Management = Set An Objective + Decide On Strategy + Implementation + Monitoring

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Knowledge Series

Edition- 1

ANAND RATHI
WEALTH LIMITED

Acknowledgements

"Nothing is difficult! What you don't know today is already known to someone else! Gather courage to begin the journey of learning, and you will be able to conquer anything!"

\- **Rakesh Rawal**, CEO, Anand Rathi Wealth Limited

Anand Rathi Wealth Limited has always been committed to creating financial awareness for its employees and clients. We believe that investor education should be part of our everydayprocesstoenhancelearningandincreasethescopeoftakingprudent investmentdecisions.Wehavebrokendownalifetimeofcollectivelearningsand experiences into conceptual notes through this Knowledge Series. We aspire that our clients become self-sufficient in understanding these financial concepts and be actively involved in their wealth journey with us.

These notes focus on the various elements of financial markets, economy, and personal finance.Ourendeavorhasbeentopresenttheminanuncomplicatedandconcise manner. Understanding them can only make your investment journey simpler.

TheKnowledgeSeriescollectionisyetanotherhumbleattemptinlinewiththe Organization?s vision of InvestorA wareness and Empowerment.And, this book would not have been possible without the contribution Of the entire Anand Rathi Wealth team.

Regards,
Chirag Muni,
Author - Knowledge Series

(Chirag Muni joined Anand Rathi Wealth Limited and has an industry experience of IS years. Currently, he is an Associate Director and a core member of the team)

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01 Equity Mutual Fund Re-Categorisation

Objective: *Understanding SEBI's re-categorisationofequity mutualfundsandhowit simplifies investment decisions*

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In 2017, SEBI issued a set of new regulations, which created a paradigm shift in the mutual fund industry. SEBI asked AMCs to re-categorise mutual fund schemes based on a few pre-defined parameters, which significantly impacted how equity mutual funds are managed.

As per the 2017 regulations and subsequent announcements, each AMC can have a maximum of 10 open-ended diversified equity funds and only one scheme in each category, excluding Index Funds or ETFs, Fund of Funds, and Sectoral / Thematic Funds.

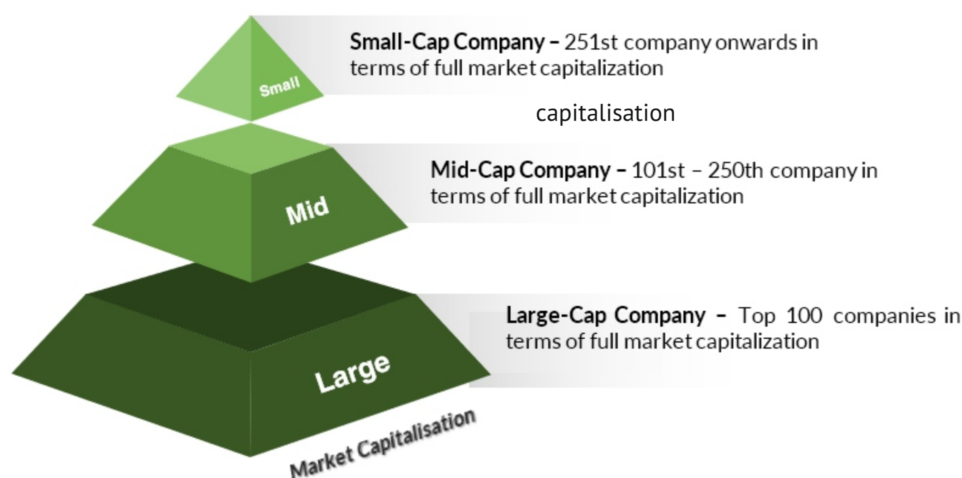
The new guidelines categorically detailed the investment criteria for each of the funds.

Sr. No.	Scheme Category	Minimum Investment Criteria		
	Market Cap	Large-Cap	Mid-Cap	Small-Cap
1	Large-Cap Fund	80%	-	-
2	Large and Mid-Cap Fund	35%	35%	-
3	Mid-Cap Fund	-	65%	-
4	Small-Cap Fund	-	-	65%
5	Multi-Cap Fund	25%	25%	25%
6	Focused Fund (Maximum 30 stocks)	No restriction		
7	Value / Contra	No restriction		
8	Dividend Yield	No restriction		
9	ELSS	No restriction		
10	Sector / Thematic	No restriction		
11	Flexi-Cap	No restriction		

Earlier, a large-cap fund had an allocation of 65%-75% in large-cap stocks and the remaining 25%-35% in the mid-cap segment. However, due to the new rules, a large-cap fund can have a maximum of 20% in mid-caps or small-caps. In effect, it will impact the generation of alpha in these funds.

Moreover, SEBI has also clearly defined the market capitalisation cut-offs. Earlier, each AMC would follow their definitions of market capitalisation.

As per the new regulations, the new definitions are as follows:



For example: As per AMFI semi-annual categorization, Biocon Ltd which was previously a large cap stock as per AMFI categorization list-June'21, has now moved into the midcap category with an average market capitalisation of Rs. 43,910 crores (AMFI List-Dec'21). Similarly, Mindtree Ltd, which was a mid-cap stock (AMFI list-June'21), has now moved to the large-cap category with an average market capitalisation of around Rs. 64,908 crore (AMFI List-Dec'21).

Lastly, SEBI rolled out two new benchmarks, namely Nifty Large-Mid 250 and Mid-cap 150 Index. A new benchmark Nifty 500 Multicap 50:25:25 was launched in January 2021 which is mainly used by Multi-Cap funds, after the category mandate was changed, for suitable benchmarking.

Also, the funds were earlier benchmarked to PRI or Price Return Index, which means the value of this index was ex-dividend. As per the new rules, the benchmark will change to TRI or Total Return Index, which also takes into account the dividend declared by the underlying companies of the benchmark.

In October 2021, in order to standardise and bring uniformity, SEBI came out with two tiered structure of benchmarking certain categories of schemes. The first tier benchmark would be reflective of category of scheme while second tier benchmark will be demonstrative of investment style of the Fund Manager within the category. The second tier benchmark would be optional and be decided by the respective AMCs. Following this, AMFI has published list of Tier 1 benchmarks, here we list down the benchmarks for diversified open ended Equity Categories:

Sr. No.	Scheme Category	Tier 1 Benchmarks	
		NSE Indices	BSE Indices
1	Large Cap Fund	Nifty 100	S&P BSE 100
2	Large and Mid Cap Fund	Nifty Large Midcap 250	S&P BSE 250 Large Midcap
3	Midcap Fund	Nifty Midcap 150	S&P BSE Midcap 150
4	Small Cap Fund	Nifty Smallcap 250	S&P BSE 250 Smallcap
5	Multi cap Fund	Nifty 500 Multicap 50:25:25	S&P BSE 500
6	Flexi Cap Fund	Nifty 500	S&P BSE 500
7	Focused Fund (Maximum 30 stocks)	Nifty 500	S&P BSE 500
8	Value / Contra	Nifty 500	S&P BSE 500
9	Dividend Yield	Nifty 500	S&P BSE 500
10	ELSS	Nifty 500	S&P BSE 500

With this move, SEBI cleared the clutter of similar funds with different names, allowing investors to better compare the funds. Also, investors have a better grasp as the mutual fund schemes now truly reflect the underlying objective of risk and return.

If you do classwork and not your homework,
then you will never learn enough and add
substantial value to the client

- **Rakesh Rawal**, CEO, Anand Rathi Wealth Limited

02 Inside Debt Mutual Funds (Part-1)

Objective: *To understand the critical components that go into the making of debt mutual funds.*

Debt as an asset class has always enjoyed the status of being a safe and secure investment. Debt mutual funds, in particular, have quite often been an obvious investment choice. Debt mutual funds have assets of over INR 12.65 lakh crores (open-ended excluding ETFs) as on March 31st 2023; its main attraction is access to the institutional debt markets, diversification, liquidity, and tax efficiency.

Despite these advantages, several debt fund investors have not had a smooth ride in the last few years. Therefore, an investor needs to understand where these debt MFs invest and their key components.

First, let us understand the 8 most common instruments that we find in a debt mutual fund.

1. Government Securities

- Government securities are fixed-income instruments issued by the government to borrow money from the market.
- Government securities are divided into short-term and long-term securities depending on the expiry date. Short-term government securities are called treasury bills. They have maturities of less than one year. There are three types of treasury bills in India – 91 days, 182 days, and 364 days. Long-term government securities are known as government bonds or gilt-edged securities. They are issued with maturity periods of five years, ten years, fifteen years, and so on and so forth.

2. Corporate Bonds / NCDs

- Corporate bonds / NCDs (Non-Convertible Debentures) are fixed-income instruments issued by corporates. The tenure of these bonds can be determined by the company depending on their short-term or long-term requirements.

3. Securitized Debt / PTCs

- Securitized debt instruments are financial securities that are created by securitizing individual loans (debt). The assets are transformed into securities, and the process is called securitization. The owner of the securities receives an income from the underlying assets; hence, the term asset-backed securities or Pass-Through Certificates (PTCs). The tenure of the certificate will depend on the type of underlying assets.
- These are issued by Banks, NBFCs, Infrastructure entities, Microfinance institutions, and urban local bodies.

4. Commercial Papers

- Commercial Papers (CPs) are unsecured money market instruments issued in the form of a promissory note. CPs are issued by corporates, financial institutions, and primary dealers.
- CPs can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.
- CPs are always issued at a discount to face value, as may be determined by the issuer.

5. Certificate of Deposit

- Certificate of Deposit (CD) is also an unsecured money market instrument issued in the form of a promissory note. CDs are issued by Banks & Financial Institutions to raise short-term funding.
- CDs can have a maturity period ranging from 7 days to 1 year. For financial institutions, it ranges from 1 year to 3 years.

6. Cash Management Bills

- Cash Management Bills (CMBs) are short-term bills issued by RBI on behalf of the central government to meet its immediate cash needs for the temporary cash flow mismatches.
- CMBs have a maturity of less than 90 days and are issued at a discount. They are redeemed at face value on maturity.

7. Call Money

- The call money is a short-term unsecured loan that banks can avail to meet liquidity requirements.
- Mutual Funds lend to banks for a minimum of 1 day to a maximum of 14 days.

8. TREPs

- TREPs (Tri-Party Repo) is a repo contract with 3 parties involved - borrower, lender and an intermediary, i.e. Clearing Corporation of India Ltd. (CCIL - the exchange that acts as a counterparty to both the borrower and lender).
- In the TREPs market, members can borrow or lend funds against the collateral of eligible securities. i.e. treasury bills, and such other securities as specified by the CCIL for 1 to14 days.
- As of date, 70% of the lending in the overnight TREP market is done by Mutual funds where the counterparty is banks.

Using the combination of the above 8 instruments, AMCs create products that would suit different risk profiles and time horizons to enhance the overall returns in an investor's portfolio.

Business can only happen if the minds match. Understanding the risk factors is more critical, and the returns are the outcome of how well we manage the risk!

\- **Rakesh Rawal**, CEO, Anand Rathi Wealth Limited

02 Inside Debt Mutual Funds (Part-2)

Objective: *Understanding the critical parameters with regards torisk,return and time horizon while investing in a debt fund. (This note has an annexure)*

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Evaluating a debt mutual fund, understanding how it contributes to the overall returns of an investor's portfolio and knowing the terms associated with the selection process can simplify the decision making. In 2017, SEBI re-categorized debt mutual funds into 16 categories (refer annexure).

An investor can evaluate funds on 5 key parameters and create a portfolio which best meets his objectives.

1. Yield to Maturity (YTM):

- It is the rate of return anticipated on the current price of the bond, if held till maturity. Hence, YTM is the future expected return and not the past performance. Moreover, YTM can be different from the coupon rate depending on the current price of the bond.
- For example, if the Face Value of a bond is 1000, Current Market price is 920, Coupon is 10%, and the maturity is 3 years, the investor will make a return of 13.41% CAGR if one holds this bond till maturity.
- The YTM of a fund is the weighted average sum of the YTMs of all underlying instruments in the fund.

Date	Cash Flows	Particulars
11-04-2023	-920	Current Market Price
11-04-2024	100	Coupon Payment
11-04-2025	100	Coupon Payment
11-04-2026	1100	Coupon and Principal
YTM	**13.40%**	**XIRR**

2. Modified Duration:

- It is a measure of interest rate risk that explains the sensitivity of bond prices to changes in interest rate.
- So, if the modified duration of a bond is 2 years, then a 1% fall in interest rate would lead to the bond price rising by 2%. In contrast, a 1% increase in interest rate would lead to the bond price declining by 2%.
- Modified Duration of a fund is the weighted average sum of the Modified Durations of all underlying instruments in the fund. Hence, the fund's overall modified duration becomes a key factor as it affects the NAV directly basis the change in interest rates.
- So, if an investor has a view that interest rates are likely to fall in the future, then ideally, the investor must select funds that have higher modified duration and vice-versa.

3. Credit Risk of Portfolio Constituents:

- Along with interest rate risk, debt funds also carry credit risk. Debt securities are rated by the credit rating agencies like CARE, CRISIL, ICRA, India Rating & Research and Brickworks on the issuer's creditworthiness and capacity to pay back.
- Fixed income securities that are rated 'AAA' are considered to be of the highest credit quality and have low credit risk. Securities that receive low credit rating below BBB- carry high default risk. Hence, knowing the credit ratings of each portfolio constituent of a debt fund becomes critical.
- Mutual funds do not invest in non-investment grade papers.

The following table exhibits the ratings:

Investment Grade										
Short Term	A1+				A1		A2+	A2	A3+	A3
Long Term	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-

Non-Investment Grade								
Short Term	A4+		A4					D
Long Term	BB+	BB	BB-	B+	B	B-	C	D

4. Average Maturity:

- Debt funds invest in various fixed income or debt instruments, and each instrument in the portfolio may have a different maturity. Average maturity is the weighted average of all the current maturities of the debt securities held in the fund. The higher the weighted average maturity, the longer it takes for the bonds in the portfolio to mature.
- While choosing debt funds, an investor needs to consider his investment horizon and align it with the average maturity of the fund to ensure that it is in line with his time horizon and risk profile.

5. Exit Load:

- It is a cost that an investor needs to bear if he or she sells the mutual fund units before a predefined time frame. For example, if the NAV is Rs. 100 at the time of redemption, and the exit load is 1%, the investor will receive Rs. 99.
- Simply put, it is a mechanism to deter investors from premature withdrawals.
- However, not all funds levy an exit charge on investors. Hence, it would be best if an investor keeps in mind the 'exit load aspect' while choosing a plan to invest.

Conclusion:

The understanding of debt mutual funds has always been superficial because it gave the perception of safe returns with minimal risk. However, knowing the specific essential components of what goes into a debt fund improves the scope of making informed decisions.

03 AT1 Bonds: You Own it, Now Know it

***Objective:**Understanding AT1 Bonds(PerpetualBonds),it’s essential risks and whether it is viable investment option for HNIs.*

In the last few years, ATI bonds offered by banks have become a significant portion of many HNIs' debt portfolios. Banks often issue ATI bonds to comply with Basel III norms.

In the aftermath of the 2008 global financial crisis, Basel III norms came into existence to strengthen the regulation, supervision and risk management of banks designed to reduce the risk of insolvency.

As a result, every bank must have a minimum capital requirement to be Basel III compliant (refer annexure). One of the sources of funds that banks access to meet this requirement is AT1 bonds.

What are AT1 bonds?

AT1 bonds are high yielding annual coupon-bearing perpetual bonds with no fixed maturity date. Banks use these instruments to increase their core equity base and they comply with Basel III norms. In the aftermath of the 2008 global financial crisis, Basel III norms came into existence to strengthen the regulation, supervision and risk management of banks designed to reduce the risk of insolvency.

As a result, every bank must have a minimum capital requirement to be Basel III compliant. One of the sources of funds that banks access to meet this requirement is AT1 bonds.

How are these bonds different from other debt instruments?

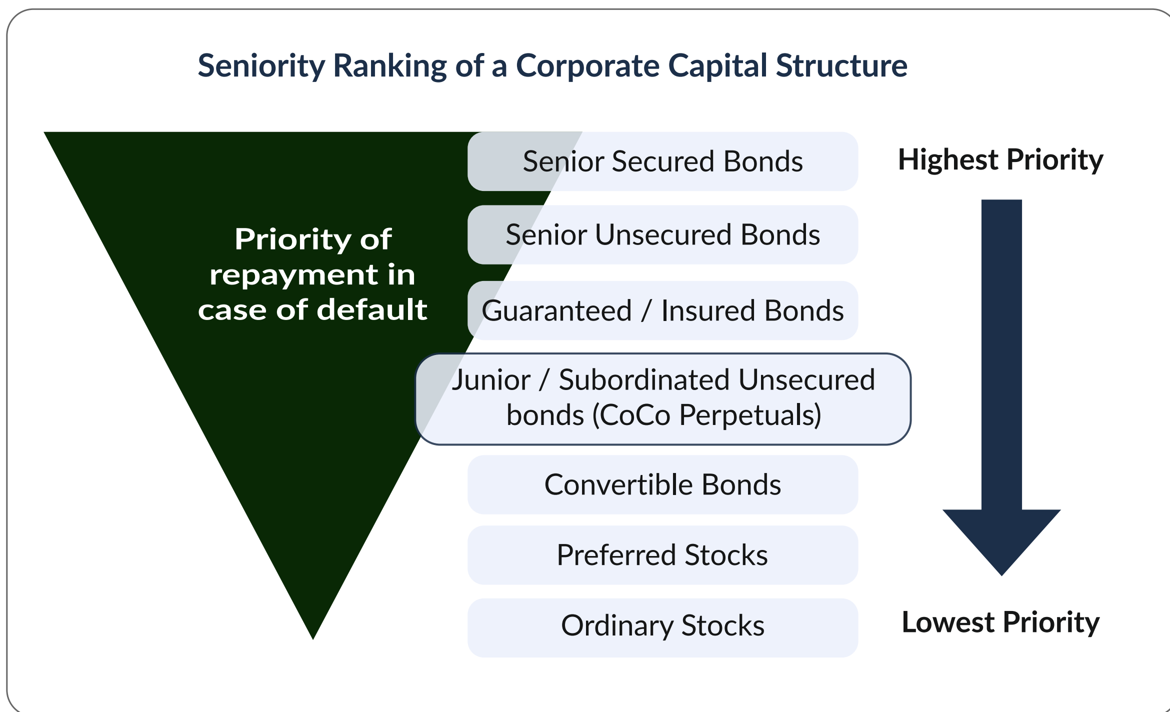
To put it simply, imagine an ideal situation – A tenant pays you a fixed rent, which is higher than the prevailing market rate, but with the condition of staying in the house perpetually. While this situation appears perfect, the tenant has not made you aware of his terms and conditions, leaving you blissfully ignorant.

The reality is: The tenant can terminate the agreement if he has found a cheaper option. The rent would depend on the tenant's income. If the tenant does not earn an income for a particular year, he will not pay you any rent for that year. If the tenant's business shuts down, the Government will take away your house because he was living in your home.

Sounds absurd - Well, that is AT1 bonds for you!

At1 bonds are high yielding annual coupon-bearing perpetual bonds with no fixed maturity date.

- The interest paid to the AT1 bondholders for a particular year is entirely at the bank's discretion.
- If the bank skips giving interest for a particular year, AT1 bondholders may not get cumulative interest.
- The banks can issue AT1 bonds with a call option – if they decide to redeem it early, usually, when the interest rate reduces from the current levels, the bondholders cannot object. However, if the interest rates go up, the banks keep the bonds alive.
- Subsequently, AT1 bondholders cannot redeem the bonds when they require liquidity. If need be, they can sell them in the secondary market, which may not fetch them their expected price.
- If the bank goes into liquidation, then AT1 bondholders would not get priority during repayment. AT1 bonds are considered subordinated, unsecured bonds.



However, the most significant risk that has not been adequately highlighted is the **LOSS ABSORBENCY CLAUSE.** Accordingly, without the need of the consent of Bondholders or Trustee, the Bonds and any claims or demands of any Bondholders, against the bank, maybe written-off or converted into common shares, in whole or in part, upon the occurrence of **the following trigger events:**

- ***Pre-Specified Trigger Level - Common Equity Tier 1 (See Annexure)*** of the Bank drops below a specified level (6.125% after March 31, 2019) – In this situation, the AT1 instruments can be written-off or converted into common equity.

Or

- ***Point of Non-Viability (as determined by RBI)***
  - In two cases, according to the RBI, the point of non-viability could trigger:
  - A decision that conversion or write-off is necessary, without which the firm would become non-viable; and
  - The decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable.

While the perpetual bonds seem like an attractive and safe debt investment option, the returns are not commensurate to the risks embedded in these bonds, quasi-equity.

A case in point here is YES Bank's ATI Bonds debacle, which left the investors high and dry when RBI decided to permanently write off Rs. 8,415 crores worth of bonds. This decision directly hit the individual investors and the Mutual Funds houses holding these bonds. As per ICRA's estimates, a total of Rs. 93,669 crores of AT1 bonds would be outstanding as of May 2020. Of this, Mutual Fund exposure as of March 2020 is approximately about Rs. 29,965 crores across 132

schemes that cover Rs. 4.8 lakh crores AUM in the debt and hybrid category having lakhs of clients invested in the scheme.

Following are the top 10 schemes of 132 debt and hybrid funds that hold AT1 bonds as per value:

Sr. No.	Scheme Name	Holding % of AUM	Perp bond AUM	Scheme AUM (Cr.)
1	HDFC Balanced Advantage Fund(G)	3.42%	1473	43052
2	ICICI Pru Banking & PSU Debt Fund(G)	13.41%	1448	10799
3	ICICI Pru Balanced Advantage Fund(G)	3.10%	1223	39479
4	ICICI Pru Equity & Debt Fund(G)	5.10%	983	19274
5	ICICI Pru Short Term Fund(G)	4.95%	909	18376
6	ICICI Pru Floating Interest Fund(G)	5.47%	798	14603
7	ICICI Pru Savings Fund(G)	3.24%	717	22114
8	SBI Equity Hybrid Fund-Reg(IDCW)	1.38%	704	50867
9	Kotak Banking and PSU Debt Fund(G)	6.92%	618	8929
10	HDFC Low Duration Fund(G)	3.46%	595	17182

Data as on 29th April, 2022

Given that many investors would be part of the above schemes, it is essential to understand the exposure of these bonds and determine how much of one's debt portfolio is quasi-equity. Consequentially, it leads to the question - how much mark to market risk is one willing to take in one's debt portfolio?

04 Altman Z-Score

Objective: *To understand why Altman Z-score is a better option of determining the credit risk of a company.*
(This note has an annexure)

While selecting any debt instrument, the most significant risk that an investor faces is the credit risk of the issuer. The most popular way of assessing credit risk is credit ratings. Now, let us understand how these rating agencies operate and if they have been able to assess the credit risk before the event of default.

Typically, rating agencies use several parameters while evaluating issuers of debt instruments, including company background, financial performance for the last few years (including different business segments and their market outlook), history of default by the company, management team and peer-to-peer comparison.

In the recent past, we have heard of many companies that have been referred to the National Company Law Tribunal (NCLT) after having defaulted to the tune of lakhs of crores. Most of these companies were given an investment-grade rating before the default.

If you take Amtek Auto's credit ratings for instance, the rating agency maintained an "AA" rating for Amtek Auto for three years from 2013 to 2015. CARE Ratings downgraded the rating by one notch to "AA-" in May 2015 and suspended ratings on 7th Aug 2015 without putting the company on credit watch. The company eventually defaulted in September 2015. Brickwork Ratings also downgraded the rating from "A+" to "C", i.e. below investment grade, at once in August 2015..

Similarly, in the case of Bhushan Steel, it saw its credit rating downgraded six notches back-to-back in two months by CARE, and sixteen notches by Brickworks Ratings in five months in 2015, only after the company defaulted. This clearly shows that credit ratings failed to show the true picture and the probability of an impending default. Surely, rating agencies are more reactive than proactive.

Hence, it would be prudent to consider a more mathematical measure of assessing credit risk which is objective in nature. One such method, which is globally used by banks, auditors, legal teams, and credit accessors for the last forty years, is the Altman-Z score. Developed by NYU Stern Finance Professor Edward Altman in 1967, the Altman-Z score predicts the probability of default by a company.

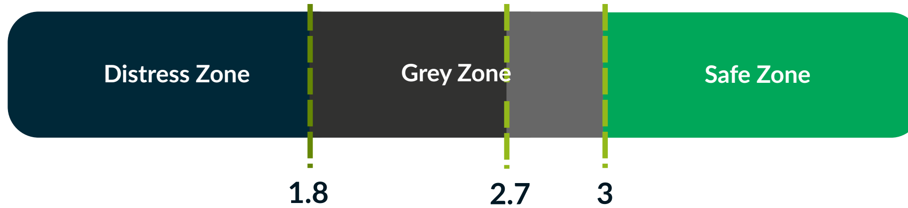
The Altman Z-score takes the following 5 parameters into account with different weights (calculated basis regression analysis) from the company's financials, calculated on an annual basis:

1. **Working Capital (X1) :-** (Working Capital / Total Assets)
2. **Earnings Retention (X2) :-** (Retained Earnings / Total Assets)
3. **Profitability (X3) :-** (Earnings Before Interest & Taxes / Total Assets)
4. **Leverage(X4) :-** (Market Value of Total Equity / Total Liabilities)
5. **Sales (X5) :-** (Total Income / Total Assets)

The following is the Altman Z-Score formula:

Z-Score: 1.2 X1 + 1.4 X2 + 3.3 X3 + 0.6 X4 + 1.0X5

If the Z-score is greater than 3, then the company is in the 'Safe Zone'. If the score is in the range of 1.8 to 3, it lies in the 'Grey Zone'. If the score is in the range of 1.8 to 2.7, the company is likely to default in 2 years. If the score does not improve and is less than 1.8, then the company is in the 'Distress Zone' with a higher likelihood of default.



Now, if the Altman Z-score formula is applied to Amtek Auto, and Bhushan Steel then the trend in the fiscal deterioration of the company would have been glaringly visible. The below table clearly shows that the credit rating agencies raised no red flags to caution the investors.

Amtek Auto	2013	2014	2015	2016
Credit Rating*	AA-	AA-	AA-	Suspended
Altman Z-Score	2.95	1.95	0.38	-1.27

CARE Ratings

Bhushan Steel	2012	2013	2014	2015
Credit Rating*	A+	A+	BB	Suspended
Altman Z-Score	1.71	1.38	0.54	-0.03

CARE Ratings

If it is a BFSI company issuing the debt, then request for the Altman Z2-score, which is a slight variation of the Z-score.

The following is the Z2-Score Formula: (*Refer Annexure*)

Z2-Score: 3.25 + 6.56 X1 + 3.26 X2 + 6.72 X3 + 1.05 X4

Hence, the Altman Z-score is a better method to assess credit risk. Before taking any decision, especially, in the case of a single-issuer debt instrument, it is imperative to check the Altman Z-score.

Into day's dynamic world, nobodycan predict
the future but you can prepare for it. Inorder to
do so, it is important to have an analytical approach
because if you can measure something, you can improve it.

- **ChiragMuni** , Associate Director, AnandRathi Wealth Limited

05 Market Linked Debentures: Understanding Option Pricing

Objective: *Understanding the basic concept of option pricing and its applicability to our Market Linked Debentures (MLD).*

In this note, the endeavor is to bring forth a deeper understanding of derivatives - the backbone of MLDs.

MLDs have two major risks – market risk and credit risk. While the topic of credit risk has been covered through the Altman Z-score, market risk is related to the underlying derivative, which is the 3-year options or LEAPS (long-term equity anticipation securities). So, it is crucial to understand the pricing of the underlying derivative.

For example, in a Protected Call, Rs. 100 goes into a fixed income instrument (NBFC), and 2 PUTS for 3 years are sold to receive a premium of Rs. 10 on every Rs. 100. So, the question is, how did Rs. 10 premium arise and not Rs. 8 or Rs. 12? For this, understanding how the pricing of options is derived, using the Black Scholes Model is essential.

The **Black Scholes Model** is one of the essential concepts in modern financial theory. This model is one of the best ways of determining fair prices of options. The model won the Nobel Prize in economics in 1997 and is widely used today in global financial markets. Globally, large institutions such as JP Morgan, Credit Suisse, UBS, Citi Bank use the BSM to calculate the fair price of the options. The Black Scholes model requires five variables to determine the price of the option.

- **The strike price of an option -** Strike price of an option is the level of the underlying security at which the option can be bought or sold at the time of exercise or expiry
- **The current underlying price -** The current price of the underlying, which is known as the SPOT level
- **Expiry date -** The date on which the option expires
- **Interest rate -** The interest rate as derived from the market
- **Volatility -** The measure of expected fluctuations in the underlying security

While pricing a Protected Call MLD, of the five variables, the following three known variables are – current market level (Spot Nifty), the strike price (106% of current Nifty level) and the option expiry date (3 years from today). The other two variables are unknown volatility and interest rate.

If these 3-year options or LEAPS are actively available on the exchange, the fair price would have been calculated using the above model by making an informed assumption on the volatility and interest rate. After which, these options would have directly traded at the fair price to receive the Premium on Day 1 and reinvest the premium with the NBFC. This transaction will give the desired pay-off on a Protected Call.

However, these long-term PUT Options may not be available at all points of time as they are illiquid. Due to this, there is a need to synthesise this expected Option premium by taking a position in the Futures market as derived from the Nobel prize-winning Black Scholes Model.

To understand this further, an example is given below.

Example: Product: Protected Call (Selling Put Option)

Investment Amount: **Rs. 1 crore**

Spot Nifty – **18000**

Strike Price: **19080 PUT**

Expiry Date**: Three years from today**

Option Price (as derived from Black Scolhes Model) – **Rs. 833**

Total Premium amount – **Rs. 10 lakh**

Quantity: **1150** (amount X no. of PUT/ Initial NIFTY level)

(From the above = Rs. 1 Cr X 2/18000 = 1150 (rounded off as per lot size of 50)

Nifty Values	Nifty Performance	Product Return	Nifty IRR	Product IRR
24840	38%	38.5%	10.67%	10.79%
19080	6%	38.5%	1.85%	10.79%
18900	5%	36.5%	1.55%	10.29%
18360	2%	30.5%	0.63%	8.74%
18000	0%	26.5%	0.00%	7.68%
16200	-10%	6.5%	-3.26%	2.00%
14400	-20%	-13.5%	-6.78%	-4.46%
12600	-30%	-33.5%	-10.62%	-12.05%

To generate the required premium of Rs. 10 lakh there is a requirement to trade PUT Options of 1150 quantity on the mobilisation of Rs. 1 crore. Since there may not always be buyers of PUT Options, the required premium has to be synthesised by trading an equivalent position in the futures market.

The number of Futures to be traded will be governed by the Delta of the Option, as derived by the Black Scholes Model. Delta is nothing but the change in sensitivity of the price of the Option to the change in the price of the underlying (NIFTY) at that point in time. It is imperative to note that the Delta of an Option is subject to change due to change in the value of underlying, expected volatility, and interest rates over a period of time.

For the example above, on **Day 1**, assume that the market is trading at 18000 levels, and the Delta of 19080 Option as calculated using the Black-Scholes model is (-0.50). In effect, for every 1-point increase in the NIFTY level, the Option price reduces by Rs. 0.50. Hence, on Day 1, if 575 quantity of Futures (1150*0.50) are purchased, they will have the same sensitivity as selling 1150 PUT Options.

Suppose if the NIFTY advances by 300 points on **Day 2** and the Delta drops to (-0.40), then only 460 quantity of Futures (1150*0.40) need to be held, as against the current holding of 575 Futures from Day 1. To make the portfolio Delta neutral for that trading day, 115 Futures (575 – 460) will be sold.

If this transaction was done in the Options market and if the Delta of the Option on **Day 1** was (-0.5), and the market went up by 300 points, the option price will also reduce accordingly by Rs. 150 (Delta*Market move = 0.5*300) and now be Rs. 683 (833 - 150 = 683).

Gain from Futures = (18300 – 18000)*575= Rs. 1,72,500

Gain from Options = (683 – 833)*(-1150) = Rs. 1,72,500

Pay-off from Futures = Pay-off from Options

Thus, using Futures, the same pay-off is created as in Options, provided the number of Futures is adjusted using the Options Delta. According to Black Scholes Model, if this process of holding the required number of Futures as per Options Delta for the duration of its tenor continues, the same amount as the premium required along with interest on that premium will be generated.

Please refer a day-wise scenario illustration below:

Day	Spot	Option Qty (A)	Option Px	Delta (B)	Open Futures (Qty)	Futures required (A*B)	Rebalancing	Futures G/L (Rs.)	Option G/L (Rs.)
Day 1	18,000	-1,150	833	-0.50	575	-	-	-	-
Day 2	18,300	-1,150	683	-0.40	575	460	-115	1,72,500	1,72,500
Day 3	18,100	-1,150	763	-0.45	460	517	57	-92,000	-92,000
Total								80,500	80,500

Hence, from the above data, it is noticed that the rebalancing of the Delta Hedge always accumulates profits since the idea is to sell high and purchase low in the Futures market. As per Black Scholes Model, these daily Delta Hedging profits will be equal to the premium of the Option along with interest, considering the assumptions on volatility and interest rates during the tenor of option held are realised. However, if there are any deviations from the assumptions on volatility and interest rate, then the pay-off will result in either profile or loss.

The impact of the assumed volatility and interest rate is explained below:

Since the product is created for the next three years, the expected volatility, also known as implied volatility, is assumed. Realised volatility is the measure of the actual fluctuations realised in the market. If there are deviations between the realised and the implied volatility, the pay-off at maturity will change accordingly. For easier understanding;

Realised volatility = Implied volatility = Replicates payoff

Realised volatility < Implied volatility = Lower return than the targeted pay-off

Realised volatility > Implied volatility = Higher return than the targeted pay-off

Similarly, there is an assumption on interest rates for the next three years, which is nothing but the rollover cost of the underlying in the Futures market. Just like the above example, if there are deviations between the realised and the implied rates, the pay-off would change accordingly. For easier understanding;

Realised interest rate = Implied interest rate = Replicates payoff

Realised interest rate > Implied interest rate = Lower return than the targeted pay-off

Realised interest rate < Implied interest rate = Higher return than the targeted pay-off

Conclusion

It is imperative to understand that the perception of Risk in MLDs is far from reality. The underlying risk of the MLD could be managed using a Noble prize-winning model like Black Scholes. Hence, one must not look at it like a Black box.

06 Where there is a Will, there is a Way!

Objective: *Understanding the importance of a WILL and knowing the necessary aspects to keep in mind while drafting a WILL.*

One of the most challenging conversations to have with a client is creating his / her WILL. Having this conversation is necessary for wealth managers because the investor's wealth could outlive his / her finite life. In India, talking about a WILL is taboo because it invokes fear on an issue that is certain in life. In fact, clients often voice out the following apprehensions:

- Talking about a WILL is too early
- Any conversation regarding WILL creation could create insecurity amongst family members
- Family members are cordial, and so there is no requirement of a WILL.

While these apprehensions are natural, it is also essential to understand the consequences of not having a WILL in place.

The following are the five critical fallouts of not having a WILL:

1. Transmission not as per the client's wishes:

If a person dies without creating a WILL, he/she is said to have died intestate. In such a scenario, wealth is passed on as per the applicable succession laws and not as per his/her desire. The succession laws are as follows:

- **Hindu Succession Act, 1956**
  - If the client is either a Hindu, Buddhist, Jain or Sikh, then the Hindu Succession Act, 1956 is applicable.
  - In case of the death of a male member, the wealth will be passed equally between the wife, mother, and children.
  - In case of the death of a female member, the wealth will be passed equally between husband and children.
- **Indian Succession Act, 1925**
  - Succession laws under this Act apply to Christians and Parsi
  - If a Christian dies intestate, then 1/3rd of his/her assets will go to the spouse and 2/3rd to lineal descendants
  - If a Parsi dies intestate, his/her assets will be passed on to the spouse and children equally. However, if the parents of the deceased are alive, then each parent will receive a share equal to half the share of each child.
- **Shariah Law**
  - As per Shariah law, the client's wealth will be distributed in a pre-determined share to the family members. For example, if a wife and children survive a deceased, then 1/8th share of the wealth will go to the wife. If the parents of the deceased are alive, then each parent gets 1/6th share of the wealth. And, the remaining 7/8th share will be distributed in the ratio of 2:1 between the son and daughter.

2. Unwanted distress:

It can delay the whole process of transmission of wealth because the client's family could be running from pillar to post, fighting for what should be rightfully theirs in the client's absence. And, imagine the gravity of the situation if the client's children are abroad. In fact, the client's family will have to get a Succession Certificate/ Letters of Administration, a process that will take more than a year.

- Succession Certificate is filed when there are ONLY movable assets of the deceased
- Letter of Administration is filed when there are both movable assets and immovable properties of the deceased.

3. Costly affair:

The cost of acquiring the Succession Certificate/ Letters of Administration could be a significant percent of the client's overall asset, including lawyer and court fees, which vary from State to State.

4. Loss in transmission:

The client's children may be unaware of all assets, and they could remain unclaimed forever. For example, even today, there are over Rs. 82,025 crores, lying unclaimed in Banks, Life Insurance Policies, Mutual Fund investments, Company stocks and EPFO accounts.

5. Bitter feuds & legal hassles:

It can create unnecessary disharmony, which could lead to court battles. Even (late) Dhirubhai Ambani thought his sons had a cordial relationship. But, upon his demise, since there was no WILL, both brothers were in a power struggle to get the best portion of the Reliance Group. Hence, it is advisable to prepare a WILL for a client's family.

A WILL should be a straightforward, transparent, and uncomplicated document, and to do that, a client needs to keep five essential points in mind.

1. Include all assets:

To ensure that family members get the entire wealth, it is mandatory to mention all assets - traditional and non-traditional. Traditional assets include immovable property, financial investments, business shareholding, future inheritance, and jewelry. Non-traditional assets include digital assets, expensive watches, and artifacts.

2. Synchronise Nominations:

In India, as the laws/rules and regulations related to nominations are inconsistent, this could possibly lead to a legal issue on the ownership of the assets.

In bank accounts, bank lockers, and fixed deposits in banks, a nominee is considered the custodian and not the owner of the financial asset. However, for PPF, EPFs, MFs, Shares and Demat securities, the nominees are considered owners. In the case of insurance policies, the

client's spouse, children, and parents are the owners. Any other person apart from them, are the custodian. In the case of immovable property in Maharashtra, the nominee becomes the custodian, whereas, in West Bengal, the nominee becomes the owner. So, it is best to synchronise the nominations on the assets as per the WILL.

3. Guardian for a minor:

In the case of minors, it is highly recommended to mention a Guardian in the absence of natural guardians.

4. Appoint an Executor

An Executor is legally responsible for following the client's wishes after the client's demise, as mentioned in the WILL. It is vital to appoint an Executor, or else the Court will appoint one. While choosing an Executor, it is recommended that the selected Executor be younger than the client and resides in India.

5. Registration of WILL:

While registration of a WILL is not mandatory, doing so establishes the authenticity of the person's signature and reduces the scope of further ambiguity. It is essential to attach a doctor's certificate stating the client is of a sound mind and able to sign his / her WILL.

One last point to be kept in mind in the transmission process is that after the client's demise, his / her legal heirs may be required to obtain a Probate from Court, primarily if the client has immovable properties in Chennai, Mumbai, and Kolkata. A Probate is a certificate by the Court which states that this is the client's Last and Final WILL. Once the client's Executor files for a Probate, the Court will issue the certificate in six months to a year. Nowadays, even Pune requires a Probate for the transfer of assets.

This note aims to ensure that a client starts thinking about transmission of wealth to the next beneficiaries when he / she is in his / her full capacity to carry out his / her wishes so that there is near to zero transmission loss of the assets.

On WILLs, Anand Rathi Wealth's Deputy CEO Mr. Feroze Azeez always says, 'WILL is nothing but writing the implied.'

07 ULIPs Decoded

Objective: *Understanding the compositions of Unit Linked Insurance Plans (ULIPs)*
(This note has an Annexure)

In the 2018 budget, the Government under Section 112(A) of the Finance Bill, 2018 reintroduced taxation on Long-Term Capital Gains on Equities.

With this move, equity investments like Direct Stocks, Mutual Funds, PMS or AIFs came under the purview of the LTCG tax. The only option available with investors for a long-term tax-free return on equities became the Unit Linked Insurance Plans or ULIPs.

Consequentially, ULIPs became a hit overnight as they were being marketed as the best equity investment option for HNIs. But, it is imperative to understand the fine print and evaluate whether this trade-off between ULIPs and other equity products would be beneficial in the long run.

The following few parameters need to be kept in mind:

1.Commissions and expenses:

Observations of the first-year commissions paid by some of the well-known Insurance Companies, which account for 60% - 65% of the market share within the private life insurers' space (i.e. excluding LIC), revealed startling data. For FY 22-23, the total premium collected (in Regular Premium ULIPs) was Rs. 19,011 crores, and the first-year commissions paid were Rs. 1,530 crores, which is 8.05% on average. Some of the top names have also paid commissions as high as 20.69%. Moreover, this commission is deducted from an investor's initial capital investment.

Insurance Company	For FY 2022-23 (Rs in Crore)		
	New Premium Collected (Rs)	1st Year Commission Paid (Rs)	Commission %
Tata AIA Life	1,978	409	20.69%
HDFC Life	2,062	213	10.33%
ICICI Pru Life	2,826	300	10.63%
Max	6,327	223	3.53%
AgeasFederal Life	112	5	4.85%
SBI	5,706	379	6.65%
Total	**19,011**	**1,530**	**8.05%**

To top this, other chargeslike Mortality, Fund Management, and Policy Administration, cumulating to roughly 2.5% p.a. It does not stop there; from the 2nd year onwards, there is an additional average of 3% premium allocation charge. As against this, an investor gets charged ~2%-2.5% p.a. (including commissions) on similar products.

Effectively, it means, if an investor invests Rs. 100 in the first year, then the actual investment into the fund ranges anywhere between Rs. 85 to Rs. 90 only and from the second year onwards, approximately Rs. 95.

Aggressive Allocation (As on 04/06/2022)			Flexi Cap Allocation (As on 04/06/2022)		
Insurance Company-Fund Name	10 Yr.	Rank	Mutual Fund Name	10 Yr.	Rank
SBI Life - Equity Elite Fund	15.86	1	Quant Flexi Cap Fund Growth Option Direct Plan	24.51	1
Tata AIA Life - Whole Life Aggressive Growth Fund	14.71	2	Quant Flexi Cap Fund Growth	23.56	2
Tata AIA Life - Life Aggressive Growth Fund	13.81	3	JM Flexicap Fund (Direct) Growth Option	20.03	3
Tata AIA Life - Life Growth Fund	13.57	4	Parag Parikh Flexi Cap Direct Growth	19.98	4
SBI Life - Equity Optimiser Pension Fund	13.52	5	Parag Parikh Flexi Cap Regular Growth	19.12	5
Kotak Mahindra Old Mutual Life - Kotak Dynamic Growth Fund	13.43	6	JM Flexicap Fund Growth	18.82	6
SBI Life - Top 300 Pension Fund	13.37	7	Aditya Birla Sun Life Flexi Cap Fund Direct Plan Growth	18.47	7
Tata AIA Life - Growth Maximiser Fund	13.28	8	HDFC Flexi Cap Fund -Direct Plan - Growth Option	18.43	8
Aditya Birla Sun Life - Individual Magnifier Fund	13.22	9	Franklin India Flexi Cap Fund Direct Growth	18.25	9
SBI Life - Top 300 Fund	13.06	10	SBI Flexicap Fund Direct Growth	18.23	10
Average	**13.85**		**Average**	**19.94**	

2. Performance:

Now, observations of the past 10-year performance of the top 10 insurance ULIP schemes and top 10 MF schemes revealed that while the ULIP schemes generated 13.85% on an average, the MF schemes generated 16.23% on an average in the multi-cap category.

For instance, if an investor had invested Rs. 25 lakh every year for the past 10 years, then in a ULIP, the investor would have reached a maturity value of Rs. 5.81 crores post-tax along with a life insurance cover of Rs. 2.5 crores. However, if the investor had split the amount into buying a pure Term-plan for the same cover of Rs. 2.5 crores, it would cost Rs. 31,000 p.a. The remaining Rs. 24.69 lakh, if invested in Mutual Funds, would generate a maturity value of Rs. 9.01 crores. After accounting for LTCG tax, it would have still been at Rs. 8.34 crores. The difference would have been an additional wealth creation of Rs. 2.53 crore ***(refer annexure)***

It is apparent that the perceived tax efficiency is eaten away due to cost inefficiency and relatively poor performance. Investors may do a combination of term life insurance which offers life cover at a reasonable premium charge and Mutual Funds, which offers better returns without paying any extra commission and fees.

Learning is about having zero resistance. It is about absorbing and correcting your thought process and not showing yourself in a good light!

\- **Feroze Azeez** Deputy CEO, Anand Rathi Wealth Limited

08 Tax Matters

***Objective:** Improving tax efficiency on an investor's portfolio by knowing 9 key provisions of the Income Tax Act*

When it comes to tax planning, most investors are overly dependent on their Chartered Accountants. Incidentally, the recommendations come only at the end of the year. Tax planning must be a continuous exercise rather than a one-time activity. Advisors and CAs over-complicate tax planning, but by knowing certain vital provisions, an investor's job is more than half done when it comes to making investment decisions.

In this note, we highlight 9 critical provisions of the Income Tax Act that can guide an investor to a large extent in minimising or setting off taxes that arise out of the five income heads.

The income heads include: Income from House Property (Rental income), Salary, Profits or gains from a business or profession, Capital gains and Income from other sources (such as interest income, dividends and lotteries).

1. Set-off and carry forward of losses [Section 70 – 74]:

- As per the above sections, if there is a loss from house property, then it can be set off against all heads of income but up to only Rs. 2 lakh.
- If there is a business loss, then it can be set off against all heads of income except salary.
- If there is a Short Term Capital Loss from any asset, it can be adjusted against any Short Term (STCG) and Long Term Capital Gains (LTCG).
- If there is a long-term capital loss from any asset, it can be adjusted against LTCG only.

The good news is that any net loss after set-off can be carried forward for 8 years. However, in the subsequent year, it has to be set off against the same income head.

For example, if an investor has taken a set-off of business loss against capital gains in the same year, the residual net loss carried forward can be set off only against the same head, which is, of business income from the following years. However, in short-term capital loss - the carried forward losses can be adjusted against the short and long-term gains in the subsequent years.

2. Capital gains from the sale of the residential house [Section 54]

Any LTCG arising out of the sale of a residential house can be exempted from tax if the capital gains are invested into 1 or 2 residential properties in India. ***(Please note that a person can exercise an option to buy 2 residential properties only once in his lifetime, provided the long term capital gains does not exceed Rs. 2 crores - as per Finance Act 2019)***

For example, - If an investor sells a house and the capital gains arising from the same is Rs. 2 crore and if the investor then buy a residential property worth Rs. 2 crore, then the investor is exempted from Capital Gains tax.

The time limit to buy this new residential house is as follows:

- In case of purchase of a house, within 2 years from the date of sale or 1 year before the date of sale
- In case of construction of a house, within 3 years from the date of sale

3. Capital gains from long term capital assets other than house property [Section 54F]

Exemption under Section 54F is similar to Section 54 with the following exceptions:

- The long term asset sold is not a residential house (e.g. jewellery).
- The new residential house should be worth the sale proceeds and not the capital gains
- An exemption is available to individuals who do not have more than 1 residential house
- Exemption concerning investment in 2 residential properties, as mentioned in Section 54 is not available.

4. LTCG from any real estate [Section 54EC]

- Exemption under Section 54EC can be availed by investing LTCG from Real Estate within six months in specified bonds. These bonds give a taxable interest of 5% for 5 years. However, the maximum amount that can be invested is Rs. 50 lakhs per individual per year.
- The effective IRR of this bond after considering the tax benefit is approximately 8.97% p.a. (refer annexure)

5. Taxation on gifts [Section 56]

Gifts received above Rs. 50,000 p.a. are taxable. However, any gifts received from a "relative" will not be taxed.

List of relatives for any individual is as follows:

a) Spouse of the individual

b) Brother or Sister of the individual

c) Brother or Sister of the spouse

d) All lineal ascendants / Descendants of the individual

e) All lineal ascendants / Descendants of the spouse

f) Brother or Sister of either of the parents of the individual

g) Spouse of all persons referred above

Apart from above, gifts received on the occasion of marriage or through a WILL, shall also not be taxed regardless of the amount and person from whom the gift is received.

6. Indexation on Long Term Capital Assets [Section 48]

- Section 48 allows indexation of all long term capital assets except for bonds / debentures.
- In Budget 2018, an amendment was made to Section 48 where the base year for indexation was changed from 1981 to 2001.
- This means any asset acquired before 2001, will have to be valued as on April 1, 2001, at fair market value.

How does this benefit an investor - *For example, if an investor bought unlisted equity shares worth Rs. 1 crore in 1981, its indexed cost as per the earlier rule would be Rs. 12.15 crore in FY 18-19. If the*

*current value is Rs. 30 crore, the LTCG would be Rs. 17.85 crore and the tax liability will be Rs. 4.27 crore. (Taxed @ 23.92% - **refer annexure)***

With the new rule, while calculating the long term capital gains, the value of the unlisted equity share as on April 1, 2001, will have to be ascertained. If this value were Rs. 10 crore, its indexed cost as per the new rule would be Rs. 28 crores for FY 18-19. Therefore the Capital Gains will be Rs. 2 crores and the tax liability will be Rs. 0.48 crore.

This new rule will help reduce the tax liability by Rs. 3.79 crores in the above example.

7. Clubbing of Income [Section 64]

As per Section 64, any income generated on the asset gifted by an investor to his or her spouse, minor child or daughter-in-law, will be clubbed to the investor's total income.

8. An exception to speculative transactions [Section 43(5)]

- As per Section 43, any transaction not involving any delivery is considered as speculative business income. Therefore, one might assume that trading in derivatives should be considered speculative. However, as per Section 43(5), trading in derivatives listed on a recognised stock exchange is excluded from the definition of the speculative transaction.
- However, if an investor deals in intraday stock trading, the income or loss will be considered as speculative in nature.

We are highlighting this because speculative losses can be adjusted against speculative gains only and speculative losses can be carried forward for 4 years only.

9. GAAR – General Anti-Avoidance Rules

- GAAR came into effect from FY 2014-15 to distinguish between tax planning and tax avoidance.
- As per the provisions, any transaction undertaken with no commercial motive but only to minimize taxes can fall under the purview of GAAR, and the income tax officer has the power to disregard the transaction.
- However, the GAAR provision can be only invoked if the transaction provides a tax benefit above Rs. 3 crore.

While entering into a financial transaction, one is prudent to keep these critical provisions in mind to achieve tax efficiency on investments.

To quote the famous words of one of the United States' founding fathers, Benjamin Franklin,

'...in this world, nothing can be said to be certain, except death and taxes.'

09 Tax Efficiency on Existing Gold Investments

Objective: *Understanding why Gold Monetization Scheme is a more tax-efficient option than holding physical gold.*

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The Indian taxation regime is such that most capital gains are taxable to the tune of 10% - 20%. However, there are 2 instruments that are exempt from capital gains tax - one, which is well-known, is insurance, and the second, which is lesser-known, is gold.

In 2015, the Government launched the Gold Monetization Scheme, which allows the conversion of physical gold into government gold bonds (minimum 30 gms) for anywhere between 1 to 15 years. On maturity, investors get tax free gains on gold.

By changing the form of holding, i.e. from physical to paper, gold investment can turn from a taxable asset to a tax-free asset. Traditionally, Indians invest in the physical form of gold through coins and bars, and the Gold Monetization Scheme acts as a substitute for this physical form of gold.

There are three benefits of this scheme:

- Capital gain tax exemption under section 2(14)(vi).
- It pays interest of up to 2.5% annually, which is tax-free under section 10(15)(vi).
- Moreover, it is backed by a sovereign guarantee, thus making it safer than keeping it in bank lockers.

The below table illustrates the impact of this difference. If an investor had opted for this scheme in 2015, then Rs. 1 crore worth of gold would be valued at Rs. 2.34 crores (capital gains + interest) as against the physical gold valued at Rs. 1.97 crores, i.e. approximately Rs. 36.25 lakhs more post-tax vis-à-vis physical gold.

Scheme Category	Date	Option 1: Hold Gold	Option 2 : Gold Monetization
Amount Invested (3746.72 grams)	31-10-2015	10,000,000.00	10,000,000.00
Interest earned (Year 1)(2.5%) part	31-03-2016		104,167
Interest earned (Year 2) (2.5%)	31-03-2017		250,000
Interest earned (Year 3) (2.5%)	31-03-2018		250,000
Interest earned (Year 4) (2.5%)	31-03-2019		250,000
Interest earned (Year 5) (2.5%)	31-03-2020		250,000
Interest earned (Year 6) (2.5%)	31-03-2021		250,000
Interest earned (Year 7) (2.5%)	31-03-2022		250,000
Interest earned (Year 8) (2.5%)	31-03-2023		250,000
Total Interest Earned (A)		NIL	18,54,167
Value today (₹5751/gram) (B)	31-03-2023	2,15,47,396	2,15,47,396
Less: Tax on capital gains @ 20.8% (C)		17,71,307	NIL
Net post tax including interest (B - C + A)		1,97,76,088.8	2,34,01,563
Return (CAGR)		8.90%	11.21%
Value Differential			36,25,474
Gold Rate as on 31-10-2015		₹2669/gram	Indexed cost* (11377952)

Now, extrapolating this for the next 10 years, assuming gold delivers 6% p.a. returns, this differential would increase to approximately Rs. 31.46 lakhs. So by staying invested in physical gold, one is destructing wealth by almost Rs. 31.46 lakhs.

Particulars	Date	Option 1: Physical Gold	Option 2: Gold Monetization Scheme
Investment Amount	01-04-2023	– 1,00,00,000	-1,00,00,000
Interest Received	31-03-2024		2,50,000
Interest Received	31-03-2025		2,50,000
Interest Received	31-03-2026		2,50,000
Interest Received	31-03-2027		2,50,000
Interest Received	31-03-2028		2,50,000
Interest Received	31-03-2029		2,50,000
Interest Received	31-03-2030		2,50,000
Interest Received	31-03-2031		2,50,000
Interest Received	31-03-2032		2,50,000
Interest Received	31-03-2033		2,50,000
Total Interest Earned (A)		NIL	25,00,000
Maturity Value (B)	31-03-2033	1,79,08,477	1,79,08,477
Less: Tax ©		-6,46,055	NIL
Return P.A		5.61%	7.96%
Net Post Tax Including Interest (B - C + A)		1,72,62,422	2,04,08,477
Net Differential Without Interest Reinvestment			31,46,055

Conclusion

Indians have been investing in gold for generations, and it has sentimental value. This trend is shifting from a physical to a paper form of holding. Gold glitters – but paper gold glitters brighter! By creating awareness, investors can immensely benefit by earning tax-free income on their paper gold deposits.

You have one CFO for your company but for your own wealth, you have more than one CFO! How does that logic work?

- **Rakesh Rawal**, CEO, Anand Rathi Wealth Limited

10 Simplified: Rolling Returns

Objective: *Understanding why rolling returns are a more accurate measure of investment performance.*

Before making any investment decision, investors place a significant emphasis on the past performance of the asset class or product. While past performance as a parameter may or may not be right, if it is chosen as a criterion, the big question is, what is the measure of the past performance?

There are two methods of evaluating past performance – point-to-point returns and rolling returns. Point-to-point returns are widely used in the mutual fund industry. However, rolling returns, which accurately measure past performance, are not used as widely. In this note, we will explain these concepts from the perspective of a mutual fund investor.

First, an example to understand point-to-point returns - If an investor wants to follow a 1-year performance of a fund, the investor looks at a point-to-point return for April 1st, 2021 – 31st March, 2022, which will give the investor one observation to measure the return for that year. This method is called trailing returns which is reflected in Mutual Fund fact sheets.

In contrast, rolling returns means measuring a fund's performance over various intervals within a stipulated period. For example, suppose an investor has to follow a 1-year performance of a fund. In that case, the investor can do an average of yearly rolling returns with a monthly reset - starting with 1st May, 2020 – 30st April, 2021, 1st June, 2020 – 31st May, 2021, 1st July, 2020 – 30th June, 2021 and so on and so forth with the last observation being 1st April, 2021 – 31st March, 2022

By doing this average, there are 12 observations instead of 1 observation for 1 year. This method gives the experience of 12 investors rather than one investor during the same period. Hence, rolling returns is a better method to gauge past performance. This method can also be done with daily resets, which will give more observations.

The benefits of using rolling returns instead of point-to-point returns are:

- It captures a fund performance across market movements during the said period.
- It helps gauge the consistency in fund performance, thus giving a true reflection of a fund's performance.
- It helps identify funds that have only recently started to perform well and do not have a history of excellent performance.

To explain the difference between point to point returns and rolling returns, we have evaluated the performance of certain funds across FY 2021-2022, which has been positive year for the equity markets. The difference between the 1-year point-to-point return and 1-year rolling returns with a daily reset of the top 10 large-cap, mid-cap and small-cap schemes by their AUM, respectively, is shown in the table below:

Returns (FY 2021-22)	Large-Cap Funds	Mid-Cap Funds	Small-Cap Funds	Difference
Point to Point	18.84%	22.55%	36.41%	34.42%
Rolling	43.55%	58.09%	79.42%	
Difference	24.71%	35.54%	43.00%	

Funds with an inception date before Apr'2020
Average difference between rolling returns & point-to-point returns

From an investor's point of view, Large-cap funds on an average have delivered 18.84% returns on a point-to-point basis for the financial year 2021-22. However, this performance looks understated. On a rolling basis, the actual measure of the funds' performance would indicate that the funds have delivered ~44% returns, i.e. the return figure is understated by ~25% over a period of 1-year.

Similarly, in a negative year, the difference between the 1-year point-to-point return and 1-year rolling returns with a daily reset of the top 10 Large-cap, Mid-cap & Small-Cap oriented schemes respectively for the period March 2019 – March 2020 can be seen as below:

Returns (FY 2019-20)	Large-Cap Funds	Mid-Cap Funds	Small-Cap Funds	Difference
Point to Point	-24.70%	-25.11%	-31.56%	27.26%
Rolling	5.35%	-0.46%	-4.49%	
Difference	30.04%	24.66%	27.07%	

Funds with an inception date before 2018
Average difference between rolling returns & point-to-point returns

From an investor's point of view, Large-cap funds on an average have delivered -24.70% returns on a point-to-point basis for the financial year 2019-20. However, this performance looks understated. On a rolling basis, the actual measure of the fund's performance would indicate that the funds have delivered ~5% returns, i.e. the return figure is understated by ~30% over a period of 1-year.

At Anand Rathi Wealth, while selecting mutual funds, rolling returns are used as one of the parameters to measure a fund's past performance to get a realistic assessment.

ANNEXURE

1. Debt Mutual Funds

The following are the 16 categories of debt mutual funds as specified by SEBI. While the investment horizon is based on the tenure of the underlying paper, the minimum investment criteria is a guideline for the fund managers.

Category of Schemes	The average tenure of underlying paper or minimum investment criteria
Overnight Fund	1 Day
Liquid Fund	Up to 91 days
Ultra-Short Duration Fund	3 months - 6 months
Low Duration Fund	6 months- 12 months
Money Market Fund	Up to 1 Year
Short Duration Fund	1 year – 3 years
Medium Duration Fund*	3 years – 4 years
Medium to Long Duration Fund*	4 – 7 years
Long Duration Fund	greater than 7 years
Dynamic Bond	Investment across duration
Corporate Bond Fund	Corporate bonds - 80% of total assets (only in AA+ and above rated instruments)
Credit Risk Fund	Corporate bonds - 65% of total assets (investment in below AA instruments)
Banking and PSU Fund	Debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds - 80% of total assets
Gilt Fund	G-secs - 80% of total assets (across maturity)
Gilt Fund with 10-year constant duration	G-secs - 80% of total assets along with a Maturity of 10 years
Floater Fund	Floating rate instruments - 65% of total assets

** The fund manager can change the portfolio duration for these categories up to 1 year in case of anticipated adverse interest rate movements.*

2. AT1 Bonds

Please find below:

- Basel III capital requirement
- Elements of Common Equity Tier 1 Capital
- Elements of Additional Tier 1 Capital
- AMC-wise Exposure Data as of March 2020
- AT1 Bond Data as of March 2020 of open-ended MF Schemes

	BASEL III CAPITAL REQUIREMENT	% of RWAs*
(I)	Minimum Common Equity Tier 1 ratio	5.5
(ii)	Capital conservation buffer (comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 ratio plus capital conservation buffer [(i)+(ii)]	8.0
(iv)	Additional Tier 1 Capital	1.5
(v)	Minimum Tier 1 capital ratio [(i) +(iv)]	7.0

Elements of Common Equity Tier 1 Capital

1	Common shares (paid up equity capital) issued by the bank
2	Stock surplus(share premium) resulting from the issue of common shares
3	Statutory reserves
4	Capital Reserve (surplus resulting out of sale proceed of assets)
5	Other disclosed free reserves if any
6	Revaluation reserves at a discount of 55%
7	Foreign Currency Translation Reserve at a discount of 25%
8	Deferred Tax assets up to 10% of CET 1 Capital
9	Balance in the P&L account at the end of previous financial year
10	Less: Deductions/Regulatory adjustments

Elements of Additional Tier 1 Capital

1	Perpetual Non-Cumulative Preference Shares(PNCPS)
2	Stock surplus(share premium) resulting from the issue of Instruments like IPDIs
3	Eligible Debt Capital Instruments (including NCDs
4	)Any other instrument as notified by the RBI from time to time
5	Less: Deductions/Regulatory adjustments

AMC Exposure Data - AS of March 2020

2. Altman Z-Score

Altman Z-Score: 1.2 X1 + 1.4 X2 + 3.3 X3 + 0.6 X4 + 1.0X5

Altman Z2-Score: 3.25 + 6.56 X1 + 3.26 X2 + 6.72 X3 + 1.05 X4

Importance/Explanation of each ratio:

1. **Working Capital / Total Assets:**
   - Measures the relative amount of liquid assets.
   - This ratio provides information about the short term financial position of the business based on the balance sheet.
   - The more working capital there is compared to the total assets, the better the liquidity

situation.

2. **Retained Earnings / Total Assets:**

- Retained earnings are the percentage of net earnings that isn't paid out as dividends – hence the word "retained."
- The company will use it to operate the business. It can be reinvested or used to pay off debt.
- If a company has little to no retained earnings, then it has to get money from somewhere to continue with operations. Where does that money come from? Debt or dilution. The lower the ratio, the company is funding assets by borrowing instead of retained earnings.

3. **EBIT / Total Assets:**

- This ratio looks at the company's ability to generate profits from its assets before deducting interest and taxes.

4. **Market value of equity / Book value of total liabilities**

- This ratio is supposed to show you how much of the company's market value could decline before liabilities exceed assets.

5. **Sales / Total assets**

- It is a great indicator of efficiency and business quality when comparing against previous years.
- Quite simply, it is looking at the dollar of sales generated by the company for every dollar of assets.
- The more money you can generate from assets, the better.

3. ULIPs Decoded

ULIPS					MUTUAL FUNDS				
Year	Annual Contribution	Total Charges	Net Contribution	Fund Value at 13.85% p.a.	Year	Annual Contribution	Total Charges	Net Contribution	Fund Value at 19.94% p.a.
06-10-2013	25,00,000	3,00,000	22,00,000	25,04,700	06-10-2013	24,69,000	49,380	24,19,620	29,02,092
06-10-2014	25,00,000	1,37,500	23,62,500	55,41,307	06-10-2014	24,69,000	49,380	24,19,620	63,82,862
06-10-2015	25,00,000	1,37,500	23,62,500	89,98,484	06-10-2015	24,69,000	49,380	24,19,620	1,05,57,696
06-10-2016	25,00,000	1,37,500	23,62,500	1,29,34,481	06-10-2016	24,69,000	49,380	24,19,620	1,55,64,993
06-10-2017	25,00,000	1,37,500	23,62,500	1,74,15,613	06-10-2017	24,69,000	49,380	24,19,620	2,15,70,745
06-10-2018	25,00,000	1,37,500	23,62,500	2,25,17,381	06-10-2018	24,69,000	49,380	24,19,620	2,87,74,044
06-10-2019	25,00,000	1,37,500	23,62,500	2,83,25,745	06-10-2019	24,69,000	49,380	24,19,620	3,74,13,681
06-10-2020	25,00,000	1,37,500	23,62,500	3,49,38,567	06-10-2020	24,69,000	49,380	24,19,620	4,77,76,061
06-10-2021	25,00,000	1,37,500	23,62,500	4,24,67,265	06-10-2021	24,69,000	49,380	24,19,620	6,02,04,700
06-10-2022	25,00,000	1,37,500	23,62,500	5,10,38,687	06-10-2022	24,69,000	49,380	24,19,620	7,51,11,609
06-10-2023	0	0	0	5,81,07,545	06-10-2023	0	0	0	9,00,88,864
Total	**2,50,00,000**	**15,37,500**	**2,34,62,500**	**5,81,07,545**	**Total**	**2,46,90,000**	**4,93,800**	**2,41,96,200**	**9,00,88,864**
Profits earned in case of Equity MF				6,58,92,664	**Online Term Plan Cost - Rs 31,000 p.a.**				
Long Term Capital Gain Tax Payable				65,89,266	**Annual Contribution - Rs 25,00,000**				
Net Fund Value in Hands				8,34,99,598	**Sum assured - Rs 2,50,00,000**				
Difference of Fund Value after LTCG				**2,53,92,052**					

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