth schemes
   - (ii) Income schemes
   - (iii) Balanced schemes
   - (iv) Money market schemes
3. **Other Schemes**
   - (i) Tax saving schemes
   - (ii) Special schemes
     - (a) Index schemes
     - (b) Sector-specific schemes

Mutual funds are grouped as under

(i) ***Open-ended Funds:*** In open-ended funds, there is no limit to the size of the funds. Investors can invest as and when they like. The purchase price is determined on the basis of Net Asset Value (NAV). NAV is the market value of the fund's assets divided by the number of outstanding shares/units of the fund.

(ii) ***Close-ended Funds:*** These funds are fixed in size as regards the corpus of the fund and the number of shares.

(iii) ***Income-oriented Funds:*** These funds offer a return much higher than the bank deposits but with less capital appreciation.

(iv) ***Growth-oriented Funds:*** These funds do not offer fixed regular returns but provide substantial capital appreciation in the long run.

(v) ***Balanced Funds or Income and Growth-oriented Funds:*** These offer a blend of immediate average returns and reasonable capital appreciation in the long run.

(vi) ***Area Funds:*** These are funds that are raised in other countries for providing access to foreign investors.

(vii) ***Specialised Funds Or Industry Funds:*** These funds are invested in a particular industry like cement, steel, jute, power or textile, etc. These funds carry high risks with them as the entire fund is exposed to a particular industry.

(viii) ***Tax Relief Funds:*** These funds are raised for providing tax relief to those investors whose income comes under taxable limits. Equity Linked Savings Scheme, under Section 80 CCB of the Income Tax Act, 1961, floated by SBI Mutual Fund, PNB Mutual Fund, LIC Mutual Fund and Canbank Mutual Fund in the month of February 1991 are such kinds of funds. These funds provide direct deductions from taxable income up to a certain limit (₹ 10, 000/- under Sec.80).

7.7 Investment in Commodities

You may have your debt and equity funds in place, but investing in commodities could just be the one element to improve your portfolio. Commodity trading provides an ideal asset allocation, also helps you hedge against inflation and buy a piece of global demand growth.

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Notes In 2003, the ban on commodity trading was lifted after 40 years in India. Now, more and more people are interested in investing in this new asset class. While price fluctuations in the sector could get rather volatile depending on the category, returns are relatively higher.

Why invest in commodities?

Commodities allow a portfolio to improve overall return at the same level of risk. Ibbotson Associates, a leading US-based authority on asset allocation estimates that commodities increased returns between 133 and 188 basis points, at no extra risk.

Who should invest?

Any investor who wants to take advantage of price movements and wishes to diversify his portfolio can invest in commodities. However, retail and small investors should be careful while investing in commodities as the swings are volatile and lack of knowledge may result in loss of wealth.

Investors must understand the demand cycles that commodities go through and should have a view on what factors may affect this. Ideally, you should invest in select commodities that you can analyse rather than speculate across products you have no idea about.

Investing in commodities should be undertaken as a kicker in your portfolio and not as the first destination for your money.

What is commodity trading?

It's an age-old phenomenon. Modern markets came up in the late 18th century, when farming began to be modernised. Though the trade's mechanisms have changed, the basics are still the same.

In common parlance, commodities means all types of products. However, the Foreign Currency Regulation Act (FCRA) defines them as 'every kind of movable property other than actionable claims, money and securities.'

Commodity trading is nothing but trading in commodity spot and derivatives (futures). If you are keen on taking a buy or sell position based on the future performance of agricultural commodities or commodities like gold, silver, metals, or crude, then you could do so by trading in commodity derivatives.

Commodity derivatives are traded on the National Commodity and Derivative Exchange (NCDEX) and the Multi-Commodity Exchange (MCX). Gold, silver, agri-commodities including grains, pulses, spices, oils and oilseeds, mentha oil, metals and crude are some of the commodities that these exchanges deal in.

Trading in commodities futures is quite similar to equity futures trading. You could take a long position (where you buy a contract) or a short position (where you sell it). Simply speaking, like in equity and other markets, if you think prices are on their way up, you take a long position and when prices are headed south you opt for a short position.

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How big is the Indian commodity trading market as compared to other Asian markets?

The commodity market in India clocks a daily average turnover of ₹ 12,000-15,000 crore (₹ 120-150 billion). The accumulative commodities derivatives trade value is estimated to have reached the equivalent of 66 per cent of the gross domestic product and the future will only see the percentage rising, says ICICI direct.com vice-president Kedar Deshpande.

What do you need to start trading?

Like equity markets, you have to fulfil the 'know your customer' norms with a commodity broker. A photo identification, PAN and proof of address are essential for registration. You will also have to sign the necessary agreements with the broker.

Is there a regulator for the commodity trading market?

The Forward Markets Commission is the regulatory body for the commodity market in India. It is the equivalent of the Securities and Exchange Board of India (Sebi), which protects the interests of investors in securities.

What kind of products can be listed on the commodity market?

All commodities produced in the agriculture, mineral and fossil sectors have been sanctioned for futures trading. These include cereals, pulses, ginned cotton, un-ginned cotton, oilseeds, oils, jute, jute products, sugar, gur, potatoes, onions, coffee, tea, petrochemicals, and bullion, among others.

What are the risk factors?

Commodity trading is done in the form of futures and that throws up a huge potential for profit and loss as it involves predictions of the future and hence uncertainty and risk. Risk factors in commodity trading are similar to futures trading in equity markets.

A major difference is that the information availability on supply and demand cycles in commodity markets is not as robust and controlled as the equity market.

What are the factors that influence the commodity prices in the market?

The commodity market is driven by demand and supply factors and inventory, when it comes to perishable commodities such as agricultural products and high demand products such as crude oil. Like any market, the demand-supply equation influences the prices.

Variables like weather, social changes, government policies and global factors influence the balance.

What is the difference between directional trading and day trading?

The key difference between commodity markets and stock markets is the nature of products traded. Agricultural produce is unpredictable and seasonal. During harvesting season, the prices of these commodities is low as supply goes up. There are traders who use these patterns to trade in the commodity market, and this is termed directional trading. Day trading in commodity markets is no different from day trading in the equity market, where positions are bought in the morning and squared off by the end of the day.

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Does commodity speculation affect agricultural income in India?

The vision for the commodity market in India is to reduce information asymmetry and make a robust market available to the end producer or farmer. It is also expected to balance out price information and give the producer a better price and a platform to hedge.

The futures market will allow the farmer to see the upside of the price over two to three months and help him decide where to sell.

How to keep updated?

Most commodity trading firms have a research team in place that prepares commodity charts and conducts detailed study on the trends of the commodity in question.

Investing strategies based on this research are usually provided to clients. They usually provide daily market reports before the market opens and intra-day calls during trading hours, along with monthly and weekly research reports.

7.8 Future and Options

Futures and options are forms of exchange- regulated forward trading in which you enter into a transaction today, the settlement of which is scheduled to take place at a future date. The settlement date is called the expiry of the contract.

Futures

A Futures Contract is an agreement between the buyer and the seller for the purchase and sale of a particular asset at a specific future date. The price at which the asset would change hands in the future is agreed upon at the time of entering into the contract.

The actual purchase or sale of the underlying involving payment of cash and delivery of the instrument does not take place until the contracted date of delivery. A future contract involves an obligation on both the parties to fulfill the terms of the contract.

Options

An option is a contract that goes a step further and provides the buyer of the option the right without the obligation, to buy or sell put as specified asset at an agreed price on or upto a specific date.

For accuring this right the buyer has to pay a premium to the seller. The seller on the other hand has the obligation to buy or sell that specific asset at the agreed price. The premium is determined taking into account a number of factors, such as the underlying's current market price, the number of days to the expiration the strike price of the option, the volatility of the underlying assets, and the risk less rate of return.

Did u know? Specifications of the options contract like the strike price, the expiration date and regular lot are specified by the Exchange.

Who trades Futures?

Futures traders are traditionally placed in one of two groups: hedgers, who have an interest in the underlying asset (which could include an intangible such as an index or interest rate) and are

seeking to hedge out the risk of price changes; and speculators, who seek to make a profit by predicting market moves and opening a derivative contract related to the asset "on paper", while they have no practical use for or intent to actually take or make delivery of the underlying asset. In other words, the investor is seeking exposure to the asset in a long futures or the opposite effect via a short futures contract.

Hedgers

Hedgers typically include producers and consumers of a commodity or the owner of an asset or assets subject to certain influences such as an interest rate.

Example: In traditional commodity markets, farmers often sell futures contracts for the crops and livestock they produce to guarantee a certain price, making it easier for them to plan. Similarly, livestock producers often purchase futures to cover their feed costs, so that they can plan on a fixed cost for feed. In modern (financial) markets, "producers" of interest rate swaps or equity derivative products will use financial futures or equity index futures to reduce or remove the risk on the swap.

Speculators

Speculators typically fall into three categories: position traders, day traders, and swing traders (swing trading), though many hybrid types and unique styles exist. In general position traders hold positions for the long term (months to years), day traders (or active traders) enter multiple trades during the day and will have exited all positions by market close, and swing traders aim to buy or sell at the bottom or top of price swings. With many investors pouring into the futures markets in recent years controversy has risen about whether speculators are responsible for increased volatility in commodities like oil, and experts are divided on the matter.

An example that has both hedge and speculative notions involves a mutual fund or separately managed account whose investment objective is to track the performance of a stock index such as the S&P 500 stock index. The Portfolio manager often "equitizes" cash inflows in an easy and cost effective manner by investing in (opening long) S&P 500 stock index futures. This gains the portfolio exposure to the index which is consistent with the fund or account investment objective without having to buy an appropriate proportion of each of the individual 500 stocks just yet. This also preserves balanced diversification, maintains a higher degree of the percent of assets invested in the market and helps reduce tracking error in the performance of the fund/account. When it is economically feasible (an efficient amount of shares of every individual position within the fund or account can be purchased), the portfolio manager can close the contract and make purchases of each individual stock.

The social utility of futures markets is considered to be mainly in the transfer of risk, and increased liquidity between traders with different risk and time preferences, from a hedger to a speculator, for example.

Options on Futures

In many cases, options are traded on futures, sometimes called simply "futures options". A put is the option to sell a futures contract, and a call is the option to buy a futures contract. For both, the option strike price is the specified futures price at which the future is traded if the option is exercised. Futures are often used since they are delta one instruments.

Investors can either take on the role of option seller/option writer or the option buyer. Option sellers are generally seen as taking on more risk because they are contractually obligated to take

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the opposite futures position if the options buyer exercises his or her right to the futures position specified in the option. The price of an option is determined by supply and demand principles and consists of the option premium, or the price paid to the option seller for offering the option and taking on risk.

Self Assessment

State True or False:

6. Hedgers typically include producers and consumers of a commodity or the owner of an asset or assets subject to certain influences such as an interest rate.
7. Hedgers typically fall into three categories: position traders, day traders, and swing traders.
8. Commodity trading provides an ideal asset allocation, also helps you hedge against inflation and buy a piece of global demand growth.
9. The primary advantage of a mutual_fund is that you can invest your money without the time or the experience that are often needed to choose a sound investment.
10. A Call is the option to sell a futures contract.

7.9 Summary

- Investment Strategy is usually considered to be more of a branch of finance than economics. It is defined as set of rules, a definite behavior or procedure guiding an investor to choose his investment portfolio.
- Return on investment (ROI) is profitable when Vf/Vi-1>0 and the investment is deemed to be unprofitable when the value of final investment is less than that of the initial investment.
- An investment strategy can be either active or passive. A passive investment strategy attempted to minimize transaction costs. An active investment strategy guide is used to maximize returns based on moves such as proper market timing.
- Small time investors can adopt the buy and hold investment strategy to invest in equities, which although volatile in nature, give favorable long run returns.
- The strategy of value investing, a classic investment strategy propagated by Benjamin Graham simply concentrates on the strategy that an investor buys shares of a company as if he was buying off the whole company without paying any attention to the stock market scenario or any exterior conditions such as the political climate.
- An investment strategy in mutual funds is probably the best bet for a profitable investment. Mutual funds is defined as a pool of money supplied by different investors and in turn used by the mutual fund company to invest in various assets such as stocks and bonds.
- Diversification is the allocation of assets to several categories in order to spread, and therefore possibly mitigate, risk. Regardless of your investment objectives, diversification is an important consideration in building any portfolio. Diversification can be achieved in any number of ways, including by: Bond Type, laddering, barbells.
- Barbells are a bond investment strategy similar to laddering, except that purchases are concentrated in the short-term and long-term maturities.
- Bond swapping is the sale of a block of bond swaps and the purchase of another block of similar market value.

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- The primary advantage of a mutual_fund is that you can invest your money without the time or the experience that are often needed to choose a sound investment.
- Commodity trading provides an ideal asset allocation, also helps you hedge against inflation and buy a piece of global demand growth. Risk factors in commodity trading are similar to futures trading in equity markets.

7.10 Keywords

Call: A call is the option to buy a futures contract.

Commodity Trading: Commodity trading is nothing but trading in commodity spot and derivatives (futures).

Diversification: Diversification is the allocation of assets to several categories in order to spread, and therefore possibly mitigate, risk.

Futures and Options: Futures and options are forms of exchange- regulated forward trading in which you enter into a transaction today, the settlement of which is scheduled to take place at a future date.

Investment Strategy: It is usually considered to be more of a branch of finance than economics. It is defined as set of rules, a definite behavior or procedure guiding an investor to choose his investment portfolio.

Put: A put is the option to sell a futures contract.

7.11 Review Questions

1. Define various types of investment options.
2. Explain the process of investing in stocks and bonds.
3. Explain briefly commodity market in India.
4. Describe the concept of future and options.
5. What are options strategies? Discuss using examples.

Answers: Self Assessment

1.	Diversification	2.	Laddering
3.	Barbells	4.	Bond swapping
5.	Benjamin Graham	6.	True
7.	False	8.	True
9.	True	10.	False

7.12 Further Readings

Books

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Online link

http://www.fei.org/

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Unit 8: Insurance Planning

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Objectives

After studying this unit, you will be able to:

- Understand the nature and functions of Insurance;
- Learn about the various types of insurance products and their need;
- Understand the purpose of various types of insurance schemes;
- Know about the need and importance of personal risk management.

Introduction

Insurance is a contract by which the insurer (Insurer Company) in consideration of the payment of a sum (premium) agrees to pay a specified sum to the insured (the person or party insuring against the risk) in the event of some untoward happening taking place. The insurer undertakes to indemnify the assured for the loss on the happening of an event.

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- Insurance is defined as a cooperative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and
- It does not reduce the risk,
- It does not alter the probability of risk, but
- It only reduces/ spreads the financial losses.

8.1 Characteristics of Insurance

An Insurance contract has the following characteristics, which are generally, observed in the case of all kinds of insurance contracts whether life, marine, fire, or miscellaneous insurance.

1. ***Risk Sharing and Risk Transfer:*** Insurance is a device to share the financial losses, which might occur to an individual or his family on the happening of a specified event. The event may be death of the earning member of the family in the case of life insurance, marine-perils in marine insurance, fire in fire insurance and other certain events in miscellaneous insurance, e.g., theft in burglary insurance, accidents in motor insurance, etc. The loss arising from these events if insured are shared by all the insured in the form of premium which they have already paid in advance. Hence, the risk is transferred from one individual to a group.
2. ***Co-operative Device:*** A group of persons who agree to share the financial loss may be brought together voluntarily or through publicity or through solicitations of the agents. An insurer, by insuring a large number of persons, is able to pay the amount of loss. Like all co-operative devices, there is no compulsion here on anybody to purchase the insurance policy (third party liability insurance in case of a vehicle owner is an exception).
3. ***Calculates Risk in Advance***: The risk is evaluated on the basis of probability theory before insuring since the premium payable on a policy is to be determined. Probability theory is that body of knowledge, which is concerned with measuring the likelihood that something will happen and making estimates on the basis of this likelihood. The likelihood of an event is assigned a numerical value between 0 and 1. Those events that are impossible are assigned a value of 0 and those that are inevitable are assigned a value of 1. The higher values (between 0 and 1) are assigned to those events estimated to have a greater likelihood or probability of occurrence.
4. ***Payment of Claim at the Occurrence of Contingency***: The payment is made on happening of a certain insured contingency. It is true for all non-life insurances that payment will be made on the happening of the specified contingency only. The life insurance claim is a certainty, because the contingency of death or the expiry of term, will certainly occur and the payment is certain.

   Similarly, in certain types of life policies, payment is not certain due to uncertainty of a particular contingency within a particular period. For example, in term-insurance the payment is made only when death of the assured occurs within the specified term, may be one or two years. Similarly, in pure endowment, payment is made only at the survival of the insured at the expiry of the period.
5. ***Amount of Payment:*** The amount of payment depends upon the value of loss suffered due to the happening of that particular insured risk, provided insurance is there upto that amount.

   In life insurance, the purpose is not to make good the financial loss suffered. Moreover, one cannot estimate the value of a human being. A person is no doubt precious to his/her

family. The insurer promises to pay a fixed sum on the happening of an event i.e. death or permanent disability.

The amount of loss at the time of contingency is immaterial in life insurance. But in the property and general insurances, the amount of loss, as well as the happening of loss, are required to be proved.

6. ***Larger Number of Insured Persons:*** The price of insurance is basically linked to the cost of claims, which is only known subsequently. In the beginning, it is an unknown factor and an estimate is made on the basis of past claims experience or empirical data about the longevity of human beings, accidents and their financial consequences.

   Generally, the past claims experience is repeated with minor variations if a large number of risks are collected. This, once again operates by the law of large numbers and is one reason why insurance companies want to do as much business as possible. The ultimate objective is to keep the insurance cost as low as possible.

7. ***Insurance must not be confused with Charity or Gambling:*** The uncertainty is changed into certainty by insuring property and life because the insurer promises to pay a definite sum at damage or death. In the absence of insurance, the property owner could at the best, practice only some form of self-insurance, which may not give him absolute certainty.

A family is protected against losses on death and damage with the help of insurance. From the point of view of an insurance company, the insurance contract is essentially non-speculative. In fact, no other business operates with greater certainties. From the insured's point of view, too, insurance is also not gambling. Failure of taking insurance, however, amounts to gambling because the uncertainty of loss is always looming on the head. One could also say, that the insurance is just the opposite of gambling. In gambling, by bidding, the person exposes himself to risk of loosing, but the insured safeguards himself through insurance, and may suffer loss only if he is not insured.

8.2 Risk and Insurance

Insurable risks have certain common features. They are enumerated below:

1. ***Financial value:*** The risk must involve a loss that is capable of financial quantification. Insurance is concerned only with situations where monetary compensation is given following a loss. Loss or damage of property may lead to a loss, which is quantifiable. In life assurance for example, the financial loss suffered by a wife on the death of her husband is difficult to quantify; still a specific sum of money is decided prior to taking out the policy.

2. ***Homogeneous exposures:*** If there are thousands of people/properties having similar exposures then the contributions could be comparatively small as the percentage of losses on the whole will decrease.

3. ***Insurance is concerned only with pure risks:*** Speculative risks, where there is the possibility of some gain, cannot be insured. This is generally the case, although certain modern developments may lead us to alter this statement in due course. Speculative risks are normally taken in the hope of a gain. All pure risks are insurable but speculative risks, on the whole, are not.

4. ***Fortuitous (by fortune)***: The loss must be entirely fortuitous as far as the person seeking insurance is concerned. It is not possible to insure against an event that will occur with certainty, as in such a case, there would be no risk, no uncertainty of loss. The frequency and severity of any risk must be completely beyond the control of the person taking the

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insurance. But in life assurance some could argue that there is no uncertainty about death: it is one of the few certainties we have. Life assurance is, however, still involved with fortuitous events as it is the timing of death that is beyond the control of the person affecting the policy.

5. ***Insurable interest:*** The risk that is to be insured must result in some form of financial loss to the person taking insurance. Otherwise any person could insure some other person's house or car so that when the house or car was damaged he, in addition to the owner of the property, would receive compensation from the insurance company. This is not allowed. One of the basic doctrines of insurance is that the person insuring must be the one who stands to suffer some financial loss if the risk materializes.

6. ***Not against public policy:*** It is a common principle in law that contracts must not be contrary to what the society considers the right and moral thing to do. This applies to insurance contracts also. Something against public policy is not insurable, E.g. risk of loss of goods while smuggling.

7. ***Risk of being fined by the police:*** A fine is intended to penalize the person and while insurance may be available to meet the losses following, say, a motor accident. It is not possible to provide insurance to pay the fine of the driver who was found guilty of some offence. The classes of risk and their insurability:

   (i) *Financial and Non-financial Risks:* There are several risks in life, which have little or no financial consequences. But insurance is concerned with indemnifying only losses arising from financial risks.

   (ii) *Static and Dynamic Risks:* Changes in the prices of essential commodities consumer tastes and technology are dynamic risks. All these risks have financial consequences, but are still not considered insurable as they are unpredictable. Static risks have nothing to do with changes in the economy but arise due to perils of nature, dishonesty or infidelity. The property may be ruined or dispossessed and there is a financial loss from such risks and they are predictable and hence insurable.

   (iii) *Fundamental and Particular Risks:* These are a group of risks which are caused by economic, social and political factors. They affect large segments of the population. Some examples are floods, war, inflation, earthquake, etc. They are uncontrollable and are considered to come under social insurance. However, some risks like earthquake are covered by commercial insurance companies. Particular risks involve losses that happen to individuals and may be dynamic or static. Destruction of a house by fire and robbery of a bank are particular risks and hence, are insurable.

   (iv) *Pure and Speculative Risks:* Risks that produce only loss but no gain are pure risks but speculative risks involve possibility of gain and are almost similar to wagering or gambling.

Self Assessment

Fill in the blanks:

1. ……..risks involve possibility of gain and are almost similar to waging or gambling.
2. The loss must be entirely …….as far as the person seeking insurance is concerned.
3. A family is protected against losses on ……with the help of insurance.
4. The life insurance claim is a……., because the contingency of death or the expiry of term, will certainly occur.
5. Insurance is concerned only with ……..risks.

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8.3 Role of Insurance

Insurance is a part of the financial system. Financial system may be defined as a set of institutions, instruments and markets, which gather savings and channel them to their most efficient use.

The system consists of individuals (savers), intermediaries, markets and users of savings. Economic activity and growth are greatly facilitated by the existence of the market in mobilizing the saving and allocating them amongst the competing users.

An economy needs institutions that impartially enforce property rights and contracts. Economic growth of a country depends on the existence of a well functioning financial infrastructure. It is essential, that the financial infrastructure be developed sufficiently so that the market operates in an efficient manner.

Insurance as a part of the financial system provides valuable services to those affected by various risks or contingencies.

It takes care of the financial consequences of certain specific contingencies but in insurance terminology, such contingencies are called risks and they cause losses when they occur.

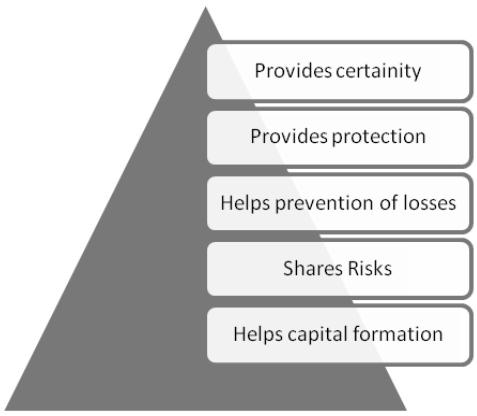
The effect of these losses on the financial system is not only negative but may be disastrous and catastrophic also. It results in substantial burden on the financial well being of those affected.

Insurance sector supports the financial system in several ways, a few have been enumerated below:

1. It accepts the risk from people and corporate bodies who are exposed to them.
2. It collects small amounts of premium, which are pooled together to be called an insurance fund. This fund is used for investment purpose.
3. It organizes compulsory insurance in certain areas as per the provisions of the law.
4. It sells voluntary insurance covers through its sales force.
5. It settles claims arising out of insured losses. Neither the insurance company nor the insured are allowed to make profits out of insurance. If insurance company gets a surplus after meeting claims, it distributes it among its policyholders in the form of bonus or reduction in premium.
6. It follows the principles of Indian Contract Act which helps to prevent its misuse or abuse.

Figure 8.1 explains the key functions of insurance:

Figure 8.1: Functions of Insurance



Notes

8.4 Rights of the Insurer

The following are the key rights and responsibilities of the insurer:

1. Right to collect the premium from the insured: Insurer has a right to collect in advance a specified sum as premium for his taking obligation of reimbursing the loss to the insured as and when it occurs.

   An insurer pays the claims to the insured from the pool of funds so build up through collection of premiums. In fact an insurer loads the premium with his administrative costs (management expenses and agents commission) as well.

2. Right to specify the rules and conditions that govern the promise made under the policy: Insurer explicitly states as to what risks the policy covers and the terms and conditions, subject to which such losses will be reimbursed.

3. Responsibility to pay for the losses occurred and claimed by the insured: Once the insured suffers losses and lodges claim, the insurer is obliged to honour payments, provided they are within the contractual terms.

8.5 Rights of the Insured

The following are the key rights and responsibilities of the insured:

1. ***Obligation to pay the premium to the insurer:*** Insured has to pay the prescribed premium to the insurer so as to create a contractual obligation on the part of insurer to reimburse the losses as and when they occur.

2. ***Right to collect payment from the insurer if a covered loss occurs:*** In the event of materialization of risk, the insured is entitled to claim reimbursement of losses from the insurer.

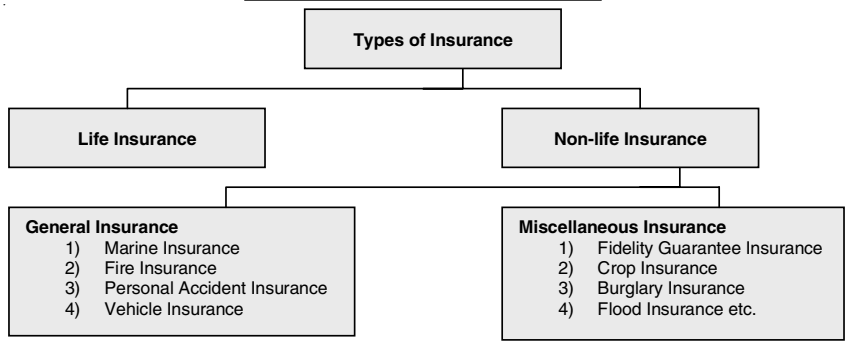
3. ***Obligation to comply with the terms and conditions prescribed by the insurer:*** Insured has to comply with all the terms and conditions laid down in the policy and also agreed by him at the time of creating the policy.

In an insurance contract, one should remember that a right created for one party represents a duty for the other party. In the event of default of premium or non-compliance of conditions by insured, an insurer may cancel the insurance or refuse to pay claims/payment of losses.

8.6 Classification of Insurance

The Figure 8.2 classifies the insurance on the bases of life and non-life insurance.

Figure 8.2: Types of Insurance



Notes

Self Assessment

State True or False:

6. Insurance as a part of the financial system provides valuable services to those affected by various risks or contingencies.
7. Obligation to pay the premium to the insurer is one of the rights of the insured.
8. Crop Insurance falls into general insurance category.
9. Financial system may be defined as a set of institutions, instruments and markets, which gather savings and channel them to their most efficient use.
10. Insurance's basic motive is meant to provide wealth creation for the insured.

8.7 Insurance Products

8.7.1 Life Insurance

Life Insurance started in India as early as the year 1818. The first Insurance Company in India "The Oriental Life Insurance Company" started in Calcutta by Europeans to help widows of their own community. The year 1870 saw the birth of life insurance business through the first Indian Insurance Company "The Bombay Life Assurance Society". The British Government enacted The Indian Insurance Act in 1870.

The Insurance Act, 1938, was the first comprehensive legislation governing both the life and non-life sectors of insurance. The life insurance business in India was nationalised on 19th January 1956, through a presidential ordinance by the then Finance Minister Sh. C.D. Deshmukh.

The Life Insurance Corporation was established on 1st September 1956 under the general direction and control of Ministry of Finance. The protective hands and a luminous flame of lamp is the insignia of "Life Insurance Corporation Of India". No doubt it signifies protection of human life through the instrument of life insurance.

Life Insurance is a contract for payment of a sum of money to the person assured or his/her nominee on the happening of the event insured against. As per the contract, the payment of the specified amount will be made on the date of maturity or on the specified dates at periodic intervals or on death if it happens earlier.

Life Insurance is an institution, that eliminates 'risk'. It substitutes certainty for uncertainty and comes to the aid of the bereaved family in the event of the unfortunate death of the assured. Life Insurance thus covers two hazards, eventuality of accidental or untimely death and thereby provides support to the dependent family, and old age social security in the case of survival of the insured.

Salient Features of Life Insurance

The following are the key features of life insurance:

- Instrument of savings.
- Provides social security.
- Risk coverage starts from the date of accepting of proposal.
- Beneficiary nominee/legal heir stands to gain.

Notes

- Policy can be assigned or mortgaged.
- Policyholders can seek loans against the policy.
- Certain policies cover up for treatment to serious ailments.
- Ministry of Finance extends income-tax benefits on the amount of premiums paid.
- Money can be set aside for children's marriage and education.
- Provision for old age.

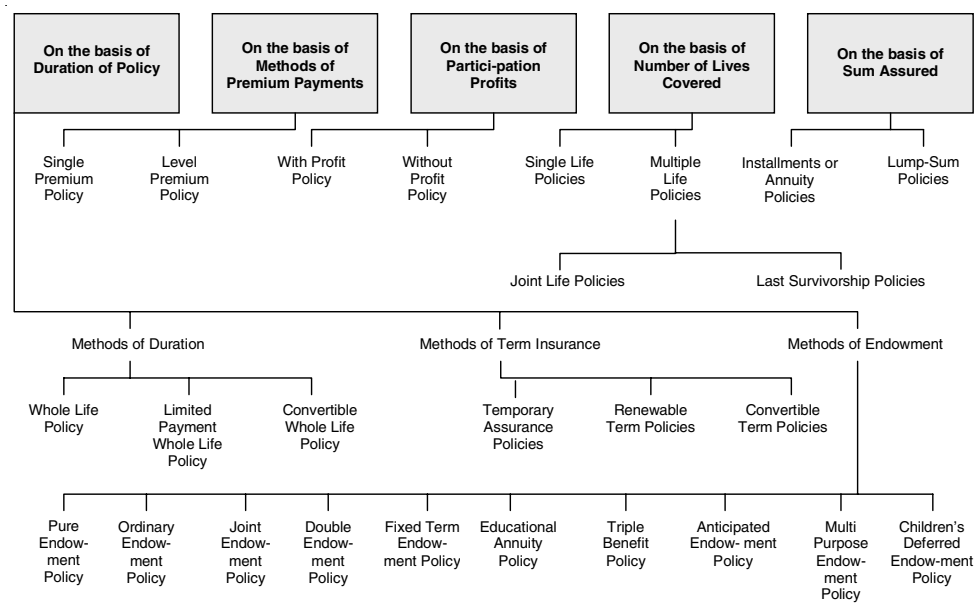
Classification of Life Insurance Policies

The Life Insurance Policies can be divided on the basis of:

1. Duration of Policy
2. Methods of Premium Payments
3. Participation in Profit
4. Number of Lives Covered
5. Method of Payment of Sum Assured

The following figure explains the different types of life insurance policies.

Figure 8.3: Classification of Insurance Policies



Schemes of Life Insurance

Life Insurance Corporation (LIC) was the exclusive agency in the field of life insurance sector till November 2000. The new insurance companies have been permitted by IRDA (Insurance Regulatory and Development Authority) under the IRDA Act. The policies in the give figure are some of the prominent policies issued by the LIC.

Notes

Some of the important policies are discussed below:

1. ***Endowment Assurance Policy:*** This is the most popular and sought after plan. The premiums under the plan are to be paid for a fixed term. In case death takes place during the term, the sum assured along with accumulated bonus is paid to the nominee. If the policyholder survives the term of the policy, he gets the sum assured himself.

   The importance of this plan is that it offers the advantage of making a provision for the family of the life assured in case of his early death and also assures a lumpsum amount at any desired age.

   The plan is available with-profit and without-profit. The with-profit policy carries bonus with it, no bonus is attached to without profit policies. Premium under the with-profit policies is obviously higher than the without-profit policies.

   Loans may be given for some specified purposes on specified terms.

   Benefits associated to the plan are:

(i)	On Maturity	Sum Assured + Bonus for Full Term.
(ii)	On Natural Death	Sum Assured + Bonus Accrued.
(iii)	Accidental Death	Double the amount of sum assured + Bonus Accrued.
(iv)	Permanent Disability amounting to incapacitating the insured	Treated as death and claim accordingly.

2. ***Whole-Life Policy (with profits):*** This is a policy offered at lower rates of premium. The premiums are payable throughout the lifetime of the assured and the sum assured becomes payable on the death of the life assured or attaining of 85 years (or as specified by insurer) of age whichever is earlier. Rate of bonus addition is at a higher rate as compared to endowment policies.

   Benefits associated to the plan are:

   (i) ***On Maturity:*** Sum Assured + Bonus Payable.

   (ii) ***Natural Death:*** Sum Assured + Bonus Accrued.

   (iii) ***Accidental Death:*** Double the amount of sum Assured + Bonus Accrued.

   (iv) ***Permanent Disability:*** Treated as death and claim given accordingly.

3. ***Whole Life Limited Payment Plan:*** The plan is suitable for persons who are in employment. It enables the assured to pay the premiums during the productive years of his life. The premium is moderate in comparison to the endowment plan.

   The plan is available both with and without profits. The plan with profit continues to participate in profits even after the completion of the premium paying term, until the death of the life assured.

   Benefits:

(i)	On Maturity	:	Sum assured + bonus payable on attainment of 85(as said by insurer) years of age or on completion of 40 years from the date of commencement, whichever later.
(ii)	Natural Death	:	Sum Assured + Bonus Accrued.
(iii)	Accidental Death	:	Double of sum assured + Bonus accrued.
(iv)	Permanent Disability	:	Treated as death and claim accordingly.

Notes

4. ***Whole Life Single Premium Plan:*** Single premium is paid at the start of the policy. The policy is available both, with and without profits.

5. ***Convertible Whole Life Plan:*** The plan is useful to the young persons who are at the start of their careers and their present income is low. The object is to provide maximum protection at minimum cost. It is a whole life without profit plan, premiums payable upto the age of 70 years of the assured. The premium charged is that of whole life without profits and therefore sufficiently low. The risk is however covered for the full sum assured.

   After 5 years, the life assured is given the option to convert it into an endowment plan with or without profits choosing the term without having to go in for a medical examination. If no option is exercised at the end of 5 years, the policy continues on its original terms as whole life without profits with the premiums ceasing at the age of 70 years.

6. ***Money Back (with profits) Scheme:*** These are fixed term policies. The premium is paid till the end of the term or till the death of the policyholder, whichever is earlier. A part of the sum assured is returned to the policyholder once in 5 years or 4 years according to the plan.

   The risk cover continues for the full sum assured even after the payment of installments to the policyholder. The bonus is also payable for the full term.

7. ***Children's Deferred Assurance Plan:*** This plan enables a parent or a legal guardian or a relative of the child to provide a sum for the child by way of a very low premium. It is an endowment assurance plan with profits, the risk for which commences at a selected age.

   The policy is in two stages, one covering the period from the date of commencement of the policy to the deferred date (the date of commencement of the risk on the child's life) and the other covering the period from the deferred date to the date on which the policy emerges as a claim either by death or on maturity of the policy. A combined policy is issued covering both the stages.

8. ***Premium Waiver Benefit:*** By payment of an additional premium, the proposer (insured) can secure the benefit of premium waiver. The premiums from the date of his death to the end of the deferment date are waived of.

9. ***Pension Plan/Annuity***: The pension plans provide for regular payment of money at a certain age in the form of monthly pension when premiums have been paid in a life policy for specified number of years.

10. ***Mediclaim Policy:*** Medical expenses have become too high. Injury or disease does not come with prior notice. The requirement of quality medical care has generated the market for health care insurance policies.

8.7.2 General Insurance

When the insured pays the premium and the insurer accepts the risk, the contract of insurance is concluded. The policy issued by the insurer to the insured is the proof of the contract between them.

We know that no contract is valid without a consideration. In case of insurance contracts, premium is the consideration from the side of the insured and the promise to indemnify is the consideration from the insurer.

Both the parties should be competent enough to contract and must give the consent for the insurance contract for covering the same risk for same peril in the same sense. Insurance contracts which are against the public policy are not valid contracts. Care should be taken by both sides

that something which is illegal cannot be insured. If insurance is affected on say for example, smuggled goods, and the insurer comes to know after some time of signing the contract, he may avoid the contract.

All Insurance contracts are governed by the basic principles of insurable interest, indemnity, utmost good faith, subrogation and proximate cause.

8.7.3 Fire Insurance

Fire insurance contracts cover the risks of damage by fire. They insure the risk of loss caused whether by fire or incidental to fire. Thus, fire insurance policies cover the insurance business in which the risk to the asset is from fire or incidental to fire. A fire insurance policy covers the fire and other occurrences as stated in the policy. The inclusion of various clauses to cover matters related to fire in the policy is essential to cover the loss caused due to various reasons.

The policy should mention clearly the subject matter/assets insured. The contract of fire insurance will not cover the assets, which are not mentioned in the policy document, though the loss is caused to the assets because of the fire. The policy document is the evidence of conclusion of the contract.

As such, presence of a physical asset is a must to have the risk of fire covered. The asset, which is insured, becomes the subject matter of the insurance contract. Occurrence of fire is essential and the damage should be caused to the asset due to fire. The damage has to be compensated and the assured has to be indemnified. The origin or cause of origin of fire damaging the asset is not of importance.

If the insurance company finds the intentions of the assured mala fide, it can take this as a defense to avoid the fire insurance claim settlement. As such fire insurance contracts are a part of general insurance and are contracts of good faith.

The word fire should be construed in its simple meaning and sense without attributing any technical or scientific concepts or meanings to the term. The risk of fire is simply an unforeseen or unexpected event caused either by accident or incident that cannot be forecasted. The contract of fire insurance is valid as long as the assured has an insurable interest in the asset insured. In the absence of the insurable interest in the contract of insurance, the contract becomes a wagering contract and thus becomes void.

Definition

Section 2(6A) of the Insurance Act, 1938 defines **Fire Insurance** as 'the business of effecting, otherwise than incidental to some other class of insurances business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies.'

Types of Fire Insurance Policies

The following are some of the fire insurance policies:

(a) ***Standard Fire Policy:*** Fire insurance business in India is governed by the All India Fire Tariff that lays down the terms of coverage, the premium rates and the conditions of the fire policy. Fire insurance policy is suitable for the owner of the property, one who holds property in trust or in commission; individuals/financial institutions, who have financial interest in the property. All movable and immovable property located at a particular premises such as building, plant and machinery, furniture, fixtures, fittings and other contents, stocks and work-in-progress along with goods held in trust or in commission

Notes

including stocks at suppliers/customer's premises, machinery temporarily removed from the premises for repairs can be insured.

The fire insurance policy has been renamed as standard fire and special perils policy.

(b) ***Reinstatement Value Policies:*** In this policy, the settlement of claims is on basis of reinstatement value. The claim amount will not be found adequate by the insured that desires to replace the property by a new one of the same kind, type or capacity.

Insurer will pay the value, which takes into account depreciation, wear and tear, but also the replacement cost. Thus the losses will be settled on the basis of market value of the property on the date of fire.

The difference between the amount payable on the basis of market value and the new replacement value will become wider and wider, particularly when due to inflation, the dxacost of rebuilding and the prices of the machinery show a sharp increase.

Under the policy, the insurers pay, not the depreciated value but, the cost of replacement of the damaged property by new property of the same kind. The sum insured is required to reflect the new replacement value and not the market value as under the normal fire policy.

(c) ***Policies for Stocks***

There are three types of policies for stocks.

Floater Policies

1. Stocks at various locations can be covered under one sum insured through floater policies, since these policies take care of frequent changes in sum insured at various locations.
2. These cover stocks for a single amount situated in more than one specified building located (1) within the limits of one city/town/village, (2) more than one city/town/village but maximum in 50 locations, (3) for more than 50 locations in various cities/towns/villages. The floating policies are not issued to transport contractors and cleaning and forwarding agents.
3. Floating policies for risks situated within the limits of one city/town/village may be issued by charging 25% loading, over and above the highest rate applicable to any one risk. 50% loading over and above the highest rate applicable to any one risk is charged under policies covering upto 50 locations in more than one city/town/village.
4. The maximum sum insured at any one location should not be more than 10% of the total sum insured.
5. The insured should essentially have a good internal audit and accounting procedure under which total amount of risk and location can, if required, be established. The condition of average is applied to the limit of sum insured at each location, and also to the total sum insured under the policy.

A policy issued to cover more than 50 locations in various cities/towns/villages in one amount is subject to the under noted regulations:

(a) Total sum insured in respect of all locations should not be less than ₹ 3 crore.

(b) The maximum sum insured at any one location should not be more than 10% of the total sum insured.

Notes

(c) The address of the locations should be declared to the company, at the inception, and changes advised as and when they occur. However, when locations can be identified or change is very frequent, the requirements of specifying address of locations is released, but the number of unspecified locations should not exceed 105 the total number of locations or 20 locations whichever is lower.

(d) The insured should have a good internal audit and accounting procedure to establish total amount at risk and locations at a particular time.

(e) The pro-rata condition of average is applied to the limit of sum insured at each location and also to the total sum insured under the policy.

Declaration Policies

Declaration Policies are useful to businesses, which face frequent fluctuations in stock quantity or value. Insurance companies can issue these policies subject to the following conditions:

1. The minimum sum insured is ₹ 1 crore.
2. Monthly declarations based on the average of the highest value at risk on each day or highest value on any day of the month is to be submitted by the insured to the insurer.
3. Reduction in sum insured is not allowed under the policy.
4. The insured can't claim refund of premium on adjustment based on the declarations in excess of 50% of the total premiums.
5. The basis of value for declaration shall be the market value prior to the loss or as otherwise agreed to, between the insurance company and the insured.

Exclusions: Declaration policies can't be issued in respect of insurance required for a short period stocks undergoing process and stocks at railway sidings.

Benefits: The premium is limited to the actual amount of risk irrespective of the sum insured. The liability of the insurer is concurrent under the policy. Provision for adjustment of premium is an incentive to the insured to effect cover for the maximum amount.

Floater Declaration Policies

These policies combine the features of both floater and declaration policies. All rules relating to floater policy and declaration policy apply in these kind of policies except:

(i) The minimum premium retention of the insurance company shall be 80% of the annual premium.

(ii) Minimum sum insured is ₹ 2 crore

(d) ***Consequential Loss Policy***

Coverage and Suitability: This policy is suitable for business establishments and corporates for whom business interruption would mean heavy monetary loss in view of huge fixed costs.

Fire consequential loss policy provides cover for:

(i) Expenses and increased cost of working as a result of business interruption following a loss covered by the fire policy.

(ii) This cover can be taken for the maximum period of the anticipated interruption in the event of loss. In addition, the supplier's and the customer's premises on which

Notes

the business is dependent, cost of auditor's fee (required to submit the monetary claim) can also be insured.

(iii) It covers reduction in gross profit due to a reduction in turnover followed by interruption of business.

(iv) The additional expenditure necessarily incurred for avoiding or reducing the fall in turnover during the interruption period is covered under this policy.

(v) Also, there are overhead expenses of running the business such as salaries, wages, taxes, interest, etc. which continue to be incurred in spite of the interruption of the production.

Premium: Premium chargeable depends on the type of industry/business, the anticipated gross profit, indemnity period chosen and additional covers required. Refund of premium (not exceeding 50%) can be claimed based on the actual gross profit figures as per the audited balance sheet after the expiry of the policy.

Basic fire policy to cover the asset at the business premises is a prerequisite. For claiming benefits under this policy, the loss should be first admitted under the fire policy. Amount of gross profit required to be insured, the indemnity period, details of the business premises to be covered and additional covers required shall be provided in the proposal form.

This policy is of immense benefit especially in case of major fire loss, when the business operations get interrupted resulting in reduced turnover and eventually in loss of profits. It is a well-known fact that fixed or standing charges have to be incurred immaterial of the fact, whether there has been any production or not. All these are not covered by the normal fire policy. It is in this context that the consequential loss policy comes into force. Thus, for overall protection to the business and its profitability, consequential policy is necessary in addition to the fire policy.

Task Prepare a project report on different private sector Insurance companies operating in India.

8.7.4 Motor Insurance

Vehicle insurance is the insurance which consumers can purchase for cars, trucks, and other vehicles. Its primary use is to provide protection against losses incurred as a result of traffic accidents.

Generally speaking it is a cover in respect of motorized vehicles including fire, theft, impact, collision and third party liability cover.

Insurance can cover some or all of the following items:

1. The insured party
2. The insured vehicle
3. Third parties

What is a motor vehicle?

Motor vehicle includes private cars, motorized two wheelers and commercial vehicles excluding vehicles running on rails.

Notes

Who can insure?

Owners of the vehicle, Financiers or Lessee, who have insurable interest in a motor vehicle, can insure the vehicle.

Public Policy

In many countries, it is compulsory to purchase auto insurance before driving on public roads. Even penalties for not purchasing auto insurance may be levied varying from state to state. Substantial fine may be charged, license and/or registration may be suspended, as well as possible jail time may be specified.

Usually the minimum requirement by law is third party insurance to protect third parties against the financial consequences of loss, damage or injury caused by a vehicle.

What does motor insurance cover?

Motor insurance policies provide cover against any loss or damage caused to the vehicle or its accessories due to the following natural and man-made calamities: Natural Calamities: Fire, explosion, self-ignition or lightning, earthquake, flood, typhoon, hurricane, storm, tempest, inundation, cyclone, hailstorm, frost, landslide, rockslide. Man-made Calamities: Burglary, theft, riot, strike, malicious act, accident by external means, terrorist activity, any damage in transit by road, rail, inland waterway, lift, elevator or air.

Motor insurance provides compulsory personal accident cover for individual owners of the vehicle while driving. One can also opt for a personal accident cover for passengers. The third party legal liability insurance is compulsory.

Third party legal liability protects against legal liability arising towards others due to accidental damages. It includes any permanent injury, death of a person and damage caused to his property.

Basis of Premium Charges

Depending on the regulations, the insurance premium can be either mandated by the government or determined by the insurance company in accordance to a framework of regulations (tariff) set by the government. Often, the insurer has more freedom to set the price on physical damage coverages than on mandatory liability coverages.

In case of non-mandated insurance-premium, the premium is calculated usually from the calculations of an actuary based on statistical data.

Various factors like the car characteristics, the coverage selected (deductible, limit, covered perils) and the usage of the car (commute to work or not, predicted annual distance driven).

Insured's Declared Value (IDV)

(a) In case of vehicle not exceeding 5 years of age, the IDV has to be arrived at by applying the percentage of depreciation specified in the tariff on the showroom price of the particular make and model of the vehicle.

(b) In case of vehicles exceeding 5 years of age and obsolete models, they have to be insured for the prevailing market value of the same as agreed to between the insurer and the insured.

Notes

What is not payable under the policy?

- War perils, Nuclear perils
- Consequential loss, depreciation, wear and tear, mechanical or electrical breakdown
- Damage suffered due to driving the vehicle under the influence of intoxicating liquor or drugs
- Claims arising outside the specified geographical area
- Claims arising when the vehicle is driven by a person without valid driving license
- Contractual liability

Notes

1. ***Transfers:*** In case of change of ownership, one must ensure to affect the transfer of Insurance policy within 14 days from the date of transfer of ownership.
2. ***Change of Vehicles:*** A vehicle can be substituted by another vehicle for the same class, for the balance period of a policy subject to adjustment of premium, if any, on pro rata basis from the date of substitution.
3. ***De-tarrification:*** Uptill now the regulator was dictating the general insurance premium tariff rates. Recently, the Insurance Regulatory & Development Authority (IRDA) has notified that from 1st January 2007 all branches of Insurance except Motor, the third party would be de-tariffed.

8.7.5 Marine Insurance

A contract of Marine insurance is defined by the **Marine Insurance Act 1963** as "an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against losses incidental to marine adventure. It may cover loss or damage to vessels, cargo, or freight".

Section 2 (C&F) of the Marine Insurance Act, 1963 defines marine insurance and includes the movables exposed to maritime perils. Movables mean movable tangible property, which includes money, valuable securities and documents, etc.

Insurable Property

Insurable property means any ship, goods or other movables exposed to maritime perils. Insurable property is also called the subject matter of insurance. Insurable property must be stated in the policy with reasonable certainty.

Marine Adventure

There is a marine adventure, when –

1. Any insurable property is exposed to marine perils.
2. The earning of freight, passage money, commission, profit or other pecuniary benefit, or the security for any advances, loans or disbursement is endangered by the exposure of insurable property to maritime perils.

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3. The owner of or other person interested in or responsible for, insurable property by reason of maritime perils may insure any liability to the third party.

Voyage

Voyage is the journey that the vessel undertakes. The route of the ship is very important in the marine insurance business. The ship should carry on the voyage in the specified route, which is mentioned in the policy. Change of voyage is permitted only in a few specified circumstances.

Maritime Perils/Perils of the Sea

Maritime Perils are also called "Perils of the Sea". It means the perils consequent on, or incidental to the navigation through the sea for example – fire, war perils, rovers, thieves, captures, seizures, jettisons, barratry and any other perils.

The term "Perils of the Sea" refers only to fortuitous accidents or casualties of the sea, and does not include the ordinary action of winds and waves.

Types of Risks/Perils covered by the Marine Insurance Policy

Sinking, stranding, and grounding of ship/vessel/boat or craft
Collision or contact of vessels, ships, boats with internal and external objects
Discharge of cargo at a port of distress
General average sacrifice
Volcanic eruption or lightning, or fire or explosion
Loss of goods or packages containing goods or articles, dropping of packets or packages during loading or unloading or while on board or off the board
Loss caused by delay, wrongful delivery, malicious damage
War, sea pirates, other perils like cyclones, typhoons, spirals
Strikes, riots, lockouts, civil commotions and terrorism
Theft, pilferage, breakage and leakage
Loss caused by heating due to the closure of ventilators to prevent the entry of seawaters
Loss caused by rats i.e. a hole made in the bottom of the ship, through which the seawater enters the ship and damages the cargo.

Through the contract of marine insurance, the assured gets insurance or security for the above mentioned risks.

Thus, the contract of marine insurance is an agreement whereby the insurer undertakes to indemnify the assured, against the maritime perils. It also includes liability to the third party incurred by the owner of the ship or other person interested in the property assured on happening of the maritime event.

As such the marine insurance business includes:

- Insurance of vessels (hull) of any description (Hull insurance is concerned with body, the machinery and technical know-how, stores tools, etc. It also includes ships, mechanized boats etc., and consignments transported by rail and road).
- Insurance of cargo in the vessels (Cargo insurance includes the goods in transit from the place of insured to the sea and from the sea to the exporter).
- Freight paid or received by the assured.

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- Other merchandize and property assured, which is in the transit either on water or on land or both.
- Insurance of third-party liability.
- Insurance of the transactions which are incidental to the marine adventure or marine transport or transport of cargo from godown to the vessel.
- Insurance also includes all perils and risks incidental to money, documents, securities, and other valuable goods in the ship.

Other incidental activities concerned with building, launching of ship or transport of stores concerned.

Kinds of Marine Insurance Policies

Though commonly in one form, Marine Policies are known by different names according to their manner of execution and the nature of risks covered. The following are the various kinds of marine insurance policies as contained in the Marine Insurance Act, 1963.

Voyage Policy
Time Policy
Voyage and Time Policy (or) Mixed Policy
Valued Policy
Unvalued Policy (or) Open Policy
Floating Policy
Wagering Policy (or) PPI Policy
Construction (or) Builders Risk Policy
Open Cover Policy
Port Risk Policy

1. ***Voyage Policy:*** As the name suggests this policy covers a voyage. This is a policy in which the limits of the risks are determined by place of particular voyage. For example Chennai to Singapore; Chennai to London. Such policies are always used for goods insurance, sometimes for freight insurance, but only rarely nowadays for hull insurance.
2. ***Time Policy:*** This policy is designed to give cover for some specified period of time, say, for example 1st Jan, 2003 to noon, 1st Jan, 2004. Time Policies are usual in the case of hull insurance, though there may be cases where an owner prefers to insure his vessel for each separate voyage under voyage policy.
3. ***Voyage and Time Policy or Mixed Policy:*** It is a combination of Voyage and Time Policy. It is a policy, which covers the risk during a particular voyage for a specified period. For example, a ship may be insured for voyages between Chennai to London for a period of one year.
4. ***Valued Policy:*** This policy specifies the agreed value of the subject matter insured, which is not necessarily the actual value. Such agreed value is referred to as the insured value. A policy may be, say, for ₹ 10,000 on Hull and Machinery etc. valued at ₹ 2,00,000 or for ₹ 7,000 on 100 cases of whisky valued at ₹ 7,000. Once a value has been agreed, it cannot be reopened unless there is proof of fraudulent intention. It remains binding on both the parties. These policies are not common nowadays.
5. ***Unvalued Policy/Open Policy:*** In the case of an Unvalued Policy, the value of the subject matter insured is not specified at the time of effecting insurance. It is taken for a specified

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amount and the insurable value is ascertained in the case of loss. Here the insurer is liable to pay only upto actual loss incurred to the policy amount. It is also known as Open Policy.

6. ***Floating Policy:*** A floating policy describes the insurance in general terms, leaving the names of the ship or ships to be defined by subsequent declaration. Such policy has the advantage of being a valid marine policy, in all respects fully complying with the requirements of the Marine Insurance Act. The declaration may be made by endorsement on the policy or in any other customary manner. Unless the policy otherwise provides, declaration must be made in the order of shipment. It must comprise all the consignments within the terms of the policy and values must be honestly stated. Errors and omissions however, may be rectified even after a loss has occurred, if made in good faith.

   When the total amount declared exhausts the amount for which the policy was originally issued, it is said to be "run off" or "full declared". The assured may then arrange for a new policy to be issued to succeed the one about to lapse, otherwise the cover terminates when the policy is fully declared.

7. ***Wagering Policy/PPI Policy:*** This policy is issued without there being any insurable interest, or a policy bearing evidence that the insured is willing to dispense with any proof of interest. If a policy contains such words as "Policy Proof of Interest", (PPI) or "Interest or No Interest" it is Wagering or Honour Policy. Under Section 4 of the Marine Insurance Act, such policies are void in law but such policies continue to be common.

8. ***Construction or Builders Risk Policy:*** This is designed to cover the risks incidental to the building of a vessel, usually giving cover from the time of laying the keel until completion of trails and handing over to owners. In the case of a very large vessel, the period may extend over several years.

9. ***Blanket/open Cover Policy:*** In order to arrange their marine insurance in advance and to be assured to cover at all times, and also to avoid the effects of possible rapidly fluctuating rates, it is the practice of regular importers and exporters to avail "Blanket Insurance".

   One good way, and the most popular one of achieving this is by means of "Open Cover". An open cover is an agreement between the assured and his underwriters under which the former agrees to declare, and the latter to accept, all shipments coming within the scope of the open cover during some stipulated period of time.

10. ***Port Risk Policies:*** This is to cover a ship or cargo during a period in port against the risks peculiar to a port as distinguished from voyage risks. This kind of policy is probably very rarely used nowadays.

8.7.6 Medical and Health Insurance

Medical and Health Insurance (MHI), is an insurance policy which is designed to cover the cost of private medical treatment, which can be very expensive, especially with hospitalisation and surgery. MHI also ensures that you won't have to worry about the cost of seeking treatment during emergencies. In addition, MHI also provides you with an income stream while you undergo treatment.

In mid 80's most of the hospitals in India were government owned and treatment was free of cost. With the advent of Private Medical Care the need for Health Insurance was felt and various Insurance Companies (New India Assurance, National Insurance Company, Oriental Insurance & United Insurance Company) introduced Mediclaim Insurance as a product. According to recent news report health insurance continues to be the fastest growing segment with annual growth rate of 25%. Health Premium has risen to ₹ 8100 crores in 2009-2010. As per the recent reports from various agencies the health sector has the potential to become a ₹ 30000-crore

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industry by 2015. Estimates of leading Chambers of Commerce also confirm these estimates. On August 15, 2007 Prime Minister had announced ₹ 2000 Crores for Health Insurance for poor citizens and the impact of the same is being seen by us in the form of success of RSBY (Rashtriya Swasth Bima Yojna). In 2001 with entry of various private Insurance companies now the customers have choice of buying this insurance from 21 Insurance companies. The Companies, which offer Health or Mediclaim Insurance, are:

1. Apollo Munich Insurance Company Limited
2. Bajaj Allianz General Insurance Co. Ltd.
3. Bharti AXA General Insurance Co. Ltd.
4. Cholamandalam MS General Insurance Co. Ltd.
5. Future Generali India Insurance Co. Ltd.
6. HDFC ERGO General Insurance Co. Ltd.
7. ICICI Lombard General Insurance Co. Ltd.
8. IFFCO Tokio General Insurance Co. Ltd.
9. Larson & Toubro General Insurance Co. Ltd.
10. Max Bupa Health Insurance Co. Ltd.
11. National Insurance Co.Ltd.
12. New India Assurance Co. Ltd.
13. Oriental Insurance Co. Ltd.
14. Raheja QBE General Insurance Co. Limited
15. Reliance General Insurance Co. Ltd.
16. Royal Sundaram Alliance Insurance Co. Ltd
17. SBI General Insurance Co. Ltd.
18. Shriram General Insurance Co. Ltd.
19. Star Health and Allied Insurance Company Limited
20. Tata AIG General Insurance Co. Ltd.
21. United India Insurance Co. Ltd.
22. Universal Sompo General Insurance Co. Ltd.

India is the only country where hospitalization insurance policy was being sold as Mediclaim Insurance Policies. The very name gives a feeling to the insured that claim has to be lodged. If motor insurance policy is not sold as motor insurance claim policy and household insurance policy is not sold as household claim policy then why this be named as Mediclaim? In the recent years the trend has emerged that some Insurance companies have started calling this product as Health Insurance. Health Insurance and Mediclaim are two different names for the same product. The change has started coming and now we have started calling it Health Insurance. ICICI Lombard has even named it as Health Insurance Policy. Calling is as Health Insurance is a positive way of looking at this Insurance. It also giving us a feeling that we as a society have started moving from curative medical care to preventive medical care. According to sources in Oriental insurance it is being felt that mindset has started changing over the last couple of years " The new middle-class of India aspires for quality healthcare service and doesn't mind going to expensive hospitals like Apollo or Escorts. There is no reason why healthcare insurance should not be successful with this class.

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8.8 Personal Risk Management

Personal Risk Management is looking around your home and your life, recognizing risk, and planning what to do about it. Corporations recognize that in business, just about the only sure thing is that you will have risk. According to a global study of financial institutions by Deloitte between the years 2002 and 2004, there was a twenty-five percent increase of board-level oversight in corporate risk management. In the corporate world, risk management referrers to a company's evaluation of its exposure to risk identification. A company may be able to identify risk easily, because it comes in the form of a decision. At other times, a company may faces risks and not even be aware of them. The majority of corporations have developed risk management programs and invest time and money into implementing changes and insuring exposures.

Personal Risk Management is exactly the same thing. I actually, consider insurance and personal risk management part of our family financial planning. When I was an active insurance agent a common question my clients would ask was, "How much Insurance should I have?"

A good insurance agent will answer that question with something like, "You need enough insurance to protect your assets, and you have to decide how much and what kind of risk are you willing to assume?"

Your personal risk management strategy may have a major impact on your family's financial bottom line. Cutting losses at the right time can save your family thousands of dollars. If you are an active and involved family, or expose yourself to a risky opportunity such as leading a youth or sports group you may want to consider this in they amount and type of personal liability insurance you carry.

If your financial goals include planning for your future and investments of any kind, then risk management should be a key part of your overall strategy. As you build an investment portfolio insurance and risk management should be a major consideration. For example, investing in rental property can be a very stable, relatively low risk investment. Deciding how much insurance and what type of coverage you need includes the consideration of all of your investments. Good well-written Landlord insurance coverage may offset the costs, or liability, of the rental house "stories" most landlords gather along the way.

When you have identified a risk your family faces, you need to decide how you will deal with the worst-case scenario. When deciding what and how much to insure it's up to you to identify the personal risks you are exposed and how much you can or are willing to pay if the worst thing happened. This series of Blogs will be a step-by-step guide to reviewing personal risk management.

The first and most important step in Personal Risk Management is to determine what you have and what you need to protect. Insurance is about protecting your assets and deciding what to do in the worst case scenario. The amount of insurance a person or family needs, depends on what they have to lose both in material property and financial security for the future. Success and building a secure financial foundation for you and your families future changes and grows as families learn to manage their risks and plan for life events.

What you insure, the value you insure for, and the deductibles you are willing to afford will determine the amount of insurance you need to be sure you family remains in the same standard of life no matter what happened. As families invest in their future, amass wealth, plan for retirement or provide for the needs of the family insurance should be one of the important things and part of sound personal risk management.

One of the big questions people (client) asked to their insurance agent is, "How much insurance do I need?" The answer is always the same, you need enough insurance to protect your assets.

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The key things to look at when trying to determine your assets are:

1. ***Personal Property:*** Keeping a record and important documentation about the personal property you own is a key part of insuring properly. Be sure to review your personal property inventory annually.
2. ***Net Worth:*** What do you have in the bank and how much do you owe the bank? The more investment and savings there is, the more there is to lose in the event of a liability claim. Insuring for your net worth is an important part of strong financial planning.
3. ***Future Worth:*** Your life and your health. Loss in this area would have huge effects on your family. Strong financial planning includes life and medical or health insurance as well as a sound retirement plan.

Once these issues have been identified then you know how much insurance you need to have. Protecting your assets basically means boiling things down to three categories:

1. The things that you have which could be lost in a huge house fire.
2. The things that you have earned and could lose if someone has a liability claim against you.
3. The security of you and your family in the event of health, retirement or death.

Case Study

How much Life Cover do you Need?

The primary purpose of life insurance is to provide risk cover that offers financial protection to a policyholder's dependents in the event of the policyholder's death. One needs to have enough life insurance so that his or her family can continue with their current lifestyle even if the breadwinner passes away.

Like every financial decision, life insurance shouldn't be and needn't be arbitrary. There is such a thing as 'the right amount of cover', which assumes greater significance in light of the fact that there's a price to pay for buying grossly less or grossly more. If you under-insure, you risk causing financial hardship to your dependents; if you over-insure, you waste money paying for something you don't need.

The amount of insurance you need depends on your personal circumstances, which comprises of many variables. The most important of these is dependents. If you don't have dependents (say, you are not married and your parents are financially self-sufficient), you don't need life insurance at all. Likewise, if your spouse is working and can live comfortably without your income, you don't need cover. However, if the two of you have taken loans, then you need to provide a back-up for those loans. And if you have young children, you will need to provide for expenses to raise them and support their higher education.

Therefore, to answer the question of how much cover, answer the question: how much capital does your family need, both in the short-term and in the long-term? The answer can be derived in three steps.

Step 1: Work out your Expenses

Living expenses: These include day-to-day expenses such as food and utilities, and non-recurring expenses your family may have. Your current annual expenses, exclude your own, can be a good indicator. If you have young children, chances are, their expenses will

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increase with age. Work out their expenses till they become financially independent that period should determine the tenure of your cover.

Current liabilities: This is the principal amount outstanding in your various loans (for example, house, car, personal loans or credit card outstanding).

***Future expenses*:** The major expenses expected in the future like higher education of children and their wedding expenses. Consider the time horizon and the impact of inflation on these expenses.

Step 2: Determine your assets Salary

If your spouse is earning, some of the day-to-day expenses can be supported from that salary.

Current assets: Value of investments like mutual funds, shares, real estate, bonds, and post office savings. Don't include the house you live in, as your family will still need to live in it.

Other payouts: Your pension and insurance plans. This includes pension or superannuation plans offered by your employer, employee provident fund and life cover from your existing insurance plans. Many employers provide life cover to their employees through a group insurance plan. Typically, the cover is a multiplier of the base salary. Check whether you are covered by such a plan, and add it to the existing cover.

Step 3: Calculate your Life Cover

We will consider the example of the Sharma family, their annual expense is ₹ 3 lakh and Mrs Sharma earns ₹ 1.2 lakh a year. That leaves a shortfall of ₹ 1.8 lakh. Now, because of inflation, this amount will increase every year. Assuming the cost of living increases by 4 per cent a year and their corpus earns 10 per cent a year (post-tax), the effective rate of return is 6 per cent. In order to earn ₹ 1.8 lakh at that rate, the Sharmas will need a capital of ₹ 30 lakh. To this, we add their current liabilities and future expenses. That's what the sharma's need to cover for. Next, we work out how much of this they can meet by what they have, namely their current assest and existing life cover. The balance is the additional life cover they need to get.

Once you have calculated the life cover, get a life insurance product that suits your need. Term plans are the cheapest and most effective. However, they don't provide any returns, which is not a bad thing. It is advisable not to mix insurance and investment, as such products are not the most efficient. The one exception to this rule is a children's plan in which the insurer pays the sum assured in case of the insured parents' death, as well as continues to pay the future premium to ensure the fund accumulation for children's education continues as planned by the parent. Lastly, assess your insurance need every three years or when there is a change in your family situation for example, marriage, birth of a child, spouse discontinuing career.

Questions

1. "The amount of insurance you need depends on your personal circumstances, which comprises of many variables." What according to you are the most important factors which an individual should consider before deciding the insurance amount?
2. Discuss the importance of considering "inflation" as a crucial factor while deciding the insurance amount.

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8.9 Summary

- The mechanism of insurance is very simple. People who are exposed to the same kind of risks come together and agree that, if any one of them suffers a loss, the others will share the loss and make good to the person who lost. All people who send goods by ship are exposed to the same risks, which are related to water damage, ship sinking, and piracy etc. Those owning factories are not exposed to these risks, but they are exposed to different kinds of risks like fire, hailstorms, earthquakes, lightning, burglary, etc.
- Likewise, different kinds of risks can be identified and separate groups made. By insurance, the heavy loss that anyone or few of them may suffer is divided into bearable small losses by all. In other words, the risk is spread among the community and the likely big impact on one or few is reduced to smaller manageable impacts on all.
- Life Insurance is a contract for payment of a sum of money to the person assured or his/her nominee on the happening of the event insured against. As per the contract, the payment of the specified amount will be made on the date of maturity or on the specified dates at periodic intervals or on death if it happens earlier. The Life Insurance Policies can be divided on the basis of:
  1. Duration of Policy.
  2. Methods of Premium Payments.
  3. Participation in Profit.
  4. Number of Lives Covered.
  5. Method of Payment of Sum Assured.
- Fire insurance contracts cover the risks of damage by fire. They insure the risk of loss caused whether by fire or incidental to fire. Thus, fire insurance policies cover the insurance business in which the risk to the asset is from fire or incidental to fire. A fire insurance policy covers the fire and other occurrences as stated in the policy. The inclusion of various clauses to cover matters related to fire in the policy is essential to cover the loss caused due to various reasons.
- Marine insurance basically covers two types of business, i.e., cargo insurance and hull insurance. The cargo insurance includes the goods in transit from the place insured to the sea and from sea to the exporter. The hull insurance is concerned with body, the machinery and technical know-how, stores tools, etc. of the ship. Marine insurance has been made mandatory in export-import business.

8.10 Keywords

Cover Note: A cover note is a document issued in advance before the issue of the policy, and is normally required if the policy cannot for some reason or the other, be issued straight away.

Declaration Policies: Declaration Policies are useful to businesses, which face frequent fluctuations in stock quantity or value.

Floating Policy: A floating policy describes the insurance in general terms, leaving the names of the ship or ships to be defined by subsequent declaration.

IDV: Insured's Declared Value

Insurance Policy: An Insurance policy, like all other contracts, creates rights and corresponding duties for the parties to the contract.

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Insurance: Insurance is a contract by which the insurer (Insurer Company) in consideration of the payment of a sum (premium) agrees to pay a specified sum to the insured (the person or party insuring against the risk) in the event of some untoward happening taking place.

Insured: The party who insured his risk with the insurer.

Insurer: The party agreeing to pay for the losses of the insured.

Premium: The amount payable by the insured as consideration, to the insurer.

Riders: Riders are add-ons to the basic insurance policy to supplement the cover provided.

Salvage Charges: It is the reward paid under maritime law to the Salver for saving or helping to save property at sea or life.

Sum Assured: The amount payable when the specified event occurs.

Term: The period during which the event must occur for the Sum Assured to become payable.

Time Policy: This policy is designed to give cover for some specified period of time, say, for example 1st Jan, 2003 to noon, 1st Jan, 2004.

Vehicle Insurance: Vehicle insurance is the insurance which consumers can purchase for cars, trucks, and other vehicles.

8.11 Review Questions

1. What is insurance?
2. What is general insurance?
3. Why should one insure?
4. Who should buy general insurance?
5. What kinds of policies are there?
6. What is the periodicity of premium payments?
7. Why do different people have different premiums?
8. What are the different types of policies available in case of life insurance?
9. What are the various types of risks covered in life insurance? Discuss.
10. What are the various types of risks covered in general insurance?

Answers: Self Assessment

1.	Speculative	2.	Fortuitous
3.	death and damage	4.	certainty
5.	pure	6.	True
7.	True	8.	False
9.	True	10.	False

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8.12 Further Readings

Books

Claims Management – Vol. II, ICFAI

Claims Management – Vol. V, ICFAI

Fundamentals of Insurance – P.K. Gupta, Himalaya Publishing House

General Insurance – Vol. I, ICFAI

Marine Insurance – IC-67-Insurance Institute of India

Practice of General Insurance – IC-11-Insurance Institute of India

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Unit 9: Retirement Planning-I

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Objectives

After studying this unit, you will be able to:

- Describe the need and objectives of retirement planning;
- Understand the process of retirement planning;
- Learn about the various sources of income for retirement planning;
- Know about the various investment options available for retirement planning.

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Introduction

Retirement is one of the most important life events many of us will ever experience. From both a personal and financial perspective, realizing a comfortable retirement is an incredibly extensive process that takes sensible planning and years of persistence. Even once it is reached, managing your retirement is an ongoing responsibility that carries well into one's golden years.

While all of us would like to retire comfortably, the complexity and time required in building a successful retirement plan can make the whole process seem nothing short of daunting. However, it can often be done with fewer headaches (and financial pain) than you might think – all it takes is a little homework, an attainable savings and investment plan, and a long-term commitment.

9.1 Meaning of Retirement Planning

Retirement planning, in a financial context, refers to the allocation of finances for retirement. This normally means the setting aside of money or other assets to obtain a steady income at retirement. The goal of retirement planning is to achieve financial independence, so that the need to be gainfully employed is optional rather than a necessity.

The process of retirement planning aims to:

- Assess readiness-to-retire given a desired retirement age and lifestyle, i.e. whether one has enough money to retire; and
- Identify actions to improve readiness-to-retire.

9.2 Why Plan for Retirement

Before we begin discussing *how* to plan a successful retirement, we need to understand *why* we need to take our retirement into our own hands in the first place. This may seem like a trivial question, but you might be surprised to learn that the key components of retirement planning run contrary to popular belief about the best way to save for the future. Further, proper implementation of those key components is essential in guaranteeing a financially secure retirement. This involves looking at each possible source of retirement income.

9.2.1 Uncertainty of Social Security and Pension Benefits

First off, we need to be up front about the prospects of government-sponsored retirement - They're not very good. As we all know, the developing world's populations are continuing to age, with fewer and fewer working-age people remaining to contribute to social security systems.

Private pension plans aren't immune to shortcomings either. Corporate collapses, such as the high-profile bankruptcy of Enron at the turn of the century, can result in your employer-sponsored stock holdings being wiped out in the blink of an eye.

Defined-benefit pension plans, which are supposed to guarantee participants a specified monthly pension for the duration of their retirement years, actually do fail every now and again, sometimes requiring increased contributions from plan sponsors, benefit reductions, or both, in order to keep operating.

In addition, many employers who used to offer defined-benefit plans are now shifting to defined-contribution plans because of the increased liability and expenses that are associated with defined-benefit plans, thus increasing the uncertainty of a financially secure retirement for many.

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These uncertainties have transferred the financing of retirement from employers and the government to individuals, leaving them with no choice but to take their retirement planning into their own hands.

9.2.2 Unforeseen Medical Expenses

While the failure of a social security system may not occur, planning your retirement on funds you don't control is certainly not the best option. Even with that risk aside, it's important to realize that social security benefits will never provide you with a financially adequate retirement. By definition, social security programs are intended to provide a basic safety net - a bare minimum standard of living for your old age.

Without your own savings to add to the mix, you'll find it difficult, if not impossible, to enjoy much beyond the minimum standard of living social security provides. This situation can quickly become alarming if your health takes a turn for the worse.

Old age typically brings medical problems and increased healthcare expenses. Without your own nest egg, living out your golden years in comfort while also covering your medical expenses may turn out to be a burden too large to bear - especially if your health (or that of your loved ones) starts to deteriorate. As such, to prevent any unforeseen illness from wiping out your retirement savings, you may want to consider obtaining insurance, such as medical and long-term Care insurance (LTC), to finance any health care needs that may arise.

9.2.3 Estate Planning

Switching to a more positive angle, let's consider your family and loved ones for a moment. Part of your retirement savings may help contribute to your children or grandchildren's lives, be it through financing their education, passing on a portion of your nest egg or simply keeping sentimental assets, such as land or real estate, within the family.

Without a well-planned retirement nest egg, you may be forced to liquidate your assets in order to cover your expenses during your retirement years. This could prevent you from leaving a financial legacy for your loved ones, or worse, cause you to become a financial burden on your family in your old age.

9.2.4 Flexibility to Deal with Changes

As we know, life tends to throw us a curve ball every now and then. Unforeseen illnesses, the financial needs of your dependents and the uncertainty of social security and pension systems are but a few of the factors at play.

Did u know? Regardless of the challenges faced throughout your life, a secure nest egg will do wonders for helping you cope. Financial hiccups can be smoothed out over the long term, provided that they don't derail your financial plan in the short term, and there is much to be said for the peace of mind that a sizable nest egg can provide.

9.3 Retirement Planning: How much will I Need?

Till now that we've been through the important parts of the *why*, let's start tackling the *how* of retirement planning by asking the No.1 retirement question: "How much money do I need to retire?"

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The answer to this question contains some good news and some bad news.

First, the bad news: There really is no single number that would guarantee everyone an adequate retirement. It depends on many factors, including your desired standard of living, your expenses (including any medical costs) and your target retirement age.

Now for the good news: It's entirely possible to determine a reasonable number for your own retirement needs. All it involves is answering a few questions and doing some number crunching. Providing you plan ahead and estimate on the conservative side, it's entirely possible for you to accumulate a nest egg sufficient to last you through your golden years.

There are several key tasks you need to complete before you can determine what size of nest egg you'll need in order to fund your retirement. These include the following:

- Decide the age at which you want to retire.
- Decide the annual income you'll need for your retirement years. It may be wise to estimate on the high end for this number. Generally speaking, it's reasonable to assume you'll need about 80% of your current annual salary in order to maintain your standard of living.
- Add up the current market value of all your savings and investments.
- Determine a realistic annualized real rate of return (net of inflation) on your investments. Conservatively assume inflation will be 4% annually. A realistic rate of return would be 6-10%. Again, estimate on the low end to be on the safe side.
- If you have a company pension plan, obtain an estimate of its value from your plan provider.

Self Assessment

State True or False:

1. Retirement planning, in a financial context, refers to the allocation of finances for retirement.
2. Defined-benefit savings plans, which are supposed to guarantee participants a specified monthly pension for the duration of their retirement years, actually do fail every now and again.
3. By definition, social security programs are intended to provide a basic safety net - a bare minimum standard of living for your pre-retirement age.
4. LTC stands for Late Transaction Cost.
5. Regardless of the challenges faced throughout your life, a secure nest egg will do wonders for helping you cope.

9.4 Retirement Planning: Where will my Money Come From?

Now that we've outlined how to calculate the money you'll need for retirement, we need to figure our where that money will come from.

While employment income seems like the obvious answer, there are actually many sources of funds you can potentially access to build your retirement nest egg. Once you lay them all out clearly, you can then determine how much money you'll need to save every month in order to reach your retirement goals.

There are typically several sources of retirement savings for the average individual. These include the following:

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9.4.1 Employment Income

As you progress through your working life, your annual employment income will probably be the largest source of incoming funds you receive and the largest component of your contributions to your retirement fund.

For your retirement plan, simply write down what your after-tax annual income is. Then subtract your annual living expenses. The amount left over represents the discretionary savings you have at your disposal. Depending upon how the numbers work out, you may be able to save a large portion of your employment income toward your retirement, or you may only be able to save a little. Be sure to use a budget and include all your recurring expenses. One way to ensure you save the projected amount for retirement is to treat the amount you plan to save as a recurring expense.

Regardless, figure out the maximum amount of your employment income you can contribute to your retirement fund each year. Also, if you are able to work part time during your retirement years, include this information in your retirement income calculations.

9.4.2 Social Security

As we mentioned earlier, social security benefits can provide a small portion of your retirement income. By visiting the PPF website of India you can estimate your retirement benefits (in today's dollars) by using the site's online calculator.

You may not want to include social security benefits in your retirement calculations because, as we already mentioned, the entire projected amount may not be available at retirement time. Alternatively, you may wish to include them at a portion of their value, say 50%, to be on the conservative side.

Either way, figure out what your estimated social security benefits are expected to be in today's dollars and add them to your list of retirement income sources. You won't be able to use this money to build your nest egg, but it will help to fund your living expenses when you're retired and reduce the size of nest egg you will need.

9.4.3 Employer-Sponsored Retirement Plan

You may or may not participate in a retirement plan through your employer. If you don't, you will need to focus on your other income sources to fund your retirement. If you do participate in an employer plan, contact your plan provider and obtain an estimate of the fund's value upon your retirement.

Your plan provider should be able to give you an estimated value (in today's Rupees) of your retirement funds in terms of a monthly allowance. Obtain this number and add it to your list of retirement income sources.

Similar to your social security benefits, the funds from your employer plan can help cover your living expenses during your retirement. However, most employer plans have rules regarding the age at which you can start receiving payments. Even if you quit working for your company at age 50, for example, your employer plan may not allow you to begin receiving payments until age 65. Or they may allow you to begin receiving payments early, but with a penalty that reduces the monthly payment you receive. Talk to your plan provider to determine what rules apply to your employer plan and consider them when you are making your retirement plan.

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9.4.4 Current Savings and Investments

Also consider what current savings and investments you have. If you already have a sizable investment portfolio, it may be sufficient to cover your retirement needs all by itself. If you have yet to begin saving for your retirement or are coming into the retirement planning game late, you will need to compensate for your lack of current savings with greater ongoing contributions.

Notes If you do have current savings and investments, be sure to include only the portion you expect to have left over by the time you have reached retirement. Don't include any portions you're planning to leave for your children or spend on other assets, such as a summer home, which will make the funds unavailable for covering your living expenses.

9.4.5 Other Sources of Funds

You may have other sources that will be available to fund your retirement needs. Perhaps you will receive an inheritance from your parents before you reach retirement age or have assets, such as real estate, that you plan to sell before retiring.

Whatever additional sources of funds you do happen to have, be sure to include them in your retirement projections only if they are certain to occur. You may be expecting to realize a large inheritance from your parents, but they may have other plans for their surplus savings, such as donating them to charity.

Other unexpected cash inflows may also come along as you build toward your retirement, such as lottery winnings, gifts, raises or bonuses, etc. When you do happen to receive these additional cash inflows, consider adding them to your retirement fund. It's also fine to include the planned sale of real estate to when you estimate your retirement funds (at a conservative price).

9.5 Retirement Planning: Building a Nest Egg

There are a myriad of investment accounts, savings plans and financial products you can use to build your retirement nest egg. Many countries have government-sanctioned retirement accounts that provide for tax-deferral while your savings are growing in the account, thus postponing taxation of your investment earnings until you withdraw your funds for retirement.

Due to the wide array of savings methods available (each with their own pros and cons) and the fact that each individual will have a different solution based on his or her circumstances and personal preferences, it would be impractical to discuss each in detail.

That said, there are financial goals and strategies common to pretty much everyone, and a core group of investment vehicles available to most as well. A quick overview of the tools at your disposal and the characteristics of each will help you determine what route is best for you. If you feel you need assistance choosing the financial vehicles with which to build your nest egg, consider consulting with a professional financial planner.

9.5.1 Government-Sponsored Vehicles

Most governments of developed countries provide a legal framework for individuals to build retirement savings with tax-saving advantages. Due to the advantages these investment accounts offer, there are usually limits regarding contribution amounts and age limits at which you will stop enjoying the benefits of those savings plans.

Notes

It's generally advisable for you to exhaust the contribution room you have for your government-sponsored accounts before you begin looking at other avenues, as whatever securities you invest in are more likely to deliver enhanced returns through compounding of tax-sheltered earnings or otherwise beneficial accounts.

9.5.2 Company Pension Plans

While private businesses have shifted from offering defined-benefit pension plans to other forms of employer-sponsored plans, such as defined contribution plans, there are still plenty that do offer defined-benefit plans to employees.

9.5.3 Other Products

There are a host of other retirement vehicles available as well. For example, retirees are able to purchase annuities through insurance companies, which essentially provide them with a defined pension for the rest of their lives, or for a fixed period. There are many different annuity types and various options for each, so if you are considering this route, be sure to carefully assess your options.

There are many other investment products that may or may not be useful for you, depending on your individual circumstances. Term life insurance can be an effective way to guarantee that your spouse or loved ones will have a sufficient nest egg if you suffer an accident or early death and cannot continue earning income to contribute to your retirement fund.

Generally, you may need life insurance if you are the primary breadwinner in the family and you need to ensure your income will be replaced should you pass away. Term life insurance is usually limited to income replacement, while whole life insurance also includes an investment component and builds cash value against which you can take a loan out. Whole life is usually a lot more expensive, and some financial professionals project that it may be wiser to purchase term life and use the extra funds to fund a retirement plan. Before purchasing any form of life insurance, consult with your financial planner to ensure you purchase the insurance that is right for you.

There are also long-term care and medical cost plans that can be tailored to specifically ensure that significant medical expenses won't affect your retirement years. All of these types of products can be useful, but it is unlikely that all of them are needed. Consider consulting with a professional financial planner to help determine what specialized products may be required or useful for your retirement plan.

9.6 Retirement Planning: Tax Implications and Compounding the Early Bird Gets … the Nest Egg

While it's not difficult to understand that building a sufficient retirement fund takes more than a few years' worth of contributions, there are some substantial benefits to starting your retirement savings plan early.

One of the most important determinants impacting how large your nest egg can get is the length of time you let your savings grow. The reason for this is that the effects of compounding can become very powerful over long periods of time, potentially making the duration of your retirement savings plan a much more critical factor than even the size of your monthly contributions.

The bottom line is if you don't start saving for retirement early on in your working life, it will be more costly trying to play catch-up later on. It's much easier to put aside a small amount of

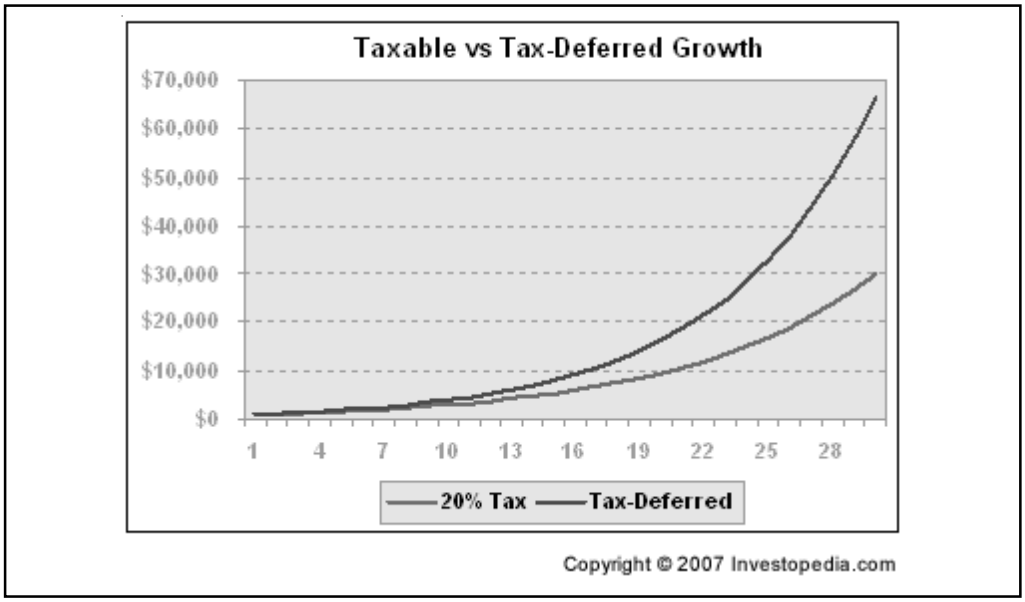
Notes

money each month starting from a young age than it is to put aside a large amount of money each month when you are older. Unless you have other serious financial pressure to take care of, such as a lot of credit card debt, you should seriously consider starting to save for your retirement as early as possible.

9.6.1 Compounding your Tax Savings

The power of compounding works when it comes to taxes, too. As we mentioned earlier, it's important that you use government-sponsored investment accounts (such as IRAs) as much as possible while carrying out your retirement plan, since they will usually afford tax-deferred benefits.

Example: Consider two investments of $1,000 invested for 30 years, one in a tax-deferred account and the other in a taxable account. Assume that taxes are paid each year on all capital gains in the taxable account. The end result after 30 years is that taxes leave the taxable investment's size at about half that of the tax-deferred account.



Of course, this graph is based on the assumption that the taxable investment account turns over its portfolio each and every year (i.e., 20% capital gains tax rate is applied to all capital gains each year). If the taxable portfolio held on to stocks for the long term, for example, the capital gains taxes would be delayed.

Regardless, it is usually not beneficial to incur taxes sooner, as opposed to later, and this example should make it clear that failing to take advantage of the tax-sheltering options available could be very costly.

9.6.2 The Bottom Line

Begin saving for retirement as early as possible and take full advantage of whatever tax-sheltering opportunities are available for as long as you can.

Self Assessment

Notes

Fill in the blanks:

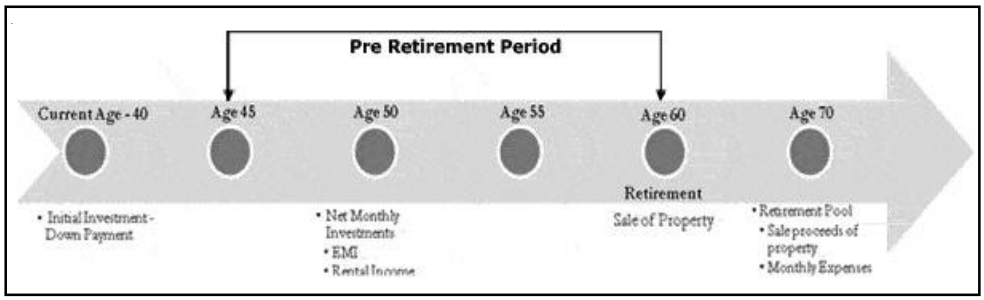
6. The power of ……..works when it comes to taxes, too.
7. One of the most important determinants impacting how large your nest egg can get is the ……..you let your savings grow.
8. Term life insurance is usually limited to ……replacement.
9. …….insurance also includes an investment component and builds cash value against which you can take a loan out.
10. There are several ….....options that can be used to achieve your retirement savings goals.

Case Study

Can a Property Investment Guarantee Comfortable Retirement?

Yashpal, 40, is going to retire after 20 years. Like everyone, he too wishes a comfortable retirement life and for that he wants to make an investment that would fetch him big money. He is certain that the realty sector would do well in the years to come, so instead of going for conventional financial tools like FD and mutual funds, he is considering investing in a property. He believes that he will receive adequate funds by selling the property upon his retirement that will be sufficient to take care of his post-retirement expenses.

Whether Yashpal is right or wrong, we will know only after a detailed analysis of the both pre-retirement and post-retirement conditions, for which we will use the following diagram.



What is the total amount needed by Yashpal post retirement?

Yashpal wants to accumulate funds to meet his post-retirement expenses which are basically going to be in two forms – monthly and lump sum. Let us, therefore, consider both of them separately.

Monthly expenses

Let us assume that Yashpal's monthly expenses are ₹ 28,000 (approx.) at today's prices. If there is an annual increase of 5 per cent in the inflation rate, the monthly expenses for Yashpal post retirement would be as follows:

Age (yrs)	40	60	70	80
Monthly Expenses (₹)	28,000	74,292	1,21,014	1,97,120

Contd...

Notes

Lump sum expenses

The possible lump sum expenses of Yashpal, in terms of today's prices, can be broken down as follows:

Children's Education (₹)	2,00,000
Children's Marriage (₹)	4,30,000
Others (₹)	1,00,000
Total (₹)	**7,30,000**

Therefore, the lump sum expenses adjusted for inflation when Yashpal retires at the age of 60 would be

= ₹ 7,30,000 x $(1 + 5\%)^{20}$

= ₹ 19,36,907

Total expenses

To calculate the total amount needed by Yashpal to finance both his monthly as well as lump sum expenses, we make the following assumptions:

1. Funds will be required for 20 years after retirement as Yashpal's expected life is 80 years
2. The return on post-retirement funds to be at 9 per cent p.a. with Yashpal striking a balance of safe and aggressive investments (earning 4 per cent above the inflation rate of 5 per cent p.a.)

After calculation, the amount needed on retirement by Yashpal will be:

Retirement Funds Required (Age: 60 years)	
Amount for lump sum expenses (₹)	19,36,907
Amount for monthly expenses for expected life (₹)	1,24,65,352
Total amount required (₹)	**1,44,02,259**

Investing in a property

We saw that Yashpal needs a total amount of ₹ 1.44 crore on retirement (60 years). This amount is to be generated by a property investment. This means, a house Yashpal will buy today should be worth ₹ 1.44 crore at the time of its sale (at Yashpal's retirement age).

1. Time for investment — 20 years
2. Property appreciation — 5 per cent p.a. (at inflation rate)
3. Funds needed for retirement — ₹ 1.44 crore

We assume that Yashpal invests in a property worth ₹ 50 lakh today. Now, let us analyse the kind of investment it would mean for him given the following facts:

1. Yashpal takes a home loan to buy ₹ 50-lakh house, after making a down payment of ₹ 10 lakh (approx.)
2. Loan duration – 20 years; rate of interest – 9 per cent p.a.
3. Maintenance charges for the house – ₹ 2,500 per month
4. Yashpal rents the house till retirement at ₹ 25,000 per month
5. Increase in rental – 5 per cent p.a. (at inflation rate)

Contd...

Notes

Questions

1. Is it a profitable investment for Yashpal?
2. What else investment options can Yashpal opt for? Explain in brief.

9.7 Summary

- As a result of an increasingly aging population, governments may be forced to suspend social security benefits in the future.
- The responsibility for financing retirement is being transferred to individuals.
- How much money you'll need to save for retirement will depend on your desired standard of living, your expenses and your target retirement age.
- To determine the size of nest egg, you'll need to: (1) Decide the age at which you want to retire. (2) Decide the annual income you'll need for your retirement years. (3) Add up the current market value of all your savings and investments. (4) Determine a realistic real rate of return for your investments. (5) Obtain an estimate of the value of your company pension plan. (6) Estimate the value of your social security benefits.
- Assume that an annual inflation rate of 4% will erode the value of your investments and adjust your savings plan accordingly to provide yourself with a margin of safety.
- Income during retirement may come from the following sources: (1) employment income, (2) social security, (3) employer-sponsored retirement plans, (4) savings and investments, (5) other sources of funds, including inheritance money, prizes and lottery winnings, gifts, raises, bonuses and real estate.
- There are several investment options that can be used to achieve your retirement savings goals. These include, but are not limited to, governments-sponsored vehicles, company pension plans, other products such as annuities and life insurance.
- Beginning to save for retirement at an early age is one of the biggest factors in ensuring success.
- The power of compounding also works with taxes - using tax-deferred investment vehicles can help you to maximize your rate of savings.

9.8 Keywords

Employee Savings Plan: A pooled investment account provided by an employer that allows employees to set aside a portion of their pretax wages for retirement savings or other long-term goals.

Retirement Planner: A practicing professional who helps individuals prepare a retirement plan. A retirement planner identifies sources of income, estimates expenses, implements a savings program and helps manage assets. Estimating future cash flows and assets is also a central part of a retirement planner's work. He or she may use a web-based calculator or software program that will predict future cash flows and assets based on the data entered.

Retirement Planning: The process of determining retirement income goals and the actions and decisions necessary to achieve those goals. Retirement planning includes identifying sources of income, estimating expenses, implementing a savings program and managing assets.

Notes

9.9 Review Questions

1. What is retirement planning?
2. Describe the need and objectives of retirement planning.
3. Describe the process of retirement planning.
4. What are the various sources of income for retirement planning?
5. What are the various investment options available for retirement planning?
6. What is a retirement Planner? What is its use?
7. Explain the importance of inflation while deciding upon retirement planning investment options. Explain using example.

Answers: Self Assessment

1.	True	2.	False
3.	False	4.	False
5.	True	6.	Compounding
7.	length of time	8.	income
9.	whole life	10.	investment

9.10 Further Readings

Books

Cohen, Jerome, B.: Zinbarg, Edward D., and Zeikel, Arthur: *Investment Analysis and Portfolio Management,* Homewood, Ill.: Richard D. Irwin, 2006.

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D. Ambrosio, Charles A.: *Guide to Successful Investing,* Englewood Cliffs, NJ Prentice-Hall, 1970.

Online links

http://www.fei.org/

http://www.investopedia.com/

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Unit 10: Retirement Planning-II

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Objectives

After studying this unit, you will be able to:

- Describe the various investment options available for retirement planning;
- Learn about the annuities and their types;
- Know about the concept of asset allocation and diversification;
- Understand the concept of mortgages and its types.

Introduction

In the last unit you have learnt about retirement planning basics and what is the significance of retirement planning in one's life. In this unit you will learn about some more crucial steps of retirement planning.

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This unit focuses on various sources of income in retirement planning and how an individual can accumulate enough wealth so as to lead a happy retirement life. It will deal with various types of investment options available for retirement planning. You will also learn about the concept of mortgages and their types in the later part of the unit.

10.1 Annuities and its Types

Most investors share the same goal of long-term wealth accumulation. Some of us have no problem watching our investments bounce up and down from day to day, while risk-averse investors or those nearing retirement generally can't withstand short-term volatility within their portfolios. If you are this type of investor – or one who has a moderate risk tolerance – annuities can be a valuable investment tool.

10.1.1 Meaning of Annuity

An annuity is a contract between you – the annuitant – and an insurance company, who promises to pay you a certain amount of money, on a periodic basis, for a specified period. The annuity provides a kind of retirement-income insurance: you contribute funds to the annuity in exchange for the guaranteed income stream of your choosing later in life. Typically, annuities are purchased by investors who wish to guarantee themselves a minimum income stream during their retirement years.

10.1.2 Benefits of Annuity

Most annuities offer tax sheltering, meaning your contributions reduce your taxable earnings for the current year, and your investment earnings grow tax-free until you begin to draw an income from them. This feature can be very attractive to young investors, who can contribute to a deferred annuity for many years and take advantage of tax-free compounding in their investments.

Because they are a long-term, retirement planning instrument, most annuities have provisions that penalize investors if they withdraw funds before accumulating for a minimum number of years. Also, tax rules generally encourage investors to prolong withdrawing annuity funds until a minimum age. However, most annuities have provisions that allow about 10-15% of the account to be withdrawn for emergency purposes without penalty.

10.1.3 Annuity Consideration

The money that an individual pays to an insurance company in exchange for a financial instrument that provides a stream of payments for a given length of time. An annuity consideration may be made as a lump sum or a as a series of gradual payments. It is also referred to as a "premium".

10.1.4 Types of Annuities

Generally speaking, there are two primary ways annuities are constructed and used by investors: **immediate annuities and deferred annuities.**

With an immediate annuity, you contribute a lump sum to the annuity account and immediately begin receiving regular payments, which can be a specified, fixed amount or variable depending upon your choice of annuity package and usually last for the rest of your life. Typically, you would choose this type of annuity if you have experienced a one-time payment of a large

amount of capital, such as lottery winnings or inheritance. Immediate annuities convert a cash pool into a lifelong income stream, providing you with a guaranteed monthly allowance for your old age.

Deferred annuities are structured to meet a different type of investor need - to contribute and accumulate capital over your working life to build a sizable income stream for your retirement. The regular contributions you make to the annuity account grow tax sheltered until you choose to draw an income from the account. This period of regular contributions and tax-sheltered growth is called the accumulation phase.

Sometimes, when establishing a deferred annuity, an investor may transfer a large sum of assets from another investment account, such as a pension plan. In this way the investor begins the accumulation phase with a large lump-sum contribution, followed by smaller periodic contributions.

Perks of Tax Deferral

It is important to note the benefits of tax sheltering during the accumulation phase of a deferred annuity. If you contribute funds to the annuity through an IRA or similar type of account, you are usually able to annually defer taxable income equal to the amount of your contributions, giving you tax savings for the year of your contributions. Also, any capital gains you realize in the annuity account over the life of the accumulation phase are not taxable. Over a long period of time, your tax savings can compound and result in substantially boosted returns.

It's also worth noting that since you're likely to earn less in retirement than in your working years, you will probably fit into a lower tax bracket once your retire. This means you will pay less taxes on the assets than you would have had you claimed the income when you earned it. In the end, this provides you with even higher after-tax return on your investment.

Retirement Income

The goal of any annuity is to provide a stable, long-term income supplement for the annuitant. Once you decide to start the distribution phase of your annuity, you inform your insurance company of your desire to do so. The insurer employs actuaries who then determine your periodic payment amount by means of a mathematical model.

The primary factors taken into account in the calculation are the current Rupee value of the account, your current age (the longer you wait before taking an income, the greater your payments will be), the expected future inflation-adjusted returns from the account's assets and your life expectancy (based on industry-standard life-expectancy tables). Finally, the spousal provisions included in the annuity contract are also factored into the equation.

Most annuitants choose to receive monthly payments for the rest of their life and their spouse's life (meaning the insurer stops issuing payments only after both parties are deceased). If you chose this distribution arrangement and you live a long retirement life, the total value you receive from your annuity contract will be significantly more than what you paid into it. However, should you pass away relatively early, you may receive less than what you paid the insurance company. Regardless of how long you live, the primary benefit you receive from your contract is peace of mind: guaranteed income for the rest of your life.

Furthermore, your insurance company – while it is impossible for you to predict your lifespan – need only be concerned with the average retirement life span of all their clients, which is relatively easy to predict. Thus, the insurer operates on certainty, pricing annuities so that it will marginally retain more funds than its aggregate payout to clients. At the same time, each client receives the certainty of a guaranteed retirement income.

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Annuities can have other provisions, such as a guaranteed number of payment years. If you (and your spouse, if applicable) die before the guaranteed payment period is over, the insurer pays the remaining funds to the annuitant's estate. Generally, the more guarantees inserted into an annuity contract, the smaller the monthly payments will be.

Fixed and Variable Annuities

Different investors place different values on a guaranteed retirement income. For some, it is critical to secure a risk-free income for their retirement. Other investors are less concerned about receiving a fixed income from their annuity investment than they are about continuing to enjoy the capital gains of their funds. Which needs and priorities you have will determine whether you choose a fixed or variable annuity.

A fixed annuity offers you a very low-risk retirement - you receive a fixed amount of money every month for the rest of their life. However, the price for removing risk is missing out on growth opportunity. Should the financial markets enjoy bull market conditions during your retirement, you forgo additional gains on your annuity funds.

Variable annuities allow you to participate in potential further appreciation of your assets while still drawing an income from your annuity. With this type of annuity, the insurance company typically guarantees a minimum income stream, through what is called a guaranteed income benefit option, and offers an excess payment amount that fluctuates with the performance of the annuity's investments. You enjoy larger payments when your managed portfolio renders high returns and smaller payments when it does not. Variable annuities may offer a comfortable balance between guaranteed retirement income and continued growth exposure.

Self Assessment

Fill in the blanks:

1. An annuity is a contract between you - the annuitant - and an ……..company, who promises to pay you a certain amount of money, on a periodic basis, for a specified period.
2. An annuity consideration may be made as a lump sum or a as a ……payments.
3. Generally speaking, there are two primary ways annuities are constructed and used by investors: …….. .
4. Most annuitants choose to receive ……payments for the rest of their life and their spouse's life.
5. ……..annuities allow you to participate in potential further appreciation of your assets while still drawing an income from your annuity.

10.2 Asset Allocation and Diversification

10.2.1 Asset Allocation

So far, we've gone through how to determine what you'll need for retirement, where you can get your retirement savings from, what types of investment accounts you can put your savings into and the benefits of long-term and tax-efficient investing. After all this you may now be asking yourself, "What the heck do I invest in?"

Notes

It isn't practical to discuss in detail the wide array of securities and investing strategies available in the market today, but we will go over the basics you'll need to know to set up your retirement investments.

If you feel you need assistance understanding and selecting securities to invest in, consider seeking the help of a professional financial planner.

Notes The assets you choose to invest in will vary depending on several factors, primarily your risk tolerance and investment time horizon. The two factors work hand in hand. The more years you have left until retirement, the higher your risk tolerance.

If you have a longer-term time horizon, say 30 years or more until retirement, investing all of your savings into common stocks is probably a reasonable idea. If you are nearing your retirement age and only have a few years left, however, you probably don't want all of your funds invested in the stock market. A downturn in the market a year before you are all set to cash out could put a serious damper on your retirement hopes. As you get closer to retirement, your risk tolerance usually decreases; therefore, it makes sense to perform frequent reassessments of your portfolio and make any necessary changes to your asset allocation.

Generally speaking, if you have a limited time horizon, you should stick with large-cap, blue chip stocks, dividend-paying stocks, high-quality bonds, or even virtually risk-free short-term Treasury bills, also called T-bills.

That said, even if you have a long-term time horizon, owning a portfolio of risky growth stocks is not an ideal scenario if you're not able to handle the ups and downs of the stock market. Some people have no problem picking up the morning paper to find out their stock has tanked 10 or 20% since last night, but many others do. The key is to find out what level of risk and volatility you are willing to handle and allocate your assets accordingly.

Of course, personal preferences are second to the financial realities of your investment plan. If you are getting into the retirement game late, or are saving a large portion of your monthly income just to build a modest retirement fund, you probably don't want to be betting your savings on high-risk stocks. On the other hand, if you have a substantial company pension plan waiting in the wings, maybe you can afford to take on a bit more investment risk than you otherwise would, since substantial investment losses won't derail your retirement.

As you progress toward retirement and eventually reach it, your asset allocation needs will change. The closer you get to retirement, the less tolerance you'll have for risk and the more concerned you'll become about keeping your principal safe.

Once you ultimately reach retirement, you'll need to shift your asset allocation away from growth securities and toward income-generating securities, such as dividend-paying stocks, high-quality bonds and T-bills.

10.2.2 Importance of Diversification

There are countless investment books that have been written on the virtues of diversification, how to best achieve it and even ways in which it can hinder your returns.

Diversification can be summed in one phrase: Don't put all of your eggs in one basket. It's really that simple.

Notes

Caution Regardless of what type of investments you choose to buy - whether they are stocks, bonds, or real estate - don't bet your retirement on one single asset.

As you contribute savings to your retirement fund month after month, year after year, the last thing you want is for all your savings to be wiped out by the next Enron. And if there's anything we have learned from the Enrons and Worldcoms of the world, it's that even the best financial analysts can't predict each and every financial problem.

Given this reality, you absolutely must diversify your investments. Doing so isn't really that difficult, and the financial markets have developed many ways to achieve diversification, even if you have only a small amount of money to invest.

10.2.3 Active vs. Passive Management

Consider buying mutual funds or exchange-traded funds (ETFs), if you are starting out with a small amount of capital, or if you aren't comfortable with picking your own investments. Both types of investments work on the same principle - many investors' funds are pooled together and the fund managers invest all the money in a diversified basket of investments.

This can be really useful if you have only a small amount of money to start investing with. It's not really possible to take ₹ 1,00,000, for example, and buy a diversified basket of 20 stocks, since the commission fees for the 20 buy and 20 sell orders would ruin your returns. But with a mutual fund or ETF, you can simply contribute a small amount of money and own a tiny piece of each of the stocks owned by the fund. In this way, you can achieve a good level of diversification with very little cost.

There are many different types of mutual funds and ETFs, but there are two basic avenues you can choose: active management and passive management. Active management refers to fund managers actively picking stocks and making buy and sell decisions in attempt to reap the highest returns possible.

Passive management, on the other hand, simply invests in an index that measures the overall stock market, such as the S&P 500. In this arrangement, stocks are only bought when they are added to the index and sold when they are removed from the index. In this way, passively managed index funds mirror the index they are based on, and since indexes such as the S&P 500 essentially are the overall stock market, you can invest in the overall stock market over the long term by simply buying and holding shares in an index fund.

If you do have a sizable amount of money with which to begin your retirement fund and are comfortable picking your own investments, you could realistically build your own diversified portfolio. For example, if you wanted to invest your retirement fund in stocks, you could buy about 20 stocks, a few from each economic sector. Provided none of the companies in your portfolio are related, you should have a good level of diversification.

The bottom line is, no matter how you choose to diversify your retirement holdings, make sure that they are properly diversified. There is no exact consensus on what number of stocks in a portfolio is required for adequate diversification, but the number is most likely greater than 10, and going to 20 or even a bit higher isn't going to hurt you.

10.2.4 Troubleshooting

As you build your retirement fund, you'll likely experience some bumps in the road along the way. One of the most common problems you'll encounter is an inability to make your monthly

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retirement contributions. A number of financial pressures can arise to make the process difficult, but fortunately there are ways that you can tilt the odds in your favor.

First of all, set up automatic payments from your checking account (your bank should be able to help you do this) into the investment account you are building your retirement fund with. This is commonly referred to as "paying yourself first". Once it's set up, each time you get your paycheck, your desired savings contribution will go right out to your investment account before you have a chance to spend it.

Automatic savings will make it a lot easier to avoid spending your contributions on things you can realistically do without. And if serious financial problems do crop up that require the use of your investment funds, you can usually access those that are deposited to an after-tax account without incurring penalties. The point of the automatic contribution is to avoid any instances of spending too much and missing out on your contributions unnecessarily.

If you do dig yourself into a deep hole of credit card debt, however, it's important you deal with the problem as quickly as possible. Create a feasible budget to pay down your debt and stick to it. Consider consolidating your debts into one account - this can lower your overall interest rate and help you pay off those debts quicker.

Other problems may crop up, but provided you're able to maintain your monthly contributions, you should be in good shape. If you are having prolonged difficulty following your plan, consider seeking the help of a financial planner.

10.2.5 What If I'm Late Getting into the Game?

If you are beginning your retirement savings late in life, you will need to work hard to catch up. The first thing you can do is create a budget for your current expenses so that you can maximize monthly contributions to your retirement fund. With budgeting, a little goes a long way, and if you track your expenses for a month you will likely find that skipping the occasional dinner out can save you hundreds of dollars, which can go a long way to boosting your retirement savings.

The main goal is to ramp up your savings rate as much as possible.

You might also consider alternative ways to boost your financial situation. Second jobs are an option, but not a particularly pleasant one. If you own your own home, consider renting out the basement or taking on a roommate in order to lower your living expenses. Converting part of your residence into an income-generating asset can do wonders for your overall retirement plan.

Once again, part-time jobs during retirement can be a feasible way to catch up. If you're able to earn a modest income during your retirement years, your financial picture can change drastically - especially if you are an active type of person. You may actually prefer semi-employment during your golden years instead of 100% leisure time.

10.2.6 Your Home may be a Source of Funding for your Retirement

If you own a home, it could serve as one of the means of financing your retirement - either by selling it and moving to a smaller, less expensive home or by using a reverse mortgage. A reverse mortgage allows you to convert a portion of the equity in your home to tax-free income while retaining ownership (of the home). A reverse mortgage can be paid to you as a lump sum, as a line of credit and/or as fixed monthly payments. If you decide to pursue a reverse mortgage, be sure to factor in the costs, which are similar to those that would usually apply when a house is being purchased. This includes origination fees and appraisal fees.

Notes

10.3 Mortgages and its Types

10.3.1 Meaning

A debt instrument that is secured by the collateral of specified real estate property and that the borrower is obliged to pay back with a predetermined set of payments. Mortgages are used by individuals and businesses to make large purchases of real estate without paying the entire value of the purchase up front.

Mortgages are also known as "liens against property" or "claims on property".

10.3.2 Types of Mortgage

The **types of mortgage** that are accepted in the Indian mortgage industry for the facilitation of mortgage loan are varied. Until recently, the Indian mortgage market was under the unorganized sector. The Government of India liberal economic policy in the late 1990s the facilitated the entry of Foreign Institutional Investors (FIIs) and Foreign Direct Investment (FDI) in the Indian market. The Indian markets which were previously closed to such investments registered tremendous economical growth across all industry sectors.

In the last 15 years, the growth of the manufacturing industry in India propelled the growth of infrastructure industry in India. Furthermore, with the growth of infrastructure industry in India, the Indian mortgage loan industry witnessed tremendous growth. Today, the organized mortgage loan sector of India is registering astronomical growth and it is estimated to be US$ 18 billion industry. The Indian mortgage loan industry is consistently registering 20-50 % growth on a year-on-year basis, from the year 2000 onwards.

Huge real estate requirements in India and their subsequent development have fueled its growth. The mortgage industry of India could break open from its age old image of being housing mortgage facilitator only. Today, the types of mortgage that are being accepted as collateral are varied and not confined to residential property only. The types of mortgage accepted as collateral security for facilitating mortgage loans in India are as follows:

- Amusement parks
- Bowling centers
- Casinos
- Auto care centers
- Auto dealerships
- Car washes
- Parking garage
- Truck terminal
- Conveniences stores
- Distribution centers
- Fitness centers
- Franchises
- Funeral homes

Notes

- Gas stations
- Golf courses
- Malls
- Retail (anchored, single tenant, unanchored)
- Mobile home arks
- Movie theaters
- Resort
- Restaurants
- Hotels
- Motels
- Hospitals
- Medical clinics
- Medical offices
- Nursing homes
- Rehabilitation facilities
- Skilled nursing facility
- Special purpose property
- Child care centers
- Independent living facilities
- Mixed use properties
- Single family
- Offices (multi-tenant, single tenant)
- Warehouse
- Industrial parks
- Industrial buildings
- Land developments
- Mini warehouses
- Office buildings
- Outlet centers
- Educational institutions
- Training institutions

The following types of rates are prevalent in the Indian mortgage market:

- ***Fixed Mortgage Rate:*** In this case the rate of interest remains fixed throughout the loan term. The mortgage rates do not vary according to market conditions. In other words, the rate of interest is pre-fixed during the process of borrowing and it generally varies between 12.5% and 25%.

Notes

- ***Flexible Mortgage Rate:*** is one in which the interest rate varies according to market movements. This type of interest rate is called 'adjusting' or 'floating' rates. The risk factor is high in this type of interest rates.

Some of the well-known mortgage-financing companies offering various types of mortgage in India are as follows:

- LIC Housing Finance
- HDFC
- ICICI Home Finance
- SBI Housing Finance
- UCO Bank
- State Bank of India
- State Bank of Mysore
- Allahabad Bank
- United Bank of India
- United Commercial Bank of India
- Bank of Baroda
- Kotak Mahindra Bank
- Citi Bank
- HSBC
- Standard Chartered Bank

Life Insurance Corporation of India enjoys complete market leadership in this sector. The private financial institutions like commercial banks, cooperative banks, and other non-banking financial companies are also registering steady growth since 2000. The estimated size of the organized mortgage industry in India account only for 25% of the total housing investment in India which is further increasing on year-on -year basis. Bottlenecks like low penetration capability, ignorance amongst masses, poor accessibility, lengthy processing time, and elaborate documentation are hampering smooth growth of this industry in India. The government of India's 5-Year Plan stresses for the overall development of the housing finance industry. Recently, the government has accepted suggestions for the revamping of land laws, rental laws, fast mutation, and registration process along with setting up of credit rating organization and modern mortgage insurance products for the fast-growing mortgage market of India.

Self Assessment

State True or False:

6. The estimated size of the organized mortgage industry in India account only for 50% of the total housing investment in India.
7. Flexible Mortgage Rate is one in which the interest rate varies according to market movements.
8. Mortgages are also known as "liens against property" or "claims on property".
9. Active management, on the other hand, simply invests in an index that measures the overall stock market.

Notes

10. Diversification will help you to reduce the amount of risk in your portfolio, increasing the chances that you'll reach your retirement savings goals.

Case Study

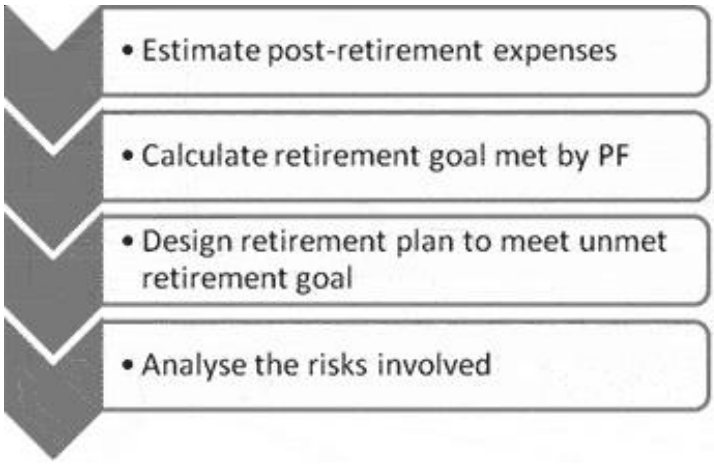
What is a Perfect Retirement Plan?

Ankur and Vanita are software professionals in their mid-thirties. They have a 4-year-old son and a 2-year-old daughter. Now that they have settled into their jobs and lives nicely, they think this is the right time to begin saving for the retirement.

Some important case facts:

1. Together, Ankur and Vanita earn a salary of ₹ 15 lakh p.a., of which ₹ 6 lakh is basic.
2. They both are 36 years old and plan to retire at the age of 60. They hope to live till 80.
3. Their Provident Fund savings is ₹ 1.5 lakh.

To start off with their retirement planning they used the following steps:



Questions

1. Will PF investments meet retirement goal?
2. What other investment options Ankur should consider?
3. What factors can affect the plan?

10.4 Summary

- Annuities offer tax-sheltered growth, which can result in significant long-term returns for you if you contribute to the annuity for a long period and wait to withdraw funds until retirement. You get peace of mind from an annuity's guaranteed income stream, and the tax benefits of deferred annuities can amount to substantial savings. Finally, variable annuities allow less risk-averse retirees prolonged exposure to the financial markets. Be sure to consider annuities as part of your overall investment strategy, as they may add value to your retirement in more ways than you think.
- Asset allocation is a key factor in building any successful portfolio. The assets you choose will depend on your risk tolerance and investment time horizon.

Notes

- Diversification will help you to reduce the amount of risk in your portfolio, increasing the chances that you'll reach your retirement savings goals.
- Make saving a priority by setting up automatic payments from your checking account to your retirement savings account, make the maximum salary deferral contribution to your employer-sponsored retirement plan and work aggressively to pay down large debts that can reduce your saving rate.
- Make a household budget to ensure that you are contributing as much as possible to saving for retirement and aim to reduce unnecessary expenses.
- A debt instrument that is secured by the collateral of specified real estate property and that the borrower is obliged to pay back with a predetermined set of payments.

10.5 Keywords

Active Management: It refers to fund managers actively picking stocks and making buy and sell decisions in attempt to reap the highest returns possible.

Annuitant: A person who receives the benefits of an annuity or pension.

Annuity: financial product sold by financial institutions that is designed to accept and grow funds from an individual and then, upon annuitization, pay out a stream of payments to the individual at a later point in time. Annuities are primarily used as a means of securing a steady cash flow for an individual during their retirement years.

Beneficiary: A person or entity named in a will or a financial contract as the inheritor of property when the property owner dies.

Deferred Annuity: A type of annuity contract that delays payments of income, installments or a lump sum until the investor elects to receive them.

Mortgage: A debt instrument that is secured by the collateral of specified real estate property and that the borrower is obliged to pay back with a predetermined set of payments.

Variable Annuity: An insurance contract in which, at the end of the accumulation stage, the insurance company guarantees a minimum payment. The remaining income payments can vary depending on the performance of the managed portfolio.

10.6 Review Questions

1. Describe the various investment options available for retirement planning.
2. What do you understand by the term annuities? What are the different types of annuities?
3. Explain the concept of asset allocation and diversification with the help of an example.
4. What are mortgages? Also explain its types.
5. How does an annuity help in retirement planning?
6. Briefly describe the Indian mortgage market.

Answers: Self Assessment

1. Insurance
2. series of gradual
3. immediate annuities and deferred annuities.
4. Monthly

Notes

5. Variable
6. False
7. True
8. True
9. False
10. True

10.7 Further Readings

Books

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Notes

Unit 11: Taxation Planning

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Objectives

After studying this unit, you will be able to:

- Define the meaning of tax management;
- Explain the types of taxes;
- State the methods of tax planning;
- Define the concept of tax evasion and tax avoidance;
- Recognize the tax planning for house property and business income;
- Define the factors affecting the tax planning;

Notes

- Define the meaning of exempted income;
- State the tax provisions for income exempt from tax.

Introduction

As a first step towards understanding income tax law in India, it would be appropriate to begin with acquiring knowledge about structure of tax regime in the country. Taxes are the basic source of revenue to the government. Revenue so raised is utilized for meeting the expenses of government as well as to carry out development works. Proper tax planning is a basic duty of every person which should be carried out religiously. Basically, there are three steps in tax planning exercise. These three steps in tax planning are:

(a) Calculate your taxable income under all heads i.e., Income from Salary, House Property, Business & Profession, Capital Gains and Income from other Sources.

(b) Calculate tax payable on gross taxable income for whole financial year (i.e., from 1st April to 31st March).

(c) After you have calculated the amount of your tax liability you have two options to choose from:

- Pay your tax (No tax planning required)
- Minimise your tax through prudent tax planning.

Most people rightly choose second option. Here you have to compare the advantages of several taxes saving schemes and depending upon your age, social liabilities, tax slabs and personal preferences, decide upon a right mix of investments, which shall reduce your tax liability to zero or the minimum possible.

Every citizen has a fundamental right to avail all the tax incentives provided by the Government. Therefore, through prudent tax planning not only income-tax liability is reduced but also a better future is ensured due to compulsory savings in highly safe Government schemes.

11.1 Types of Taxes

There are basically two types of taxes, Direct and Indirect taxes. Direct taxes are collected by the government directly from the tax payer through levies such as income tax, wealth tax and interest tax. Whereas indirect taxes are collected indirectly as a part of prices of goods and services on which these are levied. In our country these comprise of excise duty, sales tax, customs duty and value added tax. While direct taxes form 30 percent of government's revenue indirect taxes contribute a large chunk of 70 percent. Gift tax and estate duty were part of the direct tax revenue. As an ongoing process of simplification and rationalization of the direct tax structure in India, the government repealed the Gift Tax Act in 1998 and the Estate Duty Act in the late eighties.

Task Check out the current tax rates applicable for all direct and indirect taxes in India.

11.2 Tax Planning and Tax Evasion

The Indian Income Tax law is a highly complicated piece of legislation. Hence knowledge about its key features is useful for business managers and others because under the law, a taxpayer is

Notes

legitimately entitled to plan his taxes in such a manner that his tax liability is minimal and net income from the business and other sources is maximum. Tax Planning thus can be defined as an arrangement of the financial affairs within the scope of law in a manner that derives maximum benefit of the exemptions, deductions, rebates and relief and reduces tax liability to the minimal. As long as one is within the framework of law, one can plan financial affairs in such manner which keeps tax liability at its minimum. However, in the name of tax planning, one should not indulge in Tax Evasion, and the line between Tax Planning and Tax Avoidance is very thin, so one needs to tread carefully. Tax evasion is sheer non-payment of tax even when it is due to be paid in the circumstances of the case. It should be remembered that while tax planning is perfectly legal, Tax Evasion is illegal and can result into penalties and prosecution for the perpetrator. When financial transactions are arranged in a way that it becomes obvious that they were entered with a malafide intention of either not paying taxes or with a view to defeat the genuine spirit of law, they cannot be accepted as legitimate Tax Planning. Twisting of facts or taking a very strict and literal interpretation of law without understanding the basic purpose of the law can only lead to punishable offence. Given below are the key difference between the tax planning and tax evasion:

Table 11.1: Difference between Tax Planning and Tax Evasion

Tax Planning	Tax Evasion
Tax planning is an act within the permissible range of the Act conducted to achieve social and economic benefits.	Tax evasion is an attempt to avoid tax by misrepresentation of facts and falsification of accounts.
Tax planning is a legal right which enables the tax payer to achieve social and economic objectives.	Tax evasion is a legal offence which may lead to penalty and prosecution.
Tax planning accelerates development of the economy of a country by generating funds for investment in desired sectors.	Tax evasion retards the development of economy of a country by generating black money which works as a parallel economy.
Tax planning promotes professionalism and strengthens economic and political situation of the country.	Tax evasion encourages bribery and weakens economic and political situation of the country.

11.3 Tax Avoidance

Tax avoidance is minimizing the incidence of tax by adjusting the affairs in such a manner that although within the four corners of the taxation laws, the advantage is taken by finding out loopholes in the laws.

In the words of Justice O.Chinnappa Reddy of Supreme Court in Mcdowell &Co Ltd. vs. CTO(1985) 154 ITR 148(SC) at page 160, the evil consequences of Tax Avoidance are manifold and can be summarised as follows:

a. Substantial loss of much needed public revenue, particularly a welfare state like ours.

b. Serious disturbance caused to the economy of the country by piling up of black money directly causing inflation.

c. Large hidden loss to the community by some of the best brains in the country being involved in the perpetual war waged between tax avoider and his expert team of advisers, lawyers, and accountants on one side, and the Tax adviser and his perhaps not so skilful advisers on the other side.

Notes

d. Sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it.

e. Ethics (or lack of it) of transferring the burden of tax liability to the shoulders of guideless, good citizens from those of artful dodgers.

As to the ethics of Taxation, the learned judge observed: We now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation.

The Table 11.2 lists the key differences between the tax evasion and tax avoidance.

Table 11.2: Difference between Tax Avoidance and Tax Evasion

Tax Avoidance	Tax Evasion
Tax avoidance means planning for minimisation of tax according to legal requirements but it defeats the basic intention of the legislature.	Tax evasion means avoiding of tax liability illegally.
Tax avoidance takes into account various lacunas of law.	Tax evasion involves use of unfair means.
Tax avoidance is lawful but involves the elements of mala fide intention.	Tax evasion is unlawful.
Tax avoidance is planning before the actual liability for tax comes into existence.	Tax evasion involves avoidance of payment of tax after the liability of tax has arisen.

Avoidance Tax includes situations when people eliminate or reduce tax by following a transaction or many transactions that are legal. The income tax department provides many provisions through which the people can go for Tax Avoidance such as refunds, credits, benefits, and many other kinds of entitlements.

The various methods of Tax Avoidance are:

(a) Legal entities

(b) Country of residence

(c) Double taxation

(a) ***Legal Entities:*** Legal entities are a method that people follow when they want to go for Tax Avoidance. Under this method of Avoidance Tax, people legally defer paying personal taxes by creating a legal separate entity to which they donate their property. The legal separate entity that is set up is often a foundation, company, or trust. The properties are transferred to the trust or company, as a result of which the income that is earned belongs to this entity and not by the owner. Usually, people are taxed personally on earnings and property that they own and thus by transferring property to a legal separate entity, individuals can avoid personal taxation although certain taxes such as corporate taxes are still applicable. In order to go for Tax Avoidance, the foundation, company, or trust can also avoid corporate taxes if the entity is set up in a jurisdiction that considered offshore.

(b) ***Country of residence:*** Country of residence is another method that people adopt when they go for Avoidance of Tax. Under this method of Tax Avoidance, the company or person changes the tax residence to a place that is a tax haven in order to lower the amount of taxes that they pay. Under this method, the person may also become a regular traveler so that taxation can be avoided.

Notes

(c) ***Double taxation:*** Double taxation means that many countries charge taxes on the income that has been earned inside that country without taking into consideration, the resident country of the firm or person. So that people do not have to pay double taxes, once in the country where the income has been earned and then again in the resident country, many countries have gone for bilateral treaties of double taxation with other countries. This helps tax-payers as they are able to avoid paying double taxes.

Task Make a list of the countries those are having double tax avoidance agreement with India.

Did u know? Tax Avoidance reduces the revenue of the government and also brings into disrepute, the tax system. Ideally, Avoidance of Tax should not be encouraged and the government should also take measures in order to prevent it.

Self Assessment

Fill in the blanks:

1. Sale tax is a kind of ..... .
2. Tax Planning thus can be defined as an arrangement of the financial affairs within the..... .
3. Tax evasion is ..... of tax even when it is due to be paid.
4. Tax evasion is ..... .
5. Tax Avoidance reduces the ..... of the government.

11.4 Objectives of Tax Planning

The prime objectives of tax planning may be summarised as follows:

1. ***Reduction of tax liability:*** By proper tax planning, a tax payer can oblige the administrators of the taxation laws to keep their hands off from his earnings.
2. ***Minimisation of tax liability:*** Proper tax planning in conformity with the provisions of the taxation laws, the chances of unscrupulous litigations are certainly minimised and the tax payer is saved from the hardships and inconveniences caused by the unnecessary litigations.
3. ***Productive investment:*** Taxation laws offer large avenues for the productive investment of earnings, granting absolute or substantial relief from taxation. A taxpayer has to be constantly aware of such legal avenues as are designed to open the floodgates of his well-being, prosperity and happiness.
4. ***Healthy growth of economy:*** A savings of earnings by legally sanctioned devices is the prime factor for the healthy growth of the economy of a nation and its people. An income saved and wealth accumulated in violation of law are the scourge on the economy and the people. Generation of black money darkens the horizons of the national economy and leads the nation to avoidable economic destruction.
5. ***Economic stability***: Under tax planning, taxes legally due are paid without any headache either to the tax payer or to the tax collector. Avenues of productive investments are

largely availed of by the tax payers. Productive investments increase contours of the national economy embracing in itself the economic prosperity of not only the taxpayers but also of those who earn the income not chargeable to tax .The planning thereby creates economic stability of the nation and its people by even distribution of economic resources.

11.5 Income and Various Heads of Income

11.5.1 Income

In order to tax the income of a person the term itself is designed under the Income Tax Act. As per the Act the term Income includes:

a. ***Profits and gains of Business or Profession:*** This includes income from carrying on a business or income earned by doing any profession.

b. ***Dividend***

c. ***Profit in lieu of Salary, perquisite:*** This includes any amount received by an employee from his employer other then the salary amount.

d. ***Allowances granted to the assessee to meet his expenses incurred for performance of his duties:*** This includes allowances such as HRA, Medical allowance, etc given by an employer to his employee.

e. ***Any capital gains:*** This means any profit derived on sale of any capital asset.

f. Winning from lotteries, crossword puzzles, races, card game, T.V. Show , etc

g. Any sum received for fund created for welfare of employees.

Notes One interesting thing in the definition of income is that it can be received in cash or in kind. More over the Income Tax Act does not make distinction between legal source of income or illegal source of income. This means that gambling, smuggling income is also chargeable to tax under the Income Tax act. More over gifts of personal nature for e.g. birthday/marriage gifts are not treated as income (but there are some exceptions in this).

In all this one more thing is that the term income does not only means profits but there is a concept of negative income also.

11.5.2 Various Heads of Income

In the Income Tax any income earned by a person is broadly categorised into **five heads of income**. Any income earned to be taxed must come under any of the five heads of income. The five heads of income are:

Income under Head Salaries

This head taxes the income earned by an individual as salary from any firm or organisation.

As per the income tax law in India any income that is generated under the territory of the country is subjected to the income tax. Salary is taxed differently than the products as income tax is applicable on salary where as on commodities there is service tax and value added tax is applicable on it. The term salary is defines as any kind of remuneration that is generated through professional services, personal services and from different jobs in the organization.

Notes

Allowances

Section 17 of the income tax act includes:

1. Basic salary
2. Wages
3. Annuity
4. Provident fund (PF)
5. House rent allowance (HRA)
6. Gratuity
7. Cess tax and incentives generated from the salary
8. Miscellaneous amount
9. Finance tax
10. Any encashment of leave salary
11. Transport allowance

The essential conditions to notify the income as the salary income:

1. The employee and the employer relationship are of servant and master. There should be a relationship. It is different than the principal and agent as agent wont come under the full control of the employer. In India M.L.A is not come under the head salary due to the fact that it not comes under employee and employer relation ship bracket.
2. In all the government organizations pension is deducted as it is mandatory to do so.
3. Any salary that is generated outside India is taxable as per Indian income tax law.
4. Provident fund is mandatory in government as well as in the private organization.
5. As per Provident fund rule half of the amount is deducted from the salary of the employee and half of the amount will be added by the company or government. Most of the time employee claims their provident fund after leaving the job, however there is an exceptional clause under which employee can claim half of his provident fund amount at the time of buying a property or his/her wedding.

Exemption of tax in the salary:

This is a myth that every income is taxable that is received from an employer:

1. Any traveling facility provided by an employer to its employee such as train or airplane passes is not come under the tax bracket.
2. Gratuity amount is also not subjected to the income tax.
3. Any payment received by the employee of central or state government from the encashment of his/her leave balance is entitled of exemption from tax.
4. As per the provident fund act 1925. Provident fund amount is also exempted from the tax list.
5. Any sum received under life Insurance policy is exempted from the list as per sub section (3) of section 80DDA.

Notes

6. Income received by way of pension received by an individual or family for a member who was employed with central government/state government is also exempted from a tax list.
7. Armed force professional who won the gallantry award for their services towards the country are exempted from the list of income tax. Employees of central or state government who have won Param vir Chakra, Maha vir chakra and any other notified gallantry awards are exempted from the tax list.

Income from House Property

This head taxes rental income received by any person from way of renting of any immoveable property.

Income form House Property which is exempt i.e. Though there is income from house property, such income will not be taxable under the Indian Income Tax Law. The following are such situations:

1. Income from a farmhouse used for agricultural purposes.
2. Income from property earned by trade union or association of trade union.
3. Property income earned by a local authority.
4. Income from house property earned by a political party.
5. Income from property held for charitable purposes.
6. Property used for own business or profession. If such property yields any income, such income will be treated as business income and not house property income.
7. One property which is used by an individual assessee or an HUF assessee for purpose of self occupation only and not for renting out to any person will be treated as exempt property and income from that property will not be treated as taxable income.

For the purposes of understanding the provisions of this unit, let us divide the house properties into different categories:-

1. Self Occupied Properties (SOP).
2. Let Out Properties.

If an individual or HUF assessee has only one property, that property will be treated as self occupied. Accordingly, there will not be any taxable income in respect of such property. However, if the assessee owns more than one property all of which are not rented out but are self occupied, then the assessee, at his option, may choose any one property as self occupied by him and the remaining properties though not actually let out, will be deemed to be let out i.e. they will be assumed to have been let out and a notional rental value will be treated as taxable income in the hands of the owner of such property. Such properties are known as properties deemed to have been let out. In respect of properties deemed to have been let out, a notional rental value will be treated as taxable income even if no rent has actually been received by the assessee. In order to determine the notional rental value, the highest of the following will be treated as taxable income:

1. Municipal Rental Value.
2. Fair Rental Value of a similar property in a similar locality.

Notes

However if the higher of the above two exceeds the standard rent of the property determined in accordance with the Rent Control Act applicable at the concerned locality, then the standard rent will be treated as taxable rental value of such property.

Therefore in respect of self-occupied property, one property will be treated as an exempt property and in respect of other properties, a notional rental value will be treated as taxable income in the hands of the owner of the property.

Profits and Gains of Business or Profession

This head of income broadly covers income earned by a person as a result of some business or professional set-up by him.

For charging the income under the head ''Profits and Gains of business,'' the following conditions should be satisfied:

1. There should be a business or profession.
2. The business or profession should be carried on by the assessee.
3. The business or profession should have been carried on by the assessee at any time during the previous year.

Income which is chargeable to income tax under the head Profits and gains of business or profession

The following income would be chargeable under the head "Profits and gains of business or profession":

1. The profits and gains of any business or profession, which was carried on by the assessee at any time during the previous year;
2. Any compensation or other payment, due or received by the following:-
   (i) Any person, by whatever name called, managing the whole or substantially the whole of the affairs of an Indian company, at or in connection with the termination of his management or the modification of the terms and conditions relating thereto.
   (ii) Any person, by whatever name called, managing the whole or substantially the whole of the affairs in India of any other company, at or in connection with the termination of his office or the modification of the terms and conditions relating thereto.
   (iii) Any person, by whatever name called, holding an agency in India for any part of the activities relating to the business of any other person, at or in connection with the termination of any agency or the modification of the terms and conditions relating thereto.
   (iv) Any person, for or in connection with the vesting in the Government, or in any corporation owned or controlled by the Government, under any law for the time being in force, of the management of any property or business.
3. Income, derived by a trade, professional or similar association from specific services performed for its members.
4. Profits on sale of a license granted under the Imports (Control) Order, 1955, made under the Imports and Exports (Control) Act, 1947.
5. Cash assistance (by whatever name called), received or receivable by any person against exports under any scheme of the Government of India.

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6. Any duty of customs or excise repaid or repayable as drawback to any person against exports under the Customs and Central Excise Duties Drawback Rules, 1971.
7. The value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession.
8. Any interest, salary, bonus, commission or remuneration, by whatever name called, due to, or received by, a partner of a firm from such firm.

However, it is provided that where any interest, salary, bonus, commission or remuneration, by whatever name called, or any part thereof has not been allowed to be deducted under Clause (b) of section 40, the income under this clause shall be adjusted to the extent of the amount not so allowed to be deducted.

Interest Income is either assessed as ''Business Income'' or as ''Income from other sources'' depending upon the activities carried on by the assessee. If the investment yielding interest were part of the business of the assessee, the same would be assessable as ''business income'' but where the earning of the interest income is incidental to and not the direct outcome of the business carried on by the assessee, the same is assessable as ''Income from other sources''. Business implies some real, substantial and systematic or organized course of activity with a profit motive. Interest generated from such an activity is considered Business Income. Otherwise, it would be interest from other sources.

Where an owner lets out premises along with other assets or provides amenities, the income in respect of premises would be taxable as income from house property and, the balance would be taxed as income from other sources. The contract, letting out the premises along with other assets and providing amenities, is severable.

If an assessee is employed in a company where he is called Managing Agent but is in fact, the Chief Manager of the company, under what head would the remuneration that he is paid be charged

Even though he may be called a Managing Agent, the remuneration earned by him will be charged under the head of Salaries and not as Business Income. The fact that he is actually the Chief Manager of the company will make the remuneration earned by him chargeable to tax under the head Salaries. It is the true nature of the contract that will determine the relationship between the assessee and the company. Once it is established that the managing director functions subject to the control and supervision of the Board of Directors, the inevitable corollary is that an employer — employee relationship exists and that being so, his remuneration is assessable under the head "salary".

Capital Gains

This head of income taxes the income earned on sale of any investment in form of gold, precious ornaments, shares, etc or immoveable property.

Section 2(47) of the Income Tax Act, defines transfer in relation to a capital asset, and it includes

- The sale, exchange or relinquishment of the asset.
- The extinguishment of any rights therein.
- In a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment.
- Any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882(4 of 1882).

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- Any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.
- Explanation - For the purposes of sub-clauses (v) and (vi), ''immovable property'' shall have the same meaning as in clause (d) of section 269UA]

Transactions which are not deemed to be transfer for the purposes of capital gains

The Income Tax Act also exempts certain transactions from being covered under the definition of transfer. These are more specifically contained in section 46 & 47 of the Income Tax Act. In brief the transactions not regarded as transfer are as under:

a. Where the assets of a company are distributed to its share holders upon its liquidation, the distribution is not regarded as transfer. However where a share holder receives any money or other assets on the date of distribution which exceeds the amount of dividend within the meaning of section 2(22)(c), the excess is chargeable under the head capital gains.

b. Any distribution of capital assets on the total or partial partition of a HUF is not regarded as transfer.

c. Where a capital asset is transferred under the gift or will or an irrevocable trust, the transaction is not of the nature of transfer as per the Income Tax Act.

d. The transfer of a capital asset to an Indian subsidiary company by a parent company or its nominees who hold the entire share capital of the Indian subsidiary company is not regarded as transfer.

e. Any transfer of a capital asset by a wholly owned subsidiary company to its Indian holding company is also not regarded as transfer for the purposes of capital gains. However in respect of (d) & (e) above the transfer of a capital asset as stock in trade is covered by the provisions of capital gains.

f. Any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to an Indian amalgamated company is also not a transfer for the purposes of capital gains.

g. In the case where the amalgamating and the amalgamated companies are both foreign companies, the transfer of shares held in the Indian company by the foreign amalgamating company to the foreign amalgamated company is not regarded as a transfer for the purposes of capital gains if at least 25% of the share holders of the amalgamating foreign company continue to remain share holders of the amalgamated foreign company and if such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated.

h. Any transfer by a share holder, in a scheme of amalgamation, of share or shares held by him in the amalgamating company in consideration of the allotment of any share or shares in the amalgamated Indian company is not regarded as a transfer for the purposes of capital gains.

i. Where a non resident transfers any bond or shares of an Indian company which were issued in accordance with any scheme notified by the Central Government for the purposes of section 115AC or where the non resident transfer any bonds or shares of a public sector company sold by the government and purchased by the non resident in foreign currency is not regarded as a transfer for the purposes of capital gains. However this is so only when the transfer of the capital asset is made outside India by the non resident to another non resident.

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j. Where any assessee transfers any work of art, archaeological or art collection, book, manuscript, drawing , painting, photograph or print to a University, the National Museum, the National Art Gallery, the National Archives, to the Government or any other notified institution of national importance is not considered as transfer for the purposes of capital gains.

k. Any transfer by way of conversion of a company's bonds or debentures, debenture-stock or deposit certificates in any form into shares and debentures of that company is not regarded as transfer for the purpose of capital gains.

l. Where a non corporate person transfers its membership of a recognised stock exchange in India to a company in exchange of shares allotted by that company is not regarded as a transfer for the purposes of capital gains provided that such transfer was made on or before 31st day of December, 1998.

m. Any transfer of a land of a sick industrial company which is being managed by it s Worker's Cooperative is not regarded as transfer for the purposes of capital gain if the transfer is made under a scheme prepared and sanctioned under section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985. This exemption is operative only in the period commencing from the previous year in which the said company became a sick industrial company under section 17(1) of that act and ending with the previous year during which the entire net worth of such company becomes equal to or exceeds the accumulated losses. The net worth is defined in the Sick Industrial Companies Act.

n. With effect from 1-4-99 the process of sale or transfer of any capital or intangible asset of a firm is not regarded as a transfer for the purposes of capital gains where it is on account of the succession of the firm by a company in the business carried on by it. This exemption is dependent on the following conditions:

   i. All the assets and liabilities of the firm before the succession and relating to the business should become the assets and liabilities of the company.

   ii. All the partners of the firm before the succession should become share holders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of succession.

   iii. The partners of the firm should not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by allotment of shares in the company.

   iv. The aggregate share holding in the company by the partners should be more than 50% of the total voting power for a period of 5 years from the date of succession.

o. With effect from 1-4-99 where a sole proprietary concern is succeeded by a company in the business carried on by it and as a result of which the sole proprietary concern sells or transfers any capital asset or intangible asset to the company, such transfer shall not be regarded as transfer for the purposes of capital gains. This exemption is available only if the following conditions are fulfilled:

   i. All the assets and liabilities of the business of the sole proprietary concern should become the assets and liabilities of the company.

   ii. The share holding of the sole proprietor should be more than 50% of the total voting power in the company for a period of 5 years from the date of succession.

   iii. The sole proprietor should not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company.

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p. With effect from 1-4-99 any transfer in a scheme for lending of any securities under an agreement or arrangement which the assessee enters into with the borrower of such securities subject to the guidelines issued by the Securities and Exchange Board of India is not regarded as a transfer for the purposes of capital gains.

where in the transaction of lending shares of some distinctive numbers and receiving back shares of some other numbers is the result, the same would not be considered as exchange of asset within the definition of capital asset since the meaning of the word exchange necessarily involves exchange of two different assets. Thus where the asset received back is not different from what was lent in the above scheme of lending, no transfer is there for the purposes of capital gain as long as the assets received back represent the same fraction of the ownership of the company.

Income from other Sources

This head of income covers any income which is not chargeable to tax under any of the above heads of income. Any income including gambling or profit/loss on running of race horses, camels, interest income , etc are chargeable to tax under this head of income.

This is income that is not chargeable to tax under any other head of income. Such income covers.

Dividend

Under Section 10(33), any amount declared or paid by a Indian company by way of dividend is tax-exempt in the hands of shareholders. Therefore, any dividend income received from a company that is not an Indian company will be taxable in the hands of the recipient.

Winnings from lotteries, crossword puzzles, horse races and game shows:

In the case of winnings from lotteries, crossword puzzles, races (including horse races), card games, game shows and other games of any sort, or from gambling or betting of any form or nature whatsoever, ₹ 5,000 is exempt from tax. Tax will be deducted at source on the rest of the winnings at the rate of 30 per cent (plus surcharge). This means that if you hit a jackpot of, say, ₹ 50,000, TDS will be calculated as under:

Total earnings	₹ 50,000
Less: amount exempt	₹ 5,000
Taxable amount	₹ 45,000
Tax on ₹ 45,000 @ 30%	₹ 10,500
Add: Surcharge @ 2%	₹ 210
Total TDS applicable	₹ 10,710

Winnings from game shows like Kaun Banega Crorepati will be covered by this clause from 1 June 2001. Winnings before this date will not be subject to TDS; you will have to pay tax yourself.

Interest on securities: The income from interest on securities is chargeable to tax if the securities are held as an investment, and not as stock-in-trade. If the securities are held as stock-in-trade, the interest income is taxable under the head profits and gains from business or profession. Although interest income is taxed under the head income from other sources, a deduction is available in some cases under section 80L.

Others

a. The interest on bank deposits and loans (except in the case of assesses in the money-lending business).

Notes

b. Income from letting-out machinery, plant, furniture or buildings on hire if they are not chargeable to tax under the head profits and gains from business or profession.

c. Interest received on a tax refund.

d. Ground rent.

e. Royalty.

Directors fees from a company.

11.6 Tax Planning of Income from House Property

The annual value of a property, consisting of any buildings or lands appurtenant thereto, of which the assessee is the owner, is chargeable to tax under the head 'Income from house property'. However, if a house property, or any portion thereof, is occupied by the assessee, for the purpose of any business or profession, carried on by him, the profits of which are chargeable to income-tax, the value of such property is not chargeable to tax under this head. Thus, three conditions are to be satisfied for property income to be taxable under this head. These are:

1. The property should consist of buildings or lands appurtenant thereto.
2. The assessee should be the owner of the property.
3. The property should not be used by the owner for the purpose of any business or profession carried on by him, the profits of which are chargeable to income-tax.

11.6.1 Exempted House Property Income

Some incomes from house property are exempt from tax. They are neither taxable nor included in the total income of the assessee for the rate purposes. These are:

1. Income from a farm house [section 2(1A) (c) and section 10(1)].
2. Annual value of one palace in the occupation of an ex-ruler [section 10(19A)].
3. Property income of a local authority [section 10(20)].
4. Property income of an approved scientific research association [section 10(21)].
5. Property income of an educational institution and hospital [section 10(23C)].
6. Property income of a registered trade union [section 10(24)].
7. Income from property held for charitable purposes [section 11].
8. Property income of a political party [section 13A].
9. Income from property used for own business or profession [section 22].
10. Annual value of one self occupied property [section 23(2)].

11.7 Tax Planning of Business Income

The income from business and profession is known as profit and gains. While calculating the profit and gains, we deduct various expenses from it. The expenses to be deducted for calculating the gain are defined in the income tax act. Sections 30 to 37 cover expenses, which are expressly allowed as deduction while computing business income, sections 40, 40A and 43B cover expenses which are not deductible.

Notes

Expenses deductions under section 30 to 37 are of two types. The first is specific deductions which are covered under section 30 to 35 and second is general deductions which are covered under section 36 and 37. Specific deductions are allowed only to some of the businesses while general deductions are allowed to all the businesses.

There are certain provisions which allow an assessee to calculate the profit on the presumptive basis, i.e., the profit is presumed on certain basis. These provisions are contained under section 44.

11.7.1 Steps to Compute the Income from Business

Section 29 lays down that the income referred to in Section 28 shall be computed in accordance with the provisions contained in Section 30 to Section 43D. It may be added that the provisions of sections 44 to 44D are also to be taken into account in this context as they make certain special provisions regarding the computation of profits and deductions of expenditure in certain cases.

Caution It is important to note that specific allowances and deductions stated in these sections are not exhaustive. Besides these deductions, other deductions are also available on the general commercial framework while computing profit and gains of business or profession.

Following general commercial principles, losses of a capital nature which are incidental to the trade and arise expectedly in the regular course of business would be deductible, even though there may not be specific provision in the Act for such deductions. Examples of such losses are embezzlement of cash, theft of cash, robbery, destruction of assets, loss of stock in transit by fire or ravages of white ants, or by enemy action during war etc.

Further profits chargeable under the head "Profits and Gains of business or profession" should be computed in accordance with the method of accounting regularly employed by the assessee – accrual basis or receipt basis or a mixture of the two.

1. The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts. The tax is upon income, profits or gains; it is not a tax on the gross receipts. From the charging provisions of the Act, it is discernible that the words 'income' or 'profits and gains' should be understood as including losses also, so that, in one sense 'profits and gains' represent 'plus income' whereas losses represent 'minus income'. In other words, loss is negative profit. Both positive and negative profits are of a revenue character. Both must enter into computation, wherever it becomes material, in the same mode of the taxable income of the assessee.
2. The general rule of determining taxable business or professional income is that from the gross income or gross receipts or gross sales, expenses incurred for earning that income will be allowed as a deduction. The balance of profit remaining after claiming all the allowable expenses as a deduction will be the taxable income from business.
3. Expenses will be allowed as a deduction from gross receipts only if they have been incurred in the relevant previous year. Expenses incurred before setting of the business will not be allowed except where specifically provided by law.
4. Typical steps for computation of income under this head can be listed as below:
   a. Find out Profit as per P & L A/c

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b. Deduct those expenses, which are not claimed but are allowable as deduction under sections 30 to 37.

c. Add those expenses which have been debited to Profit & loss A/c but are not allowable as deduction u/s 40, 40A and 43B.

d. Deduct those incomes which have been credited to Profit & Loss A/c but which are not chargeable to income tax.

e. Add those incomes which have not been credited to Profit & Loss A/c but which are taxable as business income under Section 28 described above.

5. As stated above Sections 30 to Section 37 deal with various expenses which will be allowed as a deduction in getting the amount of taxable business or professional income.

11.7.2 Expenses allowed as Deductions

Profits of business or gains from profession are calculated after allowing all legitimate business expenditure. Some important deductions admissible in computing income from business or profession are as follows [sections 30 to 36 of Income Tax Act]:

- Rent, rates, taxes, repairs and insurance for business or professional premises [section 30 of Income Tax Act]
- Current repairs and insurance of machinery, plant and furniture [section 31 of Income Tax Act]
- Depreciation on building, machinery, plant or furniture [section 32 of Income Tax Act]
- Revenue expenditure on scientific research [section 35(1) of Income Tax Act]
- Capital expenditure on scientific research related to business (except land) [section 35(2) of Income Tax Act]
- Preliminary expenses in relation to formation of a company or in connection with extension of an undertaking or setting up of a new industrial unit can be amortized in 5 equal installments over 5 years. The preliminary expenditure is permitted only upto 5% of cost of project [section 35D]
- Insurance expenses [section 36(1)(i) of Income Tax Act]
- Insurance premium on health of employees [section 36(1)(ib) of Income Tax Act]
- Bonus or commission to employees [section 36(1)(ii) of Income Tax Act]
- Interest on borrowed capital [section 36(1)(iii) of Income Tax Act]
- Contributions towards approved provident fund, superannuation fund and gratuity fund [section 36(1)(iv) and 36(1)(v) of Income Tax Act]
- Bad debts in respect of income considered in previous years can be written off and allowable as deduction [section 36(1)(viii) of Income Tax Act]
- Banking cash transaction tax [section 36(1)(xiii) of Income Tax Act]
- Advertisement expenditure is fully allowed as deduction. However, expenditure incurred on advertisement in any souvenir, brochure, pamphlet etc. of a political party is not allowed as a deduction [section 37(2B) of Income Tax Act]
- Expenditure in maintenance of guest house is permissible as deduction [section 36(1)(i) of Income Tax Act]

Notes

- Any other expenditure which is not of capital nature or personal expenses of the assessee is allowed if it is expended wholly and exclusively for the purposes of business or profession. However, it should not have been for purpose which is an offence or is prohibited by any law [section 37 of Income Tax Act]

11.7.3 Expenditure not allowed as Deduction

Following expenditures are not allowed as deduction for purpose of income tax.

Deduction of taxes, interest etc. only on actual payment basis: Tax, duty, cess, fees payable under any law, Employer's contribution to provident fund or ESIC, bonus to employees, commission to employees, interest on any loan or borrowing from financial institutions, banks, SFC, leave encashment are eligible as deduction only if they are paid on 'due dates' on which these were payable. Even if these are not paid on due dates but are paid before filing of return, these are allowed as deduction, if proof of payment is filed along with the return. However, in case of employer's contribution to provident fund, superannuation fund or gratuity fund, the same is allowed as deduction only if it was paid before due date of payment [section 43B of Income Tax Act].

Expenditure in excess of ₹ 20,000 in cash fully disallowed: If expenditure is incurred in business or profession by payment of cash over ₹ 20,000 in a day, entire expenditure is disallowed [Earlier, 20% of such expenditure was disallowed upto AY 2007-08]. All cash transactions in a day to a party should not exceed ₹ 20,000. [Till 31-3-2008, each transaction was considered for the limit of ₹ 20,000. Now, total transactions in a day will be considered [section 40A (3) of Income Tax Act].

Payment over ₹ 20,000 should be made by cheque or demand draft. This restriction is not applicable in case of payments to RBI, other banks and financial institutions, LIC Government payments, payment by book adjustment, railway freight Payment for agricultural produce, poultry, fish etc. to the cultivator, grower or producer (i.e. payments to middlemen are not excluded from this provision) [rule 6DD]

Similarly, a person can accept loans or deposits of ₹ 20,000 or more only by account payee bank draft or cheque.

Interest on delayed payment to small industries: Interest on delayed payment made to Small Scale Industries is not allowable as deduction.

Expenditure for any purpose which is an offence in law: Section 37(1) of Income Tax Act states that any expenditure incurred for any purpose which is an offence or which is prohibited by law shall not be allowed as deduction.

11.8 Factors Affecting the Tax Planning

The following factors are essential for effective tax planning:

1. ***Residential status and citizenship of the assessee:*** We know that a non-resident in India is not liable to pay income-tax on incomes which accrue or arise and are also received outside India, whereas a resident in India is liable to pay income-tax on such incomes. Therefore, every assessee would like to be a non-resident in India, if he has any income which accrues or arises outside India.

2. ***Heads of income/assets to be included in computing net wealth:*** Before the Tax-planner goes in for his task; he has to have a full picture of the sources of income of the tax payer and the members of his family. Though total income includes all income from whatever source derived, the scope of tax planning is not similar in respect of all sources of income.

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The assessee can avail the benefits of exemption and deductions under each head of income. Further he can avail the benefit of rebate and relief under the Act.

3. ***Latest legal position:*** It is the foremost duty of a tax-planner to keep him fully conversant with the latest position of the taxation laws along with the allied laws and also the judicial pronouncements in respect thereof. For this purpose he must have a thorough and up-to-date understanding of the annual finance Acts, the Taxation Laws Amendments, the amendments, if any, of the allied laws, the latest judicial pronouncements of the High Courts and the Supreme Court, various Circulars of the Central Board of Direct Taxes which seek to clarify the legal position in so far as the Revenue is concerned.

4. ***Form v Substance:*** A tax planner has to bear in mind the following principles enunciated by the courts on the question whether form or substance of a transaction should prevail in Income-tax matters.

5. (a) *Form of transaction:* When a transaction is arranged in one form known to law, it will attract tax liability while, if it is entered into another form which is equally lawful, it may not.

   (b) *Genuineness of transaction:* In deciding whether the transaction is a genuine or colourable one because in such a situation, it is not the question of form and substance but of appearance and truth. It will be open to the authorities to pierce the corporate veil and look behind the legal façade, at the reality of the transaction.

   (c) *Expenditure:* In the case of expenditure, the mere fact that the payment is made under an agreement does not preclude the department from enquiring into the actual nature of the payment.

11.9 Tax Exemption

A tax exemption is an exemption from all or certain taxes of the nation in which part of the taxes that would normally be collected from an individual or an organization are instead foregone.

Normally a tax exemption is provided to an individual or organization which falls within a class which the government wishes to promote economically, such as charitable organizations. Tax exemptions are usually meant to either reduce the tax burden on a particular segment of society in the interests of fairness or to promote some type of economic activity through reducing the tax burden on those organizations or individuals who are involved in that activity. In certain cases, the Income tax Cat, 1961 provides exemption to pay the tax.

11.9.1 Incomes Exempt from Tax

Deductions Under Section 80

Under Income tax, deduction u/s 80C, 80CCC, 80D, 80DD, 80DDB, 80G, 80GG, 80GGA, 80GGC, 80IAB, 80IB, 80IC, 80ID, 80IE, 80JJA, 80QQB, 80RRB, 80U are relevant to Individuals depending on the condition fulfillment. The following chart of deductions will give instant and fair idea about certain deductions to individual tax payers. (section 80IAB to 80IE are not discussed which are specific to business men).

SI. No	Section	Details of deductions	Quantum
1	80C	General deduction for investment in PPF,PF,Life Insurance, ULIP, Stamp duty on house, Fixed deposits for 5 years , bonds etc	Maximum ₹ 1 ,00,000 is allowed. Investment need not be from taxable income.

Contd...

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2	80CCC	Deduction in case of contribution to pension fund. However, it should be noted that surrender value or employer contribution is considered income.	Maximum is ₹ 1,00,000
3	80CCD	Deduction in respect to contribution to new pension scheme. Employees of central and others are eligible.	Maximum is sum of employer's and employee's contribution to the maximum : 10 % of salary.
4		**It should be noted that as per section 80CCE , the maximum amount of deduction which can be claimed in aggregate of 80C, 80CCC & 80CCD is ₹ 1,00,0000**	
5	80D	Medical insurance on self, spouse , children or parents	₹ 15,000 for self , spouse & children Extra ₹ 15,000 for insurance on parents. IF parents are above 65 years, extra sum should be read as ₹ 20,000 Thus maximum is ₹ 35,000 per annum
6	80DD	For maintenance including treatment or 7insurance the lives of physical disable dependent relatives	₹ 50,000 . In case disability is severe, the amount is ₹ 1,00,000.
7	80DDB	For medical treatment of self or relatives suffering from specified disease	Acutal amount paid to the extent of ₹ 40,000. In case of patient being Sr Citizen , amount is ₹ 60,000
8	80E	For interest payment on loan taken for higher studies for self or education of spouse or children	Actual amount paid as interest and start from the financial year in which he/she starts paying interest and runs till the interest is paid in full.
9	80G	Donations to charitable institution	100% or 50% of amount of donation made to 19 entities (National defense fund , Prime minister relief fund etc.)
10	80GG	For rent paid.	This is only for people not getting any House Rent Allowance. Maximum is ₹ 2000 per month. Rule 11B is method of computation.
11	80GGA	For donation to entities in scientific research or rural development	Only those tax payers who have no business income can claim this deduction. Maximum is equivalent to 100 % of donation.
12	80GGC	For contribution to political parties	100 % of donations
13	80QQB	Allowed only to resident authors for royalty income for books other than text book	Royalty income or ₹ 3,00,000 whichever is less.
14	80RRB	For income receipt as royalty on patents of resident individuals	Actual royalty or ₹ 3,00,000 whichever is less.
15	80U	Deduction in respect of permanent physical disability including blindness to taxpayer	₹ 50,000 which goes to ₹ 1,00,000 in case taxpayer is suffering from severe disability.

Section 80C

Section 80C replaced the existing Section 88 with more or less the same investment mix available in Section 88. The new section 80C has become effective w.e.f. 1st April, 2006. Even the section 80CCC on pension scheme contributions was merged with the above 80C. However, this new section has allowed a major change in the method of providing the tax benefit. Section 80C of the Income Tax Act allows certain investments and expenditure to be tax-exempt. One must plan investments well and spread it out across the various instruments specified under this section to

avail maximum tax benefit. Unlike Section 88, there are no sub-limits and is irrespective of how much you earn and under which tax bracket you fall.

The total limit under this section is ₹ 1 lakh. Included under this heading are many small savings schemes like NSC, PPF and other pension plans. Payment of life insurance premiums and investment in specified government infrastructure bonds are also eligible for deduction under Section 80C.

Most of the Income Tax payee try to save tax by saving under Section 80C of the Income Tax Act. However, it is important to know the Section in toto so that one can make best use of the options available for exemption under income tax Act. One important point to note here is that one can not only save tax by undertaking the specified investments, but some expenditure which you normally incur can also give you the tax exemptions.

Besides these investments, the payments towards the principal amount of your home loan are also eligible for an income deduction. Education expense of children is increasing by the day. Under this section, there is provision that makes payments towards the **education fees for children** eligible for an income deduction.

Sec 80C of the Income Tax Act is the section that deals with these tax breaks. It states that qualifying investments, up to a maximum of ₹ 1 Lakh, are deductible from your income. This means that your income gets reduced by this investment amount (up to ₹ 1 Lakh), and you end up paying no tax on it at all!

This benefit is available to everyone, irrespective of their income levels. Thus, if you are in the highest tax bracket of 30%, and you invest the full ₹ 1 Lakh, you save tax of ₹ 30,000. Isn't this great? So, let's understand the qualifying investments first.

Qualifying Investments

Provident Fund (PF) & Voluntary Provident Fund (VPF): PF is automatically deducted from your salary. Both you and your employer contribute to it. While employer's contribution is exempt from tax, your contribution (i.e., employee's contribution) is counted towards section 80C investments. You also have the option to contribute additional amounts through voluntary contributions (VPF). Current rate of interest is 8.5% per annum (p.a.) and is tax-free.

Public Provident Fund (PPF): Among all the assured returns small saving schemes, Public Provident Fund (PPF) is one of the best. Current rate of interest is 8% tax-free and the normal maturity period is 15 years. Minimum amount of contribution is ₹ 500 and maximum is ₹ 70,000. A point worth noting is that interest rate is assured but not fixed. Interest on PPF is proposed to increase to 8.60% and Investment Limit is also expected to increase to ₹ 1,00,000/- very soon.

Life Insurance Premiums: Any amount that you pay towards life insurance premium for yourself, your spouse or your children can also be included in Section 80C deduction. Please note that life insurance premium paid by you for your parents (father/mother/both) or your in-laws is not eligible for deduction under section 80C. If you are paying premium for more than one insurance policy, all the premiums can be included. It is not necessary to have the insurance policy from Life Insurance Corporation (LIC) – even insurance bought from private players can be considered here.

Equity Linked Savings Scheme (ELSS): There are some mutual fund (MF) schemes specially created for offering you tax savings, and these are called Equity Linked Savings Scheme, or ELSS. The investments that you make in ELSS are eligible for deduction under Sec 80C.

Home Loan Principal Repayment: The Equated Monthly Installment (EMI) that you pay every month to repay your home loan consists of two components – Principal and Interest. The principal

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component of the EMI qualifies for deduction under Sec 80C. Even the interest component can save you significant income tax – but that would be under Section 24 of the Income Tax Act. Please read "Income Tax (IT) Benefits of a Home Loan/Housing Loan/Mortgage", which presents a full analysis of how you can save income tax through a home loan.

Stamp Duty and Registration Charges for a home: The amount you pay as stamp duty when you buy a house, and the amount you pay for the registration of the documents of the house can be claimed as deduction under section 80C in the year of purchase of the house.

National Savings Certificate (NSC): National Savings Certificate (NSC) is a 6-Yr small savings instrument eligible for section 80C tax benefit. Rate of interest is eight per cent compounded half-yearly, i.e., the effective annual rate of interest is 8.16%. If you invest Rs 1,000, it becomes Rs 1601 after six years. The interest accrued every year is liable to tax (i.e., to be included in your taxable income) but the interest is also deemed to be reinvested and thus eligible for section 80C deduction.

Infrastructure Bonds: These are also popularly called Infra Bonds. These are issued by infrastructure companies, and not the government. The amount that you invest in these bonds can also be included in Sec 80C deductions.

Pension Funds – Section 80CCC: This section – Sec 80CCC – stipulates that an investment in pension funds is eligible for deduction from your income. Section 80CCC investment limit is clubbed with the limit of Section 80C – it means that the total deduction available for 80CCC and 80C is ₹ 1 Lakh. This also means that your investment in pension funds upto ₹ 1 Lakh can be claimed as deduction u/s 80CCC. However, as mentioned earlier, the total deduction u/s 80C and 80CCC can not exceed Rs. 1 Lakh.

5-Yr bank fixed deposits (FDs): Tax-saving fixed deposits (FDs) of scheduled banks with tenure of 5 years are also entitled for section 80C deduction.

Senior Citizen Savings Scheme 2004 (SCSS): A recent addition to section 80C list, Senior Citizen Savings Scheme (SCSS) is the most lucrative scheme among all the small savings schemes but is meant only for senior citizens. Current rate of interest is 9% per annum payable quarterly. Please note that the interest is payable quarterly instead of compounded quarterly. Thus, unclaimed interest on these deposits won't earn any further interest. Interest income is chargeable to tax.

5-Yr post office time deposit (POTD) scheme: POTDs are similar to bank fixed deposits. Although available for varying time duration like one year, two year, three year and five year, only 5-Yr post-office time deposit (POTD) – which currently offers 7.5 per cent rate of interest –qualifies for tax saving under section 80C. Effective rate works out to be 7.71% per annum (p.a.) as the rate of interest is compounded quarterly but paid annually. The Interest is entirely taxable.

NABARD rural bonds: There are two types of Bonds issued by NABARD (National Bank for Agriculture and Rural Development): NABARD Rural Bonds and Bhavishya Nirman Bonds (BNB). Out of these two, only NABARD Rural Bonds qualify under section 80C.

Unit linked Insurance Plan: ULIP stands for Unit linked Saving Schemes. ULIPs cover Life insurance with benefits of equity investments. They have attracted the attention of investors and tax-savers not only because they help us save tax but they also perform well to give decent returns in the long-term.

Others: Apart form the major avenues listed above, there are some other things, like children's education expense (for which you need receipts), that can be claimed as deductions under Sec 80C.

Notes

All receipts which give rise to income are taxable unless they are specifically exempted from tax under the Act. Such exempted incomes are enumerated in section 10 of the Act. The same are summarised in the Table.

Table 11.3: Income Exempt from Tax

Section 1	Nature of Income 2	Exemption limit, if any 3
10(1)	Agricultural income	
10(2)	Share from income of HUF	
10(2A)	Share of profit from firm	
10(3)	Casual and non-recurring receipts	Winnings from races ₹ 2500/- other receipts ₹ 5000/-
10(10D)	Receipts from life Insurance Policy	
10(16)	Scholarships to meet cost of education	
10(17)	Allowances of MP and MLA.	For MLA not exceeding ₹ 600/- per month
10(17A)	Awards and rewards	
	(i) from awards by Central/State Government	
	(ii) from approved awards by others	
	(iii) Approved rewards from Central & State Governments	
10(26)	Income of Members of scheduled tribes residing in certain areas in North Eastern States or in the Ladakh region.	Only on income arising in those areas or interest on securities or dividends
10(26A)	Income of resident of Ladakh	On income arising in Ladakh or outside India
10(30)	(i) Subsidy from Tea Board under approved scheme of replantation	
10(31)	(ii) Subsidy from concerned Board under approved Scheme of replantation	
10(32)	Minor's income clubbed with individual	Upto ₹ 1,500/-
10(33)	Dividend from Indian Companies, Income from units of Unit Trust of India and Mutual Funds, and income from Venture Capital Company/fund.	
10(A)	Profit of newly established undertaking in free trade zones electronic hardware technology park on software technology park for 10 years (net beyond 10 year from 2000-01)	
10(B)	Profit of 100% export oriented undertakings manufacturing articles or things or computer software for 10 years (not beyond 10 years from 2000-01)	

Contd...

Notes

10(C)	Profit of newly established undertaking in I.I.D.C or I.G.C. in North-Eastern Region for 10 years	
Income From Interest		
10(15)(i)(iib)(iic)	Interest, premium on redemption or other payments from notified securities, bonds, Capital investment bonds, Relief bonds etc.	To the extent mentioned in notification
10(15)(iv)(h)	Income from interest payable by a Public Sector Company on notified bonds or debentures	
10(15)(iv)(i)	Interest payable by Government on deposits made by employees of Central or State Government or Public Sector Company of money due on retirement under a notified scheme	
10(15)(vi)	Interest on notified Gold Deposit bonds	
10(15)(vii)	Interest on notified bonds of local authorities	
Income from Salary		
10(5)	Leave Travel assistance/ concession	Not to exceed the amount payable by Central Government to its employees
10(5B)	Remuneration of technicians having specialised knowledge and experience in specified fields (not resident in any of the four preceding financial years) whose services commence after 31.3.93 and tax on whose remuneration is paid by the employer	Exemption in respect of income in the from of tax paid by employer for a period upto 48 months
10(7)	Allowances and perquisites by the government to citizens of India for services abroad	
10(8)	Remuneration from foreign governments for duties in India under Cooperative technical assistance programmes. Exemption is provided also in respect of any other income arising outside India provided tax on such income is payable to that Government.	
10(10)	Death-cum-retirement Gratuity-	
	(i) from Government	
	(ii) Under payment of Gratuity Act 1972	Amount as per Sub-sections (2), (3) and (4) of the Act.
	(iii) Any other	Upto one-half months salary for each year of completed service.

Contd...

Notes

10(10A)	Commutation of Pension-	
	(i) from government, statutory Corporation etc.	
	(ii) from other employers	Where gratuity is payable - value of 1/3 pension. Where gratuity is not payable - value of 1/2 pension.
	(iii) from fund set up by LIC u/s 10(23AAB)	
10(10AA)	Encashment of unutilised earned leave	
	(i) from Central or State government	
	(ii) from other employers	Upto an amount equal to 10 months salary or ₹ 1,35,360/- which ever is less
10(10B)	Retrenchment compensation	Amount u/s. 25F(b) of Industrial Dispute Act 1947 or the amount notified by the government, whichever is less.
10(10C)	Amount received on voluntary retirement or termination of service or voluntary separation under the schemes prepared as per Rule 2BA from public sector companies, statutory authorities, local authorities, Indian Institute of Technology, specified institutes of management or under any scheme of a company or Co-operative Society	Amount as per the Scheme subject to maximum of ₹ 5 lakh
10(11)	Payment under Provident Fund Act 1925 or other notified funds of Central Government	
10(12)	Payment under recognised provident funds	To the extent provided in rule 8 of Part A of Fourth Schedule
10(13)	Payment from approved Superannuation Fund	
10(13A)	House rent allowance	least of-
		(i) actual allowance
		(ii) actual rent in excess of 10% of salary
		(iii) 50% of salary in Mumbai, Chennai, Delhi and Calcutta and 40% in other places
10(14)	Prescribed [See Rule 2BB (1)] special allowances or benefits specifically granted to meet expenses wholly necessarily and exclusively incurred in the performance of duties	To the extent such expenses are actually incurred.

Contd...

Notes

10(18)	Pension including family pension of recipients of notified gallantry awards	
Exemptions to Non-citizens only		
10(6)(i)(a) and (b)	(i) passage money from employer for the employee and his family for home leave outside India	
	(ii) Passage money for the employee and his family to 'Home country' after retirement/termination of service in India.	
10(6)(ii)	Remuneration of members of diplomatic missions in India and their staff, provided the members of staff are not engaged in any business or profession or another employment in India.	
10(6)(vi)	Remuneration of employee of foreign enterprise for services rendered during his stay in India in specified circumstances provided the stay does not exceed 90 days in that previous year.	
10(6)(xi)	Remuneration of foreign Government employee on training in certain establishments in India.	
Exemptions to Non-residents only		
	Refer Chapter VII (Para 7.1.1)	
	Chapter VIII (Para 8.4)	
	Chapter IX	
	Chapter X (Para 10.4)	
Exemptions to Non-resident Indians (NRIs) only		
	Refer Chapter XI	
Exemptions to funds, institutions, etc.		
10(14A)	Public Financial Institution from exchange risk premium received from person borrowing in foreign currency if the amount of such premium is credited to a fund specified in section 10(23E)	
10(15)(iii)	Central Bank of Ceylon from interest on securities	
10(15)(v)	Securities held by Welfare Commissioners Bhopal Gas Victims, Bhopal from Interest on securities held in Reserve Bank's SGL Account No. SL/DH-048	

Contd...

Notes

10(20)	any local Authority	(a) Business income derived from Supply of water or electricity any where. Supply of other commodities or service within its own jurisdictional area.
		(b) Income from house property, other sources and capital gains.
10(20A)	Housing or other Development authorities	
10(21)	Approved Scientific Research Association	
10(23)	Notified Sports Association/ Institution for control of cricket, hockey, football, tennis or other notified games.	
10(23A)	Notified professional association/institution	All income except from house property, interest or dividends on investments and rendering of any specific services
10(23AA)	Regimental fund or Non-public fund	
10(23AAA)	Fund for welfare of employees or their dependents.	
10(23AAB)	Fund set up by LIC of India under a pension scheme	
10(23B)	Public charitable trusts or registered societies approved by Khadi or Village Industries commission	
10(23BB)	Any authority for development of khadi or village industries	
10(23BBA)	Societies for administration of public, religious or charitable trusts or endowments or of registered religious or charitable Societies.	
10(23BBB)	European Economic Community from Income from interest, dividend or capital gains	
10(23BBC)	SAARC Fund	
10(23C)	Certain funds for relief, charitable and promotional purposes, certain educational or medical institutions	
10(23D)	Notified Mutual Funds	
10(23E)	Notified Exchange Risk Administration Funds	

Contd...

Notes

10(23EA)	Notified Investors Protection Funds set up by recognised Stock Exchanges	
10(23FB)	Venture capital Fund/ company set up to raise funds for investment in venture Capital undertaking	Income from investment in venture capital undertaking
10(23G)	Infrastructure capital fund, or infrastructure capital company	Income from dividend, interest and long term capital gains from investment in approved infrastructure enterprise
10(24)	Registered Trade Unions	Income from house property and other sources
10(25)(i)	Provident Funds	Interest on securities and capital gains from transfer of such securities
10(25)(ii)	Recognised Provident Funds	
10(25)(iii)	Approved Superannuation Funds	
10(25)(iv)	Approved Gratuity Funds	
10(25)(v)	Deposit linked insurance funds	
10(25A)	Employees State Insurance Fund	
10(26B)(26BB) and (27)	Corporation or any other body set up or financed by and government for welfare of scheduled caste/ scheduled tribes/backward classes or minorities communities	
10(29)	Marketing authorities	Income from letting of godown and warehouses
10(29A)	Certain Boards such as coffee Board and others and specified Authorities	

11.9.2 Income Tax Holidays

A tax holiday is a temporary reduction or elimination of a tax. Governments usually create tax holidays as incentives for business investment. The taxes that are most commonly reduced by national and local governments are sales taxes. In developing countries, governments sometimes reduce or eliminate corporate taxes for the purpose of attracting Foreign Direct Investment or stimulating growth in selected industries.

Tax holiday is given in respect of particular activities, and sometimes also only in particular areas with a view to develop that area of business.

Tax holiday: A tax holiday is available in respect of profits derived from exports by a 100% export oriented undertaking, or an undertaking located in a free trade zone, export processing zone, special economic zone, software technology park, etc. The tax holiday is available in respect of profits derived by non-SEZ units up to years ending 31 March 2009. In the case of an

undertaking located in a special economic zone commencing activities on or after 1 April 2003, the tax incentives are available as follows:

First five years – 100%

Next two years – 50%

Last three years – 50% (to the extent amount credited to specified reserve)

In the case of new units located in a Special Economic Zone commencing activities on or after 1 April 2006, the tax incentives available are as follows:

First five years – 100%

Next two years – 50%

Last three years – 50% (to the extent amount credited to specified reserve)

Profits of Industrial undertakings: A tax holiday for a specified number of years is available in respect of either the entire or part of the profits derived by an industrial undertaking located in a backward state or district or an industrial undertaking engaged, inter alia, in any of the following activities:

1. Infrastructure facility
2. Industrial parks
3. Generation or distribution of powers
4. Power transmission
5. Renovation of existing network of power transmission
6. Gas distribution network
7. Hospitals in rural area
8. Hotels and conventions centres in specified area
9. Undertaking establishment in the north eastern state carrying on specified business
10. Undertakings deriving profits from operating and maintaining hospitals in places other than urban agglomerations.

Task Discuss the benefits of tax holidays for corporate. Make a list of different tax holidays in India.

Self Assessment

A. State True or False:

6. The securities transaction tax is applicable if equity shares or units of equity oriented mutual fund are transferred on or after October 1, 2004 in a recognized stock exchange in India.
7. Every income arising from the transfer of a capital asset being a unit of US 64 is chargeable to tax where the transfer of such assets takes place on or after April 1, 2002.

Notes

8. The amount exempt under section 10(5) is the value of any travel concession or assistance received or due to the assessee from his employer for himself and his family in connection with his proceeding on leave to any place in India.

9. Any sum received on life insurance policy (including bonus) is not chargeable to tax.

10. Only two journeys in a block of three years is exempt from tax.

B. Fill in the blanks:

11. Tax exemptions are usually meant to either reduce the tax burden or to promote some type of ..... through reducing the tax.

12. The ..... are enumerated in section 10 of the Act.

13. A tax holiday is a ..... or elimination of a tax.

14. A tax holiday is available in respect of profits derived from ..... by a 100% export oriented undertaking.

15. A new units located in a ..... can avail the100% tax benefit for first five years.

11.10 Summary

- The meaning of tax planning i.e. arrangement of one's financial and economic affairs by taking complete legitimate benefit of all deductions, exemptions, allowances and rebates so that tax liability reduces to the minimum. Tax Planning thus can be defined as an arrangement of the financial affairs within the scope of law in a manner that derives maximum benefit of the exemptions, deductions, rebates and relief and reduces tax liability to the minimal.
- As long as one is within the framework of law, one can plan financial affairs in such manner which keeps tax liability at its minimum. However, in the name of tax planning, one should not indulge in Tax Evasion, and the line between Tax Planning and Tax Avoidance is very thin, so one needs to tread carefully.
- Tax evasion is sheer non-payment of tax even when it is due to be paid in the circumstances of the case.
- Tax planning can be broadly divided into two parts: Short-term tax planning and Long-term tax planning.
- Short term tax planning is normally for a period of up to a year and it is done from year to year to achieve some particular objective. On the other hand, the long-term planning will be for a longer period and it may not pay off immediately.
- Though every income is taxable under income tax law, whether it is received in cash or in kind, whether it is capital or revenue income, but still some incomes are given exemption from tax.
- Some important incomes that are exempted from income tax include agricultural income, income of minor, family pension; leave travel commission and dividend income.

11.11 Keywords

Direct Tax: Direct taxes are collected by the government directly from the tax payer through levies such as income tax, wealth tax and interest tax.

Notes

Double Taxation: Double taxation means that many countries charge taxes on the income that has been earned inside that country without taking into consideration, the resident country of the firm or person.

Indirect Taxes: Indirect taxes are collected indirectly as a part of prices of goods and services on which these are levied.

Tax Avoidance: Tax avoidance is minimizing the incidence of tax by adjusting the affairs in such a manner that although within the four corners of the taxation laws, the advantage is taken by finding out loopholes in the laws.

Tax Evasion: Tax evasion is sheer non-payment of tax even when it is due to be paid in the circumstances of the case.

Tax Exemption: A tax exemption is an exemption from all or certain taxes of the nation in which part of the taxes that would normally be collected from an individual or an organization are instead foregone.

Tax Holiday: A tax holiday is a temporary reduction or elimination of a tax. Governments usually create tax holidays as incentives for business investment.

Tax Planning: Tax Planning thus can be defined as an arrangement of the financial affairs within the scope of law in a manner that derives maximum benefit of the exemptions, deductions, rebates and relief and reduces tax liability to the minimal.

11.12 Review Questions

1. What are the methods commonly used by tax payers to minimise tax liability? Which one will you recommend?
2. What is the difference between Tax planning and Tax evasion?
3. Can you enumerate the difference between Tax avoidance and Tax evasion?
4. What are the factors that are helpful for effective tax planning?
5. Tax planning may be effective in every area of business management. Discuss some of the important areas where tax planning may be attempted.
6. Can you summarize the objectives of Tax Planning?
7. What are the incomes from house property which is exempted from tax?
8. Explain the business expenditure which is allowed as deductions from the business income.
9. Elucidate upon any seven incomes which are exempt from tax.
10. When minors are not allowed to be employed under the Constitution of India, can a minor still have income? If yes then how? Analyze the exemption from income-tax available in the case of a minor child.
11. Elucidate upon the exemption from income-tax available in the case of dividend income received from an Indian company.
12. Define the term tax holidays. What are the different tax incentives for new units established in SEZ?

Notes

Answers: Self Assessment

1.	Indirect tax	2.	Scope of law
3.	Non-payment	4.	Unlawful
5.	Revenue	6.	True
7.	False	8.	True
9.	True	10.	False
11.	Economic activity	12.	Exempted incomes
13.	Temporary reduction	14.	Exports
15.	Special Economic Zone		

11.13 Further Readings

Books

Endres, Fuest and Spengel, *Company Taxation in the Asia-Pacific Region, India, and Russia*, Springer.

Gaur V.P., Narang D.B., Puri Rajeev, *Tax Planning (B.Com.Sambalpur).*

Notes

Unit 12: Estate Planning

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Objectives

After studying this unit, you will be able to:

- Know the need and importance of estate planning in India;
- Learn the various strategies for proper estate planning;
- Understand the significance of Will creation;
- Discuss various formats of Will creation.

Introduction

Estate planning is a very important part of personal financial planning. Writing of Will is a very important aspect of one's financial life so as to ensure that the wealth is transferred easily to the next generation. Often people take help of their financial advisors to help them make a will that can distribute their assets to their heirs in a smooth manner.

This unit will explain you the importance of making wills and powers of attorney.

12.1 Meaning of Estate

An estate is the total of all personal and real property owned by an individual. Real property is real estate and personal property is everything else such as cars, household items, shares, units, and bank accounts.

Notes

Estate planning refers to the process by which an individual or his/her family arranges the transfer of assets to the legal heirs in the event of death or disability of the individual. It includes the distribution of the real and personal property of an individual to his/her heirs.

12.2 Need of Estate Planning

As the social and family structure in India increasingly turns nuclear and the number of the affluent rises thanks to the India growth story, the need for proactive 'estate planning' is very important. Proper planning and a prudent approach are needed to safeguard your hard-earned money and every individual deserves the right to bequeath his wealth to his kith and kin, or anyone else the individual intends to.

Technically put, estate planning is a process of accumulating and disposing of an estate to maximize the goals of the estate owner. Its core objective is also to distribute wealth in a pre-determined manner to a certain beneficiary or beneficiaries to whomever the owner wishes.

One of the goals of an individual will be to protect the needs of the loved ones during lifetime and after his death. This can be achieved by way of estate planning by distributing assets among his beneficiaries. An estate plan aims to preserve the maximum amount of wealth possible for beneficiaries and flexibility for the individual prior to his death.

In India, estate planning is generally perceived to be for the rich or wealthy, who have enough cash, property or valuables to leave behind for their loved ones. The middle class can barely make ends meet, they would tell you, leave alone the lower income groups. The fact, however, is that estate planning is essential for all, regardless of one's economic standing. Run an audit on your assets and you would be surprised at its size. Most of us make the mistake of not recognizing our assets, and in turn, our final estate. Estate includes cash, property, income from property, shares, jewellery, insurance policies, provident fund, recurring and fixed deposits, among other assets.

12.3 Objectives of Estate Planning

1. ***Asset transfer to beneficiaries:*** Every individual wishes that his/her accumulated wealth should reach the hands of the beneficiary of his/her choice. Beneficiary can be his/her children, parents, friends or any other person.
2. ***Tax-effective transfer:*** To ensure least tax deduction on such transfer of wealth.
3. ***Planning incase of disabilities:*** It ensures smooth functioning of asset management within the family incase an individual gets disabled.
4. ***Time of distribution can be pre-decided:*** Individuals having minor children may wish to transfer the assets only after the children attain a certain age, to avoid misuse that may happen due to lack of maturity and discretion.
5. ***Business succession:*** Organized succession or winding up can be defined incase of an individual handling business.
6. ***Selection of trustee or guardian or the executor:*** An individual needs to be appointed to carry out the functions like:
   - (i) Distribution of assets to the beneficiaries as per the individual's wish
   - (ii) To pay testamentary and funeral expenses
   - (iii) Applying for a probate
   - (iv) Paying all the expenses and outstanding debts

Notes

(v) Ensuring all the benefits due to the deceased, such as life insurance, pension, and other benefits are received

(vi) Arranging for filing of tax returns

12.4 Steps in the Estate Planning Process

As like any other financial service, a financial planner similarly performs the following six steps in estate planning:

1. Relationship establishment
2. Information gathering
3. Determining the client's financial status
4. Draw out a plan of transfer
5. Implementing the plan
6. Regular reviewing of the plan

Figure 12.1: Process of Estate Planning

12.5 Tools of Estate Planning

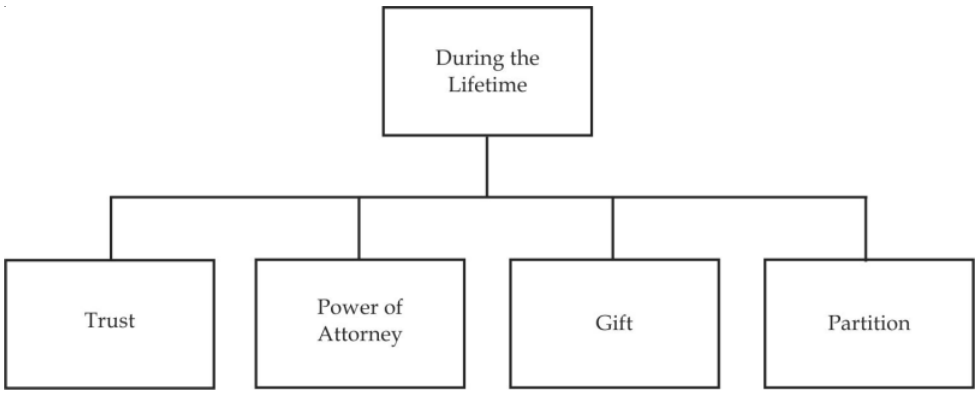
There are various tools that a financial planner can adopt for getting an estate plan in place. Some tools are effective during the lifetime of an individual while some after his/her death.

12.5.1 Tools used during the Lifetime of an Individual

Figure 12.2 shows the tools used for estate planning by transferring the assets to the beneficiary, with or without restrictions, during the lifetime of an individual.

Notes

Figure 12.2: Tools used for estate planning during the lifetime of an individual



Gifting

By implementing a gifting program, an estate owner can dramatically reduce the size of the taxable estate. If an estate owner doesn't need an asset to live on, it may make sense to give the asset away, since the recipient will likely be the person who would receive the asset at death. The advantage of gifting property while living is that the appreciation in the value and income from the gifted asset is removed from the estate. However, the estate owner who gifts property must realize that once the property is gifted, the estate owner loses all benefits and control of the property. Further, the income tax consequences (basis issues) must be also considered when gifting is contemplated.

Gift recipients can be anyone. For example, parents could conceivably give gifts to each child; grandparents could gift property to each child and grandchild. You can see the potential for large federal estate tax savings if a significant amount of property is gifted.

Trusts

A trust is used in estate planning to manage or dispose of property, either during the grantor's lifetime or after death. A trust can hold virtually any kind of property...real or personal...tangible or intangible, and can be as flexible as it needs to be to meet the estate owner's objectives.

- Distributions from a trust can be arranged in any manner the grantor desires...in amount, frequency or for whatever purpose defined by the grantor.
- Trust beneficiaries can generally be anyone or any institution named by the grantor.
- The trust can be designed so that it can be changed whenever the grantor deems necessary or it can be set up so it may not be changed or revoked.
- The trust can be established while the grantor is living or at death.
- Trusts are created for a variety of reasons:
    - Asset management - the grantor or beneficiaries of the trust may lack the expertise to manage a large portfolio of assets.
    - To benefit the grantor - the grantor can receive income from the trust and control its assets.
    - To benefit or protect others (minors, elderly, or incompetent persons) - trusts can be set up for the care of minor children or incompetent persons.

Notes

- To divide property ownership among persons and provide flexibility in use of that property.
- Federal estate or income tax purposes - trusts can contain provisions to reduce federal estate or income taxes.
- For charitable purposes.

Did u know? Trustees can generally be anyone the grantor wishes, including the grantor himself. It is not uncommon to have co-trustees. One trustee could be the grantor, or a family member, whose role is to be sure that the grantor's personal objectives are met. The other trustee could be a bank or other financial institution that would make the investment decisions on behalf of the trust beneficiaries.

Three common trusts include:

- Testamentary Trusts
- Revocable Living Trusts
- Irrevocable Trust

Globally, a lot of people are using the trust vehicle to do their estate planning. In India people want the hard work they have put in to generate wealth should be passed on to the next generation in an efficient manner.

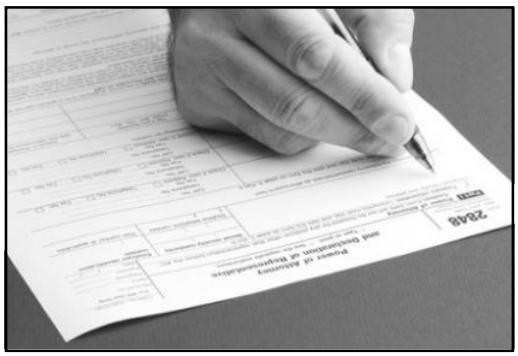
What is the difference between a trust and a will?

There are three options that a person can do today. One is not care and just don't be bothered about the next generation and the second option is to have a will. A will is very popular in India and then there is the trust.

Now, in a will there are certain disadvantages. First of all the will needs to be probated, it's a court procedure and it takes time. There are certain legal costs involved and you would require hiring lawyers. And till the time the probate is complete, the assets are frozen and the court and the public have access to the list of assets in the estate. Financial privacy lost. Once the assets are to be distributed, they are split so the beneficiaries can then do whatever they want. Sell the asset or keep it.

In the case of a trust, there is no question of probate as the ownership of the assets is passed on to the trustees. It is then no more a part of the settler's estate, and therefore the process is continuous and there are no delays.

It offers enhanced confidentiality. It is not fully confidential, but at least it is not put on the list for everyone to see. Thirdly, the trust comes into being when the settler is alive and the will when the settler is dead.



The trust is continuous; it starts the moment the settler wants it to. And the assets are not fragmented. The settler can put conditions for the beneficiaries. Say a tranche of money is disbursed when the beneficiary achieves a professional degree, another when married and so on.

Notes

Power of Attorney

A durable power of attorney allows a person you designate to access and control your financial assets. It can take effect immediately, or it can "spring" into effect if an event you define triggers its operation, such as incapacitation or unavailability.

Power of Attorney' is defined under Indian law as a legal document in which the appointer of the document authorizes someone else to act on his behalf. The rights conferred to the person depend on the specific conditions included in the format of this document, called the Power of Attorney form. Sometimes, the rights of the appointee are very limited and in some cases, the powers are very broad.

The appointee can be bestowed with several rights, such as the right to sign a contract on your behalf, the right to take your health care decisions, the right to handle your monetary transactions, the right to sell your property or any other legal right.

Indian Law: How to Issue a Power of Attorney

As per Indian law, a power of attorney is a legal document that has to be properly framed, using the right legal terminology and setting out the objectives and responsibilities that you wish to authorize the appointee to carry out on your behalf.

Caution If you want to authorize someone to act as a power of attorney on your behalf, it must be signed and notarized by a certified notary advocate, who is able to declare that you are competed at the time of signing the document to issue the said power of attorney. You will need to show your ID to the notary advocate before he/she is able to certify and issue the document.

Indian Law: Types of Power of Attorney Documents

Here are some types of power of attorney documents:

Limited Power of Attorney

A limited power of attorney gives the appointee very limited powers, to do a specific act, such as authority to sell property on the appointer's behalf.

General Power of Attorney

A general power of attorney authorizes the appointee with several rights and very broad powers, to execute any legal act on behalf of the appointer. This type of a Power of Attorney provides a list of activities that the appointer wants the appointee to perform on his behalf.

Durable Power of Attorney

A general or limited power of attorney expires in case the principal or appointer becomes incapacitated. A durable power of attorney was created to overcome this limitation. A durable power of attorney does not terminate, if the appointer becomes incapacitated. It still remains effective. However, a durable power of attorney must include specific conditions, which authorize the appointee to survive the incapacity of the appointer. Such a power of attorney comes into effect as soon as it is signed by the appointer, unless restricted by some legal condition.

Notes

Notes For a power of attorney document to be legally valid under Indian law, it must be exhaustive in its provisions, properly stamped, executed and attested by a certified notary advocate. Remember, in a court of law, if there is a dispute pertaining to the scope of the power of attorney, the interpretation of the court is always strict. Therefore, the legal document should bestow the responsibilities clearly so that the functions are specific and comprehensive.

Self Assessment

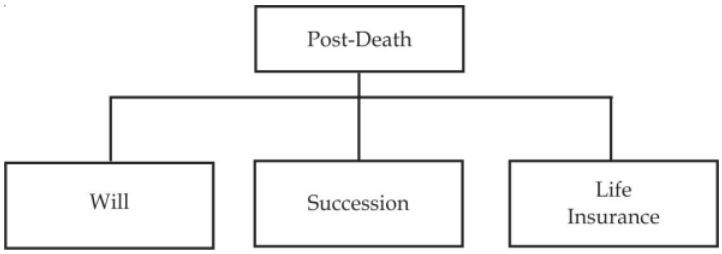
State True or False:

1. A durable power of attorney allows a person you designate to access and control your financial assets.
2. Core objective is also to distribute wealth in a pre-determined manner to a certain beneficiary or beneficiaries to whomever the owner wishes.
3. In the case of a Will, there is no question of probate as the ownership of the assets is passed on to the trustees.
4. Gift recipients can be only the family members as per Indian Law.
5. An estate is the total of all personal and real property owned by an individual.

12.5.2 Tools used after the Death of an Individual

The following Figure 12.3 shows the tools used for estate planning where the transfer of assets to the beneficiary becomes effective after the death of an individual.

Figure 12.3: Tools used for Estate Planning after the Death of an Individual



12.6 Risks and Drawbacks involved in Estate Planning

- An individual's goals or wishes on how his assets are to be distributed may not be fulfilled
- Huge costs of transfer and taxes
- An individual's family may be in financial distress if the process id not properly planned
- There may be insufficient liquidity to meet client's debts an taxes
- Time consuming legal procedures

Notes

12.7 Will

A will or testament is a legal declaration by which a person, the testator, names one or more persons to manage his/her estate and provides for the transfer of his/her property at death. For the devolution of property not disposed of by will, see inheritance and intestacy.

In the strictest sense, a "will" has historically been limited to real property while "testament" applies only to dispositions of personal property (thus giving rise to the popular title of the document as "Last Will and Testament"), though this distinction is seldom observed today. A will may also create a testamentary trust that is effective only after the death of the testator.

Requirements for a Valid Will

For a will to be legally binding a number of requirements must be met. The requirements are complex and legal advice should always be sought before making a will. The reason for this is that if the requirements are not met the will is likely to be rendered invalid, which could result in the deceased's assets being distributed other than in accordance with his or her wishes.

The requirements of a legally binding will are as follows:

1. ***Capacity:*** The testator (the person who made the will) must have been capable of making a valid will at the time when the will was made.

   To be capable of making a valid will the testator must ordinarily be aged 18 years or over, although there are certain exceptions to this rule.

   The testator must also be of sound mind, memory and understanding. Essentially, a person must know and appreciate what they are doing when they make a will.

   If a person lacks the mental capacity to make a will an application to the Court of Protection can be made under the Mental Capacity Act, 2005. However, the Mental Capacity Act, 2005 will not assist where the will has already been made by a person of unsound mind.

2. ***Intention:*** The testator must have clearly intended to dispose of his or her property, in the manner set out in the will, on his or her death. If the will has been validly executed and the testator was of sound mind when the will was made such intention will normally be assumed.

3. ***Undue Influence, force and fraud:*** If a testator is unduly influenced (coerced or pressured) or forced into making the will, a Court may set aside the will in its entirety or in part. Similarly, a Court may set aside a will or part of a will if the execution of a will was obtained by fraud or if it was forged after the person's death.

4. ***The format of the will:*** In the majority of cases they will must be in writing for it to be valid, although there are certain exceptions to this general rule. It must also be signed by or on behalf of the testator, and the signature must be made or acknowledged in the presence of 2 witnesses present at the same time.

   A will can be written in pencil or ink or can be typed. There is no legal requirement that a will should be dated, unless the will appoints a guardian of a person under the age of 18, although it is good practice to do so.

5. ***Signature:*** In the majority of cases the will must be signed by the testator, or by some other person in his or her presence and by his or her direction. Normally the testator will sign the will at the end of the will, although this has not been a legal requirement since 1982. Where a will consists of several pages, it is not necessary for the testator to sign them all, so long as all the pages are attached at the time of execution of the will.

Notes

The testator should either sign his or her will or acknowledge his or her signature in the presence of 2 or more witnesses present at the same time.

6. ***Attestation:*** The testator should either sign his or her will or acknowledge his or her signature in the presence of 2 or more witnesses present at the same time. Each witness should then either attest and sign the will or acknowledge his signature, in the presence of the testator. It is good practice to use an attestation clause for this purpose.

7. ***Alterations:*** Any alterations made in a will after it has been executed will not be valid unless the alterations have themselves been duly executed.

8. ***Revocation:*** As a general rule, a will is revoked upon the marriage of the testator or if the testator enters into a civil partnership. A will can also be revoked by a testator executing a later will or codicil or by making a written declaration declaring his or her intention to revoke the will. A will can also be revoked by a testator intentionally destroying the will. Once a will has been revoked it will no longer be valid.

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Execution and Attestation of a Will

1. The testator shall sign or shall affix his mark to the will, or some other person shall sign it in his presence and by his direction.

2. The signature or mark of the testator, or the signature of the person signing shall appear clearly and should be legible. It should appear in the manner that is appropriate and makes the will legal.

3. The will shall be attested by two or more witnesses, each of whom has seen the testator sign or affix his mark to the will or has seen other person sign the will, in the presence and by the direction of the testator, or has received from the testator.

4. Personal acknowledgement of his signature or mark, or of the signature of such other person. Each of the witnesses shall sign the will in the presence of the testator.

Source: http://www.harmonyindia.org/hportal/VirtualPageView.jsp?page_id=335 - Top

1. ***Registration of will:*** A will can be handwritten or typed and is not required to be registered, even if it relates to immovable property. Registration of a will is optional. Registration does not give any special sanctity or genuineness to the will. Even registration is not compulsory though it can be registered under the Registration Act, 1908 or deposited in the sub-registry as stated earlier.

2. ***Signature of registrar:*** The endorsement of the register is sufficient to prove the execution of the will, if all the attestators of the will are dead and if the testator affirms the contents of the will and put his thumb impression on the endorsement in the presence of the sub-registrar, the sub-registrar could also be considered to be an attesting witness.

3. ***Stamping of will:*** A will or codicil is not requires to be stamped at all.

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Revocation, Alteration, Modification and Amendment of the Will

1. ***Revocation of will:*** A will is always revocable during the lifetime of the testator, though the will is stated to be irrevocable. But it must be revoked in manner stated in section 70 of the Succession Act, "No unprivileged will or codicil nor any part thereof shall be revoked otherwise than by marriage or by another will or codicil".

Notes

(i) In case of revocation, the testator should give it in writing that he has made certain changes or has revoked the will. It must be signed by the testator and attested by two or more witnesses.

(ii) If the testator wants to revoke the will, he can do so by burning or tearing or destroying it completely. It must be done with the intention to revoke the will and mere symbolic destruction is not sufficient like cancellation etc.

(iii) There should be a clause stating that the present will is the last will of the testator and any will made prior to this would stand revoked.

(iv) The testator cannot revoke the will by just striking it off or scratching it. He must sign it and have it attested by at least two witnesses.· The essence of a will is that its revocable nature cannot be lost even by a declaration that it is irrevocable or by covenant not to revoke it.

2. ***Alteration in a will:*** While executing a will, care must be taken that there are no additions or alterations made in the will and, if made, the testator properly initiates them. Section 71 of the said act provides that no obliteration or other alteration made in any unprivileged will after execution thereof, shall have any effect except so far as the words or meaning of the will have been thereby rendered illegal or undiscernibly unless such alteration has been executed in the like manner as required for the execution of the will. This applies if the alterations are made after the will is duly executed and attested, if made before the execution, this section wont apply. It is desirable to get the alterations signed by the testator. This is a reason for which a form is prescribed by the High Court at Bombay, for the affidavit required to be made by an attesting witness in support of the petition for *probate* with the will annexed, is required to state, that the alterations or erasures made in the will were made prior or at the time of the execution of the will by the testator.

Registration of a Will

Though the registration of a will is not compulsory, it can be registered with the sub-registrar. If, at any time, the testator wishes to withdraw the will, he can do so. A will also can be sealed and kept in safe custody. This will then be released only to the testator himself or, after his death, to an authorized person who produces the death certificate. It is advisable to leave or make two copies of the will properly dated etc.

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Execution of a Will

On the death of the testator, an executor of the will or an heir of the deceased testator can apply for probate. The court will ask the other heirs of the deceased if they have any objections to the will. If there are no objections, the court will grant probate. A probate is a copy of a will, certified by the court. A probate is to be treated as conclusive evidence of the genuineness of a will.

Task Prepare a model of a Will.

In case any objections are raised by any of the heirs, a citation has to be served, calling upon them to consent. This has to be displayed prominently in the court. Thereafter, if no objection is received, the probate will be granted. It is only after this that the will comes into effect.

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Types of a Will

Notes

1. ***Privileged and Unprivileged Wills:*** Wills executed according to the provisions of section 63 of the Indian Succession Act are called Unprivileged Wills and Wills executed under section 66 of the Act, by a soldier employed in an expedition or engaged in actual warfare, or by an airman so employed or engaged, or by mariner being at sea, are called Privileged Wills. It is provided in the Act that such a Will may be written wholly by the testator with his own hands and, in such a case, it need not be signed or attested; or it may be written wholly or in part by another person, in which case, it may be signed by the testator but need not be attested. If, however, an instrument purporting to be a Will is written wholly or in part by another person and is not signed by the testator, it shall be deemed to be his Will, if it is shown that it was written by the testator's directions or was recognized by him as him Will. if, on the face of it, the instrument appears to be incomplete, it shall nevertheless, be demand to be the Will of the testator, provided the fact that it was not completed, can be attributed to some cause other than the abandonment of the testamentary intentions expressed in the instrument. Further, if such a soldier, airman or mariner has written instructions for the preparation of his Will, but has not died before it could be prepared and executed, the instructions shall be deemed to be his Will; and if such a person has, in the presence of two witnesses, given verbal instructions for the preparation of his Will, and such instructions have been reduced to writing in his lifetime, but he has died before the Will could be prepared and executed, then such instructions are to be considered to constitute his Will, although they may not have been reduced into writing in his presence, nor read over to him. It is also provided that such a soldier, airman or mariner may make a Will by word of mouth by declaring his intention before two witnesses present at the same time, but such a Will shall become null at the expiration of one month after the testator, being still alive, has ceased to be entitled to make a privileged Will.

   An unprivileged Will like Codicil can be revoked by the testator only by another Will or by some writing declaring an intention to revoke the same and executed in the manner in which an unprivileged Will can be executed under the Act or by burning, tearing or destroying of the same by the testator or by some other person in his presence and by his directions with the intention of revoking the same.

   Mere loss of a Will does not operate as a revocation but where a Will is destroyed by the testator or with his privacy or approbation, it is to be deemed to have been revoked.

   No obliteration, interlineations or other alternation made in any unprivileged Will after the execution thereof, can have any effect except so far as the words or meaning of the Will have been thereby rendered illegible or unidiscernible, unless such alteration has been executed in the same manner as is required for the execution of the Will; but a Will, as so altered, shall be deemed to be duly executed if the signature of the testator and the subscription of ht witnesses is made in the margin or some other part of the Will opposite or near to such alternation, or at the foot or end or opposite to a memorandum referring to such alteration, and written at the and or some other part of the Will.

   A privileged Will or Codicil may be revoked by the testator by an unprivileged Will or codicil, or buy any act expressing an intention to revoke it and accompanied by such formalities as would be sufficient to give validity to a privileged Will, or by the burning, tearing or otherwise destroying the same by the testator or by some person in his presence and by his direction with the intention of revoking the same. In such cases, it is not necessary that the testator should, at the it time of doing the act which has the effect of revocation of the Will or Codicil, be in a situation which entitles him to make a privileged Will.

Notes

Every Will is revoked by the marriage of the maker, except a Will made in exercise of a power of appointment, when the property over which the power of appointment is exercised, would not, in default of such appointment, pass to his or her executor or administrator, or to the person entitled in case of intestacy.

This rule as to revocation of a Will by marriage, does not, however, apply to Wills and codicils executed by Hindus, Buddhists, Sikhs or Jains.

An unprivileged Will which has once been validly revoked cannot be received otherwise than by the re – execution thereon with the prescribed formalities, or by a codicil executed with such formalities and showing an intention to revive the same. When a Will or a codicil, which has been partly revoked and afterwards wholly revoked, such revival cannot extend to so much thereof as has been revoked before the revocation of the whole thereof, unless and intention to the contrary is shown by the Will or codicil.

It has already been stated that in the case of Hindus, Buddhists, Sikhs and Jains a Will could validly be made orally and no formalities for the execution of a Will are required. This rule, however, did not apply to Wills made by Hindu, Buddhists, Sikhs or Jains, on or after the 1st of September, 1870, within the territories which were subject to the Provincial Government of Bengal or in the local limits of the ordinary civil jurisdiction of the High Courts of Judicature at Madras and Bombay, and also, to all such Wills and codicils made outside those territories or limits so far as they related to immovable property situated within these territories or limits. The execution of such Wills was previously regulated by the Hindu Wills Act (XXI of 1870). Except in the cases mentioned in that Act, oral Wills could be made by person's professing the Hindu, Buddhist, and Sikh and Jain religions. A question, however, arises whether the Indian Succession Act, 1925 has the effect of depriving such persons of the privilege of making oral Wills, or whether the provisions of section 63 of the Act do not merely provide for the formalities which must be observed, if any of such persons chooses to 'execute' a Will, i.e., chooses to reduce his testamentary dispositions to writing. It will be observed that section 63 of the Act provides for the manner of 'execution' of unprivileged Wills, it does not deal with the question of the 'making' of such Wills.

That the Act seems to make a distinction between the 'execution' and the 'making' of Wills, will appear from a comparison of the phraseology of sections 63 and 66 of the Indian Succession Act, 1925. While section 63 refers to the 'execution' of unprivileged Wills, section 63 refers to the 'execution' of unprivileged Wills, section 66 prescribes the 'mode of making' and rules for executing Privileged Wills'. A distinction, therefore, seems to be contemplate between the 'execution' and the 'making' of a Will. The former expression apparently applies to cases where the Will is to be reduced to writing, and the expression 'making of a Will' includes the execution of a Will and also an oral declaration by the testator of his testamentary disposition of his estate, if such declaration legally amounts to a Will. The matter is a debatable one, and no definite opinion, therefore, need be expressed on it at this stage.

2. ***Conditional or Contingent Wills:*** A Will may be expressed to take effect only in the event of the happening of some contingency or condition, and if the contingency does not happen or the condition fails, the Will is not be legally enforceable. Accordingly, where A executes a Will to be operative for a particular year, i.e., if he dies within that year. A lives for more years, after that years. Since A does not express an intention that the Will be subsisting even intestate. A Conditional Will is invalid if the condition imposed is invalid or contrary to law.

3. ***Joint Wills:*** A Joint Will is a testamentary instrument whereby two or more persons agree to make a conjoint Will. Where a Will is joint and is intended to take effect after the death of both, it will not be enforceable during the life– time of either. Joint Wills are revocable

Notes

at anytime by either of the testators during their joint lives, or aster the death of one, by the survivor. A Will executed by two or more testators as a single document duly executed by each testator disposing of his separate properties or his joint properties is not a single Will. It operates on the death of each and is in effect for or more Wills. On the death of each testator, the legatee would become entitled to the properties of the testator who dies.

4. ***Mutual Wills:*** A Will is mutual when two testators confer upon each other reciprocal benefits by either of them constituting the other his legatee. But when the legatees are distinct from the testators, there can be no position for Mutual Wills.

5. ***Duplicate Wills:*** A testator, for the sake of safety, may make a Will in duplicate, one to be kept by him and the other to be deposited in the safe custody with a bank or executor or trustee. If the testator mutilates or destroys the one which is in his custody it is revocation of both.

6. ***Concurrent Wills:*** Generally, a man should leave only one Will at the time of his death. However, for the sake of convenience a testator may dispose of some properties in one country by one Will and the other properties in another country by a separate will.

7. ***Sham Wills:*** If a document is deliberately executed with all due formalities purporting to be a Will, it will still be nullity if it can be shown that the testator did not intend it to have nay testamentary operation, but was to have only some collaterally object one thing must be born e in mind that the intention to make the Will is essential to the validity of a Will.

8. ***Holograph Wills:*** Such Wills are written entirely in the handwriting of the testator.

Self Assessment

Name the Following:

6. Wills that are written entirely in the handwriting of the testator.
7. A testamentary instrument whereby two or more persons agree to make a conjoint Will.
8. Wills executed according to the provisions of section 63 of the Indian Succession Act.
9. Wills that are revocable at anytime by either of the testators during their joint lives, or aster the death of one, by the survivor.
10. Wills executed according to the provisions of section 66 of the Indian Succession Act.

12.8 Summary

- Estate planning is a process of accumulating and disposing of an estate to maximise the goals of the estate owner. Its core objective is also to distribute wealth in a pre-determined manner to a certain beneficiary or beneficiaries to whomever the owner wishes.
- In India, estate planning is generally perceived to be for the rich or wealthy, who have enough cash, property or valuables to leave behind for their loved ones. The middle class can barely make ends meet, they would tell you, leave alone the lower income groups. The fact, however, is that estate planning is essential for all, regardless of one's economic standing.
- As like any other financial service, a financial planner similarly performs the following six steps in estate planning.
- There are various tools that a financial planner can adopt for getting an estate plan in place. Some tools are effective during the lifetime of an individual while some after his/her death.

Notes

- By implementing a gifting program, an estate owner can dramatically reduce the size of the taxable estate.
- A trust is used in estate planning to manage or dispose of property, either during the grantor's lifetime or after death. A trust can hold virtually any kind of property...real or personal...tangible or intangible, and can be as flexible as it needs to be to meet the estate owner's objectives.
- Power of Attorney' is defined under Indian law as a legal document in which the appointer of the document authorizes someone else to act on his behalf.
- A will or testament is a legal declaration by which a person, the testator, names one or more persons to manage his/her estate and provides for the transfer of his/her property at death.

12.9 Keywords

Gift: The distribution of assets during one's lifetime by a simple transfer.

Hindu Undivided Family: Hindu Undivided Family is a legal entity created and registered under the Hindu Act, which includes assets inherited from ancestors and the resulting income. All members have a collective right to this.

Insurance: It allows a person to leave a legacy by passing on his investment along with death benefits to the beneficiaries when he passes away.

Power of Attorney: It allows an individual to appoint a person to manage the assets on his behalf and take financial decisions if he is unable to do so.

Private Trust: Private Trust is a legal entity, which holds the title to the estate and is managed by a trustee. A trust can be created and administered while the settler is still alive.

Will: It is a legal document, which allows the testator to distribute his estate in a specified manner after his death.

12.10 Review Questions

1. What is Estate Planning?
2. What are the objectives of estate planning?
3. Explain the steps in the estate planning process.
4. List the various types of tools of estate planning.
5. What are the various tools used for estate planning during the lifetime of an individual?
6. What is the difference between a trust and a will?
7. What do you mean by Power of Attorney? What are the various types of Power of Attorney documents?
8. Enumerate the tools used for estate planning after the death of an individual.
9. Discuss the risks and drawbacks involved in estate planning.
10. Elucidate the requirements for a valid Will.
11. Explain the procedure of execution and attestation of a Will.
12. What do you mean by revocation and alteration of a will? How are they done?

Notes

13. Write short notes on following:
    (a) Privileged and Unprivileged Wills
    (b) Conditional or Contingent Wills
    (c) Joint Wills
    (d) Mutual Wills
    (e) Duplicate Wills
    (f) Concurrent Wills
    (g) Sham Wills
    (h) Holograph Wills
14. What is a will?
15. How can a person change his or her will?
16. What is a trust?

Answers: Self Assessment

1.	True	2.	True
3.	False	4.	False
5.	True	6.	Holograph Will
7.	Joint Will	8.	Unpriviliged will
9.	Joint Will	10.	Priviliged Will

12.11 Further Readings

Books

Dennis Clifford, *Estate Planning Basics*; Nolo

Goldberg G. Philip, *Estate Planning*, General Books

Notes

Unit 13: Strategies of putting together a Complete Financial Plan

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Objectives

Introduction

13.1 Strategy Development Process

13.2 Investment Decisions

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Objectives

After studying this unit, you will be able to:

- Know about the strategy development process;
- Explain the investment decisions;
- Learn about the conservative;
- Understand the asset allocation: The key to achieving higher returns.

Introduction

In the previous units you have studied various aspects relating to personal financial planning. In this unit you will learn how to devise a complete financial plan with the help of all the financial tools so that you can develop a comprehensive plan that would help in meeting your financial objectives. As you know that none of the strategies alone can secure a person's current or future financial position. The principle of comprehensive financial planning dictates that all the above strategies need to be addressed for each person.

Every person, regardless of age, will earn and spend income and, as such, will need some method of cash flow management. The retired person will have investment income and/or age pension benefit and if retiring at, say, age 60 will have an average of 16-20 years' life expectancy. The younger person will have the task of reducing liabilities such as home loans as quickly as possible along with the need to accumulate retirement capital. Simultaneously, the financial planner needs the skill to help the younger person find the right balance in their financial planning so as to enjoy life on the path to retirement.

Every person will need life insurance, income and asset protection at some stage in their financial planning strategies. In addition, the majority of people will have a need for investment planning strategy development. The strategy will also need regular review and management so as to ensure that the strategy and the investments remain appropriate for the person.

Notes

In addition, every person, no matter how young or old, has a requirement for a will in order to have the best opportunity for their assets to be passed to those whom they would wish to receive them.

Finally, many people will have a need to issue a power of attorney to a trusted family member or friend.

The comprehensive financial planning approach views the person's requirements from a holistic perspective. In this situation, the financial planner develops a range of individual strategies as the infrastructure of an all-encompassing strategy that enhances the person's whole financial position. The written comprehensive financial plan is the document that combines the individual strategies to articulate the financial planner's recommendations to the person.

13.1 Strategy Development Process

While the plan is a single, interrelated document, it is still possible to break the strategy development process into a number of steps and sub-stages.

Step 1: Check that you have all the Information

You should, first and foremost, ensure that you have all of the information required to prepare the plan.

Step 2: Secure your Current Financial Position

In developing the strategies within the comprehensive financial plan, the financial planner firstly look to securing the person's current financial position. This is achieved through a reconciliation of the person's position from the data gathered from the person on the data sheet or questionnaire.

The financial planner you hire must look to address the following questions:

- Does the person have adequate insurances (life, fixed assets, hospital/medical)? If not, what recommendations are essential to better secure the person's position?
- Does the person have a valid will?
- Does the person have a need to issue a power of attorney?
- What is the position of the person's balance sheet (assets/liabilities)? For example, are there sufficient assets to cover liabilities?
- If liabilities are high, what recommendations can be made to reduce liabilities and increase assets?
- What is the state of the person's budget (income and expenditure)?
- Is there an emergency cash reserve?
- Does the person have the capacity to accrue surplus income?

If so, how should this surplus income be accumulated to move the person closer to their short and long term financial goals?

In developing the written comprehensive financial plan, the financial planner will identify current deficiencies or problems in the person's position and then move to make recommendations to secure that position.

Notes

Step 3: Establish your Goals and Financial Concerns

During the self interview, you will have stated certain goals that they wish to achieve. These may take the form of.

- Short-term goals (such as a holiday, new car, or house deposit);
- Medium-term goals (such as saving for the children's education, mortgage reduction); and
- Long-term goals (retirement, financial independence).

However, in order for these goals to be achieved, other aspects of a person's financial situation that require addressing may be identified from analysing their current position and goals. Some examples are:

- Asset protection,
- Debt reduction in the event of death,
- Effective transfer of assets on death or disability,
- The need for an emergency account,
- Conflict between investment objectives and risk profile.

The findings from your analysis should be stated clearly alongside the goals in the comprehensive financial plan.

Step 4: Put in Place Recommendations to meet your Desired Future Financial Position

This is the step where much of your technical knowledge comes into play. Here you consider each of the major strategy options that best meets the person's financial objectives and specific personal circumstances.

Cash Flow Position and Objectives (Expenses and Income)

Expenses

Are there obvious areas where expenses may be reduced without affecting your person's lifestyle?

By examining each line of expense, you might identify other areas that you may have missed in developing the strategy. For example, the examination of medical expenses might remind you to look at the person's employee benefits position and determine whether the person is a participant in the company's group insurance.

Similarly, by looking at the taxation liability you can begin to determine if there are any simple yet effective tax strategies that you can employ These might include:

- Income splitting;
- Salary sacrifice; and
- Negative gearing.

Income

Next, you can examine the income position and while there may not be many ways of increasing income for a wage or salary earner, you should certainly ascertain if they are in receipt of all their retirement entitlements. In some respects, this may inter-link with specific investment products that you may ultimately recommend.

Notes

The investment strategy you recommend will influence the income flow, both in terms of rupee amounts and the timing of that income. Income requirements will impact on the desirable balance between growth and income in the investments chosen.

For persons approaching retirement, the income stream options such as annuities and pensions must be considered carefully, particularly in terms of their taxation implications.

On the basis of projected income and expenses, you are now in a position to establish the person's future savings capacity and put forward recommendations on how any resultant savings can be utilised (e.g., in debt reduction and in appropriate investments)

Asset Protection and Estate Planning Objectives

In Step 2 we mentioned the need to protect the person 's financial position in terms of assets, income, health (hospital /medical) and life insurance. We now need to look forward and consider that protection in the light of the person's overall financial objectives, particularly in regard to estate matters.

The first step is to determine whether or not there is adequate protection for assets and their estate planning objectives. As we know insurance is probably the most cost-effective method of providing that protection. Having stated that insurance is cost effective, one needs to be conscious of the costs of providing that cover and whether or not that cost is beneficial relative to the protection offered. You need to ensure that all tangible assets are adequately protected Make sure that home building, contents and motor vehicle insurances, for example, are in place.

Next, make sure that adequate life insurance has been provided to meet the immediate liabilities and the estate objectives of your person. Initially, this might be done through the employee's retirement fund and then through retail life insurance products.

Task Discuss with a financial planner how the strategy development process and explain it.

Investment Objectives

We now need to meet the person's short-, medium-, and long-term investment objectives.

Questions you should address include:

- What investment sector (fixed interest and cash, shares, property) allocation will enhance the opportunity to achieve the person's financial goals?
- What alternative investment strategies are available to the person and what are the relevant advantages and disadvantages of each?
- Does the recommended asset allocation align with the person's stated tolerance of investment risk?
- If not, can the financial planner justify/substantiate the deviation from the person's investment preferences?
- What is the status of investment markets and will this affect the deployment of the investment strategy?

You know how the economic climate can have a bearing on the type and class of investments recommended. We identified that some investments will perform well in certain stages of the economic cycle, while others will not. You discovered how the underlying investment class mix

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(shares, fixed interest and cash, property) will ultimately determine the long-term returns and the level of return variance. For short term investment objectives (that is, less than two years), financial planners generally make use of cash and fixed interest type investments. While returns from these types of investments are generally modest, they exhibit low volatility and there is reduced likelihood of a negative return over such a period.

Moving to medium term investment objectives, the financial planner begins to consider investments which provide growth and income. While this introduces a degree of investment volatility, it should be noted that with an investment objective of three years or more, the likely negative returns in one year will potentially be offset by positive returns in other years.

Lastly, for long term investment objectives, the competent financial planner considers the use of asset classes which provide growth. However, the financial planner should also consider the use of tax-effective investment products such as Public Provident Fund or gearing strategies to assist with achieving the person's long term investment objectives.

Self Assessment

Fill in the blanks:

1. In developing the strategies within the comprehensive financial plan, the ……..firstly look to securing the person's current financial position.
2. The ……you recommend will influence the income flow, both in terms of rupee amounts and the timing of that income.
3. …….will impact on the desirable balance between growth and income in the investments chosen.
4. The first step is to determine whether or not there is adequate protection for assets and their estate …….. .
5. The …….should also consider the use of tax-effective investment products such as Public Provident Fund or gearing strategies to assist with achieving the person's long term investment objectives.

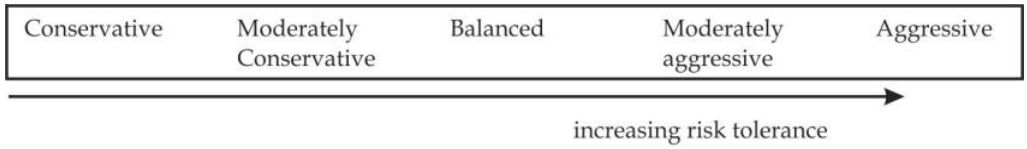
13.2 Investment Decisions

Essentially, there is a three-tier approach to investment decisions:

1. Decide on the appropriate mix of investments across the various asset sectors
2. Select the types of investments within each asset sector.
3. Select the specific investment products for recommendation to the person.

Asset Allocation Strategy

The process of determining the mix of investments in the various markets, or asset sectors, according to the person's objectives and risk profile is known as asset allocation strategy.



(use the same five categories, but with slightly different titles.)

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Whereas a conservative investment profile would see most of the funds invested in low volatility investments such as cash and fixed interest (debt), an aggressive investor would see most of the funds invested in shares and property. Furthermore, an aggressive investor may also see a high level of gearing recommended.

Over the history of financial planning, some financial planners have developed categories of person investment risk tolerances and have identified appropriate underlying asset mixes for each category of person. These categories form a spectrum from 'conservative' to 'aggressive'.

However, as we stated earlier the principle of diversification should be followed — personal circumstances, economic conditions and legislation can (and almost certainly will) change. It is therefore inappropriate to place all the person's funds in what might be considered the most appropriate asset sector for the person. Reducing investment risk through diversification is an important guiding rule.

Also, as we noted in a previous topic, as persons move through life, their attitude to investments (and the inherent risks involved) can change. This can sometimes develop through increased awareness and understanding of the various investment markets and their particular characteristics. Such knowledge and awareness may see the person acquire a greater level of comfort with investing generally. The planner may well find that they are instrumental in the development of that increased awareness and knowledge. However, the point remains — a person's risk profile may also change over time.

Matching Strategies to Asset Sectors

The following table may be of assistance in guiding a novice financial planner when considering asset allocation. The table indicates the relationship between strategies and asset sectors.

Table 13.1: Matching Strategies to Asset Sectors

Strategies	Cash	Equity	Debt	Property
Income	1	2	1	2
Capital growth	nil	1	3	2
Dividend imputation	3	1	3	3
Medium to long term	3	1	2	2
Short to medium term	2	2	2	2
Risk averse	1	3	2	2
Key				
1: Very good				.
2: Fair				
3: Poor				

Portfolio Guidelines

The benchmark guidelines provide a range within which a current asset allocation should be structured. The ranges are provided to take account of shorter-term outlooks for investment markets as well as to accommodate the particular circumstances of individual persons.

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Notes It is widely regarded that five benchmark portfolios should satisfy the investment needs of most persons. Wealth managers have been known to develop even up to sixty 'model' portfolios for their persons.

The current asset allocation is a long term strategic allocation across various asset classes based on historical returns and the outlook for those assets over at least a five year time horizon.

The benchmark portfolios are constructed to satisfy the needs of persons with differing attitudes to risk and reward and differing income requirements. The basic attributes of each benchmark portfolio are summarised as follows:

Table 13.2

Portfolio	Cash	Fixed interest (debt)	Shares	Property
Conservative Current	25	65	10	
Benchmark	20-30	40-75	5-20	
Conservative Balanced Current	20	60	20	
Benchmark	15-25	35-70	15-30	
Balanced Current	10	45	45	
Benchmark	5-15	10-50	40-60	
Growth Current	10	25	50	15
Benchmark	5-20	10-30	40-75	10-30
Aggressive Growth Current	5	5	70	20
Benchmark	0-20	0-15	45-85	10-30

Notes The above table originally included investments in international debt and shares, which we have not considered. Keeping in mind Indian conditions, property is not considered in the first three portfolios as there are no property management trust products in India.

Conservative

The portfolio aims to produce a high level of secure income with a strong emphasis on preservation of capital. The possibility of a negative total return over a one year period is low, although it may occur in a time of severe market downturns in more than one asset class. Capital growth on this portfolio is expected to be very modest over the medium to long term.

Conservative Balanced

This portfolio has a strong focus on secure income. There is also the expectation of a modest level of capital growth over the medium to long term. The income stream is relatively stable and provides some growth with its exposure to shares. The possibility of a negative total return

is relatively low, although it may occur in times of severe market downturns in more than one asset class.

Balanced

This portfolio provides a balanced exposure to a range of asset classes and aims to produce an appropriate mix of both income and capital growth over the medium to long term. Investors must be prepared to accept moderate fluctuations in the value of the portfolio with negative total returns likely to occur, on average, at least once every 10 years. The income from this portfolio should be reasonably high because of its exposure to shares.

Growth

This portfolio has an emphasis on growth in asset value rather than producing income for expenditure requirements. The relatively high exposure to shares and property will mean frequent fluctuations in the value of the portfolio with negative total returns likely to occur, on average, at least once every five to seven years.

Aggressive Growth

This portfolio aims to maximise total returns over a period of more than five years, preferably closer to 10 years. It has a high exposure to growth assets such as shares and property and it will experience considerable fluctuations in capital value in response to changes in market conditions. Investors must be prepared to accept these market fluctuations as the price which has to be paid for superior long-term returns.

The portfolio is likely, on average, to produce negative total returns at least once every five years.

Selecting Investment Types

Once the financial planner has decided on the most appropriate balance of investments across the various asset sectors, the next decision is to select the types of investments within each asset sector. In matching a type of investment with a person, the following variables we have discussed at various points throughout previous topics should be considered. These variables are:

1. ***Growth:*** What opportunity is there to achieve capital growth? How is it achieved? Historically, what levels of growth have been achieved?
2. ***Income:*** Is this an income-only investment or is there opportunity for income and growth? When is the income paid and how much can be expected?
3. ***Taxation:*** What are the taxation consequences with regard to capital gains, income tax, commuted pension, property income, tax-deferred or tax-free income?
4. ***Risk:*** How volatile is this investment type in the short, medium and long term?
5. ***Liquidity:*** How easily could the investment be turned into cash? How is this done?
6. ***Manageability:*** Will this type of investment require infrequent or regular monitoring and review? How can this be done? Are there switching options?
7. ***Asset allocation:*** Where does this investment type have its funds placed -— cash, fixed interest, shares, property? What are the minimum and maximum levels of exposure?
8. ***Costs:*** What costs are associated with the investment — entry/exit fees, management fees, trustees, administration costs, commissions?

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Selecting Specific Investment Products

Having decided on asset allocation and selected the investment types, the next step in the process is to nominate specific investment products for the person. There is a requirement to thoroughly understand the operation of the various investment products available and how they will affect a person's financial well-being.

As we know the methods of investment fall basically into two categories:

1. Direct investment such as investment into bank accounts, term deposits, and direct shareholdings.
2. Indirect investment through professional fund managers.

There are many advantages and disadvantages associated with both methods of investment. In summary, however, a person who has limited financial knowledge, a limited amount of funds to invest and a desire to have minimal direct control is probably better suited to using managed (indirect) investment products.

The main disadvantage of managed investment products relates to fees and charges compared to direct investment. However, this aspect varies with the amount of investment capital that is being used.

Once again, the products recommended should be based on proper qualitative and quantitative research. There are many providers of research and this form of independent analysis will assist in substantiating specific investment recommendations to the person.

In selecting investment products to make up the person's portfolio, consider the following four principles:

1. Quantify the risks, returns and time frame of the specific investment products.
2. Select in the portfolio some products that will provide immediate access to cash if an unforeseen financial emergency occurs.
3. Apply the principle of risk spreading amongst all asset classes.
4. Devise the appropriate terms for individual investment products to meet the person's liquidity requirements.

At this stage in your course, we don't expect you to have an in-depth knowledge of the vast number and diversity of investment products available on the market. However, you should establish professional practices that will help you gather, collate, store and analyse this product information.

Bringing Strategies together in the Written Financial Plan

The competent financial planner will take the information gained from the initial person meeting and data collection form to develop strategies and recommendations that are agriculture a written plan. The written plan, by necessity, must clearly substantiate the rationale for the recommendations. The plan must be written in such a way that the person will be able to fully understand the advice.

The benefits of using financial planning software should not be underestimated. These packages are useful in developing models and assessing the merits of various strategies. However, one should not forget that they are essentially mathematical tools and are provided to determine the potential outcomes of proposed strategies. Financial planning software, in isolation, should not be viewed as a tool for the creation of a financial plan.

If software is being used to assist in writing up the plan, be sure that the recommendations made absolutely support the person's specific needs, objectives and goals, and that the report as a whole is customised to the person. This will help avoid a sameness about all the plans you prepare.

Asset Allocation: The Key to Achieving Higher Returns

Many investors still believe that they can effectively 'beat the market' and earn a higher rate of return on their investments by picking individual assets that will outperform the overall market. This is not the factual position as the harsh reality of today's markets is that the rapid dissemination of investment information has led to a situation that no one investor knows more than the rest of the market.

The only way to boost return is by achieving better asset allocation.

Asset Allocation Theory Boosts Returns by Spreading Investment Risks

This strategy focuses on an investment portfolio technique that aims to balance risk and create diversification by dividing assets among major categories such as cash, bonds, stocks, real estate and derivatives. Each asset class has different levels of return and risk, so each will behave differently over time. For instance, while one asset category increases in value, another may be decreasing or not increasing as much. Some critics see this balance as a settlement for mediocrity, but for most investors it's the best protection against major loss should things ever go amiss in one investment class or sub-class.

The consensus among most financial professionals is that asset allocation is one of the most important decisions that investors make. In other words, your selection of stocks or bonds is secondary to the way you allocate your assets to high and low-risk stocks, to short and long-term bonds, and to cash on the sidelines.

However, taking action on asset allocation too frequently, say weekly or even monthly, may result in sacrificing returns as you move out from the outperforming asset class to the under-performing asset class. An appropriate balance needs to be achieved here.

We must emphasize that there is no simple formula that can find the right asset allocation for every individual – if there were, we certainly wouldn't be able to explain it in one article. We can, however, outline the below risk return trade off, that we feel is most important when determining the asset allocation:

The key to this investment strategy is to maximize the level of diversity within the entire portfolio by spreading the investments across all major asset classes, and then to ensure diversification in terms of how these securities react in a given set of circumstances.

Task Give an example to explain how the investments strategy and plan will work and benefit to investor.

Importance of Asset Allocation

Asset Allocation is a personal planning tool that helps assure that an investment portfolio is tuned into the goals, objectives, and relevant time frames of each individual investor. While this process can be performed on any portfolio with two or more assets, it is most commonly

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applied to asset classes. This allocation is probably the most important decision and may account for more than 80 % of the return on the portfolio. Allocate, Diversify and Rebalance. An asset allocation plan will guide how you spread investments among broad asset categories to balance risk and reward in your portfolio. There's no single plan that's right for everyone. To create the best plan for you, you'll need to consider: the time frame for investment; your investment objective and your risk appetite. Hence, though equities are giving stellar returns at present, some exposure to debt is still necessary.

13.3 Implementing the Personal Financial Plan

The next step is to implement the plan. The implementation process requires an action plan, which lays out the specific actions to be taken, by whom, and when. The FPSB Rules of Professional Conduct specifies:

Rule 708

A financial planning practitioner shall make and/or implement only recommendations that are suitable for the person and all agreed recommendations must be implemented in an accurate, efficient and timely manner.

Irrespective of whether the person agrees to proceed with the plan or chooses not to accept the advice, there are also internal administrative procedures that need to be followed. This section explores these aspects!

Action Plan

The written financial plan should, where appropriate, include an action plan which may, for example, be presented as follows:

The following steps need to be auctioned in order to implement your financial plan:

1. You need to sign the enclosed Letter of Engagement and Authority to Proceed that set out the basis of your request to engage the concerned person as your financial planners and request that them attend to the matters specified.
2. Sushmita to sign the withdrawal request to withdraw the friendly chit fund with subsequent deposit to your joint bank account.
3. Sushmita to sign the applications for investment into the equity mutual fund investments as per the recommendations.
4. Draw cheques for the recommended investments. .
5. Arrange an appointment to meet with ABC Insurance to increase your home and contents insurance. We would be happy to assist with arranging this appointment as required.
6. Meet with our insurance planning specialist/XYZ Risk Insurance to arrange an application to increase Sumit's life insurance by ₹ 2,300,000 and to arrange applications for income protection insurance for you both.
7. Arrange an appointment with your solicitor to write your wills and to discuss the issue of powers of attorney.
8. Draw a cheque for payment of our professional fees.

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Co-ordination with Other Professionals

The above action list details advice or service required from other professionals. These specialists are the general insurance consultant/broker, the life insurance and income protection insurance adviser and the solicitor.

Unless you have received written authorisation from the person(s) to discuss their situation with the other professionals, you should not discuss any aspect of the person's situation. Indeed, some may view disclosure of the person's name to another party as a breach of privacy and so you should only move to discuss a person's situation with another professional upon receipt of written authorisation from the person(s).

Once you have received written authority from the person, you may then telephone or write to the other professional seeking to arrange appointments for the person(s) with the other professional(s). Professional protocol dictates that formal correspondence should introduce the person(s) to the other adviser/professional such as below:

Dear Mr./Mrs……

We write to introduce Mr. and Mrs. Person for whom we act as financial planners.

Mr. and Mrs. Person heme instructed us to liase with you in relation to their need for…..advice.

In our analysis of Mr. and Mrs. Person's situation, we believe that they are in need of insurance/ legal advice as follows:

If you require further information in relation to Mr. and Mrs. Person's requirements, please telephone us.

Yours sincerely

Internal Implementation Procedures

When the person has either accepted the financial planner's recommendations, or alternatively chosen not to accept the advice, the person's records need to be transferred to the practice's central administration.

For the person who is proceeding to accept the advice, this may simply mean that the file, both paper and computer, continue in their existing formats and location within the practice. For large financial planning firms, there may be centralised administration systems maintain all paper and computer file records for each person. Such firms have their own processes with which the financial planner must comply in order to maintain accurate and com-plete person data. The smaller financial planner may have a personal assistant/secretary who will initiate and maintain paper and computer files for each person.

Whereas for the 'person' who has chosen not to accept the advice and therefore chosen not to become a person, both the paper and computer file should be transferred to a 'not proceeded with' filing category. In this situation, it remains vital that the financial planner/firm retain all such records generated to date as a means of verifying or substantiating advice if legal action should ever arise against the planner/firm in the future. While record keeping from a legal defence perspective is important, it may also be that the 'person' chooses not to become a person at the time of the plan preparation, but may choose to seek further advice or act on the advice with the planner/firm at a later date. As such, it is simply a process of resurrecting the file, both paper and computer, to provide service again to this person.

While methods of file/record keeping will vary from firm to firm, it is essential that whichever system is adopted by a firm, it should be used consistently across the firm by all practitioners and staff.

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'Best Practice' Record Keeping

Throughout this introductory unit we have emphasised that a vital ingredient in conducting a successful financial planning practice' is the need to maintain accurate and complete records of all aspects of your dealings with a person.

A financial planner has two main methods of file/record keeping. These are the 'paper' file and the computer file and both methods are essential these days.

Paper Files

The paper file is the one which is on hand and at ready disposal when meeting with the person. Some financial planners maintain just a single file for each person while others operate two paper files.

The single-paper file approach sees the file constructed along the following chronological lines:

- File notes of first meeting;
- Person questionnaire/data sheet;
- Photocopies of person's investments, insurances, wills and so on;
- Worksheets on plan preparation;
- Copy of final written plan;
- File notes and other material arising from plan presentation meeting;
- File notes and correspond once/material arising from any third meeting to answer person's questions about the plan;
- Copies of all investment applications and cheques drawn;
- Copies of all new investment acknowledgements/certificates/policies;
- A running record or data sheet of all investments that shows:
    - Name of investment;
    - Date made;
    - Whose name it is held in;
    - Number of units purchased;
    - Investor/policy number;
- Copies of all outward correspondence;
- Copies of all facsimiles and emails to/from the person;
- Originals of all inward correspondence relating to the person;
- Copies of all portfolio review reports and file notes from such meetings; and
- Copies of all file notes made from any person contact, i.e. in person or telephone.

The two-paper file approach sees a separate file for:

- File notes;
- Person questionnaire/data sheet;

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- Copy of financial plan;
- Inward and outward correspondence;
- Review reports and file notes; and
- A separate file maintained for investment record keeping; this file sees a separate section for each investment that records all transaction details for the investment.

All files should be codified so as to assist with easy retrieval from the filing facilities in the office. In this regard, there is a significant range of commercial filing systems and coding available.

Computer Files

Computer file record keeping begins with a database of person information as follows:

- Names, addresses, telephone numbers;
- Date(s) of birth; and
- Investments (including all of the above investment details).

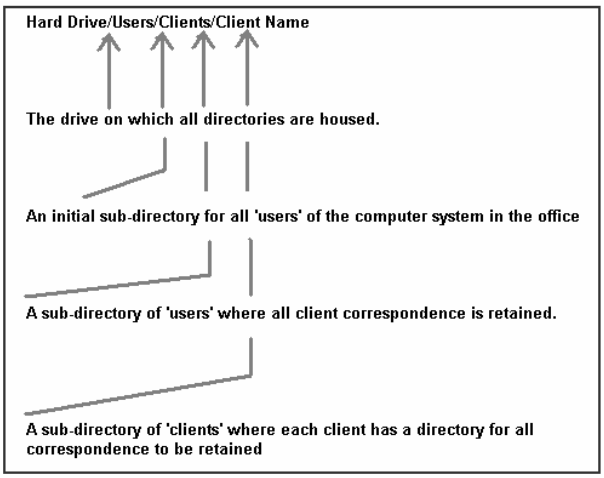
Additional computer records maintain details of the initial financial calculations/projections as well as the ongoing portfolio review/management records.

In the office of the vast majority of professional services, written correspondence is prepared on word processing software. As such, all such correspondence should be maintained on computer file.

Personal computer systems base record keeping on a 'directory' structure. One example of how to structure a directory for a financial planning practice is as follows:

Figure 13.1: Directory Structure

Under Microsoft Word ®, the 'path' of a letter written to persons Sumit and Sushmita Citizen on June 30,2000 would be as follows:



i/users/persons/citizen/letter June 30, 2000.doc

Irrespective of how that information is structured, it should facilitate any future FPSB audit.

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Self Assessment

State True or False:

6. The benchmark portfolios are constructed to satisfy the needs of persons with differing attitudes to risk and reward and differing income requirements.
7. Growth portfolio provides a balanced exposure to a range of asset classes and aims to produce an appropriate mix of both income and capital growth over the medium to long term.
8. Balanced portfolio has an emphasis on growth in asset value rather than producing income for expenditure requirements.
9. Aggressive growth portfolio aims to maximise total returns over a period of more than five years, preferably closer to 10 years.
10. Asset Allocation is a personal planning tool that helps assure that an investment portfolio is tuned into the goals, objectives, and relevant time frames of each individual investor.
11. A financial planner has two main methods of file/record keeping.

13.4 Summary

- We have stressed the importance of the written plan for the person, financial planner, and licensee. Framing the recommendations in writing meets your compliance obligations under the FPSB Code, and best serves the person.
- Whilst the format of written plans may vary, there are core elements that must be included for compliance reasons (such as disclosure of interests).
- Of paramount importance is that the document be structured and presented in such a way to facilitate person understanding of the recommendations and the reasons for them, the total costs of implementing those recommendations, and any limitations or other material matters relevant to the advice given.
- Examples of best practice in plan presentation, letters/forms and record keeping have been presented, and it would be instructive on your part to evaluate your own organisation's practices in these areas.

13.5 Keywords

Aggressive growth: This portfolio aims to maximise total returns over a period of more than five years, preferably closer to 10 years.

Asset Allocation: Asset Allocation is a personal planning tool that helps assure that an investment portfolio is tuned into the goals, objectives, and relevant time frames of each individual investor.

Balanced: This portfolio provides a balanced exposure to a range of asset classes and aims to produce an appropriate mix of both income and capital growth over the medium to long-term.

Benchmark Portfolios: The benchmark portfolios are constructed to satisfy the needs of persons with differing attitudes to risk and reward and differing income requirements.

Conservative Balanced: This portfolio has a strong focus on secure income. There is also the expectation of a modest level of capital growth over the medium to long term.

Growth: This portfolio has an emphasis on growth in asset value rather than producing income for expenditure requirements.

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13.6 Review Questions

1. Discuss the strategy development process and explain with the help of an example.
2. Describe the Implementation of the Personal Financial Plan.
3. Explain the Asset allocation theory boosts returns by spreading investment risks.
4. Describe the specific investment products.
5. Discuss the Investment decisions.

Answers: Self Assessment

1.	financial planner	2.	investment strategy
3.	Income requirements	4.	planning objectives.
5.	financial planner	6.	True
7.	False	8.	False
9.	True	10.	True
11.	True		

13.7 Further Readings

Books

Brian Anderton, 1995, *Current Issues in Financial Services*, Macmillan Press: London.

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Unit 14: Regulatory Environment

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Objectives

After studying this unit, you will be able to:

- Know about various types of regulators in Indian Financial Market;
- Understand the role and functions of various government regulators such as SEBI, IRDA and RBI;
- Learn about the various ethical issues involved in financial planning.

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Introduction

At the centre of any economy, it is the process of financial intermediation and disintermediation that helps the economy to grow and function smoothly. For instance, the credit creation function of banking institutions allows the economy to expand more than what it could do without banking institutions. Financial services industry not only channels savings into productive investments, it also helps the economic activities to take place without much difficulties. For example, the cheque facility and clearing service provided by the banks help several million people to perform economic activities. Similarly, stock brokers help investors to sell and buy shares which is critical for development of financial services and financial markets. Insurance companies give protection against the risk of many unknown events like fire, flood etc., that affect the business and allow the firms to perform their activities with confidence. The financial services have thus become indispensable in running the economy. Such an important system faces two problems – cheating an instability. During the stock market scams, many investors were cheated. Recently, internet bubble attracted several investors, who lost their wealth. While such losses are partially on account of investors overvaluing the securities, it is also on account of many firms providing misleading information. Financial markets are also highly volatile and show instability in that process. In view of its importance in the economy, this sector is governed by strict regulations. Though regulations per se may not remove cheating and reduce volatility, it would certainly help to reduce its occurrence and minimize the length of volatile period.

14.1 Financial System, Markets and Services

A financial service cannot generally be tested at the time of purchase since there is a time-lag between the purchase of service and its actual effect. For example, when you buy a share through a member of stock exchange, the service completes only at the time of physical delivery of shares. Similarly, when you buy units of mutual fund and take its expert service of investment, the results of this service is known only in the future. In case of dealings in cheques, the service concludes only when the cheque amount is credited or debited in your account but the time-lag is short. The need for regulation stems from the problems of failure of the firms which provide financial services in the meantime and thus causing hardship to the purchaser. Since financial system is closely integrated and inter-linked, failure of one firm often affects other firms and thus the entire financial system is affected. Further, in a competitive market for borrowing and lending where the spread is thin, financial services firms often take high risk to maximize the return and thus are more susceptible to default. There are several other events that can imperil the interest of investors and others who avail the services. The list includes fraud, misfeasance and collapse of an institution due to mismanagement. Regulations are thus in place to safeguard the interests of the participants of the system and prevent economic instability. The second aspect assumes more relevance recently after several East-Asian economies have suffered due to the failure of the financial system.

14.2 Types of Regulations

The regulatory framework relating to financial services can be broadly classified into three main types. One set of regulations determine the types of activities that different forms of institution are permitted to engage in. These regulations can be called as ***structural regulations***. For example, the ***Securities and Exchange Board of India (SEBI)*** insists that merchant bankers and stock broking institutions, to separate all their fund-based activities. Similarly, the ***Reserve Bank of India (RBI)*** has prescribed the activities that commercial banks can provide to the investors. Structural regulation thus involves demarcation lines between the activities of financial institutions but many of them have in fact been eroding in recent years. Banks are now providing

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various services like leasing, term loan, credit cards, etc., in addition to their traditional service of working capital lending. The rationale behind expanding the activities that can be provided by the financial service companies is the desire of regulatory authorities to create greater competition.

Exhibit 14.1: Different Levels of Regulation on Financial Services

Level I Government of India

Appellate Authority and Regulator in certain cases

Level II Legislation passed in the Parliament

Banking Regulation Act, SCRA, Insurance Act

Indian Trust Act, etc.

Level III Institutions under an Act of Parliament

UTI Act, LIC Act, GIC Act, etc.

Level IV Regulators

RBI, SEBI, IRA, Forward Market Commission

Level V Regulations given by the Regulators

RBI Directions to Commercial Banks,

NBFCs Directions issued by the RBI,

SEBI Regulations, Guidelines, Notification, etc.

Level VI Self-Regulation

By-laws, Rules and Regulations and Code of Conduct issued by the various Financial Service Industry Associations.

There are regulations that cover the internal management of financial institutions and other financial service organizations in relation to capital adequacy, liquidity and solvency. The SEBI for instance has prescribed minimum net worth requirement for various financial service firms that come under its jurisdiction. The objective of these regulation is to restrict the firms without adequate resources from entering into this field. Recently, the RBI has regulated the non-banking finance companies in raising public deposits. These regulations are known as ***prudential regulations*** as they aim to evolve certain prudential norms for the operation of the industry.

There are number of ***investor protection regulations***. All regulatory agencies in the financial sector claim that the primary objective of the agency is to protect the interest of investors. It is generally perceived that investors are the weakest participants of the financial markets and hence need protection from malpractice, fraud and collapse. The information asymmetry between the investors and financial intermediary or institution affects the investors and thus regulatory agencies step-in to protect the interest of the investors. Thus, investor protection regulations are often in the nature of demanding larger disclosure of information.

The regulations can also be classified on their scope. There are regulation which deal **Regulatory Framework** with the macro aspects of the system. For example, legislation enacted in the parliament like Banking Regulation Act, Securities Contracts Regulation Act, etc., deal with the macro aspects of respective institutions. The regulatory authorities under the legislation evolve rules, guidelines and regulations that govern the micro aspects and operational issues. In addition to the regulations passed under formal statue and regulators, there are self-regulations from the

industry association. For example, the foreign exchange dealers have their own self-regulation in addition to several other statues and guidelines that govern their activities. Similarly, the merchant bankers association is developing self-regulation that will govern their members in addition to SEBI regulation. In the US and other developed markets, there are associations for financial analysts which admit the members after they pass examination and evolve code of conducts when they desire to practice as financial analyst.

The regulations in general aim to ensure the soundness and safety of financial institutions, maintain the integrity of the transmission mechanism and protection of the consumers of financial services. The regulations also ensure freedom of operation to improve the efficiency and provide adequate scope for innovation that benefit the investors and other participants. The success of the regulation thus not only depends on its ability to ensure investors protection but is also determined by the level of advancement and sophistication the system has achieved. In other words, regulation should not block the development of financial service industry.

Tasks

1. State the broad objectives of regulation relating to financial services.
2. Give a few examples of prudential regulations relating to stock broking service.
3. Why do we need regulators when there are comprehensive legislation covering different financial services?

14.3 Regulations on Banking and Financing Services

Financial intermediaries mobilize savings and allocate (lend) capital to different users. Savings and capital allocation are two important activities of the economy and they together determine the growth of the economy. Often, these two are used to change the direction of the economy to achieve desired results. The Governments all over the world frame the polices relating to savings and capital allocation but entrust the responsibility of monitoring them to the central bank. In India, the Reserve Bank of India, as the central bank of the country, is the nerve centre of the Indian financial system. It regulates all institutions that are connected with savings and capital allocation. By regulation, it does not mean that RBI determines the savings rate or the capital allocation ratios to different sectors or firms in the economy. While in a closed economy, these are determined by the government whereas in a free-market economy to which India is slowly moving, these are by and large determined by the market forces. The role of RBI is to frame regulations that help the orderly functioning of the institutions that raise and lend the capital. Commercial banks and non-banking financial institutions are two major set of institutions that come under the regulation of RBI.

14.3.1 Banking Institutions

In order to develop a sound banking system in the country, the RBI regulates the commercial banking institutions in the following ways:

(a) It is the licensing authority to sanction the establishment of new bank or new branch;

(b) It prescribes the minimum capital, reserves and use of profits and reserves, distribution of dividends, maintenance of minimum cash reserves and other liquid assets;

(c) It has the authority to inspect or conduct investigation on the working of the banks; and

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(d) It has the power to control the appointment of Chairman and Chief Executive Officer of the private banks and nominate members in the Board of Directors.

The central bank also effectively regulates the credit flows through monetary policy. It controls the amount available for credit by prescribing cash reserve ratio and statutory liquidity ratio. It also takes away cash through treasury operations by periodically issuing bonds and REPOS. It also intervenes the credit flows by prescribing limits of credit availability to different sectors and industries or increase the bank rate to make credit unattractive. The list of techniques used to control the credit flows are (a) Open Market Operations, (b) Bank Rate, (c) Discretionary control of Refinance and Rediscounting, (d) Direct Regulation of Interest Rate on Commercial Banks Deposits and Loans (the RBI has recently allowed the banks to determine the rates on their own), (e) Cash Reserve Ratio, (f) Statutory Liquidity Ratio, (g) Direct Credit Allocation and Credit Rationing, (h) Selective Credit Controls and (i) Moral Suasion.

The RBI also regulates factoring, bill discounting and credit card services offered by the commercial banks and other institutions. The Banking Regulation Act, 1949 also regulates the activities of commercial banks. The Act was passed in 1949 to consolidate and amend the laws relating to banking companies. The Act, as amended up-to-date, is a comprehensive piece of legislation aimed at the development of sound and balanced growth of banking business in the country. It has extensively enlarged the control of RBI over the entire industry. Right from the definition of the word *banking*, its licensing, functioning, capital and reserve requirements, banking operations and management structure, liquidity provisions and profit distribution and bank inspection down to the take-overs and amalgamation of the banks and their liquidation have all been extensively covered under the Act.

14.3.2 Non-banking Financial Companies

The non-banking financial companies (NBFC) has recorded marked growth in recent years. The Khanna committee had estimated the total deposits of NBFCs at the end of March 94 at ₹ 56,559 crore and constituted 17.4 per cent of the total deposits held by the banks. There are different types of NBFCs. The list includes loan companies, investment companies, hire-purchase finance companies, equipment leasing companies, mutual benefit finance companies and housing finance companies. The mushroom growth of these institutions has also caused many unhealthy developments in this segment of the financial system. Realising the importance of these institutions, the government instead of curbing the growth of the institutions has brought regulations to ensure some discipline while discharging their functions. The Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to regulate the NBFCs.

The RBI which derives powers under the Act regulates the NBFCs as follows:

(a) It requires the NBFCs of certain categories to register with it and provide periodical statements on their working;

(b) It prescribes the types of companies which are eligible to raise funds from public and its members;

(c) It also prescribes the extent to which the funds could be raised and the terms and condition thereof;

(d) NBFCs are also required to invest certain percentage of the deposits in the approved securities and maintain reserve fund.

(e) It also has the powers to determine policy and give directions relating to deployment of funds and capital adequacy norms, accounting standards, provision for bad and doubtful debts, etc.

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(f) It also collects periodic reports and has the powers to collect information on any aspects relating to the functioning of the NBFCs, conduct inspection of the books of NBFCs and investigate on any aspects relating to the activities of the NBFCs.

(g) Finally, it has the powers to punish the erring NBFCs either imposing penalties or suspending or cancelling the license or registration and initiate appropriate actions against the management of NBFCs.

The RBI has issued three major directions to regulate different forms of non-banking financial companies and other financial institutions. They are:

(a) Non-banking Finance Companies Directions, 1977;

(b) Miscellaneous Non-Banking Finance Companies Directions, 1977; and

(c) Residuary Non-Banking Companies Directions, 1987.

The mushroom growth of non-banking financial companies' causes hardship in regulating these companies in an effective manner since the infrastructure requirement is so high that RBI is presently lacking. In order to overcome the difficulties in implementing the regulation, RBI has recently taken a number of measures especially after the failure of many such companies in meeting the deposit holders liabilities. The compulsory registration, capital adequacy norm and mandatory credit rating are some of the recent measures aimed to restrict the growth of such companies which raise funds from the public.

In addition to the regulation prescribed by the RBI, there are several Acts and regulations that govern different types of non-banking financial companies. For example, leasing companies have to take into account the provisions of Indian Contract Act, Motor Vehicles Act, Indian Stamp Act, etc. Similarly, hire-purchase transactions are governed by the Indian Contract Act, Sale of Goods Act and Hire- Purchase Act. Though the Hire-Purchase Act is yet to be enforced, in the absence of any specific law on hire-purchase transactions, the provisions of the Act can be followed as guideline particularly, where no provisions exist in the general laws. The National Housing Bank (NHB) is empowered under the provisions of the NHB Act, 1987 to regulate the housing finance companies. The SEBI also regulates all these companies whenever they approach the market to raise capital.

Self Assessment

Fill in the blanks:

1. ……regulations are often in the nature of demanding larger disclosure of information.
2. Savings and ……..are two important activities of the economy.
3. The Banking Regulation Act, 1949 also regulates the activities of……...
4. ……Act, 1963 was introduced to regulate the NBFCs.
5. The central bank also effectively regulates the credit flows through …….policy.

14.4 Regulations on Insurance Services

14.4.1 Brief History

1818 saw the **advent of life insurance business in India** with the establishment of the Oriental Life Insurance Company in Calcutta. This Company however failed in 1834. In 1829, the Madras

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Equitable had begun transacting life insurance business in the Madras Presidency. 1870 saw the enactment of the British Insurance Act and in the last three decades of the nineteenth century, the Bombay Mutual (1871), Oriental (1874) and Empire of India (1897) were started in the Bombay Residency. This era, however, was dominated by foreign insurance offices which did good business in India, namely Albert Life Assurance, Royal Insurance, Liverpool and London Globe Insurance and the Indian offices were up for hard competition from the foreign companies. In 1914, the Government of India started publishing returns of Insurance Companies in India. The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate life business. In 1928, the Indian Insurance Companies Act was enacted to enable the Government to collect statistical information about both life and non-life business transacted in India by Indian and foreign insurers including provident insurance societies. In 1938, with a view to protecting the interest of the Insurance public, the earlier legislation was consolidated and amended by the Insurance Act, 1938 with comprehensive provisions for effective control over the activities of insurers. The Insurance Amendment Act of 1950 abolished Principal Agencies. However, there were a large number of insurance companies and the level of competition was high. There were also allegations of unfair trade practices. The Government of India, therefore, decided to nationalize insurance business. An Ordinance was issued on 19th January, 1956 nationalising the Life Insurance sector and Life Insurance Corporation came into existence in the same year. The LIC absorbed 154 Indian, 16 non-Indian insurers as also 75 provident societies—245 Indian and foreign insurers in all. The LIC had monopoly till the late 90s when the Insurance sector was reopened to the private sector. The **history of general insurance dates** back to the Industrial Revolution in the west and the consequent growth of sea-faring trade and commerce in the 17th century. It came to India as a legacy of British occupation. General Insurance in India has its roots in the establishment of Triton Insurance Company Ltd., in the year 1850 in Calcutta by the British. In 1907, the Indian Mercantile Insurance Ltd, was set up. This was the first company to transact all classes of general insurance business. 1957 saw the formation of the General Insurance Council, a wing of the Insurance Association of India. The General Insurance Council framed a code of conduct for ensuring fair conduct and sound business practices. In 1968, the Insurance Act was amended to regulate investments and set minimum solvency margins. The Tariff Advisory Committee was also set up then. In 1972 with the passing of the General Insurance Business (Nationalisation) Act, general insurance business was nationalized with effect from 1st January, 1973. 107 insurers were amalgamated and grouped into four companies, namely National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd. and the United India Insurance Company Ltd. The General Insurance Corporation of India was incorporated as a company in 1971 and it commence business on January 1st 1973. This millennium has seen insurance come a full circle in a journey extending to nearly 200 years. The process of **re-opening of the sector** had begun in the early 1990s and the last decade and more has seen it been opened up substantially. In 1993, the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective was to complement the reforms initiated in the financial sector. The committee submitted its report in 1994 wherein , among other things, it recommended that the private sector be permitted to enter the insurance industry. They stated that foreign companies be allowed to enter by floating Indian companies, preferably a joint venture with Indian partners. Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the insurance industry. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premiums, while ensuring the financial security of the insurance market. The IRDA opened up the market in August 2000 with the invitation for application for registrations. Foreign companies were allowed ownership of up to 26%. The Authority has the power to frame regulations under

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Section 114A of the Insurance Act, 1938 and has from 2000 onwards framed various regulations ranging from registration of companies for carrying on insurance business to protection of policyholders' interests. In December, 2000, the subsidiaries of the General Insurance Corporation of India were restructured as independent companies and at the same time GIC was converted into a national re-insurer. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002. Today there are 24 general insurance companies including the ECGC and Agriculture Insurance Corporation of India and 23 life insurance companies operating in the country. The **insurance sector is a colossal one** and is growing at a speedy rate of 15-20%. Together with banking services, insurance services add about 7% to the country's GDP. A well-developed and evolved insurance sector is a boon for economic development as it provides long- term funds for infrastructure development at the same time strengthening the risk taking ability of the country.

14.4.2 Mission Statement of the IRDA

- To protect the interest of and secure fair treatment to policyholders;
- To bring about speedy and orderly growth of the insurance industry (including annuity and superannuation payments), for the benefit of the common man, and to provide long term funds for accelerating growth of the economy;
- To set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence of those it regulates;
- To ensure speedy settlement of genuine claims, to prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery;
- To promote fairness, transparency and orderly conduct in financial markets dealing with insurance and build a reliable management information system to enforce high standards of financial soundness amongst market players;
- To take action where such standards are inadequate or ineffectively enforced;
- To bring about optimum amount of self-regulation in day-to-day working of the industry consistent with the requirements of prudential regulation.

14.4.3 Duties, Powers and Functions of IRDA

Section 14 of IRDA Act, 1999 lays down the duties, powers and functions of IRDA. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include-

- Issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;
- Protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;
- Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents;
- Specifying the code of conduct for surveyors and loss assessors;
- Promoting efficiency in the conduct of insurance business;

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- Promoting and regulating professional organisations connected with the insurance and re-insurance business;
- Levying fees and other charges for carrying out the purposes of this Act;
- Calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;
- Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);
- Specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;
- Regulating investment of funds by insurance companies;
- Regulating maintenance of margin of solvency;
- Adjudication of disputes between insurers and intermediaries or insurance intermediaries;
- Supervising the functioning of the Tariff Advisory Committee;
- Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);
- Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and
- Exercising such other powers as may be prescribed.

Self Assessment

State True or False:

6. In 1965, the Insurance Act was amended to regulate investments and set minimum solvency margins.
7. Section 14 of IRDA Act, 1999 lays down the duties, powers and functions of IRDA.
8. GS Malhoatra, former Governor of RBI, proposed recommendations for reforms in the insurance sector.
9. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002.
10. With the passing of the General Insurance Business (Nationalisation) Act, general insurance business was nationalized and as a result 107 insurers were amalgamated and grouped into five companies.

14.5 Regulations on Investment Services

Investment services are primarily fund based activities. The mutual funds and venture capital funds directly fall under the investment services. Though portfolio management service is advisory in nature. Similarly, stock exchanges and stock broking institutions have close link with the investment activities and thus regulation on them could be conveniently discussed along with other direct investment activities.

The regulatory set up consists of Securities Contracts (Regulation) Act (SCRA), 1956, SEBI Regulations and Reserve Bank of India. Before discussing the regulatory framework under each

of the investment and investment related services, it is appropriate to know Securities and Exchange Board of India which is emerging as a powerful regulator of various financial services.

14.5.1 The Securities and Exchange Board of India (SEBI)

The complex nature of financial markets and high level of integration of different segments of the market, the National Securities Exchange Commissions have been set up to monitor the activities of financial markets and the service providers in order to ensure healthy development of the market and safeguards the interest of investors.

On the suggestion of the high powered Committee on the Stock Exchange Reforms headed by G.S.Patel, the Government of India has set up the Securities and Exchange Board of India on 12th April, 1988. The Board initially functioned as advisory agency but in 1992, the SEBI has been given the legal status by the Securities and Exchange Board of India Ordinance 1992 which has been subsequently passed in the Parliament to become an Act. The SEBI Act, 1992 entrusts the responsibility of protecting the interest of investors in securities and to promote the development of, and to regulate securities market by such measure it thinks fit. The Act also listed a few activities that SEBI could perform to achieve the above objectives. They are:

(a) Regulating the business of stock exchanges and any other securities markets;

(b) Registering and regulating the working of stock brokers, sub-brokers, share transfer agent, merchant bankers and other intermediaries who may be associated with securities market in any manner;

(c) Registering and regulating the working of collective investment schemes including mutual funds;

(d) Promoting and regulating self-regulatory organisations;

(e) Prohibiting fraudulent and unfair trade practices relating to securities markets;

(f) Promoting investors education and training of intermediaries of securities markets;

(g) Prohibiting insider trading in securities;

(h) Regulating substantial acquisition of shares and take-over of companies;

(i) Calling for information from, undertaking inspection, conducting enquires and audits of the stock exchanges, intermediaries and self-regulatory organisations in the securities markets;

(j) Performing such functions and exercising such powers under the SCRA, 1952 as may be delegated to it by the Central Government;

(k) Levying fees or other charges for carrying out these activities;

(l) Conducting research for the above purpose; and

(m) Performing such other functions as may be required.

The SEBI has, during the period of five years of its existence since it received legal status, brought out a number of regulations and guidelines to bring an orderly functioning of the securities markets. It has also created special wings for Primary Market, Secondary Market, Mutual Funds, Surveillance, Research, etc. These regulations and guidelines serve the basic structure of regulatory framework for several financial services. The SEBI Act also provides that parties aggrieved by its order can appeal to the Central Government within a prescribed time limit.

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14.5.2 Mutual Funds

The mutual funds in India could be broadly classified into three groups for the purpose of regulations governing the mutual funds. They are: Unit Trust of India, Public Sector and Private Sector Mutual Funds, and Money Market and Off-Shore Mutual Funds. The Unit Trust of India (UTI) was established by the Government of India **Regulatory Framework** as a Trust under UTI Act, 1963. Since inception, the UTI has offered several schemes and it is governed by the UTI Act, 1963.

In 1986, the government has allowed the public sector banks to enter into mutual fund service and within a short period of time several public sector banks have commenced their mutual fund service. In these public sector banks mutual funds were governed by the Reserve Bank of India. In February, 1992, the Ministry of Finance issued a notification to the effect that all mutual funds be regulated by the SEBI and allowed the private sector entry into mutual funds service. In 1993, the SEBI brought the first mutual funds regulation which prescribed the structure of the mutual funds and other requirements. The public sector and private sector mutual funds are now governed by this regulation which is periodically revised. The SEBI (Mutual Funds) Regulations, 1993 require compulsory registration of all public and private sector mutual funds companies and approval of individual schemes offered by the mutual funds. It also requires separation of mutual funds service from investment activities which has to be entrusted with a separate company known as Asset Management Company (AMC). It has also prescribed a detailed disclosure norms to ensure transparency in the operation of mutual funds schemes. The SEBI has issued a fresh set of regulations governing the mutual funds in 1996. Since Mutual Funds are established as a Trust, they are also regulated by the Indian Trust Act, 1882. The Money Market Mutual Funds (MMMF) and Off-shore Mutual Funds (OMC) are regulated by the Reserve Bank of India. The RBI has appointed a Task Force under the Chairmanship of Shri. D. Basu to study the feasibility of allowing MMMF to function in India in 1991 and the Task Force submitted its report in January, 1992. The RBI issued Guidelines for MMMF in April 1992. The SEBI has also issued guidelines for the money market transactions of mutual funds under its regulation.

Task Draw a structure of Mutual Fund Service as provided by the SEBI.

14.5.3 Venture Capital Financing

Venture Capital institutions participate in the equity of companies which are not in a position to raise equity capital directly from the market due to new technology or small size of the venture in the initial stage. The venture capital institutions sell the equity in the market once the company established its standing in the market and normally, such public offers are accompanied with a similar public offering from the company. The venture capital industry in India is of relatively recent origin. It was originally in the form of special schemes of Development Finance Institutions (DFI).

In the Union Budget 1988-89, the then Finance Minister announced the formulation of scheme under which Venture Capital Funds (VCF)/Venture Capital Companies (VCC) would be enabled to invest in new enterprises and be eligible for favourable treatment of capital gains and dividend. The Controller of Capital Issues (CCI) initially brought out a detailed guideline that govern venture capital funds. However, the SEBI was empowered in 1995 by the government to regulate the VCF/VCC and consequently the earlier regulation issued by the CCI was repealed on July 25, 1995. The SEBI has brought out a detailed regulation known as SEBI Venture Capital Funds

Regulation, 1996. The SEBI regulation on VCF prescribes compulsory registration of VCF, investment conditions, management of the company and maintenance of records. It also has an authority to inspect the books and investigate the charges and also take penal action against the erring VCF. In addition to SEBI regulation, the VCFs are also governed by the Income Tax Act. The VCFs are required to apply to the Director of Income Tax (Exemptions) to avail favourable treatment on dividend income and capital gains. The VCFs have to fulfil certain condition laid down under the Act to get such benefits. The Government of India has allowed the overseas venture capital companies to operate in India in 1995 and they require the approval of Foreign Investment Approval Board (FIPB).

14.5.4 Portfolio Management Services

The portfolio manager is one who in pursuant to a contract or arrangement with a client advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or the funds of the client. The SEBI has issued a detailed guideline in 1993 (SEBI (Portfolio Managers) Regulations, 1993) to regulate this advisory service. The regulation requires compulsory registration of portfolio managers before starting their service, terms and conditions of the schemes that could be offered, managerial requirement, disclosure norms and periodical reporting to SEBI.

The commercial banks are also offering portfolio management service to their customers. These services are regulated by the RBI which issued a detailed guideline to regulate this service in 1991.

14.5.5 Stock Broking

The stock brokers who are the members of recognized stock exchanges enable the investors to buy and sell securities in the secondary market. They also act as a broker to the companies which want to raise capital in the primary market. The stock broking service is regulated by the Securities Contracts (Regulation) Act, (SCRA) 1956 and its Rules, 1957, SEBI (Brokers and Sub-brokers) Regulation, 1992 and the by-laws of Stock Exchange where the broker is a member.

While the SCRA regulates the stock exchanges, the Securities Contracts (Regulation) Rules, 1957 prescribes the qualification for membership of a recognized stock exchange, books of accounts to be maintained by the members and the minimum number of years the documents and books are to be maintained. The SEBI regulation requires compulsory registration of members of stock exchange and prescribed net- worth requirement and capital adequacy norms, books and records to be maintained and code of conducts to be adopted by the members. The SEBI also has the powers to inspect books and records and investigate the investors and other brokers complaints against the stock broker. The sub-brokers are also governed by the same regulation and SEBI requires them to be registered through a member of stock exchange under whom the sub-broker will transact business. The by-laws of the stock exchange is in the nature of self-regulation and varies from exchange to exchange. It generally prescribes how the members have to conduct the business and deal with other members of the exchange. It also prescribes how disputes between the members and members and investors are to be settled.

Notes In addition to the above three regulations, the members of stock exchange need to have a working knowledge on the Negotiable Instruments Act, 1881, Indian Stamp Act, 1889 as in force in their respective states, and provisions relating to Service Tax introduced in the Finance Act, 1994.

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14.6 Regulations on Merchant Banking and Other Intermediaries

There are several intermediaries associated with management of public and rights issue of capital. While the Merchant Banker is the main intermediary, others associated with the issue management are Underwriter, Brokers, Market makers, Registrar, Advisors, Collection Bankers, Advertisement Consultants, Debenture Trustees and Credit Rating Agencies. The SEBI has issued a detailed guideline/ regulation on many of these intermediaries. They are:

(a) SEBI (Merchant Banker) Regulation, 1992;

(b) SEBI Rules for Underwriters.

Exhibit 14.2: A Bird's-eye View of Regulation on Financial Services

Banking Regulation Insurance Act, 1938 Securities Contracts Act, 1949 (Regulation) Act, 1956 Companies Act, 1956
Indian Trust Act, 1882
Reserve Bank of India Insurance Regulatory Securities and Authority Exchange Board of India Notifications, Rules, Regulations, Guidelines, Directions, etc. Clarifications, etc.
a) SEBI (Brokers and Sub-brokers) Regulation, 1992;
b) SEBI Rules for Registrar to an Issue and Share Transfer Agents, 1993;
c) SEBI (Bankers to an Issue) Regulations, 1994;
d) SEBI (Debenture Trustees) Regulations, 1993;
e) Code of Advertisement to Capital Offerings

The intermediaries are required to register themselves with the SEBI under the relevant regulations before commencing the business. These regulations have also prescribed the eligibility norms for registration, net worth and capital adequacy norm wherever relevant and code of conduct. As observed in other regulations, these regulations also empower the SEBI to inspect the books and record and conduct investigation on the affairs of the intermediaries and take appropriate action against them wherever required.

The SEBI relies on the merchant bankers most, when it comes to supervising the equity and debt offerings of companies. The Merchant Banker who acts as a lead manager to an issue is expected to examine whether all the provisions relating to SEBI by the company as well as other intermediaries are duly complied with and issue a due-diligence certificate to that effect. SEBI Guidelines for Disclosure and Investor Protection, 1992 which frames the rules relating to issue of capital is also relevant to the merchant bankers. If a Merchant Banker offers its service to an acquirer, the SEBI (Substantial Acquisition of Shares and Take-overs) Regulations, 1994 provides the procedure to be followed by the acquirer and the merchant banker for such acquisition of shares.

14.7 Ethical Issues in Financial Planning

There have been many scams and cases such as collapse of Enron and Worldcom which have brought ethical concerns to the forefront of public scrutiny. These cases resulted in employees to lose all of their retirement savings, and provided a wake-up call to investors across the country who held their entire retirement savings in a single stock. The failure to educate those employees about the importance of diversification was perhaps more than mere corporate or fiduciary oversight.

These headline-grabbing collapses are just two examples of how our modern maze of business models, methods of practice and investment strategies has substantially blurred traditional

ethical boundaries. Even scrupulously honest financial planners can now face real dilemmas when trying to do the right thing for their clients.

14.7.1 Uncharted Territory

A generation ago, both the tax code and the financial products and services available were simpler than they are today. For example, if someone wanted to buy stock, a stockbroker would place the trade. If someone needed permanent life coverage, a whole life policy was issued. But now, planners must decide if this traditional approach is better, or whether the client would be better off buying any number of the diverse modern products available.

The modern maze means every financial planner faces an ethical dilemma when trying to do the right thing for a client.

Ethical concern involved in financial planning states that the client's interests should be put ahead of the financial advisors interests at all times and in all situations. All financial planning services must now be accorded the care of a true fiduciary, as opposed to merely acting in the client's best interest. This also constitutes a major step up in terms of responsibility, as fiduciaries have a strict set of rules and guidelines that must be followed at all times.

14.7.2 Fees vs. Commissions

The flexibility to choose between fee based or commission based services charge also present a moral dilemma for planners.

A fee-based planner, one who charges clients based on a percentage of their assets, will increase his or her compensation simply by making the client's assets grow. If the planner charges the client a fee of 1% of assets under management, then the annual fee collected from a ₹ 100,000 portfolio will be ₹ 1,000. Therefore, if the planner is able to make the portfolio grow to ₹ 150,000, his or her compensation will increase accordingly. This type of compensation could motivate the planner to employ more aggressive investment strategies than a traditional commission-based broker.

A commission-based planner, on the other hand, is compensated for each transaction, regardless of portfolio gains or losses. These brokers face the temptation to generate transactions as a means of revenue, even if they manage to avoid the technical definition of "churning".

14.7.3 Sales vs. Advice

The boundaries between sales and advice in the financial industry are also becoming increasingly blurred as new platforms and methods of doing business continue to emerge. What this usually boils down to is getting clients to do the right thing for the right reason.

Planner should obviously need to get their client to diversify their holdings with a sensible asset allocation, or perhaps at least consider some sort of immediate annuity option. But how far should they go in encouraging them to do this? Is it okay for you to use aggressive, fear-based sales tactics, or even bend the truth a little, in order to help their client? After all, it clearly is in their best interest to do this.

14.7.4 Bottom Line

Thus it can be said that with the growing complexity of financial services, financial planning in today's world depends more than ever upon understanding a client's individual situation and objectives, and being willing to do right for them. The correct application of ethics in modern

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financial planning essentially boils down to having the client understand exactly what they are doing and why, with full knowledge of the costs and risks involved. An ethical transaction occurs when a client truly understands the ramifications of the advisor's recommendations and is willing to go forward, assuming that all pertinent laws and regulations are being obeyed. After all is said and done, ethics can still be viewed as simply knowing the right thing to do, and then doing it.

Case Study

Should Financial Systems be Rule-based?

After evaluating the pitfalls and advantages of both the systems, there is a view emerging that the financial system should be more rules-based.

The recent global meltdown has proved one thing: Neither a rules-based regulatory system nor a principles-based regulatory system is a guarantee against bank failure. However, after evaluating the pitfalls and advantages of both the systems, there is a view emerging that the financial system should be more rules-based; this is especially true in the UK.

In contrast, two committees set up in India — the Percy Mistry Committee (2007) and the Raghuram Rajan Committee (2008) — to look into financial sector reforms have recommended that India's regulatory regime should move from rules-based to a principles-based one.

Principles-based Regulation (PBR) implies moving away, wherever possible, from dictating, through detailed prescriptive rules and supervisory actions, how firms should operate their businesses. Rules-based regulation, it is pointed out, is too rigid and prescriptive, and often the regulator and the regulated adopt adversarial and antagonistic postures. Some of the countries that follow principles-based regulatory systems are the UK, Australia, Canada and Ireland. Some of the leading countries whose regulatory regime is based on rules are the US, Spain and India.

However, as noted in the Turner Review, banks in countries following either of the systems have failed. For example, banks have failed in the US and the UK. So in a way, neither of the regulatory systems has proven to be robust. One way to draw lessons from the crisis would be to examine what countries such as India, Spain and Canada did right to insulate their financial systems from succumbing to the global crisis.

Spanish Method

It would be worthwhile to examine the approaches of the various regulators to housing or mortgage finance. Spain, which follows a rules-based system, has a clearly spelt out mortgage risk policy for its credit institutions. Banco De Espana (BE) lays down that lending policy of credit institutions for mortgage should take into account the repaying capacity of the borrowers and should not just be based on the collateral. BE also emphasises on the importance of the loan to value (LTV) ratio. It cautions its credit institutions against being too permissive about LTV as this typically increases the expected losses in a mortgage loan portfolio.

The conservatism that insulated Spanish banks from crisis also played its role in keeping the banking system healthy in Canada, which follows a principles-based system of regulation. For example, mortgages with less than a 20 per cent down-payment have to be insured, and most of the securitised mortgage market consists of Canada Mortgage Bonds,

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which carry a government guarantee. The Canadian central bank also did not allow creation of complex, synthetic securitised instruments involving Canadian mortgage assets.

In India, the Reserve Bank of India (RBI) has strict rules regarding housing finance, specifying the risk weights to be attached to loans extended to borrowers. These risk weights vary according to the LTV ratios. The RBI also specifies the maximum sanctioned amount for LTV ratios as less than or equal to 75 per cent.

UK's System

In the UK, the Financial Services Authority (FSA) follows a principles-based regulation. However, in its proposed reforms for mortgage lending, it has categorically banned certain practices such as self-certified mortgages replacing it with those requiring verification of the income of the borrowers. It also now requires mortgage advisers to be personally accountable to the FSA.

Having realised that non-interventionist principles-based system need not always lead to the desired regulatory outcome, there appears to be a distinct shift in the UK from a non-interventionist stance to a more intrusive one.

The Federal Reserve has also notified a revision in its Regulation Z (which implements the Truth in Lending Act and Home Ownership and Equity Protection Act), prohibiting creditors from making higher-priced mortgage loans based on the "value of the consumer's collateral without regard to the consumer's repayment ability".

Thus, in the case of the US and the UK, at least with respect to mortgage lending, the bias is in favour of a rules-based system. But is this desirable?

One of the biggest criticisms levelled against the rules-based system is that it stifles innovation by being too interfering. In contrast, a principles-based regulation is more accommodative to innovation because it is pliant and flexible. But, as the recent meltdown has shown, while gains from financial innovation benefit a few, the losses affect a greater number through systemic instability. When it comes to a trade-off between profitability and financial stability, the choice is very clear. Financial stability creates conducive atmosphere for profitability and for carrying out banking. Therefore, a rules-based system clearly scores over a principles-based system.

A developing country like India has its own compulsions which make a rules-based system better suited when it comes to meeting our development objectives. For example, with respect to financial inclusion, unless it is specifically laid down that banks must offer no-frills accounts to their customers with zero or minimum balance and also relax criteria for identification and account opening, the goal of financial inclusion may not be achieved.

Also, there is nothing in the rules-based system that disallows innovation. If that were the case, Indian banks wouldn't have been allowed to offer several products that they now offer. The pace of innovation would be slow but if it ensures financial stability for the system, the trade-off would be well worth it.

Question

Discuss the importance of rules and regulation in financial system.

Source: http://www.thehindubusinessline.in

14.8 Summary

- The financial services industry is the most regulated segment of the economy all over the world. The objective of the regulation is not to control the growth of the industry and on

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the contrary allows growth as well as freedom to operate subject to fulfillment of certain conditions. Despite strict regulations, the industry has recorded high level of growth all over the world and efficiency and innovation are the key to the success of the industry. Thus the objectives of the regulations are to ensure orderly growth of the industry, protecting the investors and other participants of the markets and using the industry for the development of the economy.

- The regulations can be broadly classified into structural regulations, prudential regulations and investor protection regulations. While the structural regulations cover the main types of activities that different forms of institutions are permitted to engage in, the prudential regulations aim to ensure capital adequacy, liquidity and solvency of the institutions. The investor protection regulations are designed to protect the investors from the frauds, malpractice and collapse. There are three forms of regulations that govern the financial industry. At the macro level, the legislation passed by the Parliament gives a general regulatory framework and stipulate the government agency which is in charge for administrating the provisions of the Act.
- The regulatory agencies set up by the government like SEBI frame several regulations at micro level and these regulations, guidelines and notifications constitute the second form of regulation. The third form of regulation is in the nature of self-regulation where the industry association frames the operating system of the industry, code of conduct to their members and procedure for settling the dispute between the members.
- The Banking Regulation Act, 1949, Insurance Act, 1938 and Securities Contracts (Regulation) Act, 1956 provides macro level regulation on banking, insurance and securities markets transactions. The Reserve Bank of India, Insurance Regulatory Authority and Securities and Exchange Board of India are the major regulators of the industry. They have issued a number of regulations, guidelines, notifications, clarifications, etc., that govern the activities of the financial service providers. The stock exchanges, Merchant Banking Association, Foreign Exchange Dealers Association, Equipment Leasing Companies Association, etc., have formed separate by-laws and regulations that govern their members. All these regulations play a vital role for the development of the financial service industry.

14.9 Keywords

Banking Regulations: Consisting of Banking Regulation Act, 1949 and Directions from the Reserve Bank of India, govern the activities of the banking companies.

Insurance Regulatory Authority (interim): It was set up in 1996 based on the recommendations of the Malhotra Committee primarily to regulate, promote and ensure orderly growth of the insurance business in a free market economy.

Investors' Protection Regulation: It determines the nature and level of disclosure to be made by the financial service providers to the investors.

NBFC Regulations: These are those directions given by the RBI to regulate different forms of non-banking financial companies.

Prudential Regulation: It covers the internal management of financial service providers in relation to capital adequacy, liquidity and solvency.

SEBI: **A** statutory body that regulate the securities markets and their participants with a main objective of protecting the interest of investors.

SEBI Regulations: Set of regulations and guidelines issued by the SEBI on various investment institutions and market intermediaries.

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Self Regulations: Framed by various industry association that govern its members activities, code of conduct and settlement of disputes between them.

Structural Regulation: Type of activities that different forms of institutions are permitted to engage in.

14.10 Review Questions

1. Why scams and defaults occur quite frequently in the financial service industry despite regulations?
2. How do you classify the existing regulations governing the financial service industry on the basis of their scope?
3. What is the role of regulations in a free market economy?
4. How does SEBI regulate fund-based and fee-based activities?
5. What are the objectives of self-regulations? Do you feel self-regulations are better than formal regulations?

Answers: Self Assessment

1.	investor protection	2.	capital allocation
3.	commercial banks	4.	The Banking Laws (Miscellaneous Provisions)
5.	Monetary	6.	False
7.	True	8.	False
9.	True	10.	False

14.11 Further Readings

Books

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