



Portfolio Management Services (PMS) Distributors



NiSM NATIONAL INSTITUTE OF
SECURITIES MARKETS
An Educational Initiative of SEBI

Workbook for
NISM-Series-XXI-A: Portfolio Management Services (PMS) Distributors
Certification Examination



National Institute of Securities Markets
www.nism.ac.in

This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Portfolio Management Services (PMS) Distributors.

Workbook Version: October 2023¹

Published by:

National Institute of Securities Markets

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Plot 82, Sector 17, Vashi

Navi Mumbai – 400 703, India

Website: www.nism.ac.in

National Institute of Securities Markets

Patalganga Campus

Plot IS-1 & IS-2, Patalganga Industrial Area

Village Mohopada (Wasambe)

Taluka-Khalapur

District Raigad-410222

Website: www.nism.ac.in

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¹ This version of the workbook is for candidates appearing for NISM Series XXI-A: Portfolio Management Services (PMS) Distributors Certification Examination on or after January 24, 2023.

Foreword

NISM is a leading provider of high-end professional education, certifications, training and research in financial markets. NISM engages in capacity building among stakeholders in the securities markets through professional education, financial literacy, enhancing governance standards and fostering policy research. NISM works closely with all financial sector regulators in the area of financial education.

NISM Certification programs aim to enhance the quality and standards of professionals employed in various segments of the financial services sector. NISM's School for Certification of Intermediaries (SCI) develops and conducts certification examinations and Continuing Professional Education (CPE) programs that aim to ensure that professionals meet the defined minimum common knowledge benchmark for various critical market functions.

NISM certification examinations and educational programs cater to different segments of intermediaries focusing on varied product lines and functional areas. NISM Certifications have established knowledge benchmarks for various market products and functions such as Equities, Mutual Funds, Derivatives, Compliance, Operations, Advisory and Research.

NISM certification examinations and training programs provide a structured learning plan and career path to students and job aspirants who wish to make a professional career in the Securities markets. Till March 2023, NISM has issued more than 17 lakh certificates through its Certification Examinations and CPE Programs.

NISM supports candidates by providing lucid and focused workbooks that assist them in understanding the subject and preparing for NISM Examinations. The book covers about basics of investments, securities markets, investing in stocks, fixed income securities, derivatives and mutual funds. This book also provides an understanding about the role of portfolio managers, operational aspects of portfolio management services, the portfolio management process, performance measurement and evaluation of portfolio managers. The taxation, regulatory, governance and ethical aspects of portfolio managers have also been discussed in this workbook.

Dr. C.K.G Nair
Director

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While the NISM Certification examination will be largely based on material in this workbook, NISM does not guarantee that all questions in the examination will be from material covered herein.

Acknowledgement

This workbook has been developed and reviewed jointly by the Certification Team of National Institute of Securities Markets (NISM), Dr. Rachana Baid, Dr. Kameshwar Rao and Dr. Kishore Rathi. This book draws references from various NISM certification examinations workbooks and NISM acknowledges the contribution of those NISM Resource Persons.

NISM gratefully acknowledges the contribution of the Examination Committee for NISM-Series-XXI-A: Portfolio Management Services Distributors Certification Examination consisting of industry experts.

About NISM Certifications

The School for Certification of Intermediaries (SCI) at NISM is engaged in developing and administering Certification Examinations and CPE Programs for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programs are being developed and administered by NISM as mandated under Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007.

The skills, expertise and ethics of professionals in the securities markets are crucial in providing effective intermediation to investors and in increasing the investor confidence in market systems and processes. The School for Certification of Intermediaries (SCI) seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and Continuing Professional Education Programmes on Mutual Funds, Equities, Derivatives Securities Operations, Compliance, Research Analysis, Investment Advice and many more.

Certification creates quality market professionals and catalyzes greater investor participation in the markets. Certification also provides structured career paths to students and job aspirants in the securities markets.

About the Certification Examination for Portfolio Management Service Distributors

The examination seeks to create a common minimum knowledge benchmark for distributors of Portfolio Management Services (PMS). The certification aims to enhance the quality distribution and related support services in the PMS.

Examination Objectives

On successful completion of the examination, the candidate should:

- Know the basics of investments, securities markets, investing in stocks, understanding fixed income securities, derivatives and mutual funds.
- Understand the role of portfolio managers; operational aspects of portfolio management services and about the portfolio management process; performance measurement and evaluation of portfolio managers.
- Get oriented to the taxation aspects and regulatory, governance and ethical aspects of portfolio managers.

Assessment Structure

The examination consists of 80 multiple choice questions and 3 case-based questions. The assessment structure is as follows:

Multiple Choice Questions [80 questions of 1 mark each]	80*1 = 80 marks
3 Case-based Questions [2 cases (each case with 5 questions of 1 mark each)] [1 case (with 5 questions of 2 marks each)]	2*5*1 = 10 marks 1*5*2=10 marks

The examination should be completed in 2 hours. The passing score for the examination is 60 percent. There shall be negative marking of 25 percent of the marks assigned to a question.

How to register and take the examination

To find out more and register for the examination please visit www.nism.ac.in

Important

- Please note that the Test Centre workstations are equipped with either Microsoft Excel or OpenOffice Calc. Therefore, candidates are advised to be well versed with both of these softwares for computation of numericals.
- The sample caselets and multiple choice questions illustrated in the book are for reference purposes only. The level of difficulty may vary in the actual examination.

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**NISM Series-XXI-A: Portfolio Management Services (PMS) Distributors Certification
Examination**

Syllabus Outline and weightages

Units	Name of Units	Marks
1	Investments	5
2	Introduction to securities markets	3
3	Investing in stocks	8
4	Investing in fixed income securities	8
5	Derivatives	5
6	Mutual Funds	5
7	Role of portfolio managers	13
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9	Portfolio management process	13
10	Performance measurement and evaluation of portfolio managers	13
11	Taxation	5
12	Regulatory, governance and ethical aspects of portfolio managers	9
Total		100

CHAPTER 1: INVESTMENTS

LEARNING OBJECTIVES:

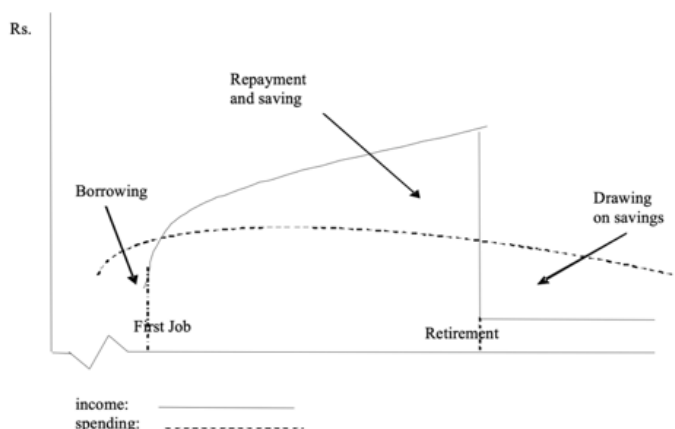
After studying this chapter, you should understand about:

- Meaning of Investments
- Difference between saving and investment
- Difference between investment and speculation
- Objectives of investments
- Components of required rate of return
- Relationship between risk and return
- Types of risks
- Types of investment opportunities

1.1 What is Investment?

People earn money and spend money. They pass through various phases in their life cycle. During some phases, they earn more money than they spend. In other phases, they earn less than they spend. Therefore, sometimes they have to borrow money to meet the shortfall and in other times they end up having surplus money. As can be seen in Exhibit 1.1, rarely the income and spending of individuals or households match.

Exhibit 1.1: The Life-Cycle Pattern of Savings for Households



People have, broadly, two options to utilise their savings. They can either keep it with them until their consumption requirements exceed their income, or, they can pass on their saving to those whose requirements exceed their income with the condition of returning it back with some increment. Therefore, those who consume more than their current income must be

willing to repay more than what they received, to those who have provided the funds. Essentially, people make a trade-off between postponing their current consumption, and an expected higher amount for future consumption. The difference between the two is referred as return.

1.1.1 Saving versus Investment

It is common to use the terms Savings and Investment interchangeably. However, they are not one and the same. Saving is just the difference between money earned and money spent. Investment is the current commitment of savings with an expectation of receiving a higher amount of committed savings. Investment involves some specific time period. It is the process of making the savings work to generate return.

Hence when people are saving, they use the short-term deposits/short-term securities which are highly liquid assets- on the other hand when people are investing they commit funds to real assets, capital market securities such as stocks and bonds, and other long-term commitments that may not be as liquid as short-term assets. See Box 1.1 to understand the difference between Financial and Real assets. Secondly, the objectives of savers and investors are different. Savers tend to accumulate funds to address short-term goals, whereas investors have longer-term goals, such as building retirement corpus or funding children's college education expenses. Those who save funds have the choice of investing. Hence, every investor is a saver but not vice versa.

Box 1.1: Financial Assets versus Real Assets

Assets can broadly be categorised as **financial assets** such as shares, debentures, bank deposits, public provident fund, mutual fund investments and others, and **physical assets** such as gold, diamonds, other precious metals and real estate. Financial assets have the advantage of greater liquidity, flexibility, convenience of investing and ease of maintaining the investments. They are primarily income generating investments, though some of them, such as equity-oriented investments are held for long-term capital appreciation. There is greater ease of investing in such assets as it allows for small and frequent investments.

1.2 Investment versus Speculation

Another term which needs to be distinguished from “Investment” is “Speculation”. Investment and speculation activities are so intermingled that it is very difficult to distinguish and separate them. An attempt can be made to distinguish between speculation and investment on the basis of criteria like investment time horizon and the process of decision making.

Financial transactions occur on a time continuum ranging from micro milli-second, micro-second, second, minute, hour, day, week, month, year, decade, century and perpetual time period. There is a tendency to describe short-term activities as speculative in nature and long-term ownership of assets as investments, which is not appropriate.

Another popular way to define speculation is by extending the dictionary meaning of the same. Dictionary meaning of the term speculation is “the forming of a theory or conjecture without firm evidence”. The activity of investment involves carrying out any exercise or process to determine the value of the asset and then buying the one whose value is determined to be higher than the current market price. However, while speculating, no cognizance is paid to the value of the asset. Here profit making seems to be the sole purpose without much consideration to the risk involved.

1.3 Investment Objectives

Most of the investors invest with a goal in mind, regarding the value of the investment at the end of the investment period. Investment objectives can be defined as investors’ goals expressed in terms of risk, return and liquidity preferences. Some investors may have the tendency to express their goals solely on the basis of return. They must be encouraged to state their goals in terms of both risk and return, as expressing goals only in terms of return may lead to inappropriate asset allocation and adoption of risky investment strategies. Given to themselves, an investor may want her wealth to double up by the end of the year. However, she must be made to understand that such a goal would entail excessive risk. The investor must be explained that the “risk leads return” and not the other way around. Hence a detailed analysis of the risk appetite of the investor i.e. her willingness and ability to take the risk should precede any discussion of the desired return.

The return objective may be simplified as follows:

1.3.1 Capital Preservation means minimizing or avoiding the chances of erosion in the principal amount of investment. Highly risk averse investors pursue this investment goal, as this investment objective requires no or minimal risk taking. Also, when funds are required for immediate short term, investors may state for capital preservation as the investment objective.

1.3.2 Capital Appreciation is an appropriate investment objective for those who want their portfolio value to grow over a period of time and are prepared to take risks. This may be an appropriate investment objective for long term investors.

1.3.3. Current Income is an investment objective pursued when investor wants her portfolio to generate income at regular interval by way of dividend, interest, rental income rather than

appreciation in the value of the portfolio. This investment objective is mostly pursued by people who are retired and want their portfolios to generate income to meet their living expenses.

1.3.4. Tax Saving: Sometimes investors do invest in some select investment alternatives, to reduce their tax burden. This is because the IT authorities provide tax benefits in terms of deductions from taxable income, or as tax rebate from the tax payable.

1.4 Estimating the required rate of return

Investment is the commitment of rupee for a period of time to earn a) pure time value of money – for investors postpone their current consumption b) compensation for expected inflation during the period of investment for the change in the general price levels and c) risk premium for the uncertainty of future payments.

The price paid for the exchange between current and future consumption is the pure rate of interest. If an investor postpones consumption worth Rs. 1000 today for a guaranteed future consumption worth Rs. 1020 then the pure rate of interest in this exchange is 2%. $((1020-1000)/1000)$.

It is the rate of return, the investor demands even if there is no inflation and no uncertainty associated with future payments. In reality, prices level rarely remains the same. Hence, if the investor expects a rise in the price level, they will require an additional return to compensate for it. Further, if there is a risk associated with future payment, investor will demand compensation for bearing the risk.

The compensation for postponement of consumption is the pure time value of money. It is referred as real risk-free rate. Real risk-free rate when adjusted for inflation expectation is referred as nominal risk-free rate. Nominal risk-free rate plus risk premium is required rate of return.

Required rate of return is the minimum rate of return investors expect when making investment decisions. It is to be noted that required rate of return is not guaranteed return or assured return. It is also different from expected or forecasted return. It is also different from realized return.

1.4.1 Nominal risk-free rate, real risk-free rate, and expected inflation

The notion that money has time value is a fundamental concept in investments. It is the central theme in calculating the rate of return. It is better to receive a sum of money today than to receive the same sum tomorrow because it can be invested and earn returns.

Investors can invest in investment opportunities like risk-free bonds, where they are promised to receive an amount more than the amount they have invested.² For example if an investor invests Rs.100 today at a risk free rate of 5% per year, the value of the investment at the end of one year will be $\text{Rs.}100 + (\text{Rs.}100 \times 5\%) = \text{Rs.}105$. Thus, Rs.105 is the future value of this current investment, one year from now. The value today is its present value. i.e. Rs.100. Conversely, if an investor is certain of receiving Rs.105, one year from today, then its present value can be calculated as $\text{Rs.}105 / (1 + 5\%) = \text{Rs.}100$. These calculations substantiate an old age saying that “a dollar today is worth more than a dollar tomorrow”.

The certainty of receiving the amount in future makes it a risk free investment. And the rate of return on the same is called a risk-free rate. In this case it is 5%. This risk-free rate is also referred as nominal rate of return. As can be seen, it ignores the potential change in the purchasing power of rupee. That is, though the investor is certain of receiving Rs.105 after one year, there is no guarantee that rupee will have the same purchasing power a year from now that it has today. From the nominal rate, inflation rate can be subtracted to calculate the real rate of return.

Hence Nominal rate of return can be decomposed into: real rate of return and inflation rate.

Real risk free rate is the basic rate of return or interest rate, assuming no inflation and no uncertainty about future cashflows. It is the compensation paid for postponing the consumption.

For example, an investor gives up Rs. 100 today for more than Rs. 100 say Rs. 102 one year from today. This is a risk-free investment and the real risk-free rate of interest is 2% $((102/100) - 1)$. The desire for current consumption influences this rate. The desire for current consumption is influenced by the investment opportunities available in the economy. The availability of investment opportunities is determined by the real growth rate of the economy. Hence, the real risk free rate is determined by an interaction between subjective factors like the desire for consumption and objective factors like the available investment opportunities and the growth rate of the economy.

As noted above, if investors expect the price level to rise during the period of investment, they would require a compensation for the expected rate of inflation. Continuing with the above example, “What if the price level in the economy increases by 6%?” In such situation, the investors should increase the required rate of return by the expected rate of inflation. If they do not do so, then they would be losing money in the real sense rather than getting a real rate of return. To maintain a consumption of Rs.102, the interest earned must be 8.12 per cent. The required nominal rate of return (NRR) would be as follows:

² An investment avenue where there is certainty of receiving the promised amount in future. Example of risk-free investment is treasury (government) bond.

$$\text{NRR} = (1 + \text{Real rate of return}) \times (1 + \text{Expected rate of inflation}) - 1$$

$$8.12\% = (1 + 2\%) \times (1 + 6\%) - 1$$

Thus, 8.12% rate of return is required in place of 2%. This rate of interest (comprising real rate of return plus the compensation for inflation compensation) is called the nominal rate of return. It is also considered as the nominal risk-free rate of return.

1.4.2 Risk Premium

As discussed above, the nominal risk-free rate of return is the rate of return, an investor is certain of receiving on the due date. Investor is certain of the amount as well as the timing of the return. Hence, it is the risk-free rate of return. Some investment opportunities such as government securities (with some caveats) fit this pattern. The returns from most of the investment opportunities do not have certainty of the amount and the timing of cashflows. Further, the uncertainty of receiving the future cashflows vary amongst investments. In such cases, investors would require compensation for the uncertainty associated with future cashflows. This additional compensation over the nominal risk-free rate is called risk premium. If the investors perceive higher risk (more uncertainty with respect to the future payment), they would demand higher risk premium.

1.4.3 Types of risks

Risk is usually understood as “exposure to a danger or hazard”, however it is not exposure to danger, rather the variability in impact when exposed to a danger. In investment, risk is defined as the possibility that the actual earnings could be different from what is expected to be earned. In more technical terms, the dispersion around the average expected return is defined as risk.

Similarly, people use risk and uncertainty interchangeably. This also is not correct. Risk is not uncertainty. When one does not have any knowledge about the future variability in the expected outcomes or their causal factors, then such a situation is known as “uncertainty”. However, when there is some existing or developing theoretical or empirical knowledge about the factors leading to uncertainty, then such situation is considered as “risk”. In summary, Risk is known uncertainty. As research evidence or scientific advancements progress towards more clarity on the causal factors leading to some phenomena or event, then everyone begins to term that phenomenon as risk and no more uncertainty. There are various types of risk viz., business risk, financial risk, liquidity risk, political risk, exchange rate risk etc..

1.4.3.1 Business risk

Variability of income flows caused by the nature of a firm’s business, is defined as business risk. Sales volatility and operating leverage determines the level of business risk. For example,

an auto manufacturer incurs high operating costs viz-a-viz a retail food company. Earnings and sales of the auto manufacturer fluctuates substantially over the business cycle leading to high business risk.

1.4.3.2 Financial risk

Financial risk relates to the means of financing assets – debt or equity. It is uncertainty caused by the use of debt financing. When a firm borrows, it is required to make fixed payments that must be paid ahead of payments to stockholders. Thus, the use of debt increases uncertainty of stockholder income. and causes an increase in the stock's risk premium. This increase in uncertainty because of use of fixed cost of financing is referred as financial leverage.

1.4.3.3 Liquidity risk

Liquidity has multiple connotations in the realm of finance. One such connotation is the ease of converting an asset into an amount of cash, nearer to its economic worth. The more difficult the conversion, the more is the liquidity risk. Liquidity risk is the uncertainty introduced by the secondary market of an investment. Treasury bills have almost no liquidity risk. They can be sold in a fraction of minute at a price worth their economic value. On the other hand, a piece of art may take longer to get converted into cash and the price may deviate significantly from its worth.

1.4.3.4 Exchange rate risk

Exchange rate risk is the volatility of return introduced by acquiring investments denominated in a currency different from that of the investor. Changes in exchange rates affect the investors return when converting an investment back into the “home” currency. As more and more investors want to reap the benefits of a globally diversified portfolio, this risk increases. As an example, suppose that an Indian investor purchases a dollar denominated bond. On such bond, interest will be paid in dollar. If the rupee has appreciated in value compared to USD, when the interest is received in dollar and converted into rupee, the investor will receive less in rupee than expected. The risk in this entire episode is arising due to the unpredictability of volatile and uncontrollable currency exchange rates.

1.4.3.5 Political Risk

Political risk is the volatility of returns caused by the possibility of a major change in the political or economic environment in a country. Individuals who invest in countries that have unstable political-economic systems must include an additional country risk-premium when determining their required rate of return.

1.4.3.6 Geopolitical Risk

Geopolitics is influence of geography and politics on the social and economic relationships between countries. Geopolitical risk is the risk associated with wars, terrorist acts, and tensions between states that affect the normal and peaceful course of international relations.

An example of geopolitical risk could include a flare-up of tensions between China and USA and how it has impacted the global trade and economy. Another example is the border tensions between India and China that escalated in May 2020

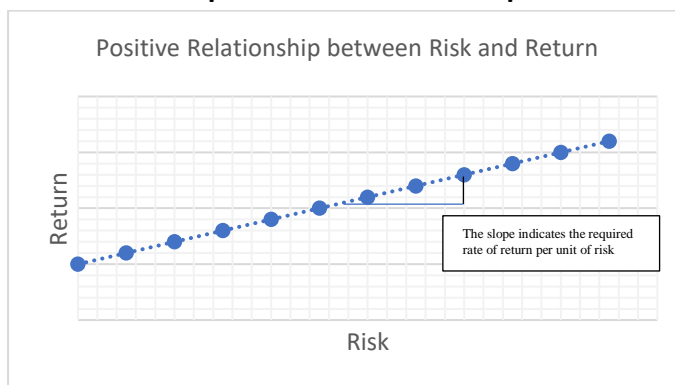
1.4.3.7 Regulatory risk

Regulatory risk is the risk associated with unpredictability about the regulatory framework pertaining to investments. It is the risk that existing regulations will become more stringent leading to higher transaction costs. Regulatory risk is higher in new investment opportunities and products than the matured and established ones.

1.4.4 Relationship between risk and return

Exhibit 1.1 plots the usual relationship between risk and return. A positive relationship exists between risk and return. The greater the risk, the higher the return. The graph demonstrates that investors increase their required rate of return as their expectation about future volatility of returns increases. As a result the risk premium goes up. The graph is just to convey the meaning of a positive relationship, however, in reality, the relationship between risk return is nonlinear, that is there is no proportionate increase in return for every unit increase of risk. Similarly this graph is also different for different individuals, due to their risk appetite or risk aversion.

Exhibit 1.1 Relationship between risk and required rate of return³



1.5 Types of Investments

There are many investment avenues. Broadly, investments can be classified into financial or non-financial investments. Non-financial investments include real estate, gold, commodities etc. Non-financial investments are also called Real Investments. Financial instruments are essentially claims on future cash flows. On the basis of claims on the cash flows, there are two generic types of financial instruments—debt and equity. Financial investments can also be classified on the basis of transferability of ownership in the secondary market, as security

³ Chapter 1, An overview of Investment Process, Analysis of Investments and Management of Portfolios, Reilly & Brown, 10th edition

and non-security form of investments. Security form of investments, like shares, bonds, notes, etc., are easily transferable in the secondary markets. Whereas non-security form of investments like, fixed deposits, insurance, etc., cannot be transferable to any other investor and they do not have secondary markets. Security form of financial investments are actively traded on both capital and money markets.

1.5.1 Equity: Role and characteristics

Equity Shares represent ownership in a company that entitles its holders a share in profits and the right to vote on the company's affairs. Equity shareholders are residual owners of firm's profit after other contractual claims on the firm are satisfied and have the ultimate control over how the firm is operated. Equity Shareholders are residual claim holders. Investments in equity shares reward investors in two ways: dividend and capital appreciation.

Investments in equities have proven time diversification benefits and considered to be a rewarding long-term investment. Time diversification benefits refer to the notion that fluctuation in investment returns tend to cancel out through time, thus more risk is diversified away over longer holding periods. It follows that investment in equities offer better risk-adjusted return if held for long time periods.

The concept of listed versus unlisted equity/ investments are explained in Box 1.2.

Box 1.2: Listed versus Unlisted

Equities or for that matter any financial investment can also be classified on the basis of the trading platforms. Listed investments are traded on a stock exchange. Unlisted investments are bought and sold over the counter. The key difference between the two is the structure of buying or selling the securities. Listed investments follow the listing rules and requirements. The segment of listed investments is called public market. The mechanism of trading at exchange floors enhances liquidity in listed securities and also leads to continuous pricing. However, prices in the public markets are more prone to market sentiments. Both equity as well as fixed income securities trade in this segment. Unlisted investment space is referred as private market. Pricing of investment in unlisted space is not continuous. It is performed at regular intervals or when the need for the same arises for buying or selling. Since these investments do not trade in stock exchange, they are relatively less liquid in comparison to listed investments. Hence, investors may demand an extra compensation for the same called "illiquidity risk premium". Buying and selling of unlisted investments takes longer time compared to the listed investments.

1.5.2. Fixed income securities: role and characteristics

Debt instruments, also called fixed income instruments, are contracts containing a promise to pay a stream of cashflows during the term of the contract to the investors. The debt

contract can be transferable, a feature specified in the contract that permits its sale to another investor, or non-transferable, which prohibits sale to another party.

Generally, the promised cashflow of a debt instrument is a periodic payment, but the parties involved can negotiate almost any sort of cashflow arrangement. A debt contract also establishes the financial requirements and restrictions that the borrower must meet and the rights of the holder of the debt instruments if the borrower defaults.

Debt securities are issued by companies, municipalities, states and sovereign governments to raise money to finance a variety of projects and activities. Debt instruments can further be classified on the basis of issuer into government debt securities and corporate debt securities where the issuer is a non-government entity. Government securities form the largest component of debt market in India as well as world over.

Government versus corporate debt securities

A Government Security (G-Sec) is a tradeable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments.

A key source of funds for corporates is debt financing. Companies issue debt securities of various maturity profiles. Many of these corporate debt papers are listed on stock exchanges. However, a bigger component of corporate borrowings lies in the unlisted space. Corporate fixed income securities pay higher interest rates than the government securities due to default risk. The difference between the yield on a government security and the corporate security for the same maturity is called "credit spread". Higher the probability of default greater would be the credit spread. Credit Spread could also be understood as the "Risk Premium" which the companies are paying to raise the debt, or the investors are charging for bearing default risk.

High yield versus investment grade

The probability of default on a fixed income paper is captured by ratings given by rating agencies. Table 1.1 gives the rating symbols given by CRISIL (a rating agency registered with SEBI). This is further discussed in Section 4.3.

Table 1.1 Rating scale and description

Rating	Description
CRISIL AAA (Highest Safety)	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
CRISIL AA (High Safety)	Instruments with this rating are considered to have the high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
CRISIL A (Adequate Safety)	Instruments with this rating are considered to have the adequate degree of safety regarding timely servicing of financial obligation. Such instruments carry low credit risk.
CRISIL BBB (Moderate Safety)	Instruments with this rating are considered to have the moderate degree of safety regarding timely servicing of financial obligation. Such instruments carry moderate credit risk.
CRISIL BB (Moderate Risk)	Instruments with this rating are considered to have the moderate risk of default regarding timely servicing of financial obligation.
CRISIL B (High Risk)	Instruments with this rating are considered to have the high risk of default regarding timely servicing of financial obligation.
CRISIL C (Very High Risk)	Instruments with this rating are considered to have the very high risk of default regarding timely servicing of financial obligation.
CRISIL D (Default)	Instruments with this rating are in default or are expected to be in default soon.

As can be observed in the rating description, higher rating denotes lower default risk and vice versa. The convention in the market is to classify bonds with rating BBB and above as investment grade and bonds below the BBB as high yield or junk bonds. Many institutional investors are prohibited from investing in junk bonds as they involve high default risk.

Money Market versus capital market

Money market securities have maturities of one year or less than one year. Treasury bills, commercial papers, certificate of deposits up to one year maturity are referred as money market instruments. Capital market is a place for long term fund mobilization. Securities with maturities greater than one year are referred to as capital market securities. Stocks and bonds are capital market securities. Since the investment horizon in capital market is longer, the uncertainty about the future cash flows go up. Investors require extra compensation for the same. It is referred as “term premium”.

1.5.3 Commodities: Role and characteristics

Both soft commodities such as corn, wheat, soybean, soybean oil and sugar and hard commodities which are mined such as gold, silver, oil, copper and aluminium are other investment avenues available to investors.

Soft commodities are perishable hence they exhibit high volatility in their prices. These commodities are subject to higher business cycle risk as their prices are determined by the demand and supply of the end products in which they are consumed. Soft commodities historically have shown low correlation to stocks and bonds.⁴ Hence, they provide benefits of risk diversification when held in a portfolio along with stock and bonds. Prediction of weather is an important factor while investing in soft commodities. Exposure to these commodities can be taken through derivative contracts like forwards or futures. Hence, investors must carefully understand the risk involved in the same.

Prices of hard commodities are determined by the interaction between global demand and supply. Hard commodities such as gold and silver have been the investments avenues for centuries, as reserve assets. Due to its global acceptability gold has acquired the status of a “safe haven” asset. It is viewed as an attractive investment in times of economic uncertainty and geopolitical crisis. Gold has shown diversification benefits historically. Unlike most of the financial investments, commodities do not generate any current income and the investor in these commodities would have to count only on capital appreciation.

1.5.4. Real Estates: Role and Characteristics

Real estate is the largest asset class in the world. It has been a significant driver of economic growth. It offers significant diversification opportunities. It has been historically viewed as good inflation hedge. Investors can invest into real estate with capital appreciation as investment objective as well as to generate regular income by way of rents. It is usually a long-term investment. Real estate is classified into two sub-classes: commercial real estate or residential real estate. It can be further broken down into terms of tier I, tier II and tier III cities. Real estate investments often involve large commitments. Real estate funds or real estate investment trusts REITs have emerged as a good option to enable investors to take exposure to this asset class with smaller outflow commitments.

1.5.5. Structured products

Structured products are customized and sophisticated investments. They provide investors

⁴ a technical term used to measure movement between two variables. The benefits of diversification rests on correlation between investments. Lower the correlation between investments, higher the benefits of diversification i.e. reduction in risk.

risk-adjusted exposure to traditional investments or to assets that are otherwise difficult to obtain. Structured products greatly use derivatives to create desired risk exposures. Many structured products are designed to provide risk-adjusted returns that are linked to equity market indices, sector indices, basket of stocks with some particular theme, currencies, interest rates, commodity or a basket of commodities. Structured products can be designed for a short term or for long terms. The terms can be customized to meet the requirements of the investing community. These products require investments a larger denominations.

They may offer investment protection from 0% to 100% and/or attractive yields. The performance of the structured product is largely driven by the underlying strategy subject to market conditions. Hence, they must not be taken as capital protection or guaranteed or assured return products.

1.5.6. Distressed Securities

Distressed securities are the securities of the companies that are in financial distress or near bankruptcy. Investors can make investments in the equity and debt securities of publicly traded companies. These may be available at huge discounts, however investments in them require higher skills and greater experience in business valuation than regular securities. These securities can be considered from the perspective of diversification of risk. These securities are also referred as 'fallen angels' and many types of funds and institutional investors are prohibited from holding these securities because of the high risk involved. It is a popular investment segment among hedge fund managers as they have deep experience in valuation and credit analysis.

1.5.7 Other investment opportunities

Art and paintings and rare collectibles are emerging as an attractive long-term investment opportunity. This category of investment has been generating moderate returns in the long term. It also has low correlation with financial investments such as equities and bonds. Hence, it provides good risk diversification benefit. However, these are big ticket investments. Also, art is not a standard investment product as each work is unique. The market for the same is unregulated. These investments do not provide any income and just like gold, capital appreciation is the only way of reward. In terms of liquidity, this category is relatively more illiquid. To make rewarding investment decisions, specialized knowledge in arts is more crucial than in traditional financial assets due to higher levels of information asymmetry and adverse selection problems. There are art and painting based investment funds. Investors can take exposure through these funds.

1.6 Channels for making investments

Investors can invest in any of the investment opportunities discussed above directly or through intermediaries providing various managed portfolio solutions.

1.6.1 Direct investments

Direct investments are when investors buy the securities issued by companies and government bodies and commodities like gold and silver. Investors can buy gold or silver directly from the sellers or dealers. In case of financial securities, a few fee-based financial intermediaries aid investors buy or sell investments viz. brokers, depositories, advisors etc., for fees or commission.

Registered Investment Advisers

Investors can take the advice from SEBI Registered Investment Adviser (RIAs). As per SEBI Regulation relating to RIAs which came in the year 2013, only qualified professionals who are licensed by SEBI as Registered Investment Advisers (RIAs) can act as 'advisers'. These advisers are paid fees by the investors who hire them for investment advice. After this regulation, the distributors of financial products like mutual fund distributors, share brokers and insurance agents who would earlier act as investment advisers, can no longer claim the title. These advisers, like other fee-based professionals, are only accountable to their investors. They are required to follow a strict code of conduct and offer advice in the investors' best interests. They are also required to disclose any conflict of interest. Advisers do basic risk profiling, assess the needs and requirements of the investors, understand their financial health and develop 'financial plans'. They help in inculcating a sense of discipline in investors. Thus advisor can help investors create an optimum investment portfolio and help them in making rational investment decisions.

1.6.2. Investments through managed portfolios

Alternatively, investors can invest through investment vehicles which pool money from investors and invest in variety of securities and other investments on their behalf. In other words, investors make indirect investments. These investment vehicles are professionally managed. Through these managed portfolios they can avail the professional expertise at much lower costs.

The following are examples of managed portfolio solutions available to investors in India:

- Mutual Funds
- Alternative Investment Funds
- Portfolio Managers

- Collective Investment Schemes

Mutual Fund

A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. Money collected through mutual fund is then invested in various investment opportunities such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized are shared by its unit holders in proportion to the number of units owned by them. Mutual fund is a pass-through intermediary in the true sense.

The following are the benefits of investing through mutual funds:

- Professional investment management
- Risk reduction through diversification
- Convenience
- Unit holders account administration and services
- Reduction in transaction costs
- Regulatory protection
- Product variety

However, mutual fund products are not 'get rich quick' investments. They are not risk-free investments. Mutual funds are strictly regulated by SEBI under Mutual Fund Regulation 1996. Mutual fund industry offers tremendous variety. There are products for different types of investment objectives and goal.

Alternative Investment Fund

Alternative Investment Fund or AIF is a privately pooled investment vehicle which collects funds from sophisticated investors, for investing it in accordance with a defined investment policy for the benefit of its investors. The words 'privately pooled' denote that the fund is pooled from select investors and not from the general public at large. These private investors are institutions and high net worth individuals who understand the nuances of higher risk taking and complex investment arrangements. The minimum investment value in AIF is one crore rupees.

AIFs are categorized into three categories under the SEBI AIF Regulations for the purposes of registration and other operational requirements. These categories are mentioned below.

Category I AIF – is an AIF that invests in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME Funds, social venture funds, infrastructure funds, special situation funds and such other AIFs as may be

specified under the regulations from time to time. Other funds that are considered economically beneficial and are provided special incentives by the government or any regulator are also considered as part of this category.

Category II AIF – is an AIF that does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements or as permitted in the regulations. For this purpose, AIFs such as private equity funds or debt funds for which no specific incentives or concessions are given by the government or any other Regulator are included under this category.

Category III AIF – is an AIF that employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. AIFs such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the government or any other Regulator are included under this Category.

Internationally, the investors in a hedge fund (AIF category III) are very popular among large institutional funds such as pension funds, investment funds, insurance companies, endowment funds, investment banks, family offices and HNIs. All these investors have large pools of funds and look for varied investment options beyond traditional investments. Hedge funds cater to the needs of such investors through alternative asset classes.

Portfolio Management Services

A portfolio manager is a body corporate who advises or directs or undertakes on behalf of the investors the management or administration of a portfolio of securities. There are two types of portfolio management services available. The discretionary portfolio manager individually and independently manages the funds of each investor. The non-discretionary portfolio manager manages the funds in accordance with the directions of the investors.

The portfolio manager enters into an agreement in writing with the investor, clearly defining the relationship and setting out their mutual rights, liabilities and obligations relating to the management of funds or portfolio of securities.

Portfolio management services are regulated by SEBI under Portfolio Manager Regulations. The regulations have not prescribed any scale of fee to be charged by the portfolio manager to its clients. However, the regulations provide that the portfolio manager shall charge fee as per the agreement with the client for rendering portfolio management services. The fee so charged may be a fixed amount or a return based fee or a combination of both.⁵ The portfolio manager is required to accept minimum Rs. 50 lakhs or securities having a minimum worth of

⁵ The fees could also be AUM based fixed fees or carry profit sharing or a combo.

Rs. 50 lakhs from the client while opening the account for the purpose of rendering portfolio management service to the client. Portfolio manager cannot borrow on behalf of his clients. Portfolio managers provide investment solutions unique to the needs of the investors.

Mutual Funds Alternate Investment Funds and Portfolio Managers

Mutual Funds, Alternate Investment Funds (AIFs) and Portfolio Managers (PMs) are managed portfolios. All three provide indirect way of investing in securities and other investments to investors. All three are regulated by SEBI. However, Mutual funds are more stringently regulated compared to AIF and PMS as mutual funds cater to retail investors. In case of AIF, the minimum amount required for investment is Rs. 1 crore and in case of PMS it is Rs. 50 lakhs. AIF and PMS cater to institutional and high net worth investors. These investors are expected to understand complex investment strategy and risks involved. The investment restrictions of PMS and AIF are also relatively less compared to mutual funds. So though, there are some similarities between them, there are important differences too.

Chapter 1: Sample Questions

1. If there is an uncertainty with respect to the future payment, the investor would require return more than the nominal required rate of return. The additional component is called _____.
 - a. Alpha
 - b. Risk free rate of return
 - c. **Risk premium**
 - d. Both b & c

2. Future value of the investment is influenced by _____.
 - a. Time period
 - b. Rate of return
 - c. **Both a & b**
 - d. None of the above

3. _____ represent ownership in a company that entitles its holders to participate in its profits and the right to vote on the company's affairs.
 - a. Bonds
 - b. Commercial Papers
 - c. **Equity Shares**
 - d. All the above

4. Which of the following statements about Speculation is FALSE?
 - a. It is investment without any significant analysis or thought
 - b. Speculation is based on some conjectures without evidence
 - c. Profit is the strongest motivation for Speculation
 - d. **Speculation always leads to higher returns**

5. Liquidity Risk refers to _____?
 - a. The ease with which one can convert an asset into Cash
 - b. The possibility of realising almost the entire economic worth of an asset.
 - a. Only A
 - b. Only B
 - c. **A and B**

CHAPTER 2: INTRODUCTION TO SECURITIES MARKETS

LEARNING OBJECTIVES:

After studying this chapter, you should understand about:

- Meaning of securities and the functions of securities market
- Structure of Securities Markets--Primary and Secondary markets
- Ways to issue securities
- Functions of different market participants
- Institutional investors and retail participants

The securities market provides an institutional structure that enables a more efficient flow of capital in the economy. If a household has some savings, such savings can be deployed to fund the capital requirement of a business enterprise, through the securities markets. The businesses issue securities, raise money from the household through a regulated contract, lists the securities on a stock exchange to ensure that the security is liquid (can be sold when needed) and provides information about its activities and financial performance to the household. This basic arrangement in the securities markets enables flow of capital from households to business, in a regulated institutionalised framework.

The term “securities” has been defined in Section 2 (h) of the Securities Contracts (Regulation) Act 1956. The Act defines securities to include:

- a) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or a pooled investment vehicle or other body corporate;
- b) derivative ⁶;
- c) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- d) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- e) units or any other such instrument issued to the investors under any mutual fund scheme (securities do not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938);

⁶As per SCRA, derivatives includes a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security; a contract which derives its value from the prices, or index of prices, of underlying securities; commodity derivatives; and such other instruments as may be declared by the Central Government to be derivatives. [Amended by the Finance Act 2017]

- f) units or any other instrument issued by any pooled investment vehicle
- g) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- h) government securities;
- i) such other instruments as may be declared by the Central Government to be securities (including onshore rupee bonds issued by multilateral institutions like the Asian Development Bank and the International Finance Corporation, electronic gold receipts, zero coupon zero principal instruments);
- j) rights or interest in securities.

A security represents the terms of exchange of money between two parties. Securities are issued by companies, financial institutions or the government. They are purchased by investors. Security ownership allows investors to convert their savings into financial assets which provide a return. The issuers of securities are able to reach out to a broader group of investors. For example, in the absence of a well-developed securities market, a household with surplus fund may have to hold all of their savings in a bank deposit even if they are willing to take on some risk for higher returns. But with the different types of equity and fixed income securities available with varying levels of risk and return, investors can choose to invest their surplus funds in the type of security that suits their specific preferences. Thus, the objectives of the issuer and the investor are complementary and the securities market provides a vehicle to mutually satisfy their goals.

The issuer of the security provides the terms on which the capital is being raised. The investor in the security has a claim to the rights represented by the securities. These rights may involve ownership, participation in management or claims on assets.

The market in which securities are issued, purchased by investors and subsequently transferred among investors is called the securities market.

2.2 Primary and Secondary market

The securities market has two interdependent and inseparable segments, viz., the primary market and the secondary market. The primary function of the securities market is to enable the flow of capital from those that have it to those that need it. Securities market helps in transfer of resources from those with idle or surplus resources to others who have a productive need for them. To state formally, securities market provides channels for conversion of savings into investments and back. The investors in the Indian securities market

have a wide choice of financial products to choose from depending upon their risk appetite and return expectations.

The securities market has two interdependent and inseparable segments:

Primary Market: The primary market, also called the new issue market, is where issuers raise capital by issuing securities to investors. Fresh securities are issued in this market.

Secondary Market: The secondary market facilitates trades in already-issued securities, thereby enabling investors to exit from an investment or new investors to buy already existing securities.

The primary market facilitates creation of financial assets, and the secondary market facilitates their marketability/tradability which makes these two segments of Financial Markets - interdependent and inseparable.

2.2.1 Primary Market

As stated above, primary market is used by companies (issuers) for raising fresh capital from the investors. Primary market offerings may be a public offering or an offer to a select group of investors in a private placement program. The shares offered may be new shares issued by the company, or it may be an offer for sale, where an existing large investor/investors or promoters offer a portion of their holding to the public. Let us understand various terms used in the primary market context.

Public issue: Securities are issued to the members of the public, and anyone eligible to invest can participate in the issue. This is primarily a retail issue of securities.

Initial Public Offer (IPO): An initial public offer of shares or IPO is the first sale of a corporate's common shares to investors at large. The main purpose of an IPO is to raise equity capital for further growth of the business. Eligibility criteria for raising capital from the public investors is defined by SEBI in its regulations and include minimum requirements for net tangible assets, profitability and net-worth. SEBI's regulations also impose timelines within which the securities must be issued and other requirements such as mandatory listing of the shares on a nationwide stock exchange and offering the shares in dematerialized form etc.

Further Public Offer (FPO): When an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, it is called a further public offer or FPO. When a company wants additional capital for growth or desires to redo its capital structure by retiring debt, it raises equity capital through a fresh issue of capital in a further public offer. An FPO may also be through an offer for sale, which usually happens when it is necessary to increase the public shareholding in the company to meet the regulatory requirements.

Rights Issue: Shares offered to existing shareholders in proportion to their existing holding in the share capital of the company are termed as “Rights shares” popularly known as rights issue. In the rights issue, the shareholders have a right to participate in the issue. It is pre-emptive rights given by the status to existing shareholders. In this rights issue, the offer is required to be made to the existing shareholders on pro-rata to their existing holdings. The shareholders who are offered may or may not subscribe to the same. They may subscribe partly or fully the offer.

Private Placement: When an issuer makes an issue of securities to a select group of persons and which is neither a rights issue nor a public issue, it is called private placement. This is primarily a wholesale issue of securities to institutional investors. It could be in the form of a Qualified Institutional Placement (QIP) or a preferential allotment.

According to Companies Act 2013, an offer to subscribe to securities, made to less than 200 persons, is called private placement of securities. The requirements of SEBI’s regulations with respect to a public issue does not apply to a private placement. A privately placed security can be listed on a stock exchange provided it meets the listing requirements of SEBI and the stock exchange. Private placement of securities can be done by a company irrespective of whether it has made a public offer of shares or not.

Preferential Issue: Preferential issue is when a listed issuer issues shares or convertible securities, to a select group of persons. The issuer is required to comply with various provisions defined by SEBI relating to pricing, disclosures in the notice, lock-in, in addition to the requirements specified in the Companies Act.

Qualified Institutions Placements (QIPs): Qualified Institutions Placement (QIP) is a private placement of shares made by a listed company to certain identified categories of investors known as Qualified Institutional Buyers (QIBs). QIBs include financial institutions, mutual funds and banks among others. SEBI has defined the eligibility criterion for corporates to be able to raise capital through QIP and other terms of issuance under QIP such as quantum and pricing etc.

Bonus Issues: A bonus issue of shares is made to the existing shareholders of a company without any consideration from them. The entitlement to the bonus shares depends upon the existing shareholding of the investor. A bonus issue in the ratio 1:3 entitles the shareholder to 1 bonus share for every 3 held. The company makes the bonus issue out of its free reserves built from genuine profits. A company cannot make a bonus issue if it has defaulted on the payment of interest or principal on any debt securities issued or any fixed deposit raised.

A company has to get the approval of its board of directors for a bonus issue. In some cases, the shareholders of the company also need to approve the issue. A bonus issue once

announced cannot be withdrawn. The record date for the bonus issue will be announced and all shareholders as on the record date will be entitled to receive the bonus.

Onshore and Offshore Offerings: While raising capital, issuers can either issue the securities in the domestic market and raise capital or approach investors outside the country. If capital is raised from domestic market, it is called onshore offering and if capital is raised from the investors outside the country, it is termed as offshore offering.

Offer for Sale (OFS): An Offer for Sale (OFS) is a form of share sale where the shares offered in an IPO or FPO are not fresh shares issued by the company, but an offer by existing shareholders to sell shares that have already been allotted to them. An OFS does not result in increase in the share capital of the company since there is no fresh issuance of shares. The proceeds from the offer go to the offerors, who may be a promoter(s) or other large investor(s). The disinvestment program of the Government of India, where the government offers shares held by it in Public Sector Undertakings (PSUs), is an example of OFS. It may be stated that OFS is a secondary market transaction done through the primary market route.

Employee Stock Ownership Plan: Some companies offer employee stock ownership plans that enable employees to own a small stake in the share capital of the company, as an incentive to participate in making the business successful. The terms and conditions on which employees can exercise the rights would be mentioned in the ESOP scheme. The option given to the employees can be exercised after a certain lock in period, which is generally more than one year. The dates on which the employees become entitled to exercise the right to acquire the shares is called as “vesting date.” The rights may vest fully or partially over the vesting period. For example, an employee is given 1000 options on 31st March, 2016 which can be exercised in phases like 30% on completion of one year, 30% on completion of second year and the balance on completion of the third year from the date of such grant.

Foreign Currency Convertible Bonds (FCCBs): FCCBs are foreign currency (usually dollar) denominated debt raised by companies in international markets but which have the option of converting into equity shares of the company before they mature.

The payment of interest and repayment of principal is in foreign currency. The conversion price is usually set at a premium to the current market price of the shares. FCCBs allow companies to raise debt at lower rates abroad. Also, the time taken to raise FCCBs may be lower than what it takes to raise pure debt abroad.

An Indian company that is not eligible to raise equity capital in the domestic market is not eligible to make an FCCB issue either. Unlisted companies that have raised capital via FCCB in foreign markets are required to list the shares on the domestic markets within a stipulated time frame.

FCCBs are regulated by RBI notifications under the Foreign Exchange Management Act, 1999 (FEMA). The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism), 1993 lays down the guidelines for such issues.

Depository Receipts - ADR / GDR: Depository receipts (DRs) are financial instruments that represent shares of a local company but are listed and traded on a stock exchange outside the country. DRs are issued in foreign currency, usually dollars.

To issue a DR, a specific quantity of underlying equity shares of a company is lodged with a custodian bank, which authorizes the issue of depository receipts against the shares. Depending on the country of issue and conditions of issue, the DRs can be converted into equity shares.

DRs are called American Depository Receipts (ADRs) if they are listed on a stock exchange in the USA such as the New York Stock Exchange (NYSE). If the DRs are listed on a stock exchange outside the US such as London Stock Exchange (LSE), they are called Global Depository Receipts (GDRs). The listing requirements of stock exchanges can be different in terms of size of the company, state of its finances, shareholding pattern and disclosure requirements.

When DRs are issued in India and listed on Indian stock exchanges here with foreign stocks as underlying shares, these are called Indian Depository Receipts (IDRs). SEBI has laid down the guidelines to be followed by companies for IDRs.

Anchor Investor: In the year 2009, SEBI introduced the concept of anchor investor in public issues. The volume and value of anchor subscriptions serve as an indicator of the firm's soundness of the offer. It also sets a benchmark and gives a guideline for issue pricing and interest among QIBs. Anchor investor means a qualified institutional buyer who makes an application for a value of ten crore rupees or more in a public issue made through the book building process in accordance with Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations.

2.2.2 Secondary Market

While the primary market is used by issuers for raising fresh capital from the investors through issue of securities, the secondary market provides liquidity to these instruments. An active secondary market promotes the growth of the primary market and capital formation, since the investors in the primary market are assured of a continuous market where they have an option to liquidate or exit their investments. Thus, in the primary market, the issuers have direct contact with the investors, while in the secondary market, the dealings are between investors only. Secondary market can be broadly divided into two segments:

Over-The-Counter (OTC) Market: OTC markets are the markets where trades are directly negotiated between two or more counterparties. In this type of market, the securities are traded and settled over the counter among the counterparties directly.

Exchange Traded Markets: The other option of trading in securities is through the stock exchange route, where trading and settlement is done through the stock exchange. The trades executed on the exchange are settled through a clearing corporation, which acts as a counterparty and guarantees the settlement of the trades to both buyers and sellers.

Trading: A formal contract to buy/sell securities is termed as trading. As defined above, trading can be done either in the Over-The-Counter (OTC) or Exchange Traded Market. Securities/stock exchanges in India feature an electronic order matching system that facilitates automatic, speedy and efficient execution of trades.

Clearing and Settlement: Clearing and settlement are post trading activities that constitute the core part of equity trade life cycle. Clearing activity is all about ascertaining the net obligations of buyers and sellers for a specific time period. Settlement is the next step of settling obligations by buyers and sellers by paying money (if transaction is a buy transaction) or delivering securities (if it is a sell transaction).

While OTC transactions are settled directly between the counterparties, clearing corporation is the entity through which settlement of securities takes place for all the trades done on stock exchanges. The details of all transactions performed by the members (and their brokers) are made available to the Clearing Corporation by the stock exchange. The Clearing Corporation gives an obligation report to members and custodians who are required to settle their money or securities obligations within the specified deadlines, failing which they are required to pay penalties. In practice, the clearing corporation provides full novation of contracts between buyers and sellers, which means it acts as buyer to every seller and seller to every buyer. As a result, the operational risk of the transaction is substantially reduced to a trading investor.

Risk Management: In OTC transactions, counterparties are expected to take care of the credit risk on their own. In exchange traded world, the clearing corporation, as defined above, gives settlement guarantee of trades to the counterparties (all buyers and sellers). This exposes the clearing corporation to the risk of default by the buyers and sellers. To handle this risk, the clearing corporation charges various kinds of margins, most prominent among these margins are Initial or upfront margin and mark to market (MTM) margins. Initial margin is a percentage of transaction value arrived at based on concept of “Value At Risk” philosophy and MTM margin is the notional loss which an outstanding trade has suffered during a specified period on account of price movements.

2.3 Market Participants and their Activities

Market Participants in securities markets include buyers, sellers and various intermediaries between the buyers and sellers. Some of these entities are defined in brief below:

2.3.1 Market Infrastructure Institutions and other intermediaries

Stock Exchanges -Stock Exchanges provide a trading platform where buyers and sellers can

transact in already issued securities. Stock markets such as NSE, BSE and MSEI are nationwide exchanges. Trading happens on these exchanges through electronic trading terminals which feature anonymous order matching. Stock exchanges also appoint clearing and settlement agencies and clearing banks that manage the funds and securities settlement that arise out of these trades.

Depositories - Depositories are institutions that hold securities (shares, debentures, bonds, government securities, mutual fund units) of investors in electronic form. Investors open an account with the depository through a registered Depository Participant. They also provide services related to transactions in the securities held in dematerialized form. Currently there are two Depositories in India that are registered with SEBI—Central Depository Services Limited (CDSL), and National Securities Depository Limited (NSDL).

Depository Participant- A Depository Participant (DP) is an agent of the depository through which it interfaces with the investors and provides depository services. Depository participants enable investors to hold and transact in securities in the dematerialized form. While the investor-level accounts in securities are held and maintained by the DP, the company level accounts of securities issued is held and maintained by the depository.

Depository Participants are appointed by the depository with the approval of SEBI. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock- brokers, clearing corporations, NBFCs and Registrar to an Issue and Share Transfer Agents complying with the requirements prescribed by SEBI, can be registered as a DP.

Trading Members/Stock Brokers :Trading members or Stock Brokers are registered members of a Stock Exchange. They facilitate buy and sell transactions of investors on stock exchanges. All secondary market transactions on stock exchanges have to be essentially conducted through registered brokers of the stock exchange. Trading members can be individuals (sole proprietor), Partnership Firms or Corporate bodies, who are permitted to become members of recognized stock exchanges subject to fulfilment of minimum prudential requirements.

Trades have to be routed only through the trading terminals of registered brokers of an exchange, to be accepted and executed on the exchange electronic system. Brokers can trade on their own account using their own funds. Such transactions are called proprietary trades.

SEBI registration to a broker is granted based on factors such as availability of adequate office space, equipment and manpower to effectively carry out his activities, past experience in securities trading etc. SEBI also ensures the capital adequacy of brokers by requiring them to deposit a base minimum capital with the stock exchange and limiting their gross exposures to a multiple of their base capital.

Brokers receive a commission for their services, which is known as brokerage.

Several brokers provide research, analysis and recommendations about securities to buy and sell, to their investors.

Authorized persons (AP): Authorised Persons are agents of the brokers (previously referred to as sub-brokers) and are registered with the respective stock exchanges.⁷ APs help in reaching the services of brokers to a larger number of investors. Several brokers provide various services such as research, analysis and recommendations about securities to buy and sell, to their investors. Brokers may also enable screen-based electronic trading of securities for their investors, or support investor orders over phone. Brokers earn a commission for their services.

Custodians: A Custodian is an entity that is vested with the responsibility of holding funds and securities of its large clients, typically institutions such as banks, insurance companies, and foreign portfolio investors. Besides safeguarding securities, a custodian also settles transactions in these securities and keeps track of corporate actions on behalf of its clients. It helps in:

- Maintaining a client's securities and funds account
- Collecting the benefits or rights accruing to the client in respect of securities held
- Keeping the client informed of the actions taken or to be taken on their portfolios.

Clearing Corporation - Clearing Corporations play an important role in safeguarding the interest of investors in the Securities Market. Clearing agencies ensure that members on the Stock Exchange meet their obligations to deliver funds or securities. These agencies act as a legal counterparty to all trades and guarantee settlement of all transactions on the Stock Exchanges. It can be a part of an exchange or a separate entity.

Clearing Banks - Clearing Bank acts as an important intermediary between clearing members and the clearing corporation. Every clearing member needs to maintain an account with the clearing bank. It is the clearing member's responsibility to make sure that the funds are available in its account with clearing bank on the day of pay-in to meet the obligations arising out of trades executed on the stock exchange. In case of a pay-out, the clearing member receives the amount in their account with clearing bank, on pay-out day.

Merchant Bankers- Merchant bankers are entities registered with SEBI and act as issue managers, investment bankers or lead managers. They help an issuer access the security market with an issuance of securities.

⁷ Vide SEBI Circular: SEBI/HO/MIRSD/DoP/CIR/P/2018/117 dated August 3, 2018, all the registered Sub-Brokers needed to migrate to act as an AP and/ or Trading Member (TM).

They are single point of contact for issuers during a new issue of securities. They evaluate the capital needs of issuers, structure an appropriate instrument, get involved in pricing the instrument and manage the entire issue process until the securities are issued and listed on a stock exchange. They engage and co-ordinate with other intermediaries such as registrars, brokers, bankers, underwriters and credit rating agencies in managing the issue process.

Underwriters - Underwriters are intermediaries in the primary market who undertake to subscribe any portion of a public offer of securities which may not be bought by investors. They serve an important function in the primary market, providing the issuer the comfort that if the securities being offered to public do not elicit the desired demand from investors, they (underwriters) will step in and buy the securities.

When the underwriters make their commitments at the initial stages of the IPO, it is called hard underwriting. For example, if the shares are not subscribed by investors, then the underwriters have to bring in the amount by subscribing to the shares.

Soft underwriting is the commitment given once the pricing is determined. The shares that devolve are usually placed with other financial institutions, thereby limiting the risk to the underwriter. Soft underwriting also comes with a clause that provides the option to exit from the commitment in the event of certain events occurring. The risk in hard underwriting is much higher than in soft underwriting.

2.3.2 Institutional Participants

Investors in securities market can be broadly classified into Retail Investors and Institutional Investors.

Institutional Investors comprises mutual funds, pension funds, insurance companies, hedge funds, alternative investment funds, foreign portfolio investors and Investment Advisers. Some of them are defined here in brief:

Mutual Funds: A mutual fund is a professionally managed collective investment scheme that pools money from many investors to purchase securities on their behalf. Mutual fund companies invest the pooled money in stocks, bonds, and other securities, depending upon the investment objective of the scheme which is stated upfront. A fund manager, with the help of a research team, takes all the major decision in terms of which companies to invest in, the percentage of each stock in the portfolio, when to exit and so on.

Pension Funds: A fund established to facilitate and organize the investment of the retirement funds contributed by the employees and employers or even only the employees in some cases. The pension fund is a common asset pool meant to generate stable growth over the long term, and provides a retirement income for the employees. Pension funds are commonly

run by a financial intermediary for the company and its employees, although some larger corporations operate their pension funds in-house.

Insurance Companies: Insurance companies' core business is to insure assets. Depending on the type of assets that are insured, there are various insurance companies like life insurance and general insurance etc. These companies have huge corpus and they are one of the most important investors in the Indian economy by investing in equity investments, government securities and other bonds. Like mutual funds, each insurance company also has designated people who are responsible for investment decisions.

Alternative Investment Funds: The SEBI (Alternative Investment Funds) Regulations 2012 (AIF Regulations) define the term 'Alternative Investment Fund' (AIF) as one which is primarily a privately pooled investment vehicle. Under the SEBI AIF Regulations 2012, we can list the following types of funds as AIFs: Venture Capital Fund, Angel Fund, Private Equity Fund, Debt Fund, Infrastructure Fund, SME Fund, Hedge Fund and Social Venture Fund.

Foreign Portfolio Investors (FPIs): A Foreign Portfolio investor (FPI) is an entity established or incorporated outside India that proposes to make investments in India. These international investors must register with the SEBI to participate in the Indian securities markets.

Investment Advisers: Investment advisers work with investors to help them decide on asset allocation and make a choice of investments based on an assessment of their needs, time horizon return expectation and ability to bear risk. They may also be involved in creating investment plans for investors, where they help investors define their financial goals and propose appropriate saving and investment strategies to meet these goals. The details are discussed later.

EPFO: EPFO (Employees' Provident Fund Organization) is a statutory body set up under the Employees' Provident Funds & Miscellaneous Provisions Act, 1952. EPFO comes under the purview of Ministry of Labour and Employment. From 2015, EPFO is allowed to invest up to 15 per cent of incremental deposits in equity or equity related schemes.⁸

National Pension System: National Pension System (NPS) is a pension cum investment scheme launched by Government of India to provide old age security to Citizens of India. This defined contribution pension system is regulated by Pension Fund Regulatory and Development Authority (PFRDA).⁹ The Central Government had introduced the National Pension System (NPS) with effect from January 1, 2004. Subsequent to Central Government, various State Governments adopted this architecture and implemented NPS with effect from different

⁸ EPFO does not invest in shares and equities of individual companies. (Source: PIB Press release)

⁹ The government's pension plan has moved from defined benefit structure, where all retired employees of a particular rank get the same pension with no contributions by the employee, to a defined contribution structure, where the employee and the employer contribute to the pension fund and the pension received on retirement will depend upon the fund accumulated.

dates. For the non-government category there are two categories available: corporate sector and All Citizens of India. NPS Corporate Sector Model is the customized version of NPS to suit various organizations. NPS schemes invest in equity shares, corporate bonds and government securities.

Family Offices: Family office can be defined as the ecosystem which the family builds around itself to manage its wealth. Family offices provide administrative support to investment management services with a view to coordinate the family financial needs, life style goals, charitable givings, estate planning etc.. Family offices generally serve multiple generations. These are investment management firms catering to ultra-high net worth households/individuals (UHNWI) providing them customized investment management solutions.

Corporate Treasuries: Corporate treasuries are increasingly seen as profit centres. Traditionally, the role of corporate treasury has been that of manager of financial risks and provider of liquidity. The focus area of corporate treasuries has been debt management to capital structure management with the key responsibility of raising long term funds and minimizing the cost of capital.

2.3.3 Retail Participants

Retail Investors include individual investors who buy and sell securities for their personal account, and not for another company or organization. As per the SEBI Issue of Capital and Disclosure Requirements (ICDR) Regulations, 2018: 'Retail individual investor' means an individual investor who applies or bids for specified securities for a value of not more than Rs.2 lakh.

Chapter 2: Sample Questions

1. When a listed company issues shares to a select group of persons, which is neither a rights nor a public issue, then it is known as _____.
 - a. Preferential issue
 - b. Private placement
 - c. Private equity

2. Which of the following is essential for the public issue of a debt security?
 - a. The debt issue size should be greater than Rs. 5000 Crs
 - b. The debt instruments must be credit rated
 - c. The debt issuer must stand as guarantor for the payment of principal and interest.
 - d. The debt instruments should have a minimum coupon specified.

3. Which of the following is the function of the secondary markets?
 - a. Provide liquidity for securities issued
 - b. Provide a platform for making public issues
 - c. Provide information about public companies
 - d. All the above

4. The undertaking of an Intermediary to buy the unsubscribed portion of any issue, during the initial stages of an IPO is _____.
 - a. Hard Underwriting
 - b. Soft Underwriting
 - c. Revocable Underwriting
 - d. Irrevocable Underwriting

5. A trade that is squared-off during the day _____.
 - a. Does not require delivery of shares
 - b. Is not guaranteed by the exchange
 - c. Is cancelled by the exchange
 - d. Is not considered in calculating trading volumes

CHAPTER 3: INVESTING IN STOCKS

LEARNING OBJECTIVES:

After studying this chapter, you should understand about:

- Equity as an investment opportunity
- Types of risk involved in equity investment
- Management of risk through diversification
- The process of equity research and stock selection
- Fundamental and Technical analysis of equity investment

3.1 Equity as an investment

Securities markets enable investors to invest and disinvest their surplus funds in various securities. These securities are pre-defined for their features, issued under regulatory supervision, and in most cases have ready liquidity. Liquidity refers to the marketability (meaning existence of sellers when one needs to buy; and buyers when one needs to sell). There are two broad types of securities that are issued by seekers of capital from investors: Equity and Debt. Equity securities are issued by companies providing ownership to the investor in their company, and Debt securities are issued by companies providing the rights of a lender to the investor. The features of both these securities differ due to the inherent difference in the claim of the investors on the company.

Equity investors also known as shareholders have residual claim¹⁰ in the business. Because they are the owners of the company and not lenders, the company which issues equity securities is not contractually obligated to repay the amount it receives from the shareholders. It is also not contractually obligated to make periodic payments to shareholders for the use of their funds, like interest payments in the case of lenders. Equity investors get voting rights. When equity investor own a sizeable amount of shares in a company, they get an opportunity to participate in the management of the business.

Investors who purchase equity shares look for capital appreciation and dividend income. There is no assurance of both by the company to the equity investor. While dividend payment depends on the profitability of the company, capital appreciation depends on the share market conditions and peculiarities. Because all residual benefits of deploying capital in a

¹⁰ Claim on the company's net assets, i.e. the value of assets after all liabilities have been paid.

business go to the equity investor, the return to equity investor is likely to be higher than that of the debt investors.

Choosing between equity and debt is a trade-off. Investors desiring lower risk, and willing to accept a lower stable return choose debt. However, if they seek a higher return, they may not be able to earn it without taking on the additional risk of the equity investment. Most investors tend to allocate their capital between these two choices, depending on their expected return, their investing time period, their risk appetite and their needs.

3.2 Diversification of risk through equity instruments

Equity is inherently riskier compared to bonds and many other asset classes. However, there are ways to mitigate the risks in stocks. The most meaningful way to risk reduction is through diversification – both on cross sectional (i.e. across business sectors and industries) as well as on time series basis (i.e. across various time periods).

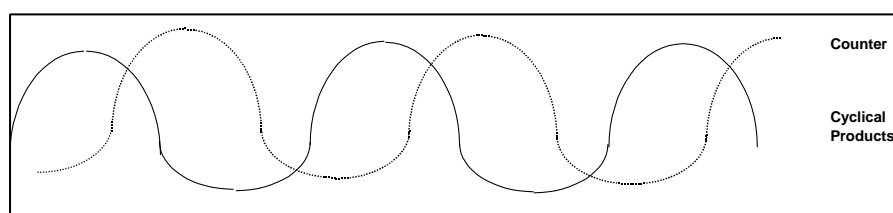
Empirical research has demonstrated that a significant portion of risk can be reduced through diversification. Conceptually, it is achieved due to the relatively less correlated behaviour of various business sectors which underlie each equity investment. This is what the old adage ‘Don’t put all your eggs in one basket’ means.

Cross sectional risk diversification is reducing risk by holding equities in many different kinds of businesses at a point in time and also across various geographies of the world. Reaping the benefits of time diversification requires investing in equities for a long period of time. The belief is that bad times will get cancelled out by good times. This is why “time in the market” is suggested for equity investment as against “timing the market”.

Underlying the word ‘diversification’ is the concept of business cycles and counter-cyclical businesses, and the phenomenon of lag and lead between the behaviour of investments returns and countries’ economic performance.

In Exhibit 3.1, a business cycle is shown as a dark line. Some businesses may be at peak when the business cycle is in its trough, as shown by the broken line. These products or businesses are called ‘counter-cyclical’ or defensive businesses. Businesses that do better in a recession are called ‘recession-proof’ businesses. Some products, sectors or countries come out of a recession faster than others (these are called as leading sectors); other products, sectors or countries may go into recession later than others (these are called lagging sectors).

Exhibit 3.1 Counter-cyclical products



3.3 Risks of equity investments

Equities are often regarded as riskier than other asset classes. The main types of risks discussed in the context of equity investments are discussed below:

3.3.1 Market risk

Market risks arise due to the fluctuations in the prices of equity shares due to various market related dynamics. These factors affect all the listed, market traded assets, irrespective of their business sector. The degree of impact may be different. Beta is a proxy measure for market risk. Market risk cannot be diversified away, though it can be hedged.

3.3.2 Sector specific risk

Risks due to sector specific factors is part of non-market risks. These risks can be diversified away. Sector specific risk is due to factors that affect the performance of businesses in a particular sector. Businesses belonging to other sectors do not get affected by them. This risk can be diversified away by investing into other shares of businesses in different sectors.

3.3.3 Company specific risk

Risks due to sector specific factors are not part of market risks. These risks can be diversified away by investing in different business sectors. Sector specific risks arise due to factors that affect the performance of businesses in a particular sector/industry. Factors affecting certain sectors might not impact certain other sectors. Such risks are also called “idiosyncratic risks”. Say for instance there are restrictions on the movement of international tourists, the airline industry and hospitality industry are going to be affected. But industries and business sectors dependent on domestic customers are not affected by such restrictions.

3.3.4 Liquidity risk

Liquidity risk is defined in Chapter 1. It is measured by impact cost. The impact cost is the percentage price movement caused by a particular order size (let’s say an order size of Rs.1 lakh) from the average of the best bid and offer price in the order book snapshot. The impact

cost is calculated for both—the buy and the sell side. Less liquid stocks are more thinly traded, and a single large trade can move their prices considerably. Such stocks have high impact costs. A lower market impact implies the stock is more liquid.

3.3.5 Currency Risk

Prima facie, it appears that currency risk is not directly related to prices of equity. However, once the financial markets are open to the international investors, currency risk sets in. Currency risk arises due to uncontrollable, unpredictable and volatile exchange rates of various pairs of currencies. When a significant proportion of players in a financial market belong to the international institutional investors groups, then that financial market is bound to be related to exchange rate movements. Many times we hear that stock market reacts to FPIs' buy and sell pressure, and FPIs move in and move out of a country with changes in their home country interest rates, or due to sudden unfavourable exchange rate movements, like deep depreciations in their host countries or due to any other socio-politico-economic, industry or market shocks.

Apart from the above most prominent risks, all other macro-economic factors like inflation, fuel prices, interest rates, economic growth, economic slowdown, do influence stock markets.

3.4 Overview of Equity Market

Equity securities represent ownership claims on a company's net assets. A thorough understanding of equity market is required to make optimal allocation to this asset class. The equity market provides various choices to investors in terms of risk-return-liquidity profile. There are opportunities in listed as well as unlisted equity space available.¹¹ Investments in listed companies is relatively more liquid than investment in unlisted companies. Listed companies have to abide by the listing norms, making this investment space more regulated with better disclosures.

In addition to equity shares, companies may also issue preference shares. Preference Shares rank above equity shares with respect to the payment of dividends and distribution of company's net assets in case of liquidation. However, preference shares do not generally have voting rights like equity shares, unless stated otherwise. Preference shares share some characteristics with debt securities like fixed dividend payment. Similar to equity shares, preference shares can be perpetual. Dividends on preference shares can be cumulative, non-cumulative, participating, non-participating or some combination thereof (i.e. cumulative

¹¹ Listing is a process through which the companies fulfilling the eligibility criteria prescribed by the Exchange(s) are admitted for trading on the Exchange.

participating, cumulative non-participating, non-cumulative participating, non-cumulative non-participating). In case preference stock is cumulative, the unpaid dividends would accumulate to be paid in full at a later time, whereas in non-cumulative stocks the unpaid or omitted dividend does not get paid.

A non-participating preference share is one in which a dividend is paid, usually at a fixed rate, and not determined by a company's earnings.

Participating preference share gives the holder the right to receive specified dividends plus an additional dividend based on some pre-specified conditions. Participating preference shares can also have liquidation preferences upon a liquidation event.

Preference shares can also be convertible. Convertible preference shares entitle shareholders to convert their preference shares into a specified number of equity shares. Since preference shares carry some characteristics of equity share and at the same time some of the debt securities, they are referred to as hybrid or blended securities.

The chief characteristic of equity shares is shareholders' participation in the governance of the company through voting rights. Generally companies issue only one kind of common shares, on the principle of 'one share, one vote'. Some companies, however issue share with differential voting rights (DVRs). Shares with DVRs can either have superior voting rights (i.e. multiple votes on one share) or inferior voting rights (i.e. a fraction of the voting right on one equity share) or differential rights as to dividend. Shares with DVRs are very popular in the western world for many decades. They have not really gained momentum in India. Though way back in 2000, the Companies Act, 1956 was amended to permit issuance of shares with DVRs, not many companies have issued shares with DVRs. Tata Motors was one of the first companies in India to issue DVRs in 2008. These DVRs carried 1/10 voting rights and 5% higher dividend than ordinary shares. Since then, Pantaloon Retails (currently Future Enterprises Ltd.), Gujarat NRE Coke Ltd., Jain Irrigation Systems Ltd. have issued DVRs.

Companies issuing equity shares can be classified on the basis of size—measured by way of their market capitalization as ultra large cap, large cap, mid-cap, small cap, micro-cap etc., each group represents a particular risk-return-liquidity profile. For example large cap companies as a group have lower variability in return than small cap companies.

Technological advancements and integration of global markets have expanded the investment opportunity set for the investors. They can invest in global equities within the restrictions placed by the RBI.

3.5 Equity research and stock selection

As there are thousands of opportunities available to investors in equity market, equity research and stock selection process plays a very important role in identifying stocks which suits the risk-return-liquidity requirements of the investors. Equity research involves thorough analysis and research of the companies and its environment. Equity research primarily means analysing the company's financials and non-financial information, study the dynamics of the sector the company belongs to, competitors of the company, economic conditions etc..

The idea behind equity research is to come up with intrinsic value of the stock to compare with market price and then decide whether to buy or hold or sell the stock. There are many frameworks/methodologies available for stock selection. Analysts use fundamental analysis - top-down approach or bottom-up approach - quantitative screens, technical indicators etc., to select stocks.

3.5.1. Fundamental Analysis

Fundamental analysis is the process of determining intrinsic value for the stock. These values depend on underlying economic factors such as future earnings or cash flows, interest rates, and risk variables. By examining these factors, intrinsic value of the stock is determined. Investor should buy the stock if its market price is below intrinsic value and do not buy, or sell, if the market price is above the intrinsic value, after taking into consideration the transaction cost. In other words, the difference between intrinsic value and market price should be enough to cover the transaction costs. Investors who are engaged in fundamental analysis believe that, intrinsic value may differ from the market price but eventually market price will merge with the intrinsic value. An investor or portfolio manager who can do a superior job of estimating intrinsic value will generate above-average returns by acquiring undervalued securities. Fundamental analysis involves economy analysis, industry analysis, company analysis.

Top Down approach versus Bottom up Approach

Analysts follow two broad approaches to fundamental analysis—top down and bottom up. The factors to consider are economic (E), industry (I) and company (C) factors. Beginning at company-specific factors and moving up to the macro factors that impact the performance of the company is called the bottom-up approach. Scanning the macro economic scenario and then identifying industries to choose from and zeroing in on companies, is the top-down approach.

EIC framework is the commonly used approach to understanding fundamental factors impacting the earnings of a company, scanning both micro and macro data and information.

Buy side research versus Sell Side Research

Though both Sell-side and Buy-side researchers and analysts take up similar works, they differ in terms of: for whom they work, how accurate they need to be, and for what are they paid.

Sell-side Analysts work for firms that provide investment banking, broking, advisory services for clients. They typically publish research reports on the securities of companies or industries with specific recommendation to buy, hold, or sell the subject security. These recommendations include the analyst's expectations of the earnings of the company and future price performance of the security ("price target"). In essence, the sell-side analysts are paid for providing useful information to be acted upon. In this regard, the expectations from the sell-side research is a broad guidance on multiple sectors, rather than accurate price predictions.

Buy-side Analysts work for fund managers like those of mutual funds, hedge funds, pension funds, or portfolio managers that purchase and sell securities for their own investment accounts or on behalf of their clients. These analysts generate investment recommendations for their internal consumption viz. use by the fund managers within organization. Research reports of these analysts are generally circulated among the top management/investment managers of the employer firms as these reports contain recommendations about which securities to buy, hold or sell. Therefore the buy-side researchers need to be more accurate and they are paid for their investment recommendations.

3.5.2. Stock Analysis Process

The value of an investment is determined by its expected cash flows and the investor's/analyst's required rate of return (i.e. its discount rate). The expected cashflows as well as required rate of return are influenced by the economic environment. The analyst needs to have good understanding of important economic variables and economic series. The macroeconomic analysis provides a framework for developing insights into sector and company analysis.

The objective of stock analysis is to make the critical risk-return decision at the market-industry-company stock level. The stock analysis process involves three steps. It requires analysis of the economy and market. Another crucial step in the process is examination of various sectors. The process culminates with the analysis of stocks.

Economy Analysis

Macro-economic environment influences all industries and companies within the industry. Monetary and fiscal policy influences the business environment of the industries and companies. Fiscal policy initiatives such as tax reduction encourages spending while removal of subsidies or additional tax on income discourages spending. Similarly, monetary policy may reduce the money supply in the economy affecting the expansionary plans and working capital requirements of all the businesses. Hence a thorough macro-economic forecast is required to value a sector/firm/equity.

Any macro-economic forecast should include estimates of all of the important economic numbers, including gross domestic product, inflation rates, interest rates unemployment etc.

The most important thing an analyst does is to watch for releases of various economic statistics by the government, central bank and private sources. Especially, they keep a keen eye on the Index of economic indicators like the WPI, CPI, monthly inflation indices, Index of Industrial Production, GDP growth rate etc. Analysts assess the economic and security market outlooks before proceeding to consider the best sector or company. Interest rate volatility affect different industries differently. Financial institution or bank stocks are typically placed among the most interest-sensitive of all stocks. Sectors such as pharmaceuticals are less affected by interest rate change.

The economy and the stock market have a strong and consistent relationship. The stock market is known as a leading economic indicator. A leading economic indicator is a measure of economic recovery that shows improvement before the actual economy does because stock price decisions reflect expectations for future economic activity, not past or current activity.

Industry/Sector Analysis

Industry analysis is an integral part of the three steps of top-down stock analysis. Rates of return and risk measures vary over time in different industries. Industry analysis helps identify both unprofitable and profitable opportunities. Industry analysis involves conducting a macro analysis of the industry to determine how different industry relates to the business cycle.

Performance of industries is related to the stage of the business cycle. Different industries perform differently in different stages of the business cycle. On the basis of the relationship different sectors share with the business cycles, they are classified as cyclical and noncyclical sectors. For example, banking and financial sector perform well towards the end of a recession. During the phase of recovery, consumer durable sectors such as producers of cars, personal computers, refrigerators, tractors etc. become attractive investments. Cyclical industries are attractive investments during the early stages of an economic recovery. These sectors employ high degree of operating costs. They benefit greatly during an economic

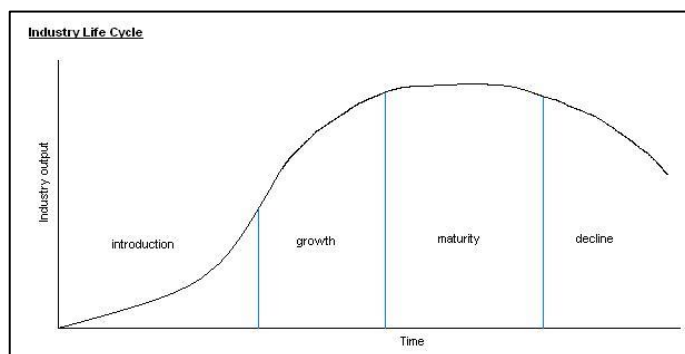
expansion due to increasing sales, as they reap the benefits of economies of scale. Similarly, sectors employing high financial leverage also benefit during this phase, as debt is good in good times.

At the peak of business cycle, inflation increases as demand overtakes supply. Inflation impacts different industries differently. There are industries, which are able to pass on the increase in the costs of products to their consumers by increasing prices. Their revenue and profits may remain unaffected by inflation. Industries producing basic materials such as oil and metals benefits the situation. Rising inflation doesn't impact the cost of extracting these products. These industries can increase prices and experience higher profit margins. However, there are industries that are not able to charge the increased costs of production to their consumers. Their profitability suffers due to inflation.

During a recession phase also, some industries do better than others. Defensive industries such as consumer staples, pharmaceuticals, FMCG, outperform other sectors. In such times, even though the spending power of consumer may decrease, people still spend money on necessities.

Analyst also see the stage the industry is in its life cycle. The number of stages in the life cycle of the industry are depicted in Exhibit 3.2.

Exhibit 3.2: Industry Life Cycle



Introduction: During this stage, industry experiences modest sale and very small or negative profit. The market of the products of the industry is small and the firms in the industry may have high development costs.

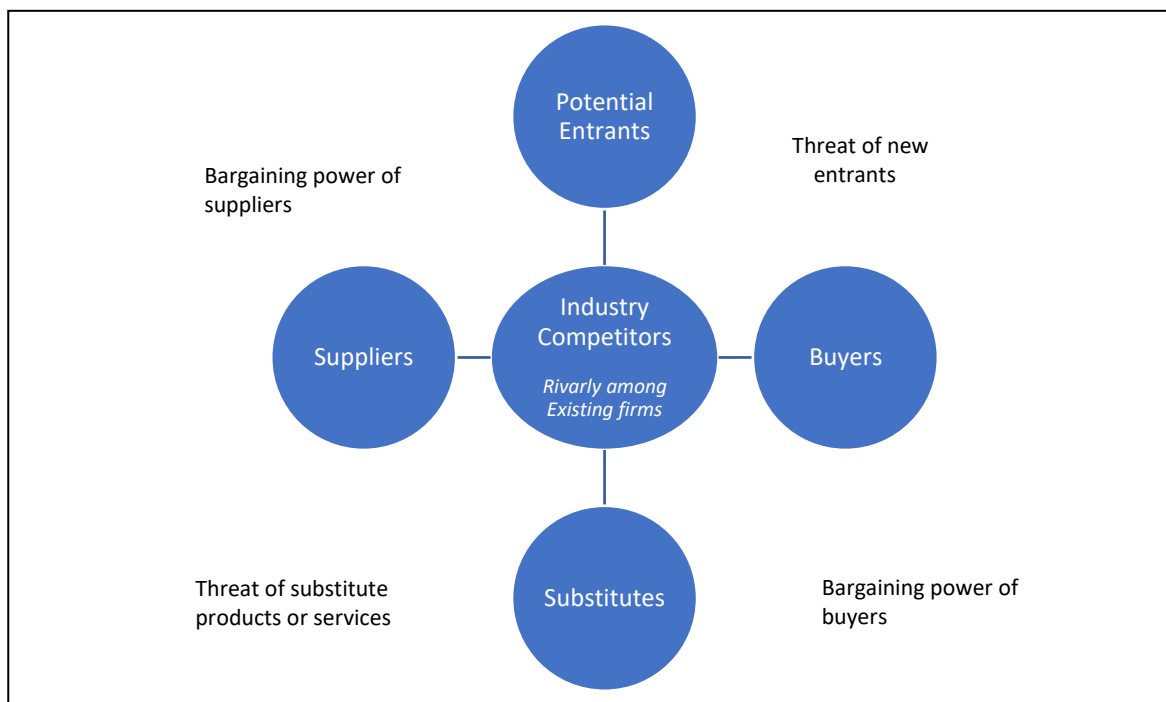
Growth: During this stage, market develops for the products or services of the industry. Number of firms in the industry is less during this phase and hence they may have little competition. Profit margins at this stage are generally high. This stage is followed by mature industry growth. The rapid growth of the earlier phase attracts competitors contributing profits margins go to normal levels.

Maturity: This is generally the longest phase in the life cycle of the industry. During this stage, growth rate in the industry normally matches with the economy's growth rate. Firms in the industry differ from one another given their cost structure and ability to control costs. Competition is high during this stage reducing the profit margin to normal levels.

Deceleration of growth and decline: This stage observes decline in sales due to shift in demand. Profits margins are under pressure and some firms may even witness negative profits.

Similar to life cycle analysis, competitive structure of the industry is to be analysed by the analysts. It is a key factor affecting the profitability of the firms in the industry. Competition influences the rate of return on invested capital. If the rate is "competitive" it will encourage investment. Porter looked at forces influencing competition in an industry and the elements of industry structure. He described these forces as industry's micro- environment. Porters model is presented in Exhibit 2.3.

Exhibit 2.3 Porter's Model



Michael Porter suggests that five competitive forces determine the intensity of competition in the industry, that in turn affects the profitability of the firms in the industry. The impact of these factors can be different for different industries.

The first factor is **rivalry among the existing competitors**. Every industry is analyzed to determine the level of rivalry amongst its firms. Rivalry increases when the industry has many

firms of the same size. And hence firms may compete very hard to sell at full capacity.

The second factor is **threat of new entrants**. The entry barriers influence the entry of new player to the industry. The analysts examine them, as they influence the future competitive structure of the industry and in turn profitability of existing firms.

The third factor is **threat of substitute products**. Substitute products influence the prices firms can charge for their products. Greater the substitutability of the product, lower the profit margins.

The fourth factor is **bargaining power of the buyers**, which influences the profitability. Buyers can influence the profitability of an industry when they are in position to demand lower prices or higher quality by showing a susceptibility to switch among competitors.

The fifth factor is **bargaining power of the supplier**. Suppliers are more powerful if they are few and large in size. They can influence future industry returns if they increase prices or reduce the quality of the product.

Company Analysis

Company analysis is the final step in the top-down approach to stock analysis. Macroeconomic analysis prepares us to understand the impact of forecasted macro-economic environment on different asset classes. It enables us to decide how much exposure to be made to equity. Industry analysis helps us in understanding the dynamics of different industries in the forecasted environment. It enables us to identify industries that will offer above-average risk-adjusted performance over the investment horizon. If trends are favourable for an industry, the company analysis focusses on firms in that industry that are positioned to benefit from the economic trends. The final investment decision to be made is with regard to which are the best companies in the desirable industries? And are they attractive investments in terms of risk-adjusted returns.

Company analysis is to be differentiated from stock valuation. Company analysis is conducted to understand its strength, weaknesses, opportunities and threats. These inputs are used to determine the fundamental intrinsic value of the company's stock. Then this value is compared with the market price of the stock. If the intrinsic value is higher than the market price, the stock is bought and vice versa. It is very important to note that stocks of good companies need not make good investment opportunities. The stock of a good company with superior management and strong performance measured by current and future sales and earnings growth can be trading at a price much higher to its intrinsic value. It may not make a good investment choice and it should not be acquired.

Company analysis is needed to determine the value of the stock. There are many components to company analysis. Financial statement analysis of the company is often the starting point

in analysing company. Analysing the profit and loss account, balance sheet and the cash flow statement of the company is imperative. The financial performance numbers of a company, as presented in the financial statements, can be used to calculate ratios that gives a snapshot view of the company's performance. The ratios of a company have to be seen in conjunction with industry trends and historical averages.

Another important component of company analysis is SWOT Analysis. SWOT analysis involves examination of a firm's, strengths, weaknesses, opportunities, and threats. Strengths and weaknesses deal with company's internal ability, like company's competitive advantage or disadvantages. Opportunities and threats deal with external situations and factors the company is exposed to. Opportunities include a favourable tax environment. An example of threat is stringent government regulation.

Company analysis also involves analysing its competitive strategies. A firm may follow a defensive strategy. A defensive strategy is one where the firm positions itself in such a way that its capabilities provide the best means to deflect the effect of competitive forces in the industry. Alternatively, a firm may be following an aggressive strategy in which the firm attempts to use its strengths to affect the competitive forces in the industry.

Michael Porter suggests two major strategies: Cost Leadership and Differentiation.

Cost Leadership: Under this strategy the firm seeks to be the low-cost producer, and hence the cost leader in its industry. Cost advantages vary from industry to industry.

Differentiation Strategy: Under this strategy, the firm positions itself as unique in the industry. Again the possibilities of differentiation differ from industry to industry.

Another very important component of company analysis is understanding the business model of the company. As part of it, the following questions need to be asked.

- What does the company do and how does it do?
- Who are the customers and why do customers buy those products and services?
- How does the company serve these customers?

Almost all successful investors and fund managers repeat this thought that one must invest only in such firms where one understands the business. In the checklist for research, this is one of the most prominent questions – 'Do I understand the business?' No analyst should move to the next question if he/she can't address what a company does in a line with preciseness and clarity.

There are over 6000 companies listed on Indian exchanges. It is not possible to track and understand all of them. Investors should consider buying shares of few companies they understand rather than invest in a number of companies they don't understand.

Further, each sector has its own unique parameters for evaluation. For the retail sector, footfalls and same store sales (SSS) are important parameters, whereas for banking it is Net Interest Income (NII)/ Net Interest Margin (NIM). For telecom, it is Average Revenue Per User (ARPU) and for hotels, it is average room tariffs etc.. Analysts must possess an in-depth knowledge of the sectors while researching companies.

Further, each company will have its unique way of doing business. The efficiency with which products and services are produced and delivered to the customers may vary from one business to another and will significantly impact its earnings. Therefore, it becomes imperative for analysts to understand the entire business model of companies.

3.5.3. Estimation of intrinsic value

Once the analysis of economy, industry and company is completed, the analyst can go ahead with estimating intrinsic value of the firm's stock. Price and value are two different concepts in investing. While price is available from the stock market and known to all, value is based on the evaluation and analysis of the entity that is undertaking the valuation of the stock at a point in time. It may be noted that Price is a Fact but Value is an Opinion. There are various approaches to valuation. They are explained in the subsequent paragraphs. There are uncertainties associated with the inputs that go into these valuation approaches. As a result, with due diligence, the final output can at best be considered an educated estimate. That is the reason, valuation is often considered an art as well as a science. It requires the combination of knowledge, experience, and professional judgment in arriving at a fair valuation of any asset. The purpose of valuation is to relate market price of the stock to its intrinsic value and judge whether it is fairly priced, over-priced, or under-priced.

Discounted Cash Flow Model

Conceptually, discounted cash flow (DCF) approach to valuation is the most appropriate approach for valuations when three things are known:

- Stream of future cash flows
- Timings of these cash flows, and
- Expected rate of return of the investors (called discount rate).

Once these three pieces of information are available, it is simple mathematics to find the present value of these cash flows which a potential investor would be willing to pay today to receive the expected cash flow stream over a period of time.

Typically, any investment involves the outflow of cash. Later the investor expects, cash inflows during the investment horizon. Finally, at the time of disinvestment, the investor expects a large cash inflow - preferably larger than the original investment - representing the return of original investment with some appreciation. The same framework can be applied to valuing businesses. Popularly, profits are compared to the regular inflows from traditional

investments. However, it should be appreciated that profits are accounting estimates rather than facts. Because accounting standards and tax authorities permit accrual accounting, there can be many valid adjustments to the figure of profit without any involvement of cashflows. Therefore profits in business and returns in the form of cashflows in financial investments are not comparable. This gave birth to the philosophy of estimating cashflows in business from the profit figures.

Business valuation professionals applied the philosophy of discounting to valuation of business entities, drawing from the postulates of time value of money and the fundamental framework, that ***“the intrinsic value of any asset, should be equal to the present value of future benefits that accrue from owning it”***. For instance, when one holds a real asset, like land and buildings, its value should logically depend on the future rental income and resale value that could be generated from it, measured in present value terms. In case of a Bond, the intrinsic value of a bond should depend on the future coupons and the redemption value, measured in present value terms. In both the cases, the entity that estimated the intrinsic value, uses a particular discounting rate, which includes, the minimum risk free rate, the compensation for the term period of the investment, the premia for the asset specific risks, the transaction costs, and the taxes. The aggregate of all these components are referred to as required rate of return. However, in common parlance the transaction costs and taxes are taken as given, so they are ignored.

Extending the logic to business valuation or equity valuation, the investor should logically discount the future benefits accruing to the business or by being an equity investor. In case of a business that has not taken any debt in its capital structure, the entire profits belong to the owners. However when the company engages borrowed capital in the business, then the lenders also have a claim in the assets and profits of the business. If booked profits are considered to be the future benefits, then Earnings Before Interest Tax Depreciation and Amortisation (EBITDA) are the profits left for both the lenders and owners to share along with government for tax. Earnings After Tax (EAT or PAT) are the profits left for only the owners of the business, as other stakeholders (lender, and government) have taken away their dues. As discussed earlier, the inherent weaknesses with the EBITDA and EAT figures, valuation experts preferred cashflow versions of the two accounting figures mentioned above.

FCFF represents the cashflow left for both the lenders and owners, out of which lenders can take their interest and principal repayments, and the owners can take their dividends. FCFE represents the cashflow left only for the owners of the business. Therefore depending on the purpose of valuation, i.e. to value a firm or equity, either FCFF or FCFE is used, respectively.

FCFF for a future year is calculated as = Expected EBIT (1-Tax Rate) + Expected Depreciation + Expected Non-Cash Expenses – Expected Capex by the firm –Expected Increase in Working Capital

FCFE for a future year is calculate as = [(Expected EBIT – INTEREST EXPENSE) * (1 – Tax Rate)] + Expected Depreciation + Expected Non-Cash Expenses – Expected Capex by the firm – Expected Increase in Working Capital – Expected Debt Repayments + Expected Fresh Borrowings

OR

FCFE = Expected FCFF – (Interest Expenses * (1- Tax Rate)) + (Expected Fresh Borrowings – Expected Debt Repayments)

OR

FCFE = Expected FCFF – (Interest Expenses * (1- Tax Rate)) + Expected Net Debt Issues

OR when the company has preference shares also in the capital, it is calculated as

FCFE = Expected FCFF – (Interest Expenses * (1- Tax Rate)) – Expected Preference Dividend + Expected Net Debt Issues + Expected Net Preference Share Issues

Apart from depreciation, other non-cash charges include amortization of intangible assets and loss on sale of assets, which are added back. Unrealised Gains on assets are deducted from the FCFF and FCFE calculations.

The FCFF and FCFE figures are known as “free” because all the other stakeholders, leaving the financiers of the business, are paid their dues before arriving at the figures. Further, the business is also treated as a stakeholder, and the funds required for its growth and sustenance are also provided in the form of CAPEX, and working capital. Therefore what is left is for the financiers’ to claim free of all encumbrances.

Rarely, FCFF may be negative, but there are reasonable chances that FCFE may be negative. In such cases the FCFF may be used for valuing the firm, and then the value of equity can be calculated by deducting the value of debt from it.

Valuation requires forecasting cashflows into the future. This can be done by applying historical growth rate exhibited by company or a rate estimated by the analysts based on their information and analysis. A firm may show a period of high growth in revenues, profitability, capex and other performance parameters, and then stabilize to a steady growth. It may be noted that growth rate in one parameter like sales, should not be considered as growth in assets, similarly the growth in assets cannot be considered as growth in profits or cashflows. However a good proxy that is used in the valuation industry for growth in profits is the product of ***retention ratio*** and ***return on equity*** as follows:

Growth in profits in a dividend paying firm = Retention Ratio * Return on Equity OR $(1 - DPR) * ROE$

Since equity is for perpetuity and it is not possible to forecast the cashflows forever, the practice is to calculate a terminal value of the firm. This terminal value is calculated as at the end of the year, till which time one could comfortably forecast the cash flows with all the available information. The terminal value may be calculated using the formula of a perpetually growing annuity. In this case cash flows are expected to grow, forever, at a steady though modest rate. The average long term GDP growth rate or inflation rate is a good proxy for this growth rate. The terminal value is calculated by multiplying the cash flow for the last year of forecasted period, by $(1 + \text{Normal Growth rate})$ and dividing the resultant value by $(\text{Discounting rate} - \text{Growth rate})$. The terminal value is added as an additional independent component, to the stream of cash flows projected during the growth period or the projection period, and then aggregate of all these cashflows are discounted to today (the day of valuation).

Say for instance one could confidently forecast cashflows for the next 5 years. Then 5th year is the last year of the confident forecast, and from the 6th year onwards the cashflows are expected to grow constantly at a particular rate as described above. The terminal value is calculated as at the end of 5th year and finally this value is discounted to today, when the valuation exercise is undertaken.

The other method to calculate the terminal value is by applying a multiple to either a financial or non-financial metric of performance of the firm, such as the EBITDA, at the end of the confident forecasted year. Meaning in the 5th year as discussed in the previous paragraph. The multiple of a comparable firm is used for the purpose.

The discount rate used in the DCF valuation should reflect the risks involved in the cash flows and also the expectations of the investors.

In most of the valuation exercises, cost of debt is taken as the prevailing interest rates in the economy for borrowers with comparable credit quality. And, cost of equity is the rate of return on investment that is required by the company's common shareholders. Capital Asset Pricing Model - CAPM, which establishes the relationship between risk and expected return forms the basis for cost of equity.

As per Capital Asset Pricing Model (CAPM), the cost of equity is computed as follows:

$$K_e = R_f + \beta * (R_m - R_f)$$

where:

- R_f : Risk Free Rate (usually the ongoing 10 years government bond yield)
- $(R_m - R_f)$: Market risk premium (MRP) (which is a historical average value for a particular market or country)
- β = Beta (it is the sensitivity of a security's return to an index's return, which is chosen as a proxy for market portfolio)

The Weighted Average Cost of Capital of the firm (WACC) is then calculated as under:

$$WACC = [K_e * (\text{Equity} / (\text{Equity} + \text{Debt}))] + [K_d * (1 - \text{Tax}) * (\text{Debt} / (\text{Equity} + \text{Debt}))] \text{ OR}$$

$$WACC = [K_e * W_e] + [K_d * (1 - T_x) * W_d]$$

where:

- K_e : Cost of Equity,
- K_d : Cost of Debt,
- W_d : Weight of Debt
- W_e : Weight of Equity

To calculate the value of the firm, its FCFF is discounted by the weighted average cost of capital (WACC). To calculate the value of equity, its FCFE is discounted using the cost of equity.

$$\text{Value of Firm} = \sum_{i=1}^n \frac{FCFF_i}{(1 + WACC)^i} + \frac{TV}{(1 + WACC)^i}$$

Where,

i = the period for which confident projects of cashflows are done, starting from 1 to n number of years in future

n = the last year for which the cashflows are projected year wise

'FCFF' and 'wacc' are as explained above

$$\text{Terminal Value} = \frac{FCFF_{n+1}}{WACC - g}$$

Where ' g ' = is the constant growth rate of the FCFF in future.

The same equations are used to calculate the value of equity of the firm. The only changes are 'FCFF' is replaced with 'FCFE'; 'wacc' is replaced with ' k_e '; ' g ' is the constant growth rate of 'FCFE'

Asset Based Valuation

Asset Based valuation methodology is used in some businesses where the business is asset heavy, and the assets are usually reflected in the financial statements at fair market value, like financial Institutions, firms in real estate and gold, gems and jewellery. Under this method, the value of the firm is equal to the "adjusted current market values of Net Tangible,

Intangible, Financial, and Net Current Assets". Value of equity is "value of firm less value of all outsider liabilities". Significantly the issue with this approach is that it does not recognise the value of future profits and cashflows of the firm, and all future possible value creation the firm can do due to its research and innovation.

Relative Valuation (Multiple Based)

When the entity that is undertaking the valuation, neither has adequate information to undertake an elaborate valuation exercise like the discounted cashflow approach, nor does it believe in the financial statement values of the assets and liabilities of a firm, it adopts Relative or Multiple based valuation.

Relative valuation arrives at the value of a firm or equity, by multiplying either a financial metric or a non-financial metric of a firm with some number. This number is called a "multiple". The multiple is created as a "ratio" by relating historical market values of either the firm, or its equity, to any chosen financial or non-financial metric. The multiple is calculated for the comparable firms, and then the average value of the same is chosen to value the target company. The value of the target firm is calculated as "the product of the target firm's financial or non-financial metric TIMES the comparable firm's multiple"

While choosing the multiple, the relative approach believes that the value of a firm should very closely relate to the value of other firms in the same business sector. Such other firms are comparable on the basis of asset size, revenue size, business model, revenue model, and product line offering etc. The assumption of this approach is that "a company into confectionary products would not be worth more than any other similar confectionary company currently traded and operating in the market".

The numerator of the multiple in most of the cases is either the Price of the equity share of a comparable firm or its Enterprise Value. Enterprise Value is the sum of "Market value of Equity and Market Value of Debt LESS the value of excess Cash in the business".

The denominator in the multiples are either various versions of Profits or Revenue or Cashflows or Book Value of Equity. Off late, the increasing start-up culture and their long gestations to experience profits in a growing firm, industry analysts have also started relating the value to non-financial metrics. The chosen metric is believed by the analyst to be a significant value driver of the firm, in that business sector. This belief may appear to be like a subjective judgement call, however there are some fundamental relationships underlying the non-financial metric and the profits or revenues. For instance "Average Revenue per Mega Byte" "Average Revenue per User" in the case of Telecom companies, "Plant Load Factor" in the case of Power companies, "Occupancy Rates" in the case of Lodging Hotels, "Footfall" in the case of Retail sector, etc.,

The following are some of the popular multiples used in the valuation of equity and firm.

P/E Ratio

The most common stock valuation measure used by analysts is the price to earnings ratio, or P/E.

For computing this ratio, the stock price is divided by the EPS figure.

For example, if the stock is trading at Rs. 100 and the EPS is Rs. 5, the P/E is 20 times.

Historical or trailing P/Es are computed by dividing the current market price of the equity share by the sum of the last four quarters' EPS. Forward or leading P/Es are computed by dividing the current market price of the equity share by the sum of the expected next four quarters of EPS. Current P/E Ratio is current market price of the equity share divided by the current or the immediate recent annual EPS of a company.

For example, consider a company whose fiscal year ends in March every year. In order to compute the forward P/E for the financial year ending 2019 (technically called FY19), an investor would add together the quarterly EPS estimates for the future quarters ending June 2019, September 2019, December 2019 and March 2020. Then the current market price of equity is divided by this number aggregate number to get a forward P/E Ratio.

A stock's P/E tells us how much investor is willing to invest in an equity share, per rupee of earnings. Therefore a P/E ratio of 10 suggests that investors in the stock are willing to invest Rs. 10 for every Re. 1 of earnings that the company generates.

For judging whether the target firm is fairly valued, undervalued or overvalued, its PE ratio is compared with the market PE ratio (i.e. of Nifty 50, S&P Sensex, SX40, among others), or the average PE ratio of the industry to which it belongs, or with the PE ratios of peer group companies. For example the PE Ratio of the target company is 18, and that of the industry, market or the comparable firms is 22, then the firm is judged to be undervalued.

There are certain limitations to using the PE ratio as a valuation indicator. The projected P/E ratios are calculated based on analyst estimates of future earnings that may not be accurate. PE ratios of companies that are not profitable, and consequently have a negative EPS, are difficult to interpret. P/E ratios change constantly and the ratio needs to be recomputed every time there is a change in the price or earnings estimates. The average P/E ratio in the market and among industries fluctuates significantly depending on economic conditions.

As a general guidance one is advised to approach relation valuation in this manner. For example, all things being equal, a Rs.10 stock is enjoying a P/E of 75, then it is should be considered "expensive" than a Rs.100 stock with a P/E of 20.

Price to Book Value Ratio

Price to Book Value (P/BV) is another relative valuation ratio used by investors. It compares a stock's price per share (market value) to its book value of equity per share. The P/BV ratio is an indication of how the market is valuing the book value of equity or how much more less are the shareholders valuing the equity to be. The market price being above or below the book value is much to do with market players and investor's expectations of the value currently not recognised in the books.

$$\text{Price/Book Value Ratio} = \frac{\text{Stock Price per Share}}{\text{Shareholders' Equity per Share}}$$

The book value per share is calculated by dividing the reported shareholders' equity by the number of equity shares outstanding. Care should be taken, to exclude any existing miscellaneous assets in the balance sheet from the reported shareholder's equity value. Because the value equity has already been eroded as per books, to the extent of value of miscellaneous assets.

If a company's stock price (market value) is lower than its book value, it can indicate one of two possibilities. The first scenario is that the stock is being incorrectly undervalued by investors due to lack of information, and hence the company's stock represents an attractive buying opportunity. On the other hand, if the company is being correctly valued in the opinion of the investors, then it is due to the existence of some "value less" assets in the books or fictitious profits or reserves in the shareholder's equity.

The use of book value as a valuation parameter also has limitations because a company's assets are recorded at historical cost less depreciation. Depending on the age of these assets and their physical location, the difference between current market value and book value can be substantial. Also, assets like intellectual property are difficult to assess in terms of value. Hence, book value may undervalue these kinds of assets. Though P/B ratio has its shortcomings, is still widely used as a valuation metric especially in valuing financial services and banking stocks where the assets are marked to market.

P/S Ratio

The price-to-sales ratio (Price/Sales or P/S) is calculated by taking a company's market capitalization (the number of outstanding shares multiplied by the share price) and divide it by the company's total sales or revenue over the past 12 months. The logics applied for identifying the undervalued and overvalued shares are similar in this multiple too. Sometimes concerns are raised regarding the tendency of the firms to manipulate earnings. In such situations, price to sales ratio can be used instead of earning based ratios as sales are less prone to manipulation. Also in case of companies not earning profits yet, or companies in high volume low margin businesses instead of earning based ratios investors can look at the P/S ratio to determine whether the stock is undervalued or overvalued. Typically the forward Price to Sales ratio is given as below

$$\frac{P}{S} = \frac{P_t}{S_{t+1}}$$

P_t = end of the year stock price for the firm

S_{t+1} = expected annual sales per share for the firm for the next year

Price Earnings to Growth Ratio

Price earnings to growth ratio (PEG Ratio) takes three factors into account—the price, earnings and earnings growth rates. The formula used to compute the PEG ratio is as below:

$$\text{PEG Ratio} = \frac{\text{Price/Earnings (P/E) Ratio}}{\text{Earnings Per Share (EPS) Growth}}$$

(EPS is calculated as Profit after tax (PAT)/Number of outstanding common shares of the company)

This ratio may be interpreted as the price that an investor is willing to pay for a company, as justified by the growth in earnings. The assumption with high P/E stocks is that investors are willing to buy at a high price because they believe that the stock has significant growth potential. The PEG ratio is an improvisation of the PE ratio using a companion variable called growth. Using either the industry or the comparable firms' PEG ratios one can decide whether the target firm's equity is overvalued or undervalued. The PEG ratio may show that one company, compared to another, may not have the growth rate to justify its higher P/E, and its stock price may appear overvalued.

The thumb rule is that if the PEG ratio is 1, it means that the market is valuing a stock in accordance with the stock's estimated EPS growth. If the PEG ratio is less than 1, it means that the stock's price is undervalued given its growth rate. On the other hand, stocks with PEG ratios greater than 1 can indicate just the opposite - that the stock is currently overvalued. This is based on an assumption that P/E ratios should approximate the long-term growth rate of a company's earnings.

The efficacy of the PEG ratio as a valuation measure will depend upon the accuracy with which the earnings growth numbers are estimated. Overestimation or underestimation of future earnings will lead to erroneous conclusions about the valuation of the share.

EVA and MVA

There are many ways analysts can estimate the value of a company. EVA and MVA are the most common metrics used to determine a company's value.

Economic value added (EVA) attempts to measure the true economic profit produced by a company. It is also referred to as "economic profit". Economic profit can be calculated by

taking a company's net after-tax operating profit and subtracting from it the product of the company's invested capital multiplied by its percentage cost of capital.

EVA provides a measurement of a company's economic success over a period of time. This measure is useful for investors who wish to determine how well a company has produced value for its investors.

Market Value Added (MVA) is the difference between the current market value of a firm and the original capital contributed by investors. If the MVA is positive, the firm has added value. If it is negative, the firm has destroyed value. The amount of value added needs to be greater than the firm's investors opportunity cost. The opportunity cost is calculated by estimating the return the investors would have got by investment in the market portfolio adjusted for the leverage of the firm.

EBIT/EV and EV/EBITDA Ratio

Enterprise Value (EV) is an important component of many ratios analysts use to compare companies, such as the EBIT/EV multiple and EV/EBITDA.

The EV of a business is: Market capitalization of equity + Market Value of Debt - Excess cash and cash equivalents

There can be two ways to understand EV. One is to understand how much capital is actually committed in the enterprise that is revenue generating. The other is when some entity is interested to acquire another firm, how much cash would be required to buy the target firm. The assumption is that no entity would be interested in paying cash to acquire cash.

EV can be related to Earnings/Cash from Operations available to the entire fund providers i.e. equity and debt holders. The appropriate financial metric would be Earnings before Interest and Taxes (EBIT). However EBIT is again influenced by the accrual mechanics of the accounting system, and hence to adjust it to make it a cashflow based measure, analysts have coined EBITDA (Earnings Before Interest Tax Depreciation and Amortisation).

The EV/EBITDA multiple is extremely useful in valuing firms which are highly capital intensive and they are not yet making book profits at PAT level or at EBIT level, however, at a gross level and in terms of cash available to the fund providers (i.e. EBITDA) it is surplus. If one goes by the P/E ratio, then unless the company is profitable, the P/E ratio would not be meaningful at all for valuation. Though the company is listed and has a good price in the market, the earnings per share is negative, which is not intuitive to analysts and investors. Investors can still be bullish and positive about such companies, because they understand the need to wait till the company breaks-even or till the impact of capital expenditure on the revenues and profits kicks off. EV/EBITDA accommodates this thought process. It can be used to judge

whether the firm is overvalued or undervalued by comparing its EV/EBITDA value with that of the industry average, or its relevant decile or quintile.

EV/S Ratio

Enterprise value-to-sales (EV/sales) compares the enterprise value (EV) of a company to its annual sales. The EV/sales multiple enables investors to value a company based on its sales, while taking account of both the company's equity and debt, and hence, comprehensive than Price to Sales Ratio. This ratio is more meaningful when the firm is highly capital intensive and its sales and profits cannot be ascribed only to equity investments.

Industry/sector specific valuation metrics

As discussed above, there are different valuation tools. No one method is perfect for all the sectors and companies. Different sectors are valued on different metrics. Non-cyclical sectors like FMCG and Pharma which generate predictable cashflows can be valued using discounted cashflow technique. Replacement cost method is applied for valuing businesses which are capital intensive like cement and steel. Relative valuation tools like P/E Ratio are used as add on metrics across all sectors. It is also popularly used to comment on the valuation of market, comparing it with other markets and also doing comparison over a period of time. Often newspapers and media report the P/E ratio of the market and comment that it is expensive or cheap, compared to other emerging markets. P/B ratio is very popular among banks and financial service sector. Investors/analyst should understand the characteristics and attributes of the sector before they select a particular valuation tool.

3.5.4 Combining relative valuation and discounted cash flow models

Discounting models are used to estimate the intrinsic value of the stock. The relative valuation multiples arrive at the likely market value the firm would compare, by comparing it to similar firms or industry at large. Further the multiples can be categorised as transaction multiple or trading multiples, which provide a good handle for the valuation professionals to justify their valuation and also to adjust their intrinsic valuations according to the latest market sentiments. Trading multiples are based on the prices in the markets at which trades have consummated. Transaction multiples are based on the recent corporate acquisitions which depict the motivations and future prospects as seen by strategic acquirers, who are unlike the intraday or technical based traders in the markets.

Discounting models are dependent on the (1) the growth rates of whichever variable is chosen in the numerator and (2) the required rate of return as the discount rate. If Dividends are substituted in the DCF models that used FCFF or FCFE as discussed in the previous sections and with an assumption that dividends of a firm are going to be given eternally with a constant

growth rate, then the formula for terminal value calculations can be applied to arrive at the intrinsic value of dividends as follows.

This ratio is also influenced by the same variables that influence the value under the discounted cash flow techniques. Price is calculated as follow. This is also the famous Dividend Discounting Model.

$$P = \frac{D_1}{k - g}$$

D_1 = is the dividend that is expected one year hence. This can be as $D_0 \cdot (1+g)$ where 'g' denote expected growth in dividend, and D_0 indicates current dividend. 'k' is the discount rate which is the proxy for the required rate of return of the equity investors. A deeper look into the formula that D_1 can be expressed as $E_1 \cdot \text{DPR}$ which is the expected Earnings Per Share a year hence multiplied by Dividend Payout Ratio (DPR). So the formula can be expressed as follows

$$P = (E_1 \cdot \text{DPR}) / (k - g)$$

Now, let us look at the P/E ratio to understand the connection between discounted techniques and relative valuation:

$$\text{Forward P/E Ratio} = \text{Price} / \text{Expected Earnings Per Share or } P / E_1$$

To convert the dividend discounting model depicted above to a P/E ratio, one can divide both the sides of the equation by E_1 (expected earning during the next time period) to get

$$\frac{P}{E_1} = \frac{\text{DPR}}{k - g}$$

Thus P/E Ratio is affected by three variables:

1. Required rate of return of the equity investors (k)
2. Expected growth rate of dividends (g)
3. The dividend payout ratio of the firm.

Higher the expected growth rate of dividends, higher would be the P/E ratio. Higher the required rate of return on equity, lower would be the P/E ratio. Higher the dividend payout ratio higher would be the P/E ratio. The above equation is usually known as "Fundamental P/E" of a company, which is derived based on how the firm is performing and the expectations of the equity investors. However this ratio appears to show its dependence on dividend payout ratio, and hence it should be cautiously applied to only companies which are stable dividend paying and then compare with such companies only. This approach cannot be

applied to start-ups, irregular dividend paying companies, and companies which are in a growth path and the markets are accounting for such a growth in the price.

3.6 Technical Analysis

Technical analysis is based on the assumption that all information that can affect the performance of a stock, the company fundamentals, the economic factors and market sentiments, are reflected already in its stock prices. Accordingly, technical analysts do not analyse the fundamentals of the business. Instead, the approach is to forecast the direction of prices through the study of patterns in historical market data—price and volume. Technicians (sometimes called chartists) believe that market activity will generate indicators/signals through price trends that can be used to forecast the direction and magnitude of stock price movements in future.

There are three essential assumptions in technical analysis about the price and volume behaviour:

1. The history of past prices provides indications of the underlying trend and its direction.
2. The volume of trading that accompanies price movements provides important inputs on the underlying strength of the trend.
3. The time span over which price and volume are observed influences the strength or weakness of the underlying trend.

Technical analysis integrates these three elements into price charts, points of support and resistance in charts and price trends. By observing price and volume patterns, technical analysts try to understand if there is adequate buying interest that may take prices up, or vice versa.

Technical Analysis is a specialized stream in itself and involves study of various trends—upwards, downwards or sideways, so that traders can benefit by trading in line with the trend. Identifying support and resistance levels, which represent points at which there is a lot of buying and selling interest respectively, and the implications on the price if a support and resistance level is broken, are important conclusions that are drawn from past price movements. For example, if a stock price is moving closer to an established resistance level, a holder of the stock can benefit by booking profits at this stage since the prices are likely to retract once it is close to the resistance level. If a support or resistance is broken, accompanied by strong volumes, it may indicate that the trend has accelerated and supply and demand situation has changed. Trading volumes are important parameters to confirm a trend. An upward or downward trend should be accompanied by strong volumes. If a trend is not supported by volumes or the volumes decrease, it may indicate a weakness in the trend.

Technical analysis converts the price and volume data into charts that represent the stock price movements over a period of time. Some of the charts used include line charts, bar

charts, candlestick chart. The patterns thrown up by the charts are used to identify trends, reversal of trends and triggers for buying or selling a stock. Typically, chartists use moving average of the price of the stock to reduce the impact of day to day fluctuations in prices that may make it difficult to identify the trend.

3.6.1. Assumptions of technical analysis

From the above discussion on what technical analysts do, the following assumption are delineated:

1. The market price is determined by the interaction of supply and demand.
2. Supply and demand are governed by many rational and irrational factors.
3. Price adjustments are not instantaneous and prices move in trends
4. Trends persist for appreciable lengths of time.
5. Trends change in reaction to shifts in supply and demand relationships.
6. These shifts can be detected in the action of the market itself.

3.6.2. Technical versus Fundamental Analysis

Fundamental analysis involves determining the intrinsic worth of the stock and comparing it with the prevailing market price to make investment decisions. Fundamental analysts believe that prices will move towards their intrinsic value sooner or later. Technical analysis is not concerned if the stock is trading at a fair price relative to its intrinsic value. It limits itself to the future movements in prices as indicated by the historical data. It is used for short-term trading activities and not necessarily long-term investing.

3.6.3 Advantages of technical Analysis

Technicians feel that the major advantage of their method is that it is not heavily dependent on financial accounting statements. They feel that a great deal of information is lacking in financial statements. They also contend that a lot of non-financial information and psychological factors do not appear in the financial statements.

Technicians also feel that unlike fundamental analysts, they do not need to collect information to derive the intrinsic value of the stocks. They only need to quickly recognize a movement to a new equilibrium value for whatever reason. Hence they save time in collecting enormous information and data which is a prerequisite for fundamental analysis.

3.6.4 Technical Rules and Indicators

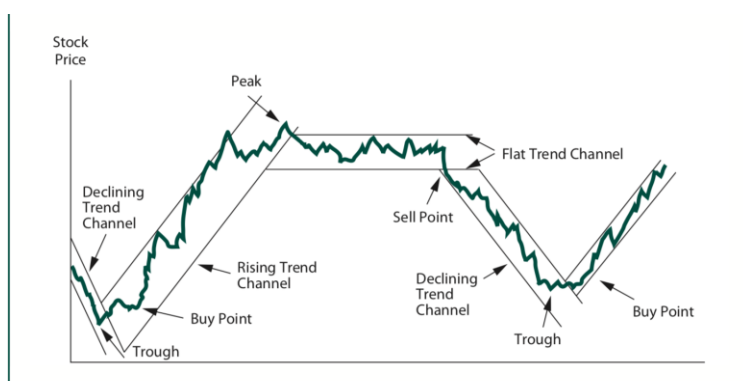
There are numerous trading rules and indicators. There are indicators of overall market momentum, used to make aggregate market decisions. There are trading rules and indicators to be applied for individual securities. Some of the popular ones are:

- Trend-line analysis
- Moving averages
- Bollinger-Band Analysis

Trend-Line Analysis

The graph (Exhibit 3.4) shows a peak and trough, along with a rising trend channel, a flat trend channel, a declining trend channel, and indications of when a technical analyst would ideally want to trade.

Exhibit 3.4: Stock price trend line



Moving-Average Analysis

Moving-Average Analysis is the most popular technical indicator. The moving average of a time series of past prices can provide a nonlinear graphic of price movements. Generally a 5, 10, 30, 50, 100, and 200 days moving averages are calculated. One simple strategy for using the moving-average analysis is to buy when the price is sufficiently below the moving average and sell when the price is sufficiently above the moving average.

Bollinger-Band Analysis

Bollinger bands use normal distribution to calculate the deviation of the market price from the moving average. For example, when the price goes two standard deviations above the moving average, the stock might be regarded as overbought. If the price goes two standard deviations below the moving average, the stock might be regarded as oversold.

3.6.5 Fixed income securities and Technical analysis

The techniques depicted above can also be applied to the fixed income securities as long as price and volume data is available. The theory and rationale for technical analysis of bonds

are the same as for stocks, and many of the same trading rules are in fact used by analysts in bond markets.

3.7 Understanding Corporate Governance

While analysing companies, the qualitative aspects of the companies are equally important if not more. Corporate governance practices are the cornerstone in evaluating a business. Corporate governance has become a well-discussed topic in business world. Newspapers and media report detailed accounts of corporate fraud, accounting scandals, excessive compensation etc., some leading to even bankruptcy of the companies fraught in such mis governance.

Corporate governance includes a wide array of mechanisms and expectations that are of importance to businesses, the economy, and society. World over economies are dominated by companies of different sizes. How these companies are governed affects not only the shareholders of the companies but also thousands of people who work with such companies, buy products of these companies or are affected by them implicitly.

Governance aspects are reflected in acts, rules and regulations, contracts, and in important institutions such as stock exchange listing standards and the audit process.

The components of corporate governance vary by country, over time, and by company type, size, and ownership . Analysts and investors play a very important role in driving good practices and highlighting companies with poor governance practices. There are some important aspects analysts should look for. For example they should also pay attention to the quality of independent directors in a business. Analysts should focus on the qualifications and experiences of these independent directors, how many meetings they attend and what are their contributions to the business. It may be good practice to interact with some of them to understand them better. Good governance practices can also be used as filters for selecting the investment universe.

Chapter 3: Sample Questions

1. _____ industries rise and fall and very closely follow the general economic activity in comparison to other industries.

- a. **Cyclical**
- b. Consumer staples
- c. Defensive
- d. Financial

2. Under the typical assumption that a stock's dividend will grow at a constant rate, what will be the intrinsic value of the stock if $D_1 = \text{Rs. } 3$, $k = 9\%$, $g = 6\%$?

- a. Rs. 95
- b. Rs. 105
- c. Rs. 110
- d. **Rs. 100**

3. Under relative valuation techniques, value of a stock is estimated based upon its current price relative to variables considered to be significant in valuation, such as _____.

- a. Earnings
- b. cash flow
- c. book value
- d. **All of these**

4. ratio compares the price of the stock to the earning it generates.

- a. **P/E ratio**
- b. P/B Ratio
- c. Price/Cash flow ratio
- d. Price/sales ratio

5. Market Risk refers to risk in equity investment arising due to _____.

- a. **The price dynamics in the market created by various players**
- b. The gap between book value and market value of an equity share
- c. The price dynamics created by the underlying business profitability
- d. The price dynamics to government intervention in the stock markets

CHAPTER 4: INVESTING IN FIXED INCOME SECURITIES

LEARNING OBJECTIVES:

After reading this chapter, the reader should understand about:

- Basic characteristics of fixed income securities
- Components of fixed income securities
- Relationship between bond price and yield
- Alternative yield measure like YTM, Coupon Yield, Current yield
- Interest rate risk
- Duration of the bond

4.1 Overview of Fixed Income Securities

Investors find it less exciting to talk about bonds or fixed income securities (bonds). A typical investor has more focus on equities when it comes to investment discussions. It is an irony because the global total market value of bonds is larger than the total market value of equity. As of 2020, global equity market capitalization was USD 105.8 trillion and global bond market outstanding was US\$ 123.5 trillion.¹² Generally, Government is the single largest issuer of bonds. Not only the size but also in terms of number of issues, bonds overtake equities as unlike equity, companies can issue many different bond issues outstanding at the same time. Governments issue bonds of many kinds and varied maturity profile.

In India, the fixed income market is classified on the basis of the entities issuing fixed income securities. Fixed income securities are issued by legal entities such as the Central and State Governments, Public Bodies, Banks and Institutions, statutory corporations and other corporate bodies¹³. The fixed income instruments traded can be classified into the following segments on the basis of the issuer of these securities (Table 4.1):

Table 4.1: Types of Fixed Income Instruments

Market Segment	Issuer
Government Securities	Central Government
	State Governments
Public Sector Bonds	Government Agencies / Statutory Bodies
	Public Sector Undertakings

¹² <https://www.sifma.org/wp-content/uploads/2021/07/CM-Fact-Book-2021-SIFMA.pdf>

¹³ In India, the long-term debt securities issued by the Government of India or any of the State Government's or undertakings owned by them or by development financial institutions are called as bonds. Instruments issued by other entities are called debentures.

Private Sector Bonds	Corporates
	Banks
	Financial Institutions

Government securities or G-Secs, constitute the largest segment of the Indian fixed income market. The next largest section of the rupee-denominated debt market is the corporate bond market. This segment has grown substantially in recent years .

The Indian primary market in corporate debt is basically a private placement market with most of the corporate bond issues being privately placed among the wholesale investors i.e. the banks, financial institutions, mutual funds, large corporate & other large investors. This situation has restricted the retail participation in the bond market. The share of retail investors in corporate bond market is very small.¹⁴

The issue and trading of fixed income securities by each of these entities are regulated by different bodies in India. Government securities and securities issued by banks, non-banking finance companies (NBFCs) are regulated by the RBI. The issue of non-government securities comprising basically issues of corporate debt is regulated by SEBI.

4.2 Bond Characteristics

Since bonds create fixed financial obligations on the issuers, they are referred as fixed income securities. The issuer of a bond agrees to 1) pay a fixed amount (known as coupon) periodically and 2) repay the fixed amount of principal (known as face value) at the date of maturity. The fixed obligations of the security are the most defining characteristic of bond. Mostly bonds make semi-annual coupon payments, though some may make annual, quarterly or monthly coupon payments. The coupon payment is always calculated as a fixed promised percentage applied on the face value of the bond.

There are however zero coupon bonds which do not make any coupon payments. Typically, a zero coupon bond is issued for less than its face value and the face value is paid on the maturity date. Bonds have fixed maturity date beyond which they cease to exist as a legal financial instrument. Perpetual bonds, which do not have any maturity date exist forever. On the basis of term to maturity, bonds with a year or less than a year maturity are termed as money market securities. Long-term obligations with maturities in excess of 1 year, are referred as capital market securities. Thus, long term bonds as they move towards maturity become money market securities.

The issue price, coupon, maturity period, face value, redemption value are important intrinsic features of a bond. The issue price would define the amount guaranteed capital gain a bond holder would enjoy if the bond is held till maturity. The coupon of a bond indicates the regular

¹⁴<https://content.ftserussell.com/sites/default/files/research/ftse-sbi-indian-bond-index-series-jan-2019-final.pdf>

income/coupon income that the bond holder will receive over the life (or holding period) of the bond.

The term to maturity is the time period before a bond matures. All G-Secs are normally coupon bearing and have semi-annual coupon or interest payments with a tenor of between 5 to 30 years. Maturity period is also known as tenor or tenure. Though not found in common, sometimes corporate bonds might promise some premium on redemption, hence making the redemption value different than the face value (or par value)

The face value or par value of the bond is the original value of the obligation. It is similar to the principal on a loan. Face value of the bond is different from bond's market price. This situation can arise when the interest rates prevailing in the market are different than the coupon rate promised on the bond. When coupons and the prevailing market rate of interest are not the same, market price of the bond can be lower or higher than principal value. If the market interest rate is above the coupon rate, the bond will sell at a discount to the par value. If the market rate is below the bond's coupon, the bond will sell at a premium to the par value. This behaviour is mathematically quite intuitive. Let's consider the example below.

Let's imagine that a bond with a face value of Rs.1000 has been issued for a period of 1 year, with a coupon rate of 12% p.a. and the coupon being paid on maturity. At the end of end of 1 year , i.e. on maturity the bond would repay the face value of Rs.1000. Therefore for any one who is interested to invest in this bond would have Rs. 1000 of outflow today and Rs. 1120 (Coupon of Rs.120 and Face Value of Rs. 1000) of inflow at the end of 1 year. Then the return in percentage to any investor who has invested in this bond would be $(1120 - 1000) / 1000 = 12\%$. Because the investment was held for a period of 1 year, then the return is annual return.

Going by the basic tenets of time value of money and compounding an investor who is ready to invest Rs.1000 today and seeks a return of 12% would expected Rs.1120 at the end of 1 year, and hence this bond would exactly match his investment preference. Depicting it mathematically:

$$1000 * (1.12)^1 = 1120;$$

where " $(1.12)^1$ " is the future value interest factor, and this is compounding today's cashflow to future date. OTHER WISE it could also be depicted in a discounting format. This approach would help someone to calculate what is the maturity value of an investment which is promising some interest rate.

$$1120 / (1.12)^1 = 1000;$$

where " $1/(1.12)^1$ " is the present value interest factor, and it is discounting a future cashflow to today. This approach would help someone to calculate what is the amount that needs to

be invested, in case an investment avenue is promising a definitive cashflow at the end of 1 year. That means an investor seeking 12% return should invest not more than Rs.1000 in this bond which is promising Rs.1120 at the end of 1 year.

Then what should be the maximum amount an investor who seeks 15% p.a. return pay for the same bond?

It would be $\text{Rs.}1120 / (1.15)^1 = 973.91$. Because only this amount would generate him a return of 15% p.a.

In the same manner, an investor who wants only 8% would be ready to pay upto $\text{Rs.}1120 / (1.08)^1 = 1037.40$. An investor is paying either less or more than the face value not because the bonds are different. In fact, the bond characteristics in terms of face value, coupon rate, date of coupon payment, and the date of maturity are all fixed. Therefore the only thing which was making the difference was the expected rate of return.

While the above example was that of an individual investor and the expected rate of return was clear in the investor's mind. What if many investors are participating in a market and bidding for this bond. Logically one consensus interest would naturally emerge when the bond is finally bought or sold. But the issue is that this interest rate is not visible directly. Hence the fixed income markets reverse calculates this hidden or implied expected rate of return in a fixed income security, from its traded prices. This is referred to as "yield".

It should be clear that Yield on a bond is a consensus interest rate that emerged due to the demand and supply forces of the investors in the market, and their required rate of return was definitely influenced by the ongoing government benchmark interest rates. This inverse relationship between interest rates and bond prices as explained above is underlying the bond theorems, that "with all other things remaining the same, an increase in the market interest rates would decrease the prices of fixed income securities".

Another interesting thing about bonds is that unlike equity shares, government or companies can have many different bonds outstanding at the same time, but each of them could have a different maturity period and a coupon rates. These features of the bonds will be part of the indenture.¹⁵ Logically every new issue of a bond by a company would always provide coupon rates according to the then prevailing interest rates in the market rates.

4.2.1 Bonds with options

Bonds can also be issued with embedded options.¹⁶ Some common types of bonds with embedded options are: bonds with call option, bonds with put option and convertible bonds.

¹⁵ Indenture is the legal agreement between two parties, in case of bond indenture the two parties are the bond issuer (borrower) and the investors (lender).

¹⁶ Options are financial derivatives that give buyers the right, but not the obligation, to buy or sell an underlying asset at an agreed-upon price at a future date, where the price is agreed upon today.

A callable bond gives the issuer the right to redeem all or part of the outstanding bonds before the specified maturity date. Callable bonds are advantageous to the issuer of the security but they present investors with a higher level of reinvestment risk than non-callable bonds. The issuer will call the bond before its maturity only when the interest rates for similar bonds fall in market. The investor will receive the face value of the bond before its maturity, and will be forced to reinvest that money for the remaining period lower interest rates. This is called reinvestment risk.

A put provision gives the bondholders the right to sell the bond back to the issuer at a pre-determined price on specified dates. Puttable bonds are beneficial to the bondholder by guaranteeing a pre-specified selling price at the redemption dates.

A convertible bond is a combination of a plain vanilla bond plus an embedded equity call option. It gives the bondholder the right to exchange the bond for a specified number of common shares of the issuing company.

4.3 Determinants of bond safety

Bonds being fixed income securities, are expected to generate a pre-specified stream of cashflows in terms of coupon and principal payment. The previous discussion on return while investing in a bond and the price of a bond, are all dependent on a fundamental assumption, that the bonds are literally default risk free. Meaning the coupon and principal repayment would be as much as promised, and will occur at the same time which is promised. Therefore safety aspects of bonds are tied to their probability of defaulting on these payments or possibility of delaying in the payments. This probability and possibility is the underlying phenomenon of credit risk to which bond holders are exposed. Credit Risk is, the risk of loss resulting when the issuer fails to make full and timely payments of interest and/or repayments of principal.

The most important document to understand the safety aspects of the bond is its indenture. It is the legal agreement between the firm issuing the bond and the bondholders, providing the specific terms of the debt agreement. All the features of the bond i.e. its par value, coupon rate, maturity period, periodicity of coupon payments, collateral for the bond, seniority of the payments will be set forth in the indenture. Indenture also provides information on covenants. Covenants are clauses specifying the rights of the bond holders and restrictions on the bond issuers. Covenants are broadly of two kinds: Positive covenants and Negative covenants. Positive covenants are actions which issuers are required to do, whereas negative covenants specify what issuers are prohibited from doing. These are necessary to protect an investor's investment in the debt security.

Companies issue different kinds of bonds. Some may be secured against some specified property of the issuer in the case of default. The value of the asset against which the bond is secured determines the quality of the bond. Some bonds are unsecured. These are backed by the promise of the issuer to pay coupon and principal on a timely basis. In such a situation, the credit worthiness of the issuer determines bond quality.

To understand the probability of default by the issuer, most bond investors rely on Rating Agencies. Rating agencies play an integral role in bond markets. These agencies are specialized firms that determine the ability and willingness of the issuers to meet their financial obligations on time and as promised.

The actual level of default risk faced on an investment depends on the financial situation of the borrower. Default risk can be assessed by tracking the credit rating of an investment. Credit rating agencies assign credit ratings after carrying out a detailed analysis of the issuer's financial ability to honour the payments on time. These ratings are in the form of alphanumeric symbols. Rating is given for an instrument and not to a firm; so two different instruments issued by the same firm can have different ratings. The higher the credit rating, the lower is the default risk. SEBI has standardized the rating symbols used by the credit rating agencies so that investors are able to easily gauge the level of credit risk assigned to an instrument. The rating symbols and their definitions are reproduced below in Box 4.1 and Box 4.2.

Rating agencies have their own methodology to gauge the creditworthiness of the issuer and also the probability that the particular instrument will not default. They use symbols to express their opinion. Typically, ratings are expressed as grades from 'AAA' to 'D' to communicate the relative level of credit risk. (See Box 4.1) Bonds with higher credit risk receive a lower credit rating from the bond rating firms and vice versa. Bond markets are also classified on the basis of creditworthiness reflected in the credit rating as investment grade and non-investment grade (speculative) bond market.

Box 4.1: Credit rating symbols and Definitions for Long Term Instruments
<i>Long term debt instruments: The instruments with original maturity exceeding one year</i>
Rating symbols should have CRA's first name as prefix
AAA - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
AA - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
A - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
BBB - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
BB - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
B - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
C - Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
D - Instruments with this rating are in default or are expected to be in default soon.
<i>Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AA to C. The modifiers reflect the comparative standing within the category.</i>

Box 4.2: Credit Rating Symbols and Definitions for Short Term Debt instruments
<i>Short term debt instruments: The instruments with original maturity of upto one year</i>
Rating symbols should have CRA's first name as prefix
A1 – Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.
A2 - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.
A3 - Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.
A4 - Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.
D - Instruments with this rating are in default or expected to be in default on maturity.
<i>Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 to A4. The modifier reflects the comparative standing within the category.</i>

4.4 Valuation of Bonds

Since bonds are fixed income securities, generating a series of pre-specified cashflows, their value can be estimated adopting the discounting cashflow approach. The discounting cashflows approach uses the required rate of return of the investor and discounts all the future cashflows received from a bond, to arrive at the intrinsic value of the bond, at a particular point in time. The motivation to arrive at the value of a bond is to compare its intrinsic value with the ongoing market price, just like how an equity share is compared, and then judge whether it is overvalued or undervalued. Therefore, investment decisions in the bonds can also be taken by estimating their intrinsic values. When the intrinsic value of a bond is greater than the ongoing current market price, one could invest in it. Or else, if the investor is already holding the bond, then the bond could be sold.

Alternatively, the investment and disinvestment decisions can also be taken by comparing the implied yield by investing in the bond at the ongoing current market price. If the calculated yield is greater than the required yield or required rate of return of the investor, then the investor can buy the bond. Similarly, if the yield is lesser than what the investor requires, then the bond could be sold. The following sections would discuss these further.

4.4.1. Intrinsic Value of a Bond

The intrinsic value of a bond is the sum of present value of all future cash flows of the bond discounted at a required rate of return.

$$IV_0 = \sum_{t=1}^{n*cf} \frac{Coupon\ Payment_t}{(1 + (\frac{r}{cf}))^t} + \frac{Face\ Value\ or\ Redemption\ Value}{(1 + (\frac{r}{cf}))^{n*cf}}$$

IV₀ = Intrinsic Value of a Bond

Coupon_t = is the periodic cashflow paid by the bond as promised. It is not the annual payment, but the actual amount that is adjusted to the frequency of coupon payment.

Face Value or Redemption Value = It is the Par value of the bond which is promised to be repaid on the date of maturity. In case the bond promises an amount different than the face value, then it would be termed as redemption value.

r = discount rate which is either the investor's required rate or a comparable bond's yield to maturity calculated at its ongoing market prices. The discounting rate needs to be adjusted to the frequency of coupon payment, so that discounting is in tune with the principle.

t = is the time period when the coupon is paid. It is represented in the form of a digit.

n = the time period when the payment of last coupon and the face value takes place on the date of maturity. It is also represented in the form of a digit adjusted to the frequency of coupon payment.

cf = frequency of coupon payment in the bond. In case the bond pays coupons half-yearly, then the value it takes is 2, quarterly 4, monthly 12 and so on.

It may be noted that whenever a bond paying coupons more than once in a year is being evaluated, then both the discounting rate and the maturity period need to be adjusted accordingly. Where the time period is multiplied with the frequency of coupon payment, and the discounting rate is divided by the frequency of coupon payment.

The above equation needs to be solved using a mathematical calculator and one should be conversant with the aggregation operator used in the equation. Otherwise, the readymade interest rate factors can be used to calculate the intrinsic value. The interest rate factors are available as readymade tables where the rows are the periods and the columns are the discounting rates. Because coupons are annuities and the face value that is repaid at maturity

is a lumpsum payment, the following representation can achieve the same objective as shown in the previous equation.

$$IV_0 = \text{Coupon Payment (PVIFA } r/cf, n*cf) + \text{Face Value or Redemption Value (PVIF } r/cf, n*cf)$$

Where,

PVIFA $r, n*cf$ = It is the present value interest rate factor for annuity for discounting rate 'r' and for $n * cf$ coupon payments.

PVIF $r, n*cf$ = It is the present value interest rate factor for discounting rate 'r' and for $n * cf$ time period.

Say for instance an investor with an expected rate of 14% p.a. is calculating the intrinsic value of a bond with a face value of Rs.1000, that is offering a semi-annual coupon of 12% p.a., and which has a remaining term to maturity of 5 years. The bond would be worth Rs.1000 at maturity. The intrinsic value of the bond can be calculated using the equation and the present value interest factors as follows.

$$IV_0 = \sum_{t=1}^{5*2} \frac{60_t}{(1 + 0.14/2)^t} + \frac{1000}{(1 + 0.14/2)^{5*2}}$$

Solving this would yield the answer 929.72. This can also be calculated using the interest rate factors as follows:

$$IV_0 = 60 (PVIFA_{14\%/2, 5*2}) + 1000 (PVIF_{14\%/2, 5*2})$$

$$\text{That is } = 60 * (7.0236) + 1000 * (0.5083) = 421.42 + 508.30 = 929.72$$

Therefore the intrinsic value of the bond with the above face value, maturity date, and coupon payment is Rs.929.72. It may be noted that the value is lesser than the face value. This is in tune with the inverse relationship between interest rates and price of the bond discussed in the earlier paragraphs. Because the bond is paying a coupon of only 12% p.a., but the investor requires 14% p.a., based on the ongoing market interest rates, or the investor's personal risk appetite or perception, the bond is not worth the face value, but something lesser than that.

The intrinsic value of a bond can be also calculated using the excel "PRICE" function in the MS Excel as illustrated in Illustration 4.1. The intrinsic value of the same bond that is used the example above is also used for the illustration. The table represents the sheet in excel and columns A and B can be related to that in the excel sheet. The letters in red in column A exactly represent the inputs (according to syntax) of the "PRICE" function in MS Excel, and the values in column B need to be given as inputs into MS Excel to get the answer. The black

letters in column A in parenthesis are explanations to understand what does the word in red colour mean. The column B in the last shows the syntax for the MS Excel function to be used to get the answer for the intrinsic value of a bond.

There might be a point of confusion when the words “YIELD” and “PRICE” are used in the function. However the clarity is “YIELD” should be considered as the required rate of return of the investor and not “YIELD TO MATURITY” of the bond. Similarly “PRICE” is the final output one would get, which is the intrinsic value of the bond at the required rate of return and not the “ONGOING CURRENT MARKET PRICE”

Illustration 4.1: Calculating Intrinsic Value of a Bond in excel

A	B
Settlement (the date on which the valuation is being done)	01-01-2022
Maturity (the date of maturity reckoned from date of valuation)	01-01-2027
Rate (Coupon rate depicted on per annum basis)	12%
Yield (Discount rate applied or required rate of return of the investor)	15%
Redemption (The value proportionately expressed per Rs.100)	100
Frequency (It takes a number 1 for yearly, 2 for half-yearly, 4 for quarterly, 12 for monthly)	2
Basis (indicates the day count convention that is used [Day count basis: 0 or omitted = US (NASD) 30/360; 1 = Actual/actual; 2 = Actual/360; 3 = Actual/365; 4 = European 30/360])	0
PRICE (The intrinsic value of a bond, which would be the answer) the result in column should be multiplied by 10, because the answer is for a bond with face value of Rs.100, and the face value of the bond in our illustration is Rs.1000. The values in column B would result into an answer 929.76 (Please input the values in MS Excel and verify by doing it yourself)	=PRICE(Settlement, Maturity, Rate, Yield, Redemption, Frequency, Basis)

4.4.2. Bond Yield Measures

Bond holders receive return from one or more of the following sources, when they buy bond:

1. The coupon payments made by the issuer;
2. The capital gain (or capital loss) when the bond is sold/matured; and
3. Income from reinvestment of the interest payments that is interest-on-interest.

There are yield measures commonly used to measure the return from investing in a bond are briefly described below:

Coupon Yield:

The coupon yield is the coupon payment as a percentage of the face value. It can be considered as a nominal interest payment on a fixed interest bond.

$$\text{Coupon yield} = (\text{Coupon Payment} / \text{Face Value}) * 100$$

Illustration:

Coupon: Rs. 8.24; Face Value: Rs. 100; Market Value: Rs. 103.00; Coupon yield = $8.24/100 = 8.24\%$

Current Yield:

The current yield is the coupon payment as a percentage of the bond's current market price.

$$\text{Current yield} = (\text{Annual coupon rate} / \text{current market price of the bond}) * 100\%$$

Illustration:

The current yield for a 10 year 8.24% coupon paying bond selling for Rs. 103.00 with a face value of Rs. 100 is calculated as below:

$$\text{Annual coupon interest} = 8.24\% \times \text{Rs. } 100 = \text{₹}8.24$$

$$\text{Current yield} = (8.24/103) \times 100 = 8.00\%$$

Yield to Maturity:

Yield to Maturity (YTM) is that rate which discounts the future cash flows from a bond, and makes the sum of the present values of such cashflows equal to the current market price of the bond. It is the rate of return that can be expected in a bond investment, when purchased at the ongoing market price, and when it is held until its maturity. YTM can also be considered as the Implied Rate of Return, or Internal Rate of Return of the bond. Mathematically, when we substitute the IVo in the formula of intrinsic value of a bond with the current market price, and then solve it to extract the 'r', then that 'r' would be the YTM.

$$P_0 = \sum_{t=1}^{n*cf} \frac{\text{Coupon Payment}_t}{(1 + r/cf)^t} + \frac{\text{Face Value or Redemption Value}}{(1 + r/cf)^{n*cf}}$$

P_0 = Current Market Price of the of bond

All other variables are same as explained in the previous sections. Again a word of caution, that if the frequency of coupon payment is more than once in an year, then accordingly the 'r' that is extracted needs to be annualised by multiplying with the frequency of coupon

payment. For instance if the solved 'r' is 5% for a semi-annual coupon paying bond, then YTM per annum basis would be $5\% \times 2 = 10\%$.

The calculation of YTM involves a trial-and-error procedure. Therefore one has to try by using different values in the 'r' and try to equate it to the current market price using the calculator. Because very rarely does a rate without decimal match the true YTM, so extrapolation is required to arrive at the accurate YTM. Instead MS Excel has a function 'YIELD' which calculates the YTM of a bond, given all its details and the current market price, for a face value of Rs.100. Continuing the above example used to calculate the intrinsic value, and by considering the current market price of the bond to be Rs.975, the YTM would be calculated in MS Excel as shown in illustration 4.2.

Illustration 4.2: Calculating Yield to Maturity of a Bond in excel

A	B
Settlement (the date on which the bond is going to be purchased)	01-01-2022
Maturity (the date of maturity reckoned from date of purchase)	01-01-2027
Rate (Coupon rate depicted on per annum basis)	12%
Price (Current Market Price of the Bond, expressed per Rs.100)	97.5
Redemption (The value proportionately expressed per Rs.100)	100
Frequency (It takes number 1 for yearly, 2 for half-yearly, 4 for quarterly, 12 for monthly)	2
Basis (indicates the day count convention that is used [Day count basis: 0 or omitted = US (NASD) & INDIA 30/360; 1 = Actual/actual; 2 = Actual/360; 3 = Actual/365; 4 = European 30/360] [see box 4.3 for Day count convention])	0
YIELD (The Yield to Maturity would be 12.69%, when the cell is formatted to percentage with two decimals. (Please input the values in MS Excel and verify by doing it yourself)	=YIELD(Settlement, Maturity, Rate, Price, Redemption, Frequency, Basis)

Box 4.3: Day Count convention

Day count convention refers to the method used for arriving at the holding period (number of days) of a bond to calculate the accrued interest. As the use of different day count conventions can result in different accrued interest amounts, it is appropriate that all the participants in the market follow a uniform day count convention.

For example, the conventions followed in Indian market for bonds is 30/360, which means that irrespective of the actual number of days in a month, the number of days in a month is taken as 30 and the number of days in a year is taken as 360.

Whereas in the money market the day count convention followed is actual/365, which means that the actual number of days in a month is taken for number of days (numerator) whereas the number of days in a year is taken as 365 days. Hence, in the case of T-Bills, which are essentially money market instruments, money market convention is followed.

In some countries, participants use actual/actual, some countries use actual/360 while some use 30/actual. Hence the convention changes in different countries and in different markets within the same country (e.g. Money market convention is different than the bond market convention in India).

As previously discussed when market interest rates rise, the prices of a bonds fall. Conversely, if the market interest rates decline, the prices of bonds rise. In other words, the yield of a bond is inversely related to its price. The relationship between yield to maturity and coupon rate of bond may be stated as follows:

- When the market price of a bond is less than its face value, i.e., the bond is selling at a discount, then YTM would be $>$ Coupon Yield.
- When the market price of a bond is more than its face value, i.e., the bond is selling at a premium, then YTM would be $<$ Coupon Yield .
- When the market price of a bond is equal to its face value, i.e., the bond is selling at par, then YTM would be $=$ Coupon Yield.

Yield to call

In the case of bonds with an embedded call feature another measure of Yield is also popularly calculated by the markets along with Yield to Maturity. It is known as Yield to Call. The name comes from the entitlement retained by the issuing entity to repay amounts on the bond prior to its maturity. The amount repaid might not be equal to the face value, because it is being

paid prior to the date of maturity. Depending on the market interest rates forecasted by the issuer, the amount repaid, in a call may be higher or lower than the face value(par value). The price and date at which a bond can be called is mentioned at the time of issue. and it is referred to as “Call Price”. Sometimes the issuing entities give a schedule of dates along with their respective Call Prices, when the decision to call can be taken any time within a given range of dates. Yield to call measures the estimated rate of return for bond held till the first call date. The formula used to calculate the Yield to Maturity can be used to calculate the Yield to Call too. In this formula the “Face Value or Redemption Value” variable is substituted with “Call Price”. Then ‘n’ in the equation can be taken as the period till the date of the first call. Usually when there is nothing mentioned specifically, then the first call date is considered as the date on which Call would happen, and the Yield to Call at this date is calculated.

$$P_0 = \sum_{t=1}^{n*cf} \frac{\text{Coupon Payment}_t}{(1 + r/cf)^t} + \frac{\text{Call Price}}{(1 + r/cf)^{n*cf}}$$

Every other term in the equation means the same as discussed above.

For instance, a 20 year old bond paying 12% coupon, semi-annually, and redeeming at par value of Rs.1000 is currently selling at Rs. 1180. Suppose the first call date is 8 years from today, and the issuer is going to call it at Rs. 1050, then the r which will equate the cashflows to the current market price would be the Yield to Call.

$$1180 = \sum_{t=1}^{8*2} \frac{60}{(1 + r)^t} + \frac{1050}{(1 + r)^{8*2}}$$

The same can be solved easily with MS Excel by using the tweaking the “Yield Function” as shown in illustration 4.3.

Illustration 4.3: Calculating Yield to Call of a Bond in excel

A	B
Settlement (the date on which the bond is going to be purchased)	01-01-2022
Maturity (the date of maturity reckoned from date of purchase)	01-01-2030
Rate (Coupon rate depicted on per annum basis)	12%
Price (Current Market Price of the Bond, expressed per Rs.100)	118
Redemption (The value proportionately expressed per Rs.100)	105
Frequency (It takes number 1 for yearly, 2 for half-yearly, 4 for quarterly, 12 for monthly)	2
Basis (indicates the day count convention that is used [Day count basis: 0 or omitted = US (NASD) & INDIA 30/360; 1 = Actual/actual; 2 = Actual/360; 3 = Actual/365; 4 = European 30/360])	0

YIELD (The Yield to Call would be 9.21%, when the cell is formatted to percentage with two decimals.	=YIELD(Settlement, Maturity, Rate, Price, Redemption, Frequency, Basis)
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4.5 Measuring Price Volatility of bonds

Market price of a bond is a function of four factors: (1) Par value of the bond; (2) Coupon rate of the bond; (3) Maturity period i.e. no. of years to maturity and (4) Prevailing market interest rate.

There are mathematical proofs that demonstrate the following relationships between yield (interest rate) changes and bond price behaviour:

1. Bond prices and the interest rates have inverse relationship.
2. Bond price volatility is inversely related to coupon. **Bonds with higher coupons show smaller percentage price fluctuation for a given change in interest rates** . For example, if many bonds with same maturity period of 10 years are taken, experiencing the same change in YTM say from 5% to 6%, the smaller coupon bond will experience the larger percentage price change. If a zero coupon bond is also included in the example, it will experience the largest percentage price change.
3. Bond price volatility is directly related to term to maturity, longer maturity bonds experience larger price changes for a given change in yields. Bond price volatility increases at a diminishing rate as term to maturity increases.
4. Bond price movements resulting from equal absolute increases or decreases in yield are not symmetrical. A decrease in yield raises bond prices by more than an increase in yield of the same amount lowers prices.

4.5.1. Interest rate risk

Interest Rate Risk is defined as the risk emanating from changes in the market interest rates. As discussed above, market price of the bond reflects the present value of all future cash flows of the bond. The discount rate used to calculate the present value is the function of prevailing interest rates over various maturities. If the interest rate in the economy increases, the discounting factor to find out the present value of the future cash flows also increases, resulting in the fall in the value of the bond.

A related concept to interest rate risk is reinvestment rate risk. Reinvestment risk is when the investor may not be able to reinvest the intermittent cash flows (coupons) at yields prevalent at the time of making the investment due to either decrease or increase in interest rates prevailing at the time of receipt of cash flows by investors. Yield to maturity computation

implicitly assumes that all coupon cash flows will be reinvested at yield to maturity. If, after the purchase of the bond, interest rates decline, the coupon cash flows will be reinvested at rates below the yield to maturity. Conversely, if interest rates increase, the coupon cash flows will be reinvested at rates above yield to maturity.

4.5.2 Concept of Duration

One of the popular measures of measuring interest rate risk in a bond is Macaulay's Duration and another derived indicator from it is Modified Duration. By construct both the measures are expressed in number of years. Hence the popular understanding that Duration is some kind of time period in which the bond investor would recoup the initial investment, from the cashflows from the bond. However theoreticians caution this interpretation of Duration. Alternatively they suggest, that it is a good measure of price sensitivity of a Bond for a given change in the market interest rates, yields, or required rates of return of the bond investor. Duration also shares the same properties of a bond as discussed in the Price Volatility segment in Section 4.5.1

Modified Duration is calculated as

$$\text{Macaulay's Duration in Years} / (1 + \text{YTM adjusted to frequency of coupon payment})$$

Say for instance the Macaulay's Duration is 5 years and the YTM p.a. is 12%, and the frequency of coupon payment is half-yearly. Then the Modified Duration is

$$5 / (1 + 0.12/2) \quad \text{OR} \quad 5 / (1.06) = 4.72 \text{ years.}$$

The approximate change in price of a bond for a given change in market interest rates can be estimated using the modified duration as follows

% change in the price = - Modified Duration * Change in market interest rates in decimals.

Continuing the above example, if the modified duration of a bond is 4.72 years and there is a change in the market interest rates or yields from 2.5% to 2.7%. The expected percentage change in the price of the bond will be

- 4.72 * 0.002 = - 0.944%. i.e. due to the negative relationship between interest rates and the bond prices, an increase in interest rates would decrease the prices of the bond.

4.5.2.1. Determining Macaulay's Duration

Duration (also known as Macaulay Duration) of a bond is popularly known as a measure of time taken to recover the initial investment in present value terms. Duration is expressed in number of years. Based on the calculation involved, it is interpreted as Weighted Average Time to recover the initial investment in the bond (the current market price). It is always less than or equal to the overall life (to maturity) of the bond in years. Only a zero coupon bond (a bond with no coupons) will have duration equal to its remaining maturity. Theoreticians also believe that the price sensitivity of a bond to changes in interest rates can be approximated by the bond's duration. The significance of duration is that greater the duration, more volatile is bond's price or return on bond investment, for given changes in the level of interest rates. Duration of a bond can be calculated in two ways one is Manually and the other using MS Excel

Calculating Duration in MS Excel:

Duration can be calculated in MS Excel using the "DURATION" function in the finance functions. The syntax is = DURATION (Settlement date, Maturity date, Coupon Rate, Yield to Maturity, Frequency of Coupon payments, Basis)

Illustration 4.4: A bond is currently selling at Rs.1168.51 generating a yield to maturity of 9%, when the bond is paying a coupon of 12%, its face value is Rs.1000, and the balance term to maturity is 8 years. The YTM of the bond can be calculated as 9% p.a., using the bond data.

A	B
Settlement (the date on which the bond is going to be purchased)	01-01-2022
Maturity (the date of maturity reckoned from date of purchase)	01-01-2030
Rate (Coupon rate depicted on per annum basis)	12%
Yield (Yield to Maturity at Current Market Price of the bond)	9%
Frequency (It takes number 1 for yearly, 2 for half-yearly, 4 for quarterly, 12 for monthly)	2
Basis (indicates the day count convention that is used [Day count basis: 0 or omitted = US (NASD) & INDIA 30/360; 1 = Actual/actual; 2 = Actual/360; 3 = Actual/365; 4 = European 30/360])	0
DURATION (The answer is in years, and it will be 5.569 years)	=YIELD(Settlement, Maturity, Rate, Yield, Frequency, and Basis)

Manual Calculation of Macaulay's Duration of Bond: To calculate the duration of a bond, one needs the current market price, the coupon rate, the face value of the bonds, the balance term to maturity, and the YTM of the bond at the ongoing market price, and the frequency of

coupon payment. Later the following step by step approach can be followed to arrive at the Duration of the bond.

1. Calculate the YTM of a bond using the current market price, balance term to maturity, coupon rate, and face value, and the final redemption value (Usually at par)
2. Calculate the coupons for each time period when the bond pays the coupons, till the bond's maturity date
3. Arrive at the present values of the coupons and the final repayment value of the bond, using the interest rate factors calculated using YTM adjusted for the frequency of coupon payment.
4. Now multiply each of the cashflow at each point in time, with the digit representing the time when the cashflow is received. For instance, when calculating the duration of a semi-annual coupon paying bond with remaining life of 5 years, the digits representing the time periods would be 1 to 10.
5. Add all the products of the present value of cashflows and their respective time periods.
6. Finally divide the sum of the weighted present value of cashflows with the current market price of the bond. This gives the Duration in days.

Time	Coupon/Cashflow	PV interest factor @ 4.5%	PV of Coupons/Cashflows	Time * PVCFs
1	Rs.60	0.9569	57.4163	57.4163
2	Rs.60	0.9157	54.9438	109.88
3	Rs.60	0.8763	52.5778	157.733
4	Rs.60	0.8385	500.3137	201.255
5	Rs.60	0.8024	48.1471	240.735
6	Rs.60	0.7679	46.0737	276.442
7	Rs.60	0.7348	44.0897	308.628
8	Rs.60	0.7032	42.1911	337.529
9	Rs.60	0.6729	40.3743	363.368
10	Rs.60	0.6439	38.6357	386.357
11	Rs.60	0.6162	36.9719	406.691
12	Rs.60	0.5897	35.3798	424.558
13	Rs.60	0.5643	33.8563	440.132
14	Rs.60	0.5399	32.3984	453.577
15	Rs.60	0.5167	31.0032	465.048
16	Rs.60	0.49447	29.6682	474.691
16	Rs.1000	0.49447	494.47	7911.52
		Total	1168.51	13015.60

Sum of PV of Cashflows = 1168.51 (Which is nothing but the current market price)

Sum of Weighted PV of Cashflows = 13015.60

Duration = (Sum PV of Weighted Cashflows / Sum of PV of Cashflows) / Frequency of Coupon Payment

Macaulay's Duration = $(13015.60 / 1168.51) / 2 = 5.569$ (We can see that both manual and MS Excel answers are the same).

Modified Duration = $5.569 \text{ Years} / (1.0450) = 5.33$

Chapter 4: Sample Questions

- 1) Government securities carry practically no risk of _____ and, hence are called risk-free or gilt-edged instruments.
- a) Tradability
 - b) liquidity
 - c) default**
 - d) negotiability
- 2) _____ risk arises from the fact that income flows received from an investment at the coupon rate may not be able to earn the same interest.
- a) Re-investment**
 - b) Default risk
 - c) Credit risk
 - d) None of the above
- 3) The feature that allows the issuing firms to retire the bonds before the maturity by paying a prescribed price is called _____.
- a) Callability (call option)**
 - b) Putability (put option)
 - c) Convertibility
 - d) Redemption
- 4) Typical putability (put option) feature of a bond _____.
- a) Gives the bond holders the option to convert the bond into another security, typically the common stock of the firm issuing the convertible bonds
 - b) Gives the holder the right, under certain circumstances to sell the bond back to the issuer**
 - c) Allows the issuing firms to retire the bonds before the maturity by paying a prescribed price
 - d) Allows the investor to redeem the bond

CHAPTER 5: DERIVATIVES

LEARNING OBJECTIVES:

After reading this chapter, the reader should understand about:

- Underlying concepts in derivatives
- Types of derivative products
- Structure of derivative markets
- Purpose of Derivatives
- Costs, benefits and risk of derivatives

5.1 Definition of Derivatives

Derivative is a contract or a product whose value is derived from value of some other asset known as underlying. Derivatives are based on wide range of underlying assets. These include:

- Metals such as gold, silver, aluminum, copper, zinc, nickel, tin, lead etc.
- Energy resources such as oil (crude oil, products, cracks), coal, electricity, natural gas, etc.
- Agri commodities such as wheat, sugar, coffee, cotton, pulses etc.
- Financial assets such as shares, bonds and foreign exchange.

In the Indian context the Securities Contracts (Regulation) Act, 1956 [SC(R)A] defines "derivative" to include-

1. A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
2. A contract which derives its value from the prices, or index of prices, of underlying securities.

Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A.

The term derivative has also been defined in section 45U(a) of the RBI act 1934 as follows:

An instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by RBI from time to time.

5.2 Types of derivative products

The four commonly used derivative products are:

- Forwards
- Futures
- Options
- Swaps

5.2.1 Forwards

Forward contract is an agreement made directly between two parties to buy or sell an asset on a specific date in the future, at the terms decided today. Forwards are widely used in commodities, foreign exchange, equity and interest rate markets.

Let us understand with the help of an example. What is the basic difference between cash market and forwards? Assume on March 9, 2018 you wanted to purchase gold from a goldsmith. The market price for gold on March 9, 2018 was Rs. 30,425 for 10 gram and goldsmith agrees to sell you gold at market price. You paid him Rs. 30,425 for 10 gram of gold and took gold. This is a cash market transaction at a price (in this case Rs. 30,425) referred to as spot price.

Now suppose you do not want to buy gold on March 9, 2018, but only after 1 month. Goldsmith quotes you Rs. 30,450 for 10 grams of gold. You agree to the forward price for 10 grams of gold and go away. Here, in this example, you have bought forward or you are long forward, whereas the goldsmith has sold forwards or short forwards. There is no exchange of money or gold at this point of time. After 1 month, you come back to the goldsmith pay him Rs. 30,450 and collect your gold. This is a forward, where both the parties are obliged to go through with the contract irrespective of the value of the underlying asset (in this case gold) at the point of delivery.

Essential features of a Forward contract are:

- It is a contract between two parties (Bilateral contract).
- All terms of the contract like price, quantity and quality of underlying, delivery terms like place, settlement procedure etc. are fixed on the day of entering into the contract.

In other words, Forwards are bilateral over-the-counter (OTC) transactions where the terms of the contract, such as price, quantity, quality, time and place are negotiated between two parties to the contract. Any alteration in the terms of the contract is possible if both parties agree to it. Corporations, traders and investing institutions extensively use OTC transactions to meet their specific requirements. The essential idea of entering into a forward is to fix the

price and thereby avoid the price risk. Thus, by entering into forwards, one is assured of the price at which one can buy/sell an underlying asset.

Major limitations of forward contracts

Liquidity Risk

As forwards are tailor made contracts i.e. the terms of the contract are according to the specific requirements of the parties, other market participants may not be interested in these contracts. Forwards are not listed or traded on exchanges, which makes it difficult for other market participants to easily access these contracts or contracting parties.

Counterparty risk

Counterparty risk is the risk of an economic loss from the failure of counterparty to fulfil its contractual obligation. For example, A and B enter into a bilateral agreement, where A will purchase 100 kg of rice at Rs.20 per kg from B after 6 months. Here, A is counterparty to B and vice versa. After 6 months, if price of rice is Rs.30 in the market then B may forego his obligation to deliver 100 kg of rice at Rs.20 to A. Similarly, if price of rice falls to Rs.15 then A may purchase from the market at a lower price, instead of honouring the contract. Thus, a party to the contract may default on his obligation if there is incentive to default. This risk is also called default risk or credit risk.

In addition to the illiquidity and counterparty risks, there are several issues like lack of transparency, settlement complications as it is to be done directly between the contracting parties. Simple solution to all these issues lies in bringing these contracts to the centralized trading platform. This is what futures contracts do.

5.2.2 Futures

Futures markets were innovated to overcome the limitations of forwards. A futures contract is an agreement made through an organized exchange to buy or sell a fixed amount of a commodity or a financial asset on a future date at an agreed price.

Simply, futures are standardised forward contracts that are traded on an exchange. Exchange becomes counterparty to both buyer and seller of a futures contract through a clearing house. Futures create an obligation on both buyer and seller's part. The terms of the contract are specified by the exchange and are subjected to change as and when necessary. The clearing corporation associated with the exchange guarantees settlement of these trades. A trader, who buys futures contract, takes a long position and the one, who sells futures, takes a short position. The words buy and sell are figurative only because no money or underlying asset changes hand, between buyer and seller, when the deal is signed.

Features of futures contract

In futures market, exchange decides all the contract terms of the contract other than price. Accordingly, futures contracts have following features:

- Contract between two parties through Exchange
- Centralised trading platform i.e. exchange
- Price discovery through free interaction of buyers and sellers
- Margins are payable by both the parties
- Quality decided today (standardized)
- Quantity decided today (standardized)

5.2.3 Options

An Option is a contract that gives its buyers the right, but not an obligation, to buy or sell the underlying asset on or before a stated date/day, at a stated price, for a premium (price). The party taking a long position i.e. buying the option is called buyer/ holder of the option and the party taking a short position i.e. selling the option is called the seller/ writer of the option. The option buyer has the right but no obligation with regards to buying or selling the underlying asset, while the option writer has the obligation to its commitment in the contract.

Therefore, option buyer/ holder will exercise his option only when the situation is favourable to her, but, when she decides to exercise, option writer is legally bound to honour the contract.

Options are of mainly two types—call and put option.

Option, which gives buyer a right to buy the underlying asset, is called Call option and the option which gives buyer a right to sell the underlying asset, is called Put option.

Option Terminology

Arvind buys a call option on the Nifty index from Salim, to buy the Nifty at a value of Rs. 10000, three months from today. Arvind pays a premium of Rs 100 to Salim. What does this mean?

- Arvind is the buyer of the call option.
- Salim is the seller or writer of the call option.
- The contract is entered into today, but will be completed three months later on the settlement date.
- Rs. 10000 is the price Arvind is willing to pay for Nifty, three months from today. This is called the strike price or exercise price.

- Arvind may or may not exercise the option to buy Nifty at Rs. 10000 on the settlement date.
- But if Arvind exercises the option, Salim is under the obligation to sell Nifty at Rs. 10000 to Arvind.
- Arvind pays Salim Rs.100 as the upfront payment. This is called the option premium. This is also called as the price of the option.
- On the settlement date, Nifty is at Rs. 10200. This means Arvind's option is "in-the-money." He can buy the Nifty at Rs.10000, by exercising his option.
- Salim earned Rs.100 as premium, but lost as he has to sell Nifty at Rs.10000 to meet his obligation, while the market price was Rs. 10200.
- On the other hand, if on the settlement date, the Nifty is at Rs. 9800, Arvind's option will be "out-of-the-money."
- There is no point paying Rs.10000 to buy the Nifty, when the market price is Rs. 9800. Arvind will not exercise the option. Salim will pocket the Rs.100 he collected as premium.

5.2.4 Swaps

A swap is a contract in which two parties agree to a specified exchange of cash flows on a future date(s). Swaps are common in interest rate and currency markets.

Example:

A borrower has to pay a quarterly interest rate defined as the Treasury bill rate on that date, plus a spread. This floating rate interest payment means that the actual obligation of the borrower will depend on what the Treasury bill rate would be on the date of settlement. The borrower however prefers to pay a fixed rate of interest.

She can use the interest rate swap markets to get into the following swap arrangement:

- Pay a fixed rate to the swap dealer every quarter
- Receive T-bill plus spread from the swap dealer every quarter

The swap in this contract is that one party pays a fixed rate to the other, and receives a floating rate in return. The principal amount on which the interest will be computed is agreed upon between counterparties and is never exchanged. Only the interest rate on this amount is exchanged on each settlement date (every quarter) between counterparties. The principal amount is also known as notional amount.

The borrower will use the floating rate that she has received from the swap market and pay the floating rate dues on her borrowing. These two legs are thus cancelled, and her net obligation is the payment of a fixed interest rate to the swap dealer. By using the swap market, the borrower has converted his floating rate borrowing into a fixed rate obligation.

Swaps are very common in currency and interest rate markets. Though swap transactions are OTC, they are governed by rules and regulations accepted by Swap Dealer Associations. In India, we have Fixed Income Market and Derivatives Association of India(FIMMDA). It is an association of commercial banks, financial institutions and primary Dealers. FIMMDA is a voluntary market body for the bond, money and derivatives markets.

The objectives of FIMMDA are:

1. To function as the principal interface with the regulators on various issues that impact the functioning of these markets.
2. To undertake developmental activities, such as, introduction of benchmark rates and new derivatives instruments, etc.
3. To provide training and development support to dealers and support personnel at member institutions.
4. To adopt/develop international standard practices and a code of conduct in the above fields of activity.
5. To devise standardized best market practices.
6. To function as an arbitrator for disputes, if any, between member institutions.
7. To develop standardized sets of documentation.
8. To assume any other relevant role facilitating smooth and orderly functioning of the said markets.

5.3 Structure of derivative markets

A derivative market is formed when different players with different needs to manage their risks come together and try to secure themselves from the respective risky events that they fear in the future.

In India, the following derivative products are available on various stock exchanges:

- Equity index options
- Equity index futures
- Individual stock options
- Individual stock futures
- Currency options and futures on select currency pairs
- Interest rate futures
- Commodity futures for a select set of commodities

Apart from the above, forward markets for agricultural commodities and swap markets for interest rates are available in the OTC markets.

OTC Markets

Some derivative contracts are settled between counterparties on terms mutually agreed upon between them. These are called over the counter (OTC) derivatives. They are non-standard and they depend on the trust between counterparties to meet their commitment as promised. These are prevalent only between institutions, which are comfortable dealing with each other.

Exchange Traded Markets

Exchange-traded derivatives are standard derivative contracts defined by an exchange, and are usually settled through a clearing house. The buyers and sellers maintain margins with the clearing-corporations, which enables players that do not know one another (anonymous) to enter into contracts on the strength of the settlement process of the clearing house. Forwards are OTC derivatives; futures are exchange-traded derivatives.

5.4 Purpose of Derivatives

A derivative is a risk management tool used commonly in transactions where there is risk due to an unknown future value. Derivatives are typically used for three purposes—Hedging, Speculation and Arbitrage.

Hedging

When an investor has an investment in any asset or portfolio of assets, and further she also has a desired return or any specific investment objective, then she can use the derivative markets to protect the desired value of that investment from the risk of future price movements.

Speculation

A speculative trade in a derivative is not supported by an underlying existing investment in asset or portfolio. It simply involves implementation of an investment or trading strategy based on a view about the future prices of the relevant asset underlying the specific derivative product. For instance, a buyer of a futures contract carries the view that the price of the underlying asset would move up, and she would gain having bought the futures contract at a lower price, as of now, because such a view is not reflecting in the current futures price. In the process the investor has to bear the cost of this long position, which is related to cost incurred in the management of margins required in the futures contracts.

Arbitrage

The law of one price states that two goods (assets) that are identical, cannot trade at different prices in two different markets. If not, one would buy from the cheaper market and sell at the costlier market, and make riskless profits. However, such buying and selling itself will reduce the gap in prices. The demand in the cheaper market will increase prices there and the supply into the costlier market will reduce prices, bringing the prices in both markets to the same level. Arbitrageurs are specialists who identify such price differential in two markets and indulge in trades that reduce such differences in price. Prices in two markets for the same

tradable asset will be different only to the extent of transaction costs. These costs can include transportation, storage, insurance, interest costs and any other cost that impacts the activities of buying and selling.

5.5 Commodity and Currency Futures and Options

The basic concept of a derivative contract remains the same for all the underlying assets, whether the underlying happens to be a commodity or currency. When the underlying asset is a commodity, e.g. Oil or Wheat, the contract is termed a “commodity derivative”. When the underlying is an exchange rate, the contract is termed a “currency derivative”. Both future and options contracts are available on commodities and as well as on currencies.

Commodity derivatives

Derivatives have become an integral part of today’s commodity trading and are used for various types of risk protection and in innovative investment strategies. Commodity derivatives markets play an increasingly important role in the commodity market value chain by performing key economic functions such as risk management through risk reduction and risk transfer, price discovery and transactional efficiency. Commodity derivatives markets allow market participants such as farmers, traders, processors, etc. to hedge their risk against price volatility through commodity futures and options.

Commodity futures contracts are highly uniform and are well-defined. These contracts explicitly state the commodities (quantity and quality of the goods) that have to be delivered at a certain time and place (acceptable delivery date) in a certain manner (method for closing the contract) and define their permissible price fluctuations (minimum and maximum daily price changes). Therefore, a commodity futures contract is a standardized contract to buy or sell commodities for a particular price and for delivery on a certain date in the future.

For instance, if a Biscuit manufacturer wants to buy 10 tonnes of wheat today, he can buy the wheat in the spot market for immediate use. If he wants to buy 10 tonnes of wheat for future use, he can buy wheat futures contracts at a commodity futures exchange. The futures contracts provide for the delivery of a physical commodity at the originally contracted price at a specified future date, irrespective of the actual price prevailing on the actual date of delivery.

Futures trading in commodities can be conducted between members of an approved exchange only. Futures trading in commodities is organized by these exchanges after obtaining a certificate of registration from the SEBI. The national exchanges in which commodity derivatives are currently traded in India are: Multi Commodity Exchange of India Limited (MCX), National Commodity & Derivatives Exchange Limited (NCDEX), Indian Commodity Exchange Limited (ICEX), National Stock Exchange of India Limited (NSE) and BSE Limited (Bombay Stock Exchange).

Commodities that are traded on Indian exchanges can be grouped into four major categories: Bullion, Metals, Energy and Agriculture. An indicative list of commodities traded in the Indian derivatives exchanges are:

Bullion: Gold, Silver, Diamond

Metals: Aluminium, Brass, Copper, Lead, Nickel, Steel, Zinc

Energy: Crude Oil, Natural Gas

Agriculture: Barley, Chana, Maize, Wheat, Guar Seed, Guar Gum, Isabgul Seed, Pepper, Cardamom, Coriander, Jeera, Turmeric, Sugar, Copra, Rubber, Jute, Cotton, Cotton Seed Oilcake, Castor Seed Oil, Mentha Oil, Soy Bean, Soy Bean Oil, Refined Soy Oil, Degummed Soy Oil, Rape/Mustard Seed, Crude Palm Oil, RBD Palmolein.

Commodity options in India devolve into Commodity Futures. That means, buyers of commodity options would get a right to have a position in underlying commodity futures rather than getting a right to out-rightly buy/sell the actual commodity on expiry. Therefore, the underlying for a commodity options contract is a commodity futures contract of a specified month traded on the corresponding exchange. This is one example where a derivative has another derivative as underlying. Such an instrument is also called Exotic Option in this case.

Currency derivatives

Unlike any other traded asset class, the most significant part of currency market is the concept of currency pairs. In currency market, while initiating a trade you buy one currency and sell another currency. Every trade in FX market is a currency pair: one currency is bought with or sold for another currency. In case of currency derivatives, the underlying is an exchange rate. Currency risks could be managed through any of the currency derivatives i.e. forwards, futures, swaps and options. Each of these instruments has its role in managing the currency risk.

A currency future, also known as FX future, is a futures contract to exchange one currency for another at a specified date in the future at a price (exchange rate) that is fixed on the purchase date. Currency Options are contracts that grant the buyer of the option the right, but not the obligation, to buy or sell underlying currency at a specified exchange rate during a specified period of time. For this right, the buyer pays a premium to the seller of the option.

Currency Derivatives are available on four currency pairs viz. US Dollars (USD), Euro (EUR), Great Britain Pound (GBP) and Japanese Yen (JPY). Cross Currency Futures & Options contracts on EUR-USD, GBP-USD and USD-JPY are also available for trading in Currency Derivatives segment.

5.6 Underlying concepts in derivatives

Zero Sum Game

In a futures contract, the counterparties who enter into the contract have opposing views and needs. The seller of gold futures thinks prices will fall, and benefits if the price falls below the price at which she entered into the futures contract. The buyer of gold futures thinks prices will rise, and benefits if the price rises beyond the price at which she has agreed to buy gold in the future. On maturity the market price of the underlying would be same for both the futures contracts, leading to profits to only one of them. But when the net positions of both the buyer and seller are considered, it always amounts to zero. Hence the word Zero Sum Game suits appropriately to describe the net positions of derivative instruments. However there are the two usual assumptions to this conclusion, that there are no taxes and no transaction costs.

Settlement Mechanism

Earlier most derivative contracts were settled in cash. Cash settlement is a settlement method where upon expiration or exercise of the derivatives contract, the counterparties to the contract settle their position through exchange of the price differentials and do not deliver the actual (physical) underlying asset.

However, SEBI has mandated physical settlement (settlement by delivery of underlying stock) for all stock derivatives.

Arbitrage

The law of one price states that two goods (assets) that are identical, cannot trade at different prices in two different markets. If not, it will be easy to buy from the cheaper market and sell at the costlier market, and make riskless profits. However, such buying and selling itself will reduce the gap in prices. The demand in the cheaper market will increase prices there and the supply into the costlier market will reduce prices, bringing the prices in both markets to the same level. Arbitrageurs are specialists who identify such price differential in two markets and indulge in trades that reduce such differences in price. Prices in two markets for the same tradable asset will be different only to the extent of transaction costs. These costs can include transportation, storage, insurance, interest costs and any other cost that impacts the activities of buying and selling.

In the derivative market, the underlying asset is the same as it is in the cash market. But the price to buy the same asset in the derivative market can be different from that of the cash market due to the presence of other costs such as physical warehousing or interest costs. The pricing of derivatives takes into account these costs.

Margining Process

Margin is defined as the funds or securities which must be deposited by Clearing Members as collateral before executing a trade. The provision of collateral is intended to ensure that all financial commitments related to the open positions of a Clearing Member can be offset within specified period of time.

There are different kinds of margins. The initial margin is charged to the trading account on the assumption that the position will be carried out till the expiry of the contract. The initial margin has two components; SPAN¹⁷ margins and ELM margins based on exposure. Both margins have to be mandatorily deposited before taking a trade. The initial margin should be large enough to cover the loss in 99 per cent of the cases. The greater the volatility of the stock, greater the risk and, therefore greater is the initial margin.

In addition to Initial Margin, a Premium Margin is charged to trading members trading in Option contracts.

The premium margin is paid by the buyers of the Options contracts and is equal to the value of the options premium multiplied by the quantity of Options purchased.

Open Interest

Open interest is commonly associated with the futures and options markets. Open interest is the total number of outstanding derivative contracts that have not been settled. The open interest number only changes when a new buyer and seller enter the market, creating a new contract, or when a buyer and seller meet—thereby closing both positions. Open interest is a measure of market activity. However, it is to be noted that it is not trading volume. Open interest is a measure of the flow of money into a futures or options market. Increasing open interest represents new or additional money coming into the market while decreasing open interest indicates money flowing out of the market.

5.7 Investment in Derivatives in PMS

Portfolio managers are permitted to invest in derivatives, including transactions for the purpose of hedging and portfolio rebalancing, through recognised stock exchanges. Portfolio managers can invest in derivatives on the terms specified in the Portfolio Management Agreement. The Agreement should contain complete details pertaining to the manner and terms of usage in derivatives product including quantum of exposure to derivatives (in

¹⁷ The margin calculation is carried out using a software called - SPAN[®] (Standard Portfolio Analysis of Risk). It is a product developed by Chicago Mercantile Exchange (CME) and is extensively used by leading stock exchanges of the world.

absolute terms and as a percentage of investment in other securities in the portfolio), type of derivative instruments, purpose of using derivatives, type of derivative position and the exposure thereof, terming of valuing and liquidating derivative contracts in the event of liquidation of portfolio management scheme, prior permission from the investors in the event of any changes in the manner or terms of usage of derivative contracts etc.

The total exposure of the portfolio client in derivatives should not exceed his portfolio funds placed with the Portfolio Manager and Portfolio Manager should, in essence, invest and borrow on behalf of his clients. Investment in derivatives is only on the terms mutually agreed between the Portfolio Managers and the client through Portfolio Management agreement. In the event of any violation of the terms of the agreement, the portfolio manager shall be responsible. Portfolio Managers are required to provide necessary disclosures in the Disclosure Document in terms of the PM Regulations.

Portfolio Managers are permitted to participate in Exchange Traded Commodity Derivatives on behalf of their clients subject to the regulatory stipulations.

Chapter 5: Sample Questions

1. In a Nifty 50 futures contract ,the underlying is _____.
 - a. the top traded stocks of the Nifty 50 index
 - b. the average price of the stocks of the Nifty 50 index
 - c. the value of the Nifty 50 index**
 - d. all of the above

2. The counterparty risk in a futures contract is mitigated primarily through _____.
 - a. collateralisation by one of the parties to the contract
 - b. settlement on gross basis between two parties
 - c. the functions of the clearing corporation**
 - d. the limits on positions and trading volumes

3. The settlement price for determining daily mark-to-market margins for a futures contract is _____.
 - a. the last traded price
 - b. the average of the high, low and closing prices
 - c. the weighted average price of last 30 minutes of trading**
 - d. the average of the last 60 minutes of trading

4. Arbitrage opportunities can exist between _____.
 - a. Spot and futures prices
 - b. Two futures prices
 - c. Futures and options prices
 - d. All of the above**

CHAPTER 6: MUTUAL FUND

LEARNING OBJECTIVES:

After reading this chapter, the reader should understand about:

- Concept and Role of Mutual Fund
- Benefits of investing through mutual funds
- Legal Structure of Mutual Fund in India
- Working of mutual funds
- Types of Mutual fund products
- Reading mutual fund information through factsheet

6.1 Concept and Role of Mutual Fund

Mutual fund is a vehicle (in the form of a “trust”) to mobilize money from investors, to invest in different markets and securities, in line with stated investment objectives. In other words, through investment in a mutual fund, an investor can get access to equities, bonds, money market instruments and/or other securities and avail of the professional fund management services offered by an asset management company. When someone says that one has invested in a mutual fund scheme, often, the scheme is perceived to be competing with the traditional instruments of investment, viz. equity shares, debentures, bonds, etc. Rather, the reality is that a mutual fund scheme is not competing, but channelizing investor’s money into the traditional instruments.

Mutual funds offer different kinds of schemes to cater to the need of diverse investors. Various investors have different investment preferences and needs. In order to accommodate these preferences, mutual funds mobilize different pools of money. Each such pool of money is called a mutual fund scheme. Every scheme has a pre-announced investment objective. In line with the objectives that the scheme would decide the investment universe i.e. the types of securities to invest in. Investors choose a mutual fund scheme whose investment objectives reflects their own needs and preference.

The money mobilized from investors is invested by the mutual fund scheme in a portfolio of securities as per the stated investment objective. Profits or losses, as the case might be, belong to the investors or unitholders. No other entity involved in the mutual fund in any capacity participates in the scheme’s profits or losses. They are all paid a fee or commission for the contributions they make to launch and operate the schemes.

6.2 Benefits of investing through mutual funds

Mutual fund investment simplifies the process of investing and holding securities. Mutual funds offer investors the opportunity to earn an income or build their wealth through professional management of their investible funds. There are several aspects to such professional management viz. investing in line with the investment objective, investing based on adequate research, and ensuring that prudent investment processes are followed. Mutual fund benefits are not restricted to research and selection of securities to construct a portfolio of investments, but also to take care of various administrative tasks like collection of corporate benefits (for example: interest payments, dividends, rights issues, buybacks, etc.), or follow up on the same. The calculation and publishing of NAV on a daily basis means that the accounting of the entire portfolio is done on a daily basis. The investor managing one's portfolio independently needs to take all this efforts. All these benefits come at a very low cost and are available even for the smallest investments through mutual fund investments. Some of these benefits are elaborated below:

Affordable Portfolio Diversification

Investing in the units of a scheme provide investors the exposure to a range of securities held in the investment portfolio of the scheme in proportion to their holding in the scheme. Thus, an investor can get proportionate ownership in a diversified investment portfolio even for a small investment of Rs. 500 in a mutual fund scheme.

With diversification, an investor ensures that “all the eggs are not in the same basket”. Consequently, the investor is less likely to lose money on all the investments at the same time. Thus, diversification helps reduce the risk in investment. This kind of diversification is neither economically viable nor achievable by an individual investor. Instead, they can achieve the diversification through an investment of less than thousand rupees in a mutual fund scheme.

Economies of Scale

Pooling of large sums of money from many investors makes it possible for the mutual fund to engage professional managers for managing investments. Individual investors with small amounts to invest cannot, by themselves, afford to engage such professional management.

Large investment corpus leads to various other economies of scale. For instance, costs related to investment research and office space gets spread across investors. Further, the higher transaction volume makes it possible to negotiate better terms with brokers, bankers and other service providers.

Transparency

An investor is well served if relevant information is available on time. Availability of such information is critical for taking informed investment decision. The structure of mutual funds and the regulations by SEBI have ensured that investors get such transparency about their

investments. There are three essential places from where the investor can get enough information for taking informed decisions, viz., scheme related documents (Scheme Information Document (SID), Statement of Additional Information (SAI), and Key Information Memorandum (KIM), portfolio disclosures, and the NAV of the scheme. Incidentally, even a prospective investor can access all this information.

Tax benefits

Specific schemes of mutual funds (Equity Linked Savings Schemes (ELSS) give investors the benefit of deduction of the amount subscribed (upto Rs. 150,000 in a financial year), from their income that is liable to tax. This reduces their taxable income, and therefore the tax liability.

Convenient Options

The options offered under a scheme allow investors to structure their investments in line with their liquidity preference and tax position.

There are also transaction conveniences like the ability to withdraw only part of the money from the investment account, ability to invest additional amount to the account, etc.

Regulatory Comfort

The regulator, Securities and Exchange Board of India (SEBI), has mandated strict checks and balances in the structure of mutual funds and their activities. Mutual fund investors benefit from such protection.

6.3 Legal Structure of Mutual Fund in India

SEBI (Mutual Fund) Regulations, 1996 define “mutual fund” as “a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, money market instruments, gold or gold-related instruments, silver or silver related instruments, real estate assets and such other assets and instruments as specified by SEBI from time to time.” The firm must set up a separate Asset Management Company (AMC) to run mutual fund business.

Key features of a mutual fund that flow from the above definition are:

- It is established as a trust
- It raises money through sale of units to the public or a section of the public
- The units are sold under one or more schemes
- The schemes invest in securities (including money market instruments) or gold or gold-related instruments or real estate assets.

SEBI has stipulated the legal structure under which mutual funds in India need to be constituted. The structure, which has inherent checks and balances to protect the interests of the investors, can be briefly described as follows:

- Mutual funds are constituted as Trusts. Therefore, they are governed by the Indian Trusts Act, 1882
- The mutual fund trust is created by one or more Sponsors, who are the main persons behind the mutual fund business.
- Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund.
- The operations of the mutual fund trust are governed by a Trust Deed, which is executed between the sponsors and the trustees. SEBI has laid down various clauses that need to be part of the Trust Deed.
- The Trust acts through its trustees. Therefore, the role of protecting the interests of the beneficiaries (investors) is that of the Trustees. The first trustees are named in the Trust Deed, which also prescribes the procedure for change in Trustees.
- To perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be appointed. When individuals are appointed as trustees, they are jointly referred to as 'Board of Trustees'. A trustee company functions through its Board of Directors.
- Day to day management of the schemes is handled by an Asset Management Company (AMC). The AMC is appointed by the sponsor or the Trustees.
- The trustees execute an investment management agreement with the AMC, setting out its responsibilities.
- Although the AMC manages the schemes, custody of the assets of the scheme (securities, gold, gold-related instruments & real estate assets) is with a Custodian, who is appointed by the Trustees.
- Investors invest in various schemes of the mutual fund. The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA)

6.4 Working of mutual funds

Day to day operations of mutual fund is handled by the AMC. The sponsor or, the trustees if so authorized by the trust deed, shall appoint the AMC with the approval of SEBI.

Chart 6.1: Organisation Structure of Asset Management Company

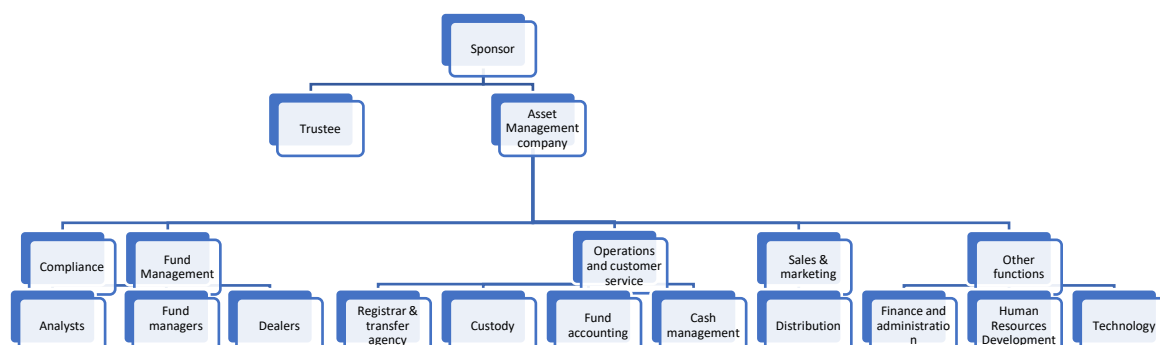


Chart 6.1 is used for explanation of various functions within an AMC. Individual AMCs may have some differences in the structure.

Compliance Function

Compliance Officer needs to ensure all the legal compliances. In the scheme documents of new issues, the Compliance Officer signs a due-diligence certificate to the effect that all regulations have been complied with, and that all the intermediaries mentioned in the scheme related documents have the requisite statutory registrations and approvals. To ensure independence, the Compliance Officer reports directly to the head of the AMC. The Compliance Officer works closely with the Trustees on various compliance and regulatory issues. It is the responsibility of the compliance officer to report any issue of non-compliance directly and immediately to the trustees.

Fund management

Fund management is the most critical function in an Asset Management Company. It is at the core of the value proposition offered by the firm. The main function of this team is to invest the investors' money in line with the stated objective of the scheme, and to manage the same effectively.

Normally, the team can be broken into three sub-teams, viz., the analysts, the fund managers, and the dealers.

The analysts analyse various opportunities, be it individual securities, or sectors, or the state of the markets, or the economy. Some of them may analyse the stock markets, whereas some may analyse debt markets. Within debt markets, some may evaluate credit opportunities, whereas some may analyse the interest rate movements. Their job is to identify investment opportunities.

The fund managers evaluate the opportunities presented to them by the analysts, the brokers, and other research firms. They may also identify opportunities by themselves. Performance of the scheme is the fund manager's responsibility.

The third sub-team is that of the dealers, whose responsibility is to place orders with securities brokers based on the instructions of the fund managers.

Operations and customer services team

When a customer visits a branch office of an AMC, s/he is attended to by the customer services team. Such a team is also called the front office team. Apart from this front office team, there is also a team in the back office to help investors by resolving various queries. Both these together are part of the Customer Services Team. Many AMCs have adopted

information technology solutions and have set up call centres and chat bots to answer customer queries and to resolve service issues.

The Registrar and Transfer Agency (RTA), which is a big part of this unit, maintains investor records as well as allots or redeems units, processes purchase/redemption/switch requests, dividends, etc.. It also generates the account statement that an investor receives.

There is a Custody Team within this group that interacts with the custodian for the purpose of settlement of various transactions that the fund management team initiates.

Fund accounting team maintains books of accounts of each individual mutual fund scheme and calculates NAV on a daily basis.

Cash management team works as an interface between the banks and the fund management team—they ensure that money received in the bank when investors purchase units are passed on to the fund managers for further investment in securities and the investors get the redemption proceeds when they submit the redemption request.

Sales and Marketing Team

This team reaches out to the investors through mass media, marketing campaigns and through distribution channel. Their major responsibilities include branding, advertising, management of various events, and distribution of mutual fund products through various distribution channels. Mostly, it is this team that would interact with the mutual fund distributors, and take care of relationship management and engagement. This team also helps in the growth of the distribution network through various interactions and training programs.

Other functions

These functions are largely support functions to run the AMC operations smoothly. These include Finance/Accounts, Administration, Human Resources (HR) and Development, Information Technology. They perform various tasks that ensure smooth functioning of the AMC, as well as improve customer experiences.

- The Accounts team handles the finances of the AMC. This unit is different from the fund accounting team.
- There is an Administration Department that takes care of various facilities, offices, and other infrastructure. In many AMCs, the administration reports to the finance function.
- The HR department is responsible for attracting, nurturing and retaining talent within the firm. They take care of learning and development requirements of the personnel.
- The Information Technology department, also referred as the Technology team, takes care of the IT infrastructure required by various functions and departments. This may

also include the AMC website, as well as many facilities offered to investors and distributors with the help of technology.

6.5 Types of Mutual fund products

Mutual funds can be classified into multiple ways. Funds can be classified based on the investment objective like growth funds, income funds, and liquid funds. The names of the categories suggest the investment objectives of the schemes. The other ways in which the mutual funds can be classified have been discussed below.

By the structure of the fund – open ended and close ended schemes and interval schemes

Mutual fund schemes are structured differently. Some schemes are open for purchase and repurchase on a perpetual basis. Once the scheme is launched, the scheme remains open for transactions, and hence the name of this category of schemes is open-ended funds. On the other hand, some schemes have a fixed maturity date. This means that these schemes are structured to operate for a fixed period till the maturity date and cease to exist thereafter. Since the closure of the scheme is pre-decided, such schemes are known as close-ended schemes.

Open-ended funds allow the investors to enter or exit at any time, after the NFO. Investors can buy additional units in the scheme any time after the scheme opens for on-going transactions. Prospective investors can also buy units. At any time, the existing investors can redeem their investments, that is, they can sell the units back to the scheme to get their money back.

Close-ended funds have a fixed maturity. Investors can buy units of a close-ended scheme, from the fund, only during its NFO. The investors cannot transact with the fund after the NFO is over. At the end of the maturity period, the scheme is wound up, units are cancelled and the money is returned to the investors. The fund makes arrangements for providing liquidity, post-NFO through listing of the units on a stock exchange. Such listing is compulsory for close-ended schemes to provide liquidity to the investors.

Interval funds combine features of both open-ended and close-ended schemes. They are largely close-ended but become open-ended at pre-specified intervals. For instance, an interval scheme might become open-ended between January 1 to 15, and July 1 to 15, each year. The benefit for investors is that, unlike in a purely close-ended scheme, they are not completely dependent on the stock exchange to be able to buy or sell units of the interval fund. However, to provide liquidity to the investors between these intervals, the units must be compulsorily listed on stock exchanges to allow investors an exit route. The periods when an interval scheme becomes open-ended, are called 'transaction periods'; the period between the close of a transaction period, and the opening of the next transaction period is called 'interval period'. Minimum duration of transaction period is 2 days, and maximum

duration of interval period is 15 days. No redemption/repurchase of units is allowed except during the specified transaction period (during which both subscription and redemption may be made to and from the scheme).

By the management of the portfolio – active funds and passive funds

Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme. Since this increases the role of the fund manager, the expenses for running the fund turn out to be higher. Investors expect actively managed funds to perform better than the market.

Passive funds invest on the basis of a specified index; whose performance it seeks to track. Thus, a passive fund tracking the S&P BSE Sensex would buy only the shares that are part of the composition of the S&P BSE Sensex. The proportion of each share in the scheme's portfolio would also be the same as the weightage assigned to the share in the S&P BSE Sensex. Thus, the performance of these funds tends to mirror the concerned index. They are not designed to perform better than the market. Such schemes are also called index schemes. Since the portfolio is determined by the index itself, the fund manager has no role in deciding on investments. Therefore, these schemes have low running costs.

By the investment universe: equity funds, fixed income funds, money market funds, gold funds, international funds

This type of classification looks at the investment universe where the scheme may invest money. There are equity funds, fixed income funds, money market funds, gold funds, international funds, etc. Here, the category names indicate where the money could be invested.

This classification may get further specific depending on narrowing the investment universe. For example, within equity funds, we have large-cap funds, mid-cap funds, etc. Similarly, within debt funds, we have Government Securities funds, and corporate debt funds.

6.6 Processes of investing in mutual funds

SEBI regulations prescribe the categories of investors who are eligible to invest in mutual fund in India. This includes resident individuals, Non Resident Indians (NRIs), Persons of Indian Origin (PIOs), Foreign nationals, Institutions and Trusts. Eligible investors in a mutual fund have to undergo a 'Know Your Customer' (KYC) procedure prescribed by SEBI to be able to invest in mutual funds. All investors in mutual funds must have a Permanent Account Number or PAN. The PAN is mandatory information that has to be provided at the time of applying for units. The only exception where PAN need not be provided is where investments made by an individual investor, either as lump sum or systematic investment plans, do not exceed Rs. 50,000 per annum per mutual fund.

Purchasing units of a mutual fund

Units of a mutual fund are first available for investing when the scheme is launched in a New Fund Offer (NFO). The NFO will be open for a period of 15 days during which the investor has to make the application. Payment for the units can be made only through approved payment modes that are mentioned in the offer document. These include cheque and online payment facilities like internet banking (NEFT and RTGS), Application Supported by Blocked Amount (ASBA) etc. Investors can invest in open-ended funds after the NFO period also. Sale of units on an ongoing basis by an open-ended fund is called continuous offer. The price of units in the continuous offer depends on the NAV of the fund, and is declared for every business day.

Units of close ended mutual funds are mandatorily listed on the stock exchange. Both purchase and redemption of both close ended and open ended schemes can be done using this channel. The units need to be held in dematerialised form to be able to conduct transactions through this channel.

Redemptions of units

Redemption refers to encashing or withdrawing the investment made in a mutual fund by selling the units back to the mutual fund. Investments made in an open-ended fund can be redeemed at any time at the current applicable NAV. Units of a closed-ended fund can be redeemed with the mutual fund only when the fund matures. Alternatively, they can be sold at stock exchange where they are listed.

6.6.1. Systematic transaction

Transactions with mutual funds can be automated by signing on for the facility of systematic transactions offered by mutual funds. This can be for purchases (Systematic Investment plan), redemptions (Systematic withdrawal plan) or transfers from one scheme to another (Systematic Transfer Plan). Investors specify the details of the periodic transactions to be done at the time of initiating the facility. The mutual fund will periodically execute the systematic transactions as directed. The details that have to be specified are:

- Type of transaction: Purchases, redemptions, transfers.
- Period: Length of time for which the transactions will run, say one year.
- Periodicity of transactions: The frequency of transactions, say monthly, quarterly, half yearly.
- Day of transaction: the day of the month on which each transaction will be executed, say 15th of the month.
- Amount: For each transaction and the total amount intended to be invested over a defined period.

6.7 Legal and Regulatory Framework – Key SEBI Regulation

A mutual fund is authorised by regulations to pool funds from investors and invest the funds on their behalf. The Securities and Exchange Board of India (SEBI) is the primary regulator of mutual funds in India. Only entities registered with SEBI under the SEBI (Mutual Fund) Regulations, 1996 can conduct the business of a mutual fund. The regulatory provisions are designed to protect the interests of the investors who invest in a fund.

The following are the key features of Mutual Fund Regulation:

1. A mutual fund is created as trust. The investors' funds and investments are held in this trust. The trust has trustees who are responsible for ensuring that the fund's managers manage the funds in the investors' interest and according to the stated objectives and regulations. Investor's money is held independently and not in the AMC's balance sheet.
2. The track record and capital that the promoters of AMCs should have and the role and responsibilities of the trustees and AMC have been defined in the regulations.
3. Mutual fund schemes cannot be offered to the public before the approval of the trustees and SEBI. The format and details of disclosures to be provided in the offer documents is defined in the regulations.
4. The investment portfolio has to adhere to the scheme objectives and be well diversified. The regulations specify limits on investments that the fund manager can make in a portfolio so that the risk to the investor is managed. The valuation of securities held in a portfolio and accounting for income and expenses are defined by SEBI regulations. This ensures that investors get a correct representation of the value of their investments.
5. The types of expenses that a mutual fund can charge to a scheme and the limits on these expenses are subject to SEBI regulations. This is to ensure that investors do not pay an unreasonably high fee for the services of the fund managers.
6. SEBI regulation prescribes periodic reporting of the fund's performance and investment details to the investors. The content and format of reporting information is specified by SEBI. For example, an equity fund has to publish its returns along with the return of the benchmark indices with which the AMC and trustees would compare the performance of the scheme so that investors are able to assess how the fund has performed relative to the markets in which the fund has invested.
7. The AMC has to make periodic reports and disclosures to SEBI, trustees and the Board of Directors of the AMC.

6.8 Fact Sheet - Scheme Related Information

One of the most popular document from the mutual fund is the monthly Fund Factsheet. This document is extensively used by investors, fund distributors, fund rating agencies, research analysts, media and others to access information about the various schemes of the mutual fund. While it is not a regulatory requirement to publish the monthly fact sheet, it is a market practice followed by all the fund houses, on a voluntary basis. Since fund factsheet is a marketing and information document, various SEBI regulations pertaining to information disclosure are applicable to it.

6.8.1. Reading mutual fund information

The fund factsheet contains the basic information of each scheme such as the inception date, corpus size (AUM), current NAV, benchmark and a pictorial depiction of the fund's style of managing the fund. The fund's performance relative to the benchmark is provided for the different periods along with the benchmark returns, as required by SEBI's regulations. The factsheet also provides the SIP returns in the scheme, portfolio allocation to different sectors and securities. However, some fund houses do not disclose the entire portfolio but only the top 10 holdings.

In the factsheet, security wise as well as sector wise allocation is provided for equity schemes. Some factsheets also disclose the derivatives exposure taken by the mutual fund schemes. In the debt funds, the factsheet discloses the rating profile of the various securities, and a snapshot of exposure of the scheme to various rating baskets.

Portfolio features such as the price-earnings ratio (PE), Beta and risk measures such as standard deviation and Sharpe ratio (in case of equity funds), credit rating profile, average maturity and duration (in case of debt funds) are also available in the factsheet. The factsheet also provides investment details such as the minimum investment amount, the plans and options available in the scheme, the loads and expenses and systematic transaction facilities available in the fund.

6.9 Net Asset Value, Total Expense Ratio, Pricing of Units

Net Asset Value : Mutual fund pools the money contributed by investors to a scheme and invests them in a portfolio of securities. The investments made by the fund belong to the investors, who will share the profits or losses made and the costs incurred in proportion to their investment.

An investor's investment in a mutual fund is represented by the number of units holding and a mutual fund investor is called a unit holder. The money contributed by investors in a mutual fund is invested in a portfolio of securities. The value of these securities will fluctuate and lead to an increase or decrease in the value of the portfolio. A mutual fund has to calculate and declare to its investors the current market value of each unit every day by taking the current market price of the securities held in the portfolio.

The NAV is the current value of a mutual fund unit. This will depend upon the current market to market (MTM) value of the securities held in the portfolio of the fund and any income earned such as dividend and interest. From this value, the costs and expenses charged for managing the fund are deducted. The value remaining is called the net assets of the fund. The net assets divided by the number of outstanding units give the Net Asset Value of the fund.

Pricing of Units: In case of open-ended funds, transactions are priced using the NAV to ensure parity among investors that buy new units, investors that stay in the fund, and investors that move out of a fund. Whereas close ended units are listed at the stock exchange, and price of those units is determined by the demand and supply of the units, which of course is influenced by the NAV of the units.

Total Expense Ratio: All types of expenses incurred by the Asset Management Company have to be clearly identified and appropriated for all mutual fund schemes. The most important expense is the **Investment and Advisory Fees** charged to the scheme by the AMC.

6.10 Mutual Fund Scheme Performance

The portfolio is the main driver of performance for mutual fund scheme. The asset class in which the fund invests, the segment or sectors of the market in which the fund will focus on, the styles adopted to select securities for the portfolio and the strategies adopted to manage the portfolio determines the risk and return in a mutual fund scheme. The underlying factors are different for each asset class. In case of equity based portfolios, market risk, sector specific risk and company risk drive the performance. In case of debt portfolios, interest rate risk and credit risk are the driving factors. Investors need to remember that return performance of a fund is driven by underlying risk factors.

6.11 Key performance measures

As per the Advertisement Guidelines for Mutual Funds by SEBI, the performance of the mutual fund schemes need to be disclosed as follows:

- When the mutual fund scheme has been in existence for more than three years:
 - Performance advertisement of mutual fund schemes shall be provided in terms of CAGR for the past 1 year, 3 years, 5 years and since inception along with their respective benchmark.
 - Point-to-point returns on a standard investment of Rs. 10,000 shall also be shown in addition to CAGR for the scheme to provide ease of understanding to retail investors.
- In the case of money market schemes or cash and liquid schemes, wherein investors have very short investment horizon, the performance can be advertised by simple annualization of yields if a performance figure is available for at least 7 days, 15 days and

30 days. Further, it should not give an unrealistic or misleading picture about the performance or future performance of the scheme.

For measuring the risk, variance, standard deviation, beta and tracking errors are calculated.

In addition to these measures, in the factsheets of the mutual funds, the following performance measures are disclosed:

- Sharpe Ratio
- Treynor Ratio
- Information Ratio
- Alpha
- Tracking error (in case of Index funds)

All these measures are discussed in detail in Chapter 10.

Chapter 6: Sample Questions

1. A _____ is a trust that pools the savings of a number of investors who share a common financial goal.
 - a. Custodian
 - b. Depository
 - c. Bank
 - d. **Mutual Fund**

2. The following is/are the benefits of investing through mutual funds:
 - a. Professional investment Management
 - b. Risk reduction through diversification
 - c. Convenience of making transactions and record keeping
 - d. **All the above**

3. The types of securities purchased by the fund, depends on _____.
 - a. **the investment objectives of the fund**
 - b. decisions of SEBI about the fund
 - c. decisions of RBI about the fund
 - d. Decisions of the fund advisors

4. The following schemes have the features of:
 - Continuous sale and purchase of units at NAV or NAV related prices,
 - Investor can enter and exit the scheme any time during the life of a fund
 - The scheme does not have specific time frame
 - a. **Open ended scheme**
 - b. Close ended scheme
 - c. Interval scheme
 - d. All the above

5. The SEBI (Mutual Funds) Regulations came in the year:
 - a. **1996**
 - b. 1998
 - c. 2000
 - d. 1964

CHAPTER 7: ROLE OF PORTFOLIO MANAGERS

LEARNING OBJECTIVES:

After reading this chapter, the reader should understand about:

- Different kinds of portfolio management services
- Organisation Structure of PMS in India
- Registration requirements of a Portfolio Manager
- Responsibilities of a Portfolio Manager
- Administration of the portfolio
- Dos and don'ts for the portfolio managers

7.1 Overview of portfolio managers in India

Risk and return are the two important aspects of financial investment. Portfolio management involves selecting and managing a basket of assets that minimizes risk, while maximizing return on investments. A portfolio manager plays a pivotal role in designing customized investment solutions for the clients.

A portfolio manager is a body corporate which, 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 client's funds. Portfolio managers are registered and regulated under SEBI (Portfolio Managers) Regulations, 2020. According to SEBI guidelines, portfolio management services (PMS) can be offered only by SEBI registered entities.

January 1993, marked the beginning of Portfolio Management Service when SEBI issued Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993. These were one of the first few regulations issued by the regulators. These regulations came even before the mutual fund regulations. This shows the importance of the sector to the regulator.

In India, the major providers of portfolio management services are big brokerage firms, asset management companies and independent experts.

According to the Asia-Pacific Wealth Report 2017, the Asia-Pacific region is recognized as having the highest net worth individuals (HNIs) and as being the region with the highest HNI wealth.¹⁸ As per the report, India is home to the fourth largest population of HNIs in the Asia-

¹⁸ https://www.capgemini.com/wp-content/uploads/2017/11/asia-pacific-wealth-report_2017_web_final.pdf

Pacific region. According to the report, India's HNI population and wealth increased by 9.6 per cent and 10 per cent respectively during 2016. This is evident in the expanding clientele base of the portfolio management industry. The asset under management (AUM) has also been growing steadily year on year as can be observed in the Table 7.1.

Table 7.1: Assets Managed by Portfolio Managers (AUM is in Rs. Crore)

	No. of Clients				AUM				
	Discretionary	Non-Discretionary	Advisory	Total	Discretionary (EPFO/PFs)	Discretionary (Non EPFO/PFs)	Non-Discretionary	Advisory	Total
2009-10	54,520	3,771	5,734	64,025	NA	2,73,420	9,301	NA	NA
2010-11	69,691	3,748	8,770	82,209	NA	2,84,980	10,456	86,016	NA
2011-12	65,600	5,712	9,296	80,608	3,86,410	37,365	18,759	73,914	5,16,448
2012-13	50,937	4,461	11,187	66,585	4,99,851	36,864	26,298	79,841	6,05,990
2013-14	42,771	4,932	9,774	57,477	5,41,655	43,939	39,728	1,43,004	7,68,326
2014-15	40,558	3,297	2,851	46,706	6,31,091	68,213	47,957	1,80,123	9,27,385
2015-16	46,088	3,915	2,285	52,288	7,34,892	76,141	60,122	1,74,272	10,45,428
2016-17	70,994	4,674	1,482	77,150	8,55,978	1,11,057	75,061	1,88,385	12,30,482
2017-18	1,13,776	5,427	2,158	1,21,361	9,94,748	1,57,375	89,797	2,25,131	14,67,051
2018-19	1,38,829	6,853	4,038	1,49,720	11,30,451	1,72,690	1,09,031	1,93,620	16,05,792
2019-20	1,53,232	9,393	3,923	1,66,548	13,93,447	1,14,271	1,15,202	1,91,451	18,14,371
2020-21	1,17,380	8,037	1,906	1,27,323	15,52,385	1,99,071	1,31,148	1,84,601	20,67,205
2021-22	1,30,525	7,512	1,912	1,39,949	17,69,845	2,65,250	1,75,943	2,08,331	24,19,269

Source: SEBI

7.2 Types of portfolio management services

On the basis of provider of the services PMS can be classified as:

1. PMS by asset management companies
2. PMS by brokerage houses
3. Boutique (independent) PMS houses

They can further be classified on the basis of product class as:

1. Equity based PMS
2. Fixed Income based PMS
3. Commodity PMS
4. Mutual Fund PMS
5. Multi Asset based PMS

Portfolio managers may classify their clients on the basis of their net-worth.

Another way which also finds mention in the regulation also is on the basis of the services provided by the portfolio managers. The following are the types of portfolio management services:

7.2.1 Discretionary Services

As per SEBI's Portfolio Managers Regulations, 2020 "discretionary portfolio manager" means a portfolio manager who under a contract relating to portfolio management, exercises or may exercise, any degree of discretion as to the investment of funds or management of the portfolio of securities of the client, as the case may be.

In other words, discretionary portfolio manager individually and independently manages the funds of each investor as per the contract. This could be based on an existing investment approach or strategy which the portfolio manager is offering or can be customized based on client's requirement.

7.2.2 Non-Discretionary Services

Non-discretionary portfolio manager manages the funds in accordance with the directions of the client. The portfolio manager does not exercise his/her discretion for the buy or sell decisions. The portfolio manager has to consult the client for every transaction. Decisions such as 'What to buy/sell?' and 'When to buy/sell?' vests with the investor. The execution of trade is done by the portfolio manager. So in this case, the Portfolio Manager provides investment execution services but not investment management services.

7.2.3 Advisory Services

In advisory role, the portfolio manager suggests the investment ideas or provides non-binding investment advice. The investor take the decisions. The investors also executes the transactions. These kind of services are typically used for institutional clients, who manages portfolio's on their own, but typically hires country experts in each country.

7.3 Organizational structure of PMS in India

A portfolio manager is a body corporate who, 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.

Body corporate broadly means a corporate entity which has a legal existence.

The Companies Act has provided an extensive definition of the term body corporate. The term "body corporate" is defined in Section 2(11) of the Companies Act, 2013.

“Body corporate” or “Corporation” includes a company incorporated outside India, but does not include—

- (i) a co-operative society registered under any law relating to co-operative societies; and
- (ii) any other body corporate (not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf;

In simple terms, the term body corporate includes a private company, public company, one persona company, small company, Limited Liability Partnerships, foreign company etc.

A body corporate means any entity that has its separate legal existence apart from the persons forming it. It enjoys a completely different legal status apart from its members.

7.4 Registration requirements of a Portfolio Manager

To act as a portfolio manager, obtaining certificate of registration from SEBI under the Portfolio Managers Regulations is a mandatory requirement.

The application for obtaining the certificate needs to be made to SEBI along with non-refundable fee.

The application needs to be made in *Form A* of Schedule I.¹⁹

Form A is a very detailed form. It requires mainly the following information.

No.	Part	Details required to be given
1	Particulars of the applicants	Name of the Applicant: PAN Address of Registered office Address for Correspondence. Address - Principal place of business (Where PMS activity shall be carried out) If PMS activity is proposed to be carried out from any branch offices, details of such Branch Offices, including address, name of contact person, mobile number of contact person, email of contact person etc.

¹⁹ Candidates are advised to refer to the latest application form available on SEBI website.

2	Organization Structure	<p>The objectives of the entity seeking registration, (Memorandum and Articles of Association/ Partnership Deed to be enclosed). (Copy of Board Resolution to be enclosed)</p> <p>Date and Place of Incorporation: (ROC Registration No.)</p> <p>Status of the Applicant: (e.g. Limited Company-Private/Public, LLP etc. If listed, names of the recognized stock exchanges to be given.)</p> <p>Organization Chart: [separately showing functional responsibilities (names and designations) of portfolio management activities to be enclosed]</p> <p>Particulars of all Directors/ Partners Name; Address; Qualification; Date of Appointment; DIN; PAN (Copy of PAN Card); Telephone No.; Mobile; Email; Experience (Entity name, designation, area of work, nature of work, experience (in years); other directorship/partnerships (entity name, date of appointment, no. of shares, percentage of shareholding)</p> <p>Key Management Personnel [Name; Address; Qualification; Date of Appointment; DIN; PAN (Copy of PAN Card); Telephone No.; Mobile; Email; experience (Entity name, designation, area of work, nature of work, experience (in years); other directorship details (name of entity, date of appointment, no. of shares, percentage of shareholding)</p> <p>Particulars of Promoters (Type (Individual/Corporate); Name, PAN, Address, Telephone, Mobile, Email)</p> <p>Particulars of Compliance Officer (Name, PAN (Copy of PAN card), Address, Qualification, Date of appointment, Address, Experience (company name, designation, area of work, nature of work, experience (in years).</p> <p>Particulars of Principal Officer [Name;; Qualification; Date of Appointment;; PAN (Copy of PAN Card);, Certification details (date of test, result, percentage, certificate no., validity from (date) and validity till date)</p> <p>Information of the total number of employees and number of employees for Portfolio Management services</p> <p>Name and activities of associate companies/ entities Details of registration with SEBI or any other Govt. Regulatory body (Name of the regulator, Registration No., Registration start/end date, Registration status, details of action taken in the past (if any).</p>
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		List of major shareholders/ partners of the Applicant (holding 5% or more voting rights)
3	Infrastructural Facilities	Principal Place of Business and for branch office <ul style="list-style-type: none"> • Office Space • Office Equipment • Furniture and Fixtures • Communication Facilities • Data Processing Capacity: in-house and others • Computer facility : hardware and software • Details of Disaster Recovery Set up / Business Continuity Plan
4	Business Plan (for three years)	History, Major events and present activities Proposed business plan and means of achieving the same. Projected Profitability (Next three years) (Targets, <i>modus operandi</i> to achieve targets, Resultant Income)
5	Financial Information	Capital Structure : Paid-up capital & Free Reserves (excluding revaluation reserves) for Year prior to the preceding year of current year, Preceding year, Current Year Net worth of Applicant (Net worth certificate not older than 3 months from the date of application to be enclosed) Deployment Deployment of Resources in Fixed assets, plant machinery and office equipment, investments etc., for Year prior to the preceding year of current year, Preceding year, Current Year Major Sources of Income for Year prior to the preceding year of current year, Preceding year, Current Year Net Profit for Year prior to the preceding year of current year, Preceding year, Current Year Particulars of Principal Banks Particulars of Auditors
6	Other Information	Details of all settled and pending disputes of previous 3 years Indictment of involvement in any economic offences in the last three years. Any other information considered relevant to the nature of services rendered by the company. Details of Membership with the recognized Stock Exchanges

7	Business Information	<p>Indicate type of activity carried on/ proposed to be carried on.</p> <p>Indicate the facilities for making decision on portfolio investment.</p> <p>Details of risk profiling procedure to be followed by the Portfolio Manager.</p> <p>Details of grievance redressal and dispute resolution mechanism to be followed by the Portfolio Manager.</p> <p>Provide list of approved share brokers through whom orders shall be placed, involved for Portfolio Management activities and state whether any of them were suspended/had defaulted with any Stock Exchange authority.</p> <p>Describe Accounting system followed/to be followed for Portfolio Management Services.</p> <p>Indicate various research and database facilities provided.</p> <p>Details of activities proposed to be outsourced.</p>
8	Experience	Experience in financial services rendered: details of activity etc.,
9	Additional Information	<p>Copy of Draft Agreement with Client to be provided</p> <p>Copy of Draft Disclosure Document to be provided</p> <p>Details of Custodian: (Name, Address, SEBI Registration No., Date of Appointment)</p> <p>Details of Registration with other Regulatory bodies.</p>
10	Declaration	<p>a) Declaration of compliance with Regulation 7 (2) signed by at least Two Directors or designated partners.</p> <p>b) Declaration for Fit and Proper Person as specified in SEBI (Intermediaries) Regulations, 2008.</p> <p>c) Declaration of Compliance with clause 12 (b) of Schedule III of the Regulations.</p> <p>d) Declaration of Compliance with SEBI circular on fees and charges.</p> <p>e) Declaration of type and frequency of reports sent/ proposed to be sent to clients.</p> <p>f) Declaration of time taken for transfer of securities into client accounts.</p> <p>g) Declaration of submission of periodic reports and Disclosure Document to SEBI.</p> <p>h) Declaration of compliance with clause (e) of sub-regulation (1) of Regulation 27 -regarding maintenance of records for Investment rationale.</p> <p>Declaration of availability of Disclosure document on website of Portfolio Manager</p>

In addition to the information required to be furnished as discussed above, the regulator may require the applicant to furnish further information or clarification regarding matters relevant to his activity of a portfolio manager. The applicant or its principal officer if required, need to appear before the regulator for personal representation.

Before issuing a certificate of registration, the regulator will ensure **whether**:

1. the applicant is a body corporate;
2. the applicant has the necessary infrastructure like adequate office space, equipment and the manpower to effectively discharge the activities of a portfolio manager;
3. the applicant has appointed a compliance officer;
4. the principal officer²⁰ of the applicant has a) a professional qualification in finance, law, accountancy or business management from a university or an institution recognized by the Central Government or any State Government or a foreign university or a professional qualification by completing a Post Graduate Program in the Securities Market (Portfolio Management) from NISM of a duration not less than one year or a professional qualification by obtaining a CFA charter from the CFA institute; b) experience of at least five years in related activities in the securities market including in a portfolio manager, stock broker, investment advisor, research analyst or as a fund manager; ²¹ and c) the relevant NISM certification as specified by SEBI from time to time.
5. In addition to the Principal Officer and Compliance Officer, the applicant has in its employment at least one person who has a graduation from a university or an institution recognized by the Central Government or any State Government or a foreign university; and an experience of at least two years in related activities in the securities market including in a portfolio manager, stock broker, investment advisor or as a fund manager. Further, any employee of the Portfolio Manager, who has decision making authority related to fund management shall have the same minimum qualification, experience and certification as specified by the Principal Officer.

²⁰ “principal officer” means an employee of the portfolio manager who is responsible for:-

(A) the decisions made by the portfolio manager for the management or administration of portfolio of securities or the funds of the client, as the case may be.

(B) the overall supervision of the operations of the portfolio manager.

²¹ Provided that atleast 2 years of relevant experience in portfolio management or investment advisory services or in the areas related to fund management.

Provided further that a portfolio manager, who was granted a certificate of registration prior to the commencement of the Securities and Exchange Board of India (Portfolio Managers) Regulations, shall comply with the stipulated conditions (sub clauses (i) and (ii) of clause (d) of sub-regulation (2) of regulation 7 within thirty-six months from such commencement. Provided further that a fresh NISM Certification shall be obtained before expiry of the validity of the existing certification to ensure continuity in compliance with the certification requirements.

6. Any disciplinary action has been taken by SEBI against a person directly or indirectly connected with the applicant.
7. The applicant fulfils the net worth requirement (Rupees five crore).
8. The applicant, its director or partner, principal officer, compliance officer or the employee is involved in any litigation connected with the securities market that has an adverse bearing on the business of the applicant.
9. The applicant, its director or partner, principal officer, compliance officer or the employee has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.
10. The applicant is a fit and proper person.
11. The grant of certificate to the applicant is in the interest of investors.

The certificate of registration granted shall be valid unless it is suspended or cancelled by SEBI.

7.5 General Responsibilities of a Portfolio Manager

The Portfolio Managers Regulations by SEBI has enumerated the following general responsibilities on the portfolio managers:

1. The discretionary portfolio manager shall individually and independently manage the funds of each client in accordance with the needs of the client, in a manner which does not partake character of a Mutual Fund, whereas the non-discretionary portfolio manager shall manage the funds in accordance with the directions of the client.
2. The portfolio manager shall not accept from the client, funds or securities worth less than fifty lakh rupees. Provided that the minimum investment amount per client shall be applicable for new clients and fresh investments by existing clients. Provided further that subject to appropriate disclosures in the disclosure document and the terms agreed between the client and the portfolio manager, the requirement of minimum investment amount per client shall not apply to an accredited investor. Provided further that the requirement of minimum investment amount per client shall not apply to the co-investment portfolio manager.
3. The portfolio manager shall act in a fiduciary capacity with regard to the client's funds.
4. The portfolio manager shall segregate each client's holding in securities in separate accounts.
5. The portfolio manager shall keep the funds of all clients in a separate account to be maintained by it in a Scheduled Commercial Bank.
6. The portfolio manager shall transact in securities within the limitation placed by the client himself with regard to dealing in securities under the provisions of the Reserve Bank of India Act, 1934 (2 of 1934).
7. The portfolio manager shall not derive any direct or indirect benefit out of client's funds or securities.
8. The portfolio manager shall not borrow funds or securities on behalf of the client.

9. The portfolio manager shall not lend securities held on behalf of the clients to a third person except as provided under these regulations.
10. The portfolio manager shall ensure proper and timely handling of complaints from his clients and take appropriate action immediately.
11. The portfolio manager shall ensure that any person or entity involved in the distribution of its services is carrying out the distribution activities in compliance with these regulations and circulars issued thereunder from time to time.

7.6 Administration of investor's portfolio

The portfolio manager has to manage and administer the funds of the investors within the regulatory framework. There are two popular models of execution. First one is pool execution i.e. trading for all clients together and then allocating individual securities to each client's demat account and the other one is trading in individual client name. In this case, allocation happens automatically since trade is in individual name. The portfolio manager enters into an agreement in writing before taking up an assignment of management of funds and portfolio on behalf of a client. The agreement clearly defines the relationship and sets out their mutual rights, liabilities and obligations relating to management of portfolio. The following are some aspects regarding the administration of the funds.

7.6.1 Defining the universe of securities for the purpose of investments

The agreement between the portfolio manager and the client includes the investment approach. An investment approach is a broad outlay of the type of securities and permissible instruments to be invested in by the portfolio manager for the customer, taking into account factors specific to clients and securities. The agreement also includes the areas of investment and restrictions, if any, imposed by the client with regard to the investment in a particular company or industry. Thus, the universe of securities for the purpose of investments is well defined in the agreement. As mentioned, it is a regulatory requirement.

7.6.2 Circumstances leading to pre-mature withdrawal of funds

The funds or securities can be withdrawn or taken back by the client before the maturity of the contract. However, the terms of premature withdrawal would be as per the agreement between the client and the portfolio manager.

The agreement between the portfolio manager and the client should include the terms for early withdrawal of funds or securities by the clients. It should also include the withdrawal fees in terms of percentage as well as the amount. Portfolio managers cannot impose a lock-in on the investment of their clients.

As the PMS Circular dated February 13, 2020²² in case client portfolio is redeemed in part or full, the exit load charged shall be as under:

- a) In the first year of investment, maximum of 3% of the amount redeemed.
- b) In the second year of investment, maximum of 2% of the amount redeemed.
- c) In the third year of investment, maximum of 1% of the amount redeemed.
- d) After a period of three years from the date of investment, no exit load.

7.6.3. Do's and Don'ts for the portfolio managers

The portfolio manager shall abide by the provisions of the SEBI Act, 1992 and the regulations. Following are the Do's and Don'ts for portfolio managers.

Do's:

1. The portfolio manager shall take adequate steps for redressal of grievances of the investors within the time stipulated by SEBI and keep SEBI informed about the number, nature and other particulars of the complaints received.²³
2. Portfolio manager shall abide by the Code of Conduct.
3. The portfolio manager shall segregate each client's holding in securities in separate accounts.
4. The portfolio manager shall keep the funds of all clients in a separate account to be maintained by it in a Scheduled Commercial Bank.
5. The portfolio manager shall transact in securities within the limitation placed by the client himself with regard to dealing in securities under the provisions of the Reserve Bank of India Act, 1934 (2 of 1934).
6. The portfolio manager shall segregate each clients' funds and portfolio of securities and keep them separately from his own funds and securities and be responsible for safekeeping of clients' funds and securities.

Don'ts:

1. The portfolio manager shall not derive any direct or indirect benefit out of the client's funds or securities.
2. The portfolio manager shall not borrow funds or securities on behalf of the client.
3. The portfolio manager shall not lend securities held on behalf of the clients to a third person except as provided under SEBI Portfolio Managers regulations.
4. The money or securities accepted by the portfolio manager shall not be invested or managed by the portfolio manager except in terms of the agreement between the portfolio manager and the client.

²²https://www.sebi.gov.in/legal/circulars/feb-2020/guidelines-for-portfolio-managers_45981.html

²³https://www.sebi.gov.in/legal/regulations/aug-2023/securities-and-exchange-board-of-india-portfolio-managers-regulations-2020-last-amended-on-august-18-2023-_76366.html

5. The portfolio manager while investing in units of mutual funds through direct plan shall not charge any kind of distribution related fees to the client.
6. The portfolio manager shall not leverage the portfolio of its clients for investment in derivatives.
7. The portfolio manager shall not deploy the clients' funds in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies.
8. The portfolio manager shall not invest the clients' funds in the portfolio managed or administered by another portfolio manager.
9. The portfolio manager shall not invest client's fund based on the advice of any other entity.
10. The portfolio manager shall not while dealing with clients' funds indulge in speculative transactions i.e., it shall not enter into any transaction for purchase or sale of any security which is periodically or ultimately settled otherwise than by actual delivery or transfer of security except the transactions in derivatives.
11. The portfolio manager shall, ordinarily purchase or sell securities separately for each client. However, in the event of aggregation of purchases or sales for economy of scale, *inter se* allocation shall be done on a *pro rata* basis and at weighted average price of the day's transactions. The portfolio manager shall not keep any open position in respect of allocation of sales or purchases effected in a day.
12. The portfolio manager shall not hold the securities belonging to the portfolio account, in its own name on behalf of its clients either by virtue of contract with clients or otherwise.
13. The portfolio manager shall not execute off market transfers in client's account except:
 - (a) for settlement of the clients' own trades;
 - (b) for providing margin/ collateral for clients' own positions;
 - (c) for dealing in unlisted securities in accordance with the regulations;
 - (d) with specific consent of the client for each transaction;
 - (e) for any other reason specified by SEBI from time to time.

7.6.4. Appointment of custodian

Except for the portfolio manager who provides only the advisory services, every portfolio manager shall appoint a custodian in respect of securities managed or administered by it. Details of custodian like its Name, Address, SEBI Registration No., Date of Appointment need to be furnished in the application for obtaining registration to the regulator.

7.6.5. Maintenance of records

Every portfolio manager shall keep and maintain the following books of accounts, records and documents namely: -

- (a) a copy of balance sheet at the end of each accounting period;
- (b) a copy of the profit and loss account for each accounting period;
- (c) a copy of the auditor's report on the accounts for each accounting period;
- (d) a statement of financial position and;
- (e) records in support of every investment transaction or recommendation which will indicate the data, facts and opinion leading to the investment decision.

Such records are maintained under the hands of the Principle Officer of the portfolio manager.

The portfolio manager should intimate to SEBI the place where the books of accounts, records and documents are maintained. The portfolio manager should after the end of each accounting period, furnish to SEBI copies of the balance sheet, profit and loss account and such other documents. It should furnish to SEBI a net worth certificate issued by a chartered accountant as and when required. The portfolio manager is required to preserve the books of account and other records and documents for preceding five accounting years and furnish to SEBI as and when required.

7.6.6. Accounts and audit

The portfolio manager shall maintain separate client-wise accounts. The funds received from the clients, investments or disinvestments, all the credits to the account of the client like interest, dividend, bonus, or any other beneficial interest received on the investment and debits for expenses, if any, shall be properly accounted for and details thereof shall be properly reflected in the client's account.

The tax deducted at source as required under the provisions of the Income-Tax Act, 1961, (43 of 1961) shall be recorded in the portfolio account.

The books of account will be audited yearly by qualified auditor to ensure that the portfolio manager has followed proper accounting methods and procedures and that the portfolio manager has performed his duties in accordance with the law.

The portfolio accounts of the portfolio manager shall be audited annually by an independent chartered accountant and a copy of the certificate issued by the chartered accountant shall be given to the client.

The client may appoint a chartered accountant to audit the books and accounts of the portfolio manager relating to his transactions and the portfolio manager shall co-operate with such chartered accountant in course of the audit.

7.6.7. Appointment of compliance officer

Every portfolio manager shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc., issued by SEBI or the Central Government and for redressal of investors' grievances. The compliance officer shall immediately and independently report to SEBI any non-compliance observed.

Chapter 7: Sample Questions

1) The net worth requirement to be registered as a PMS provider, as per SEBI(Portfolio Managers)Regulations, 2020, is?

- a. **Rs. 5 crore**
- b. Rs. 2 crore
- c. Rs. 50 lakhs
- d. Rs. 10 crore

2) An _____ is a broad outlay of the type of securities and permissible instruments to be invested in by the portfolio manager for the customer, taking into account factors specific to clients and securities.

- a. **investment approach**
- b. investment statement
- c. investment objectives
- d. investment profile

3) Except for the one that provides only the _____, every portfolio manager shall appoint a custodian in respect of securities managed or administered by it.

- a. **advisory services**
- b. discretionary services
- c. Non-discretionary services
- d. None of the above

4) The following is the requirement for granting the certificate of registration under Portfolio Managers Regulations 2020:

- a. the applicant is a body corporate;
- b. the applicant has the necessary infrastructure like adequate office space, equipment and the manpower to effectively discharge the activities of a portfolio manager;
- c. the applicant has appointed a compliance officer;
- d. **all of the above**

5) _____ portfolio manager manages the funds in accordance with the directions of the client.

- a. **Non-discretionary**
- b. Discretionary
- c. Advisory
- d. All the above

CHAPTER 8: OPERATIONAL ASPECTS OF PORTFOLIO MANAGERS

LEARNING OBJECTIVES:

After reading this chapter, the reader should know about:

- Entities which can invest in a PMS
- Disclosures made by the PMS to the prospective investors
- The process of onboarding of clients
- Content of agreement between the portfolio manager and investor
- PMS's liability in case of default
- Disclosures requirements of PMS to various regulators
- Costs, expenses and fees of investing in PMS

8.1 Entities which can invest in PMS

The following entities can invest in PMS with a minimum investment of Rs. 50 lacs:

- Individuals
- Non-resident Indians (as per the RBI guidelines)
- Hindu Undivided Family
- Proprietorship firms
- Association of person
- Partnership Firms
- Limited liability Partnership
- Trust
- Body Corporate

8.2 Disclosures to the prospective clients

Accurate and standardized disclosure by PMS providers is needed to help existing & prospective investors take well informed investment decisions.

SEBI (Portfolio Managers) Regulation 2020 requires that the disclosure document is to be given to the prospective client along with the account opening form prior to signing of the agreement. This change in the regulation has been made in 2020. Prior to this change, disclosure document was to be given to the prospective client along with the account opening form at least two days in advance of signing of the agreement. Keeping audit trail of each client having received the disclosure document at least two days prior to agreement execution appeared to be an onerous task and resulted in gaps in the process of keeping track of the same, as noted by the working group on the portfolio managers regulation, 1993. Therefore, it proposed that the requirement of providing disclosure document to the

prospective client at least two days prior to signing the PMS agreement be discontinued. Instead, it may be mandated that disclosure document be provided at any time before or at the time of entering into the agreement vide hard/soft copy and be made available at all times on Portfolio Manager's website. Due care shall be taken to present the information in simple language and in a clear, concise and easily understandable manner in the disclosure document.

The contents of the disclosure document are given below.

No.	Heading	Content
1	Disclaimer clause	A statement to the effect that the particulars have been prepared in accordance with the SEBI (Portfolio Managers) Regulations, 2020 and filed with SEBI. This Document has neither been approved or disapproved by SEBI nor has SEBI certified the accuracy or adequacy of the contents of the Document.
2	Definitions	<p>All terms used in the Disclosure Document be defined.</p> <p>The language and terminology used in the Disclosure Document shall be as provided in the Regulations.</p> <p>Any new term if used shall be clearly defined. All terms shall be used uniformly throughout the text of the Disclosure Document.</p>
3	Description	<p>History, Present Business and Background of the portfolio manager.</p> <p>Promoters of the portfolio manager, directors and their background.</p> <p>Top 10 Group companies/firms of the portfolio manager on turnover basis (latest audited financial statements may be used for this purpose).</p> <p>Details of the services being offered: Discretionary/ Non-discretionary / Advisory.</p>
4	Penalties, pending litigation or proceedings, findings of inspection or investigation for	<p>All cases of penalties imposed by SEBI or the directions issued by SEBI under the SEBI Act or rules or regulations made thereunder.</p> <p>The nature of the penalty/direction.</p>

	<p>which action may have been taken or initiated by any regulatory authority.</p>	<p>Penalties/fines imposed for any economic offence and/ or for violation of any securities laws.</p> <p>Any pending material litigation/legal proceedings against the portfolio manager/key personnel with separate disclosure regarding pending criminal cases, if any.</p> <p>Any deficiency in the systems and operations of the portfolio manager observed by SEBI or any regulatory agency.</p> <p>Any enquiry/ adjudication proceedings initiated by SEBI against the portfolio manager or its directors, principal officer or employee or any person directly or indirectly connected with the portfolio manager or its directors, principal officer or employee, under the Act or rules or regulations made thereunder.</p>
5	Services Offered	<p>The present investment objectives and policies including the types of securities in which it generally invests shall be clearly and concisely stated in the document for easy understanding of the potential investor.</p> <p>Investment Approaches of the Portfolio Manager</p> <p>The policies for investments in associates/group companies of the portfolio manager and the maximum percentage of such investments therein subject to the applicable laws/regulations/ guidelines.</p>
6	Risk factors	<p>Statement to the effect that securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.</p> <p>Statement to the effect that past performance of the portfolio manager does not indicate its future performance.</p> <p>Risk arising from the investment approach, investment objective, investment strategy and asset allocation.</p> <p>Risk arising out of non-diversification, if any.</p> <p>If the portfolio manager has no previous experience/ track record a disclosure to that effect shall be made.</p>

		<p>All transactions of purchase and sale of securities by portfolio manager and its employees who are directly involved in investment operations shall be disclosed if found having conflict of interest with the transactions in any of the client's portfolio.</p> <p>If the portfolio manager has group companies, a disclosure of conflict of interest related to services offered by group companies of the portfolio manager if any.</p>
7.	Client Representation	<p>Category of clients</p> <p>No. of clients</p> <p>Funds managed</p> <p>Discretionary / Non- Discretionary (<i>if available</i>)</p> <p>Associate/group companies (last 3 years)</p> <p>Others (last 3 years)</p> <p>Total</p> <p>Complete disclosure in respect of transactions with related parties as per the standards specified by the Institute of Chartered Accountants of India.</p>
8.	Financial Performance	The Financial Performance of the portfolio manager based on audited financial statements and in terms of procedure specified by SEBI for assessing the performance.
9.	Performance of Portfolio Manager	Portfolio Management performance of the portfolio manager for the last three years, and in case of discretionary portfolio manager disclosure of performance indicators calculated using 'Time Weighted Rate of Return' method .
10.	Audit Observations	Audit observations of the preceding 3 years
11.	Nature of expenses	Investment management and advisory fees. Custodian fee Registrar and transfer agent fee Brokerage and transaction cost.
12.	Taxation	Disclose the tax implications of investments in securities and the tax provisions on Income/ Loss or Tax Deduction at Source on various investors.

13.	Accounting policies	Disclose the accounting policy followed by the portfolio manager while accounting for the portfolio investments of the clients.
14.	Investors services	Name, address and telephone number of the investor relation officer who shall attend to the investor queries and complaints. Grievance redressal and dispute settlement mechanism.

8.2.1 Written down policies by Portfolio Manager

Portfolio Managers shall put in place a written down policy, which detail the specific activities, role and responsibilities of various teams engaged in fund management, dealing, compliance, risk management, back-office, etc., with regard to management of client funds and securities including the order placement, execution of order, trade allocation amongst clients and other related matters.

Portfolio Managers shall also put in place a specific policy, which provide for the following:

- Specific situations (not generic) wherein the orders shall be placed foreach client individually or pooled from trading account of Portfolio Manager.
- Scenarios/situations in which deviation from the allotment of securities as intended at the time of placement of order would be permissible, if at all.
- Scenarios, wherein, the Portfolio Manager is required to place certain margins/collaterals in order to execute certain transactions, details onhow such margins/collaterals shall be segregated/placed from amongst various clients, without affecting the interest of any client.
- Deviations, if any, shall be on account of exigency only and require prior written approval of the Principal Officer and Compliance officer ofthe Portfolio Manager with a detailed rationale for such deviation.

These policies as need to be approved by the Board/equivalent body of the Portfolio Manager.

Fair and equitable treatment of all clients

Portfolio Managers shall ensure that all clients are treated in a fair and equitable manner and ensure compliance with the following:

Requirements with respect to investments in all instruments:

- Portfolio Managers shall constitute a dealing team (DT) which shall be responsible for order placement and execution of all orders in accordance with the aforesaid policies

of the Portfolio Manager. DT may include the Principal Officer or the person appointed in terms of Regulation 7(2) (e) of the PM Regulations.

- Portfolio Managers shall ensure that DT is suitably staffed and comply with the following:
 - All conversations of DT shall be only through the dedicated recorded telephone lines or through emails from authorized email ids.
 - Mobile phones or any other communication devices other than the recorded telephone lines shall not be allowed inside the dealing room.
 - Access to internet facilities on computers and other devices inside the dealing room shall be restricted and shall only be used for activities related to trade execution.
 - Entry/access to the dealing room shall be restricted to authorized employees as defined in the aforementioned policies of the Portfolio Manager.
 - There shall be no sharing of information through any mode, except for trade execution under the approved policies of the Portfolio Manager.
- For equity, equity-related instruments and Mutual Funds units²⁷
 - Portfolio Managers with assets under management of INR 1000 crores or more under discretionary and non-discretionary services, shall have in place an automated system with minimal manual intervention for ensuring effective funds and securities management including order management and allocation of securities to each client.

Portfolio Managers shall maintain audit trail of all activities related to management of funds and securities of clients including order placement, trade execution and allocation. Further, there shall be time stamping with respect to order placement, order execution and trade allocation.

8.2.2 Best Practices for the disclosures – Global Investment Performance Standards (GIPS®)²⁴

The GIPS standards are ethical standards for calculating and presenting investment performance based on the principles of fair representation and full disclosure. These standards were originally created for investment firms managing composite strategies, with a focus on how firms present performance of composites to prospective clients. Asset

²⁴GIPS® is a registered trademark owned by CFA Institute. The GIPS standards are a set of standardized, industry-wide ethical principles that guide investment managers and asset owners on how to fairly calculate and present their investment results, with the goal of promoting performance transparency and comparability. <https://www.cfainstitute.org/-/media/documents/code/gips/2020-gips-standards-firms.ashx>

managers and both existing and prospective clients benefit from an established global standard for calculating and presenting investment performance.

Following are **some** of the disclosure requirements by GIPS:

Here the term firm is used as the entity defined for compliance with the GIPS standards.

1. The firm must disclose the composite description. A composite is an aggregation of one or more portfolios that are managed according to a similar investment mandate, objective, or strategy. The idea is to enable a prospective client to understand the key characteristics of the composite's investment mandate, objective, or strategy, including:
 - a. The material risks of the composite's strategy.
 - b. How leverage, derivatives, and short positions may be used, if they are a material part of the strategy.
 - c. If illiquid investments are a material part of the strategy.
2. The firm must disclose the benchmark description, which must include the key features of the benchmark or the name of the benchmark for a readily recognized index or other point of reference.
3. When presenting gross-of-fees returns, the firm must disclose if any other fees are deducted in addition to transaction costs.
4. When presenting net-of-fees returns, the firm must disclose:
 - a. If any other fees are deducted in addition to investment management fees and transaction costs.
 - b. If net-of-fees returns are net of any performance-based fees or carried interest.
 - c. If model or actual investment management fees are used.
 - d. If model investment management fees are used, and composite gross-of-fees returns are not presented, the model investment management fee used to calculate net-of-fees returns.
 - e. If model investment management fees are used, the methodology used to calculate net-of-fees returns.
5. The firm must disclose which fees and expenses other than investment management fees (e.g., research costs) are separately charged by the firm to clients, if material.
6. The firm must disclose or otherwise indicate the reporting currency.
7. The firm must disclose which measure of internal dispersion is presented.
8. The firm must disclose the current fee schedule appropriate to prospective clients or prospective investors.
9. If the fee schedule includes performance-based fees or carried interest, the firm must disclose the performance-based fee description or carried interest description.
10. The firm must disclose the composite inception date and creation date.

11. The firm must disclose that policies for valuing investments, calculating performance, and preparing GIPS reports are available upon request.
12. The firm must disclose how leverage, derivatives, and short positions have been used historically, if material.
13. If the firm determines that no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.
14. If a custom benchmark or combination of multiple benchmarks is used, the firm must:
 - a. Disclose the benchmark components, weights, and rebalancing process, if applicable.
 - b. Disclose the calculation methodology.
 - c. Clearly label the benchmark to indicate that it is a custom benchmark.
15. If the firm presents additional risk measures, the firm must:
 - a. Describe any additional risk measure.
 - b. Disclose the name of the risk-free rate if a risk-free rate is used in the calculation of the additional risk measure.

8.3 Process of On-boarding of clients

The two important elements of the customer life cycle are: client onboarding and reporting. The following are the important aspects of the client onboarding process in case of a PMS service:

1. Reading of disclosure document

SEBI (Portfolio Managers) Regulation 2020 requires that the disclosure document is to be given to the prospective client along with the account opening form prior to signing of the agreement. Disclosure document is to be provided at any time before or at the time of entering in to the agreement vide hard /soft copy and be made available at all times on Portfolio Manager's website.

2. Fulfilling KYC requirements

Investors need to fulfil certain mandatory requirements to be eligible to invest in PMS. The 'Know Your Customer (KYC)' process has to be undergone by all investors in compliance with the regulations of the Prevention of Money Laundering Act, 2002. In order to ensure that illegal funds are not routed into Indian markets, the government has promulgated the Prevention of Money Laundering Act (PMLA). According to this Act, the identity of those entering into financial transactions must be known and verified. The KYC process involves verification of proof of identity and proof of residence of the customer. Investor's identity has to be verified with a document carrying their photograph. Such identification can be a passport, driving license, voter's identity card, Aadhaar Card and the like. Proof of address can be verified from address as stated in the passport, ration card, voter's identity card, and

latest utility bills. The KYC process also requires verification of the PAN card. It is mandatory for all investors who wish to invest in PMS to complete KYC formalities.

Banks, depository participants, insurance companies, post office, brokers and other financial intermediaries like portfolio manager conduct the KYC compliance process at the time of initiating a transaction with an investor. An authorized official of the intermediary conducts an in-person verification (IPV) of the applicant as part of the process.

Investors deal with multiple capital market intermediaries such as asset management companies, depository participants (DPs), stock brokers, portfolio managers, venture capital funds and others. Investors were required, to undergo, the KYC process at the time of initiating transactions with each intermediary. To eliminate this duplication, SEBI has mandated a uniform KYC procedure for compliance by clients from January 1, 2012. This means that an investor who has undergone a KYC procedure with any of the specified intermediaries can use the same to invest with a portfolio manager and vice versa.

The new KYC form has two parts. Part one will have information to establish identity and address, common to all intermediaries. Additional information as required by each intermediary can be collected using part two of the KYC form.

SEBI has introduced the system of KYC Registration Agency (KRA) to enable this. Intermediaries covered under the uniform KYC norms include mutual funds, DPs, stock brokers, portfolio managers, venture capital funds and collective investment schemes.

As per the 2015 amendment to PML (Maintenance of Records) Rules, 2005 every reporting entity shall capture the KYC information for sharing with the Central KYC Records Registry (CKYCR) in the manner mentioned in the Rules as per the KYC template for 'individuals' finalised by Central Registration of Securitisation Asset Reconstruction and Security Interest of India (CERSAI).

Accordingly the KYC template finalised by CERSAI has to be used by the registered intermediaries as Part I of the Account Opening Form for individuals. The registered intermediaries shall upload the KYC data with Central KYC Records Registry (CKYCR) in respect of all individual accounts opened on or after August 1, 2016 where KYC is required to be carried out as per the circulars issued by SEBI from time to time.

When a customer submits a KYC identifier to a reporting entity, then such reporting entity shall download the KYC records from the Central KYC Registry by using the KYC Identifier and shall not require a customer to submit the documents again unless:

- There is a change in the information of the customer as existing in the records of Central KYC Registry.
- The current address of the client is required to be verified.

- The reporting entity considers it necessary in order to verify the identity or address of the client, or to perform enhanced due diligence or to build an appropriate risk profile of the client.

KYC for Non-Residents

NRIs have to be KYC compliant in order to make investments in India. The following is the additional documentation, apart from proof of identity, proof of address and PAN card, for NRIs and PIOs:

- Certified True Copy of Passport
- Certified True Copy of the Overseas address
- Permanent address
- A certified true copy of the PIO Card (for PIOs)
- In case of Merchant Navy NRIs, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.

All documents must be submitted in English and can be attested by the Consulate office or overseas branches of scheduled commercial banks registered in India.

The Central Board of Direct Taxes has notified Rules 114F to 114H, as part of the Income-tax Rules, 1962, that require Indian financial institutions to seek additional personal, tax and beneficial owner information and certain certifications and documentation from all investors/account holders.

From 2015, it is mandatory for an Indian financial institution to maintain and report the information pertaining to Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standards (CRS) reportable accounts. In light of the above, it is mandatory for an Indian financial institution to obtain FATCA and CRS self-declaration from all investors (existing and new) to comply with the above Income Tax Rules read with CBDT guidelines. The common information mandated are fields such as—Name, Permanent Account Number (PAN), Address, Place (city/state) of birth, Country of birth Nationality, occupation and if a person is the resident of another country. If the country of residence is other than India then the Tax ID number, and type are required. In case of non-individual entities, the details of the Ultimate Beneficial owner (UBO) are also required to be submitted.

NRI Demat account

NRIs can open a demat account with any Depository Participant in India. NRI's needs to mention the type ('NRI' as compared to 'Resident') and the sub-type ('Repatriable' or 'Non-Repatriable') in the account opening form. No permission is required from RBI to open a demat account. However, credits and debits from demat account may require general or specific permissions as the case may be, from designated authorised dealers. Holding securities in demat only constitutes change in form and does not need any special permission.

NRI must open separate demat accounts for holding 'repatriable' and 'non-repatriable' securities. NRIs can hold joint demat accounts. For the purpose of determining ownership of holding, the first holder is taken into account. Hence, even though other joint holders may be person residing in India, the sale proceeds of such securities can be repatriated in case the first holder is permitted to repatriate funds.

NRI Trading account

NRI investors can open a trading account with a registered broker of a stock exchange. NRIs can have two separate trading accounts linked to NRE & NRO accounts.

Special considerations in case of NRI trading accounts:

- NRIs cannot trade in securities which are in the breach list (List of companies where foreign investment has reached its permissible limit as applicable for FPI/NRI/Overall Sectoral Limit).
- Clear funds should be available for purchases.
- Securities should be available before making a sell order.
- Depending upon whether the purchases are made on repatriation/non-repatriation basis, pay-out of the securities is transferred to the respective demat account.
- Purchase/Sale transactions in cash segment are settled by delivery only.
- The contract notes in original have to be submitted to the designated branch where the investor holds the PIS account within the time specified.

3. Submitting duly filled application form²⁵:

The following format is given for the account opening form in Portfolio Managers Regulation 2020.

1) General information about the client

(a) Name, primary mailing address, secondary (back up) mailing address, identity information such as photograph, Permanent Account Number (PAN), driving license etc.

(b) Occupation

(c) Introduced by (name and full address)

(d) Annual incomes for the last 3 financial years and the net worth as on the last date of the respective years. (optional)

²⁵ Candidates are advised to check the latest account opening form from SEBI Website/Portfolio managers regulation.

2) Investment profile of the client

- (a) Investment experience regarding securities.
- (b) Indicative percentage of total investment portfolio proposed to be invested with the portfolio manager (optional).
- (c) Overall investment goals such as capital appreciation or capital appreciation and regular income or regular income.
- (d) Risk tolerance i.e. low, medium or high.
- (e) Time period for which investments are proposed to be made with the portfolio manager. (This has to be same as the term of the agreement)
- (f) Provisions for systematic withdrawal on a monthly, quarterly, annual basis etc.

3) Investment approach opted by the client

4) Details of portfolio construction for the client

- (a) Equity: Nature of equities in which investments are desired, may be indicated.
- (b) Balanced: Percentage of debt/equity.
- (c) Debt: Government Bonds, corporate debt etc.
- (d) Mutual funds,
- (e) Others.

8.3.1. Content of agreement between the portfolio manager and investor²⁶

The portfolio manager before taking up an assignment of management of funds and portfolio on behalf of a client, enters into an agreement in writing with such client that clearly defines the *inter se* relationship and sets out their mutual rights, liabilities, and obligations relating to management of portfolio. The clients also shall separately sign and add in their own handwriting (physical mode)/ by typing or written electronically (digital mode)/by typing or written electronically (digital mode) that they have understood the fee/charges structure.

²⁶ For details, candidates are advised to refer to Schedule IV of Portfolio Managers Regulations, 2020.

The agreement between the portfolio manager and the client include the following:

1. the investment objectives and the services to be provided;
2. period of the contract and provision of early termination, if any;
3. investment approach, areas of investment and restrictions, if any, imposed by the client with regard to the investment in a particular company or industry;²⁷
4. type of instruments and proportion of exposure;
5. tenure of portfolio investments;
6. terms for early withdrawal of funds or securities by the clients;
7. attendant risks involved in the management of the portfolio;
8. amount to be invested subject to the restrictions provided under these regulations;
9. procedure of settling client's account including form of repayment on maturity or early termination of contract;
10. fees payable to the portfolio manager;
11. the quantum and manner of fees payable by the client for each activity for which service is rendered by the portfolio manager directly or indirectly (where such service is out sourced);
12. custody of securities;
13. in case of a discretionary portfolio manager; a condition that the liability of a client shall not exceed his investment with the portfolio manager;
14. accounting terms, audit and furnishing of the reports to the clients as per the provisions of the regulations; and
15. other terms of portfolio investment subject to the prescribed regulations.

[Fee calculation tool shall be provided to all clients by the Portfolio Manager. Fee illustrations to be provided whenever performance fess is charged to clients. No additional fees and charges to be levied other than those specified in the agreement. The Portfolio Manager shall provide to clients a “most important Terms and Conditions (MITC)” document as per the standard format.]

8.4 Direct On-boarding in PMS

As per the SEBI circular, Portfolio Managers shall provide an option to clients to be on-boarded directly, without intermediation of persons engaged in distribution services. Portfolio Managers shall prominently disclose in its disclosure documents, marketing material and on its website, about the option for direct on-boarding. At the time of on-boarding of

²⁷ An investment approach is a broad outlay of the type of securities and permissible instruments to be invested in by the portfolio manager for the customer, taking into account factors specific to clients and securities.

clients directly, no charges except statutory charges shall be levied. Alternatively, investors can invest in PMS through distributors.²⁸

8.4.1 Process Flow

Investors can invest in PMS products in cash or in securities or a combination of the two worth minimum Rs. 50 lacs. The portfolio manager shall not accept from the client, funds or securities worth less than rupees fifty lacs. The valuation of the securities on the on-boarding date should meet the regulatory criteria. The portfolio manager may execute the sale of all or part of such securities to meet the investment objectives of the client within the investment approach.

8.4.2 Joint Holder in PMS

An investment in PMS may be held jointly. The investment records are created in the name of the first holder and all the benefits of the investment such as dividends, interest and redemption proceeds are made to the first holder's account. All the joint holders must sign the application and comply with the requirements of PAN and KYC norms. The mode of operating the account may be single, joint or anyone or survivor. Any change to the mode of operation, or addition or deletion of joint holders can be done only with the signatures of all holders. In case of a demat account, addition or deletion of holders is not allowed once the account is opened.

8.5 Liability in case of Default

The portfolio manager who contravenes any of the provisions of the SEBI Act, rules or regulations shall be liable including the action under Chapter V of the SEBI (Intermediaries) Regulations, 2008.

Chapter V the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 includes the following actions in case of default:

- 1) suspension of certificate of registration for a specified period;
- 2) cancellation of certificate of registration;
- 3) prohibiting the portfolio manager to take up any new assignment or contract or launch a new scheme for the period specified in the order;
- 4) debarring a principal officer of the portfolio manager from being employed or associated with any registered intermediary or other registered person for the period specified in the order;

²⁸ https://www.sebi.gov.in/legal/circulars/feb-2020/guidelines-for-portfolio-managers_45981.html (SEBI Circular on Guidelines for Portfolio Managers dated February 13, 2020)

- 5) debarring a branch or an office of the portfolio from carrying out activities for the specified period;
- 6) warning the portfolio manager.

8.6 Redressal of investors grievances

The portfolio manager shall take adequate steps for redressal of grievances of the investors within the time stipulated by SEBI and keep SEBI informed about the number, nature and other particulars of the complaints received. This is one of the conditions of obtaining certification of registration under regulations . Contents of agreement between the portfolio manager and his clients also includes provisions for redressal of grievances.

The portfolio manager is required to appoint a **compliance officer** who shall be responsible for monitoring redressal of investors' grievances.

Securities and Exchange Board of India ('SEBI') has introduced an Online Dispute Resolution Portal (ODR Portal), a platform for resolution of disputes arising in the Indian Securities Market with Market participants.

ODR Portal named SMART ODR Portal – 'Securities Market Approach for Resolution Through ODR' is being made available for investors on <https://smartodr.in/login>.

8.7 Disclosures to the regulator

Portfolio managers are required to make mandatory disclosure to regulatory bodies under various acts and regulation. The following sections gives the details of the same.

8.7.1 Disclosures to SEBI

SEBI may also ask portfolio manager to disclose any information as and when required including the following: -

- (a) particulars regarding the management of a portfolio;
- (b) any change in the information or particulars previously furnished, which have a bearing on the certificate granted to him;
- (c) the names of the clients whose portfolio it has managed;
- (d) particulars relating to the net worth requirement as specified in regulation 9 of Portfolio Managers Regulation 2020.

8.7.2 Disclosures to Financial Intelligence Unit – India

The Government of India has put a policy framework to combat money laundering through the Prevention of Money Laundering Act, 2002 (PMLA 2002). PMLA 2002 and the Rules notified there under (PMLA Rules) came into effect from July 1, 2005. SEBI has mandated that all registered intermediaries to formulate and implement a comprehensive policy framework on anti-money laundering and adopt 'Know Your Customer' (KYC) norms. Further, SEBI vide Circular No. CIR/ISD/AML/3/2010 dated December 31, 2010 (which supersedes all the earlier circular) issued a 'Master Circular for Anti Money Laundering (AML) Standards/ Combating the Financing of Terrorism (CFT) /Obligations of Securities Market Intermediaries under the Prevention of Money Laundering Act, 2002' consolidating all the requirements/instructions/obligations of Securities Market Intermediaries.²⁹ The Portfolio Manager is required to comply with all applicable anti money laundering laws and regulations in all of its operations.

Financial Intelligence Unit - India (FIU-IND) is the central, national agency responsible for receiving, processing, analysing and disseminating information relating to suspect financial transactions to enforcement agencies and foreign FIUs.

The portfolio manager is required to report any suspicious transaction within 7 working days to FIU.

8.8 Costs, expenses and fees of investing in PMS

The portfolio manager can charge an agreed fee from the clients for rendering portfolio management services. The exact nature of these fees and expenses would form part of the client agreement. The following are the indicative lists of fees and expenses. The fees and expenses could vary depending on the asset class / type of portfolio. Also all these fees may apply to all kinds of portfolios.

Investment management and advisory fee : The fee so charged may be a fixed fee or a return based fee or a combination of both. These are typically on actuals and reimbursed to Portfolio Manager.

Custodian fee / Depository fee: The charges relating to opening and operation of dematerialized accounts, custody and transfer charges for shares, bonds and units, dematerialization and other charges in connection with the operation and management of the depository accounts.

Registrar and Transfer agent fee: Charges payable to registrars and transfer agents in connection with effecting transfer of securities and bonds.

²⁹ Candidates are advised to read the latest circular/guidelines on Anti-money laundering from SEBI website.

Brokerage and transaction costs: Brokerage and related transaction costs, are part of the acquisition cost / sale realization including STT, stamp duty etc.. Brokerage at actuals shall be charged to clients as expense.

Certification charges, Fund Accounting charges and Professional fee: Any charges payable for outsourced professional services like fund accounting, taxation, auditing, and any legal services, franking charges, affidavits, notarizations, courier etc. incurred on behalf of the client by the portfolio manager.

Out of Pocket and Other Incidental Expenses: Charges in connection with day to day operations like service tax, other statutory levies, telephone expenses, opening of bank, trading and demat accounts and any other out of pocket expenses incurred by the portfolio manager, on behalf of the client.

As per regulation 22, the quantum and manner of payment of fees and charges for each activity for which services are rendered by the portfolio manager directly or indirectly (where such service is outsourced) such as investment management, advisory and transfer, and transaction costs with specific references to brokerage costs, custody charge etc. shall be mentioned in the agreement between the portfolio manager and its client. The portfolio manager shall take prior permission from the client in this respect.

In the disclosure document, a brief explanation shall be given to assist the investor in understanding the various costs and expenses that an investor may have to bear directly or indirectly.

In partial modification to circular on Regulation of Fees and Charges, issued in 2010, the following is mandated via circular issued by SEBI on Feb 13, 2020:

1. As provided in Regulation 22 (11) of the PMS Regulations, no upfront fees shall be charged by the Portfolio Managers, either directly or indirectly, to the clients.
2. Brokerage at actuals shall be charged to clients as expense.
3. Operating expenses excluding brokerage, over and above the fees charged for Portfolio Management Service, shall not exceed 0.50% per annum of the client's average daily Assets under Management (AUM).
4. In case client portfolio is redeemed in part or full, the exit load charged shall be as under: ³⁰
 - a) In the first year of investment, maximum of 3% of the amount redeemed.
 - b) In the second year of investment, maximum of 2% of the amount redeemed.
 - c) In the third

³⁰ https://www.sebi.gov.in/legal/circulars/feb-2020/guidelines-for-portfolio-managers_45981.html

year of investment, maximum of 1% of the amount redeemed. d) After a period of three years from the date of investment, no exit load.

8.8.1. High Water Mark is the highest value that the portfolio/account has reached. The portfolio manager charges performance based fee only on increase in portfolio value in excess of the previously achieved high water mark.

For example, suppose a client's initial contribution is Rs.100,00,000, which then rises to Rs.120,00,000 in its first year; a performance fee/ profit sharing would be payable on the Rs.20,00,000 return. In the next year the portfolio value drops to Rs.110,00,000 hence no performance fee would be payable. If in the third year the Portfolio rises to Rs.130,00,000, a performance fee/profit sharing would be payable only on the Rs. 10,00,000 profit which is portfolio value in excess of the previously achieved high water mark of Rs.120,00,000, rather than on the full return during that year from Rs.110,00,000 to Rs.130,00,000.

8.8.2. Hurdle Rate

Profit sharing/performance related fees are usually charged by portfolio managers upon exceeding a hurdle rate or benchmark as specified in the agreement. An illustration of performance fee is presented below:³¹

Particulars	Year 1	Year 2	Year 3	Year 4
Initial Corpus	50,00,000	65,92,000	47,98,976	70,92,887
Hurdle rate of return (A)	8%	8%	8%	8%
Performance fee over hurdle rate (B)	20%	20%	20%	20%
Fixed Fee (C)	1.5%	1.5%	1.5%	1.5%
Brokerage p.a. (D)	0.20%	0.20%	0.20%	0.20%
Other Expenses (E)	0.50%	0.50%	0.50%	0.50%
Rate of return on the portfolio (I)	40%	-25%	50%	40%

Assumptions:

1. Performance linked fee and fixed management fee are calculated on an annual basis (i.e, performance period = 1 year)
2. All figures in the tables have been assumed for the purpose of illustration
3. Other expenses mentioned include Custody & FA charges, RTA fees etc

³¹ Source: SEBI FAQ dated October 28, 2020.

All amounts in Rs. & all returns are pre-tax

Box 8.1: Calculation of Performance Fee

Sl No.	Particulars	Year 1		Year 2		Year 3		Year 4		Year 5
1	Initial corpus	50,00,000		65,92,000		47,98,976		70,92,887		
	Hurdle Rate (A)	8.00%		8.00%		8.00%		8.00%		
	Performance fee over hurdle rate (B)	20.00%		20.00%		20.00%		20.00%		
	Fixed Fee (C)	1.50%		1.50%		1.50%		1.50%		
	Brokerage p.a. (D)	0.20%		0.20%		0.20%		0.20%		
	Other expenses (E)	0.50%		0.50%		0.50%		0.50%		
	Rate of return on Portfolio (I)	40.00%		-25.00%		50.00%		40.00%		
		Year 1		Year 2		Year 3		Year 4		
		Amount in Rs.		Amount in Rs.		Amount in Rs.		Amount in Rs.		
1	Amount invested by client/opening value	50,00,000		65,92,000		47,98,976		70,92,887		
2	Portfolio returns during the year (=I*1)	20,00,000		-16,48,000		23,99,488		28,37,155		
3	Brokerage and transaction cost at 20 bps (=D*1)	10,000		13,184		9,598		14,186		
4	Other expenses (=E*1)	25,000		32,960		23,995		35,464		
5	Fixed management fee (=C *1)	75,000		98,880		71,985		1,06,393		
6	Pre performance fee closing value of portfolio 1+2-3-4-5	68,90,000	70,00,000	47,98,976	49,44,000	70,92,887	71,98,464	97,73,998	99,30,041	
7	Returns realised by investor (pre-performance fee) over High Water Mark (= (6-14)/14*100) [For Year 1, returns over initial corpus would be considered]	37.80%		-30.35%		2.94%		37.80%		
8	Returns realised by investor over hurdle rate (= 7-A, and in case of negative returns, it shall be zero)	29.80%		0%		-5.06%		29.80%		
9	Performance fee levied by PM (in %) (Perf. Fee = 8*B)	5.96%		0%		0%				
10	Amount of performance fee recovered by PM (high-watermark applicable) on Capital Amount (= 9*1)	2,98,000		-		-		4,22,736		
11	Total Charges During the year (=3+4+5+10)		4,08,000	-	1,45,024		1,05,577		5,78,779	
12	Net Value of the portfolio at the end of year (=1+2-11)		65,92,000		47,98,976		70,92,887		93,51,262	
13	Overall Returns to investor in % (=12-1)/1) *100		31.84%		-27.20%		47.80%		31.84%	

14	High Water Mark for calculation of performance fee for the next performance period (6)			68,90,000		68,90,000		70,92,887		97,73,998
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Chapter 8: Sample Questions

1. The following entity is eligible to invest into PMS:
 - a. Proprietorship firms
 - b. Association of person
 - c. Partnership Firms
 - d. **All of the above**

2. The following entities can invest in PMS:
 - a. Individuals
 - b. Non-resident Indians (as per the RBI guidelines)
 - c. Hindu Undivided Family
 - d. **All the above**

3. The minimum investment required for PMS investment is:
 - a. **Rs. 50 lacs**
 - b. Rs. 25 Lacs
 - c. Rs. 5 Lacs
 - d. Rs. 100 Lacs

4. _____ is the central, national agency responsible for receiving, processing, analysing and disseminating information relating to suspect financial transactions to enforcement agencies.
 - a. **FIU-IND**
 - b. SEBI
 - c. RBI
 - d. CBI

- 5 The agreement between the portfolio manager and the client should include the following:
 - a. the investment objectives and the services to be provided
 - b. period of the contract and provision of early termination, if any
 - c. investment approach, areas of investment and restrictions, if any, imposed by the client with regard to the investment in a particular company or industry
 - d. **all the above**

CHAPTER 9: PORTFOLIO MANAGEMENT PROCESS

LEARNING OBJECTIVES:

After reading this chapter, the reader should be familiar with:

- Importance of Asset allocation decision
- Steps in Portfolio Management Process
- Need and constituents of Investment Policy Statement
- Difference between strategic and tactical asset allocation
- Benefits and difficulties of rebalancing the portfolios

9.1. Importance of Asset Allocation Decision

Asset allocation is the process of deciding how to distribute an investor's wealth into different asset classes for investment purposes. An asset class is defined as a collection of securities that have similar characteristics, attributes, and risk/return relationships for example, bonds, equities, cash and cash like securities etc., A broad asset class, such as "bonds," can be divided into sub-asset classes, like treasury bonds, corporate bonds, and junk bonds. Equity can further be divided into large cap, mid cap & small cap.

Asset allocation decision is a very important investment decision. Professional investment experience has been suggesting that in the long run, asset-allocation decision majorly influences the performance of investment portfolios. The asset allocation decision is not an isolated decision, it is a component of portfolio management process.

9.2 Understanding correlation across asset classes and securities

Correlation measures the strength and direction of relationship between two variables. Correlation coefficients vary in the range -1 to $+1$. A value of $+1$ (-1) indicates a perfect positive (negative) relationship between the two variables. A positive relationship between two variables means that they both move together in the same direction, either in an upward trend or downward trend. Negative relationship means the opposite. The value of the correlation coefficient indicates the strength of the relationship between the two variables. Understanding correlation across asset classes is very crucial in making asset allocation decision. As described in section 9.1, an asset class is described based on the similarity of characteristics of the assets, and as a natural consequence investments that are part of same asset class are sensitive to the same major economic and/or investment factors. Hence, the correlation between assets that are part of the same asset class is expected to be high where

correlation between two different asset classes is expected to be low. These assumptions hold good in normal circumstance that is when the economy, industry are stable. In situations of distress, like COVID-19 pandemic, the all-round fear, uncertainty, speculation about gloomy prospects, impacts all the asset classes in a similar way to a large extent, however this relationship reverses once the normalcy is regained.

Correlation is the most relevant factor in reaping the benefits of risk diversification i.e. in reducing portfolio risk. Correlations among asset class returns can and do change over time and also in different economic situations. Asset return correlation in future may also differ from those observed in the past because of changing economic and market regimes.

Investors should take these factors into consideration while making asset allocation decisions and should not solely depend on past correlation metrics.³²

9.3 Steps in Portfolio Management Process

Portfolio management process involves a set of integrated activities undertaken in a logical, orderly and consistent manner to create and maintain optimum portfolio. The elements in the portfolio management process are planning, execution and feedback as discussed below:

1. The first step in the process of portfolio management is development of policy statement for the portfolio. It is a road map that identifies investors risk appetite and defines investment objectives, goals and investment constraints.
2. The second step involves study of current financial conditions and forecast future trends.
3. The third step is construction of portfolio after taking into consideration policy statement and financial markets forecast. Investor needs and financial market forecasts being dynamic, portfolio requires continuous monitoring and rebalancing.
4. The fourth step in portfolio management process is performance measurement & evaluation.

Thus, the portfolio management process moves from planning through execution and then to feedback.

9.3.1 Investment Policy Statement (IPS)

Development of Investment Policy Statement (IPS) is the key step in the process of portfolio management. IPS is the road map that guides the investment process. Either investors or their advisors draft the IPS specifying their investment objectives, goals, constraints, preferences and risks they are willing to take. All investment decision are based on IPS considering

³² Financial services data integrators like Bloomberg, Capital IQ etc., provide information on correlation coefficient between various assets and securities. Alternatively, users can calculate correlation coefficient using simple Microsoft excel Functions.

investors' goal and objectives, risk appetite etc.. Since investors requirement's change over a period time, IPS also needs to be updated and revised periodically. IPS forms the basis for strategic asset allocation which is essentially an interaction between investors risk-return requirements and expected investments' return.

9.3.2. Need for IPS

IPS is an important planning tool which help investors understand their requirements and also help portfolio managers in creating and maintaining optimum portfolios for the investors. Preparation of IPS inculcates a disciplined system and process in managing investments. It reduces the possibility of making inappropriate decisions.

There are four important purposes the policy statement serves:

1. It enables investors to have realistic return expectation from their investments.
2. It enables portfolio manager to make effective investment decisions.
3. It provides a framework for portfolio managers evaluation with respect to the investments.
4. It protects the investor against portfolio manager's inappropriate investment decisions or unethical behaviour.

In summary, a well-defined policy portfolio goes a long way in serving the investor's interest. It enables construction of an optimal investment portfolio.

9.3.3. Constituents of IPS

Since IPS is the most important document, it needs to be prepared with caution. The investor has be upfront with the advisor or portfolio manager with regard to their financial situations, requirements and risk bearing temperament. The advisor or the manager preparing the IPS is also required to show utmost patience to obtain deep understanding of the investor's profile.

9.3.4. Investment Objectives

Investors' objectives are identified in relation to risk-return-liquidity. Risk is the variability in the expected returns. Return is the additional amount an investor generates over and above the initial investment, that is expressed as a percentage and per annum. Liquidity can be explained as the preference of an investor to convert her investment into cash, whenever required, without much delay, and loss in value of the investment. When this preference is sought after in an asset, then the same is expressed as a feature or characteristic of that asset, which makes it readily and easily sold out to another investor without much decline in its quoted value. Indirectly it conveys that the phenomenon of liquidity in finance needs a stable and vibrant financial market, with buyers and sellers always ready to invest and disinvest.

Investors may state their investment objectives in terms of desired return in absolute or relative sense. The desired absolute return is the return of the investment, measured on a standalone basis without any comparison with any other asset. Like an investor's objective could be "to generate 15% p.a. on her investment for the next 'n' number of years". The same objective can also be expressed as "to generate 5% p.a. more than the return on NIFTY 50 each year on the investment for the next 'n' number of years".

An investor needs to bear in mind that risk and return typically have a positive relationship. Higher the risk, higher would be the associated return. On the other hand, liquidity has an inverse relationship with return (when expressed as a discount rate). Higher the liquidity, lower would be discount, and vice versa. It operates like this, when an asset can be sold and bought in the market readily and very easily without much price discount, then the difference between the quoted price to sell and the actual realised price when the trade is complete would be minimal.

Generally, investors invest for preservation of capital, regular income, and capital appreciation. Sometimes investors also choose investments to save taxes, however it may be noted that tax saving is not appreciated as the sole motto of investment. The investment objectives lead to asset allocation decision. If the investment objective is capital appreciation, then investments need to be high return investments (like equity). Of course, these investments will have higher risk than government securities or bank fixed deposits. On the other hand, if capital preservation is the primary investment objective, asset allocation will be tilted towards safe bonds and debt securities. If regular income is the investment objective, funds will be invested in asset classes generating periodical income like dividend paying stocks, interest paying bond or/and rent paying realty.

9.3.5. Investment Constraints

Constraints are limitations on investors to take exposure to certain investment opportunities. Constraints relates to investors liquidity needs, time horizon, and other unique needs and preferences.

Liquidity constraint

Different investors have different liquidity requirements. Younger people usually have lesser liquidity requirements than older people. Some may have some health or medical concerns which require them to maintain certain liquid funds. Others may have requirements of college fees or wedding in the family or some other needs. Generally investors prefer to have liquid funds to meet their day to day expenses. Additionally they may like to keep some amount of liquidity to meet contingency requirements like sudden medical expenses etc..

The needs for liquidity fall into following categories:

Emergency Cash: The emergency cash reserve is usually measured as two to three months' spending, but it could be more if the individual's source of income is at risk or volatile.

Near term goal. These needs vary with the individual. For known goals due within a year, the amount needed to achieve these goals should be in assets with relatively good liquidity.

Investment Flexibility. The ability to take advantage of market opportunities as asset classes become overvalued and undervalued would require greater degree of liquidity.

To meet such requirements, some portion of the portfolio should be in cash or cash like securities. The advisor or the manager needs to make detailed assessment of the liquidity needs of the investors. Keeping too much money for liquidity may hit the overall portfolio return. On the other hand, not maintaining sufficient liquidity will lead to inconvenience and selling of other investments untimely. The liquidity constraints of the investor need to be clearly specified in the IPS.

Regulatory constraints

Generally individual investors do not have many regulatory constraints. But if there are any, they need to be followed. Regulations can also constraint the investment choices available to the investors. For example, as per the Reserve Bank of India's notification, Liberalised Remittance Scheme (LRS), an Indian resident individual can only invest up to \$250,000 overseas per year.³³ Indian resident individual investors cannot make investments greater than the amount specified by the regulator. Another example is the sale or purchase of securities on the basis of information that is not publicly known. Usually people who have access to such information are insiders of the company and they are prohibited from trading on the basis of insider information.

Tax Constraint

Investment process is complicated by tax concerns. Tax plays a very important role in portfolio management and drives investment decisions. Different investments and different kinds of income are taxed differently. Return in form of income like interest, dividend and rents versus

³³ Under the Liberalised Remittance Scheme, all resident individuals, including minors, are allowed to freely remit up to USD 2,50,000 per financial year (April – March) for any permissible current or capital account transaction or a combination of both. Further, resident individuals can avail of foreign exchange facility for the purposes mentioned in Para 1 of Schedule III of FEM (CAT) Amendment Rules 2015, dated May 26, 2015, within the limit of USD 2,50,000 only. The Scheme was introduced on February 4, 2004, with a limit of USD 25,000. The LRS limit has been revised in stages consistent with prevailing macro and micro economic conditions

return in form of capital appreciation are taxed differently. The same form of return may attract different tax liability depending on the tax bracket, the recipient belongs to. Hence a thorough understanding of the tax code applicable to the investor needs to be part of the IPS.

Exposures limits to different sectors, Entities and Asset Classes

As per the SEBI PMS Regulations 2020 the agreement between the portfolio manager and the investor should include the investment approach. An investment approach is a broad outlay of the type of securities and permissible instruments to be invested in by the portfolio manager for the investor, taking into account factors specific to investor and securities. It should also include the type of instruments and proportion of exposure.

After taking into consideration the investor's objective, risk appetite, liquidity needs, tax and other regulatory constraints, time horizon for investment, exposure limits to specific sectors, entities and asset classes can be set to avoid the concentration risk. The portfolio manager needs to adhere to these exposure limits while managing investments.

Unique needs and preferences

Sometimes investors have idiosyncratic concerns. They may have personal, social ethical, cultural and preferences beliefs. For example an investor, may not want her money to be invested in the stocks of companies selling environmentally harmful products. Another example could be of an investor owning stocks of company in which he/she is working and is reluctant to sell the same even when it is financially prudent, due to emotional attachment. The point is that each investor is unique and if he/she has any specific preference, the same should be clearly specified in the IPS.

In addition to the above mentioned section, the IPS may also include reporting requirements, portfolio rebalancing schedules, frequency of performance communication, investment strategy and styles etc.

9.3.6. Assessments of needs and requirements of investor

Investors invest to meet their various goals and objectives. Assessment of the needs and requirements of the investors is critical in making investment decisions. People have many financial goals, some are to be achieved in near term, some are medium or long term goals. The goals also have different priority – some are high priority goals where as others may not be very important to achieve. Investors can put their needs and goals down along with the priority and the time frame for each of those goals, with the funds needed for the same. A proforma for creating a goal sheet is shown in Exhibit 9.1.

Exhibit 9.1: Proforma Goal Sheet

No.	Goal	Priority	Time period	Amount needed

Near-Term High Priority Goals have a high emotional priority which the investor wishes to achieve within just a few years at most. As a result, investment vehicles for these goals tend to be either cash equivalents or fixed-income instruments with maturity dates that match the goal date. For people of limited to modest means, the cost of not achieving those goals is just too great to take a risk with more-volatile approaches.

For many investors building a retirement corpus is a **long-term high priority goal**. When investors start planning for this goal well in advance, they have enough time to accumulate the corpus. Because of the long-term nature of such goals, a diversified approach utilizing several different classes of assets is usually preferred.

People also have many **low priority goals**. There are goals that are not particularly painful if they are not achieved. These could range from buying a farm house to a luxury car. For these goals, more-aggressive investment approaches are usually taken.

9.3.7 Analysing the financial position of the investor

A convenient way to analyse the financial position is by constructing personal financial statements. This helps in organizing financial data in a systematic way. Personal financial statements include a statement of net worth-balance sheet and income-expense statements.

For calculating net worth, all the assets the investor owns, i.e. the house, the car, the investments in stocks, bonds & mutual fund, balance in the saving accounts, value of the jewels owned and the value of all other financial assets and real assets are to be recorded at the estimated market value. Then all the liabilities need to be subtracted from the assets. Liabilities may include the outstanding car loan amount, credit card loans, home loan and any other amount he owes like the personal loan, education loan etc.. The difference between the value of assets and the liability is net worth.

It is suggested that net worth is to be calculated periodically, at least once in a year. The next step is calculating whether the person's present income exceeds spending and by how much amount. This is the amount which would be available periodically for investment purposes. The income expenditure statement can be prepared on monthly basis.

9.3.8. Psychographic analysis of investor

In investment process, investor's behavioural traits and personality characteristics also play an important role in setting investors risk profile.

Psychographic analysis of investor bridges the gap between standard finance which treats investors as rational human beings and behavioural finance which view them as normal human beings who have biases and make cognitive errors. In other words, psychographic analysis of investor recognizes investors as normal human beings who are susceptible to biased or irrational behaviour.

All investors have unique personalities. Though it is difficult to categorize the personalities because they all are human beings and they are so different; some basic classification system has evolved after years of research. There are many frameworks available to perform psychographic analysis. For illustration purpose, given below is the framework given by Bailard, Biehl & Kaiser (BB&K).

Bailard, Biehl & Kaiser (BB&K) classifies investor personalities by focusing on two aspects: the level of confidence and the method of action. The first deals with how the investor approaches life in terms of career, wealth or money. The second element deals with whether investor is careful, methodical and analytical in the approach towards life. The two elements can be thought of as two "axis" of individual psychology: one axis is the confidence/anxiousness the other is carefulness/impetuousness.

The different personality characteristics are shown through Exhibit 9.2

Exhibit 9.2: Investor Personality Characteristics



The Five Personalities

The upper-right corner of Exhibit 9.2 represents the **adventurer**-people who are willing to put it all in one major bet and "go for it" because they have confidence. As far as they are

concerned, it is a carefully considered decision. They are confident as well as impetuous. In that quadrant, one typically will find entrepreneurial people, people who are willing to stick their necks out in their careers or in their money management strategies. They normally have their own ideas about investing. They are willing to take risks, and they normally do not go for the investment advisers. They prefer concentrating their bets.

The lower-right quadrant of the exhibit is the **Celebrity** quadrant. These people like to be where the action is. They are afraid of being left out. These investors will keep bringing up the latest hot topic, asking, "Should I be in this, or should I be in that?" They really do not have their own ideas about investments. These people normally go for investment advisers. However, they are the most difficult investors because of their own belief.

The **Individualist** is in the upper-left quadrant. These people have certain degree of confidence about them, but they are also careful, methodical, and analytical. Individualists like to do their own research and tend to avoid extreme volatility. They are often contrarian investors because they do sit back and think about where they want to go and which investments make good value sense.

The lower-left quadrant represents the **Guardian** personality. Typically as people get older and begin considering retirement, they approach this personality profile. Guardians are people who are cautiously trying to preserve their wealth. They are definitely not interested in volatility or excitement.

Finally, there are always people who are so well balanced that they cannot be placed in any specific quadrant, so they fall near the centre; this investor is called a **Straight-Arrow** investors. On average, this group of investors is a relatively balanced composite of each of the other four investor types, and by implication a group willing to be exposed to medium risk.

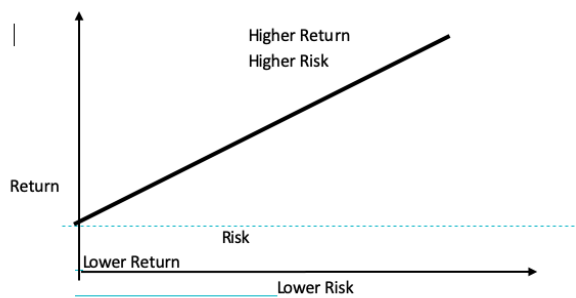
It is also worth noting that each investor at times exhibits some characteristics of personalities other than his normal one. This can be particularly influenced by his most recent investment experience. A guardian can become more aggressive for a time, like an adventurer, if he is on a winning streak. Conversely, most investors become more guardian like just after an event with heightened volatility.

Experience has shown that each of the five types of investors requires a different approach in portfolio management.

9.3.9. Life cycle analysis of investor

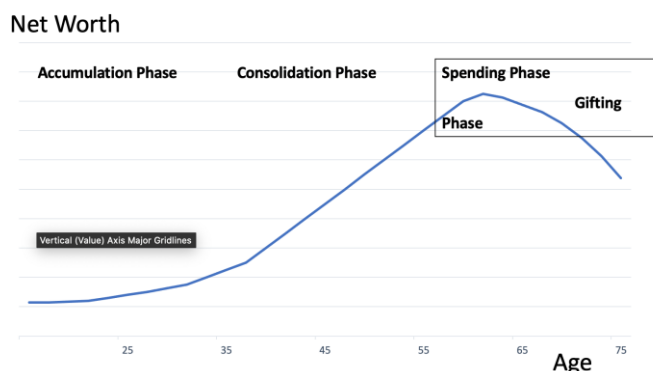
It is important to understand the various stages in the life cycle; because of the impact they have on an investor's risk appetite (Exhibit 9.3).

Exhibit 9.3: Risk/Return Trade-Offs for Investors



Every investor has thoughts about where she might be along that line, especially when the points are described in terms of risk and returns. Generally younger individuals who are just beginning to earn money tend to be on the right side of the line, while older individuals move increasingly to the left side on the line. This life cycle of investing can be broken into phases: the accumulation, consolidation, spending, and gifting phases. This is depicted in Exhibit 9.4.

Exhibit 9.4: Lifecycle of investing



Accumulation Phase: During this phase, net worth is typically small relative to liabilities. Investments are fewer and typically non-diversified. Goals may include children's education, a house, and if possible, investments for future financial independence. Since the individual has a very long time horizon and a potentially growing income stream, she can undertake more high-return, high-risk capital gain-oriented investments.

Consolidation Phase: The consolidation or mid-to-late-career stage of the typical life cycle is characterized by the period when income exceeds expenses. As a result, this stage is characterized by the consolidation of investment portfolio. At this time, while the time horizon to retirement is still relatively long (15 or 20 years), investors may start looking for capital preservation. High capital gain investments are balanced with some lower-risk assets.

Spending Phase: This is the period when living expenses are covered not from earned income but from accumulated assets such as investments and retirement corpus. Because of the heavy reliance on investments in this phase and the unlikelihood of going back to work, the focus is on stability in investment portfolio. Preference will be on investment that generate dividend, interest, and rental income. As the investor's time horizon may still be well over 15 or 20 years, so some investments in the portfolio should continue to have growth and inflation-hedge potential.

Gifting Phase: This is the final phase when a person realizes that she has more assets than she will need for spending. In such cases the attitude about the purpose of investments does change. Investments at this stage may be made to leave legacy, support a charitable cause etc..

It is important to note that the boundaries between the stages are fuzzy on time scale.

9.3.10. Forecasting risk and return of various asset classes

Portfolio Management is the process of integrating two sets of information. The first set of required inputs have already been listed above viz., investment objectives, goals and requirements, personality type, phase in the life cycle, liquidity needs, tax and other constraints etc.. The second set of required inputs is the capital market forecasts that establishes the expected risk-return opportunities available to the investors as discussed in Chapter 3.

The various investment opportunities available to the investors need to be listed and their returns need to be forecasted along with the possibilities of deviations in those returns. Historical risk-return on various asset classes provide a good starting point to understand the relationship between risk and return and proceed to make the forecast about their future return possibilities.

9.3.11. Benchmarking the client's portfolio

The investment policy statement needs to provide a framework for evaluating the performance of the portfolio. It will typically include a benchmark portfolio which matches in composition of the investor's portfolio. The idea is to compare "apple with apple". If the investment is made in large cap equities, then the BSE 30 or NIFTY 50 index can be an appropriate benchmark. If the investment is made in long term bonds, a bond index with similar maturity and credit profile will be an appropriate benchmark.

Performance Benchmarking³⁴

An investment approach (IA) is the documented investment philosophy to be adopted by the Portfolio Managers while managing the client funds in order to achieve client's investment objectives. Now, in addition to investment approach, an additional layer of broadly defined investment themes called 'strategies' shall be adopted by Portfolio Managers. These broad strategies shall be 'equity', 'debt', 'hybrid' and 'multi-asset'. Each investment approach (IA) shall be tagged to one and only one strategy from the strategies as above. This tagging shall be at the discretion of the concerned Portfolio Manager. A Portfolio Manager may tag more than one Investment strategy to an investment approach to a strategy but each investment approach must be tagged to only one strategy.

Association of Portfolio Managers of India (APMI) shall prescribe a maximum of three benchmarks for each strategy. These benchmarks shall reflect the core philosophy of the Strategy. While tagging an investment approach to a particular strategy, the portfolio manager shall select one benchmark from those prescribed for that strategy to enable the investor to evaluate relative performance of the Portfolio Managers.

The Board of the Portfolio Managers shall be responsible for ensuring appropriate selection of Strategy and benchmark for each IA. Once an IA is tagged to a Strategy and/or to a benchmark, the tagging shall be changed only after offering an option to subscribers to the IA to exit without any exit load. The performance track record (of the specific IA whose tagging with Strategy/ benchmark was changed) prior to the change shall not be used by the Portfolio Manager for performance reporting. Further, the same shall be verified as part of annual audit under Regulation 30 of the SEBI (Portfolio Managers) Regulations, 2020 .

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9.4 Asset allocation decision

The interaction between the two sets of information – about the investor and about the risk-return on investment opportunity culminates into asset allocation decision. The asset allocation decision follows logically from the investor's needs and goals, risk preferences and liquidity needs. After developing a forecast on risk and return on various asset classes, the

³⁴ https://www.sebi.gov.in/legal/circulars/dec-2022/performance-benchmarking-and-reporting-of-performance-by-portfolio-managers_66256.html

portfolio manager has to decide the mix of assets that maximizes the after-tax returns for the investor.

9.5 Strategic versus Tactical Asset Allocation

The asset allocation decision which is made after taking into consideration investor's characteristics is strategic asset allocation (SAA). It is the target policy portfolio. It provides target allocation among the major asset classes; in that sense it is essentially translation of an investment policy statement into asset weights. SAA is the long-term asset allocation decision. SAA is designed to meet the investors goals and objective over a longer period of time.

There is, however, a dynamic component to asset allocation – tactical asset allocation (TAA). Tactical asset allocation (TAA) is short-term asset allocation decision. These decision are taken more frequently than SAA. The idea behind TAA is to take the advantage of the opportunities in the financial markets.

When market conditions favour one asset class over other, the portfolio manager may temporarily shift money from one asset class to another to exploit discrepancy in market with a view to earn returns. In TAA, portfolio managers time markets, i.e., determine which asset classes are likely to go up more than expected and which less than expected. Then they will alter the target asset allocation accordingly. Thus, if a portfolio manager believes that the stock market is overvalued and is up for a correction, while debt market is undervalued, then it may reduce the proportion of the portfolio that is allocated to equities and increase the proportion allocated to debt.

After booking the gains, the portfolio needs to be rebalanced to pursue the target allocation.

Thus, TAA attempts to beat the markets. SAA decisions involve “time in the market” whereas TAA is for “timing the markets”.

9.5.1. Importance of asset allocation decision—empirical support

Asset allocation is considered as the most important investment decision. This is because asset allocation is the major determinant of risk and return for a given portfolio. There is a huge empirical support for the same. Brinson, Hood, and Beebower (1986) in a landmark paper concluded that a portfolio's target asset allocation explained the majority of a broadly diversified portfolio's return variability over time. These findings were confirmed by Ibbotson, Roger G., and Paul D. Kaplan (2000) suggesting that a portfolio's investment policy is an important contributor to return variability.

Across all portfolios, asset allocation decision explains an average of 40 percent of the variation in fund returns. For a single fund, asset allocation explain 90 percent of the fund's variation in returns over time.

9.6 Rebalancing of Portfolio

Portfolio needs to be continuously monitored and periodically rebalanced. The need for rebalancing arises due to price changes in portfolio holdings. Over time, asset classes produce different returns that can change the portfolio's asset allocation. To keep the portfolio's original risk-and-return characteristics, the portfolio may require rebalancing. Portfolio may also require re-balancing due to changes in investor's goals and objectives, risk tolerance etc..

The IPS should include a policy regarding rebalancing the portfolio answering questions relating to rebalancing like "how often" and "how much" i.e. the periodicity for portfolio rebalancing and the tolerance for deviation from target policy portfolio.

9.6.1. Benefits and difficulties of rebalancing

Portfolio rebalancing involves a simple trade-off: the cost of rebalancing versus the cost of not rebalancing. While deciding the frequency of rebalancing, the trade-off between the cost of doing it and not doing it is to be arrived at. If investor's target asset allocation is considered optimal, any deviation from it due to price fluctuations is undesirable. However, rebalancing costs need to be borne in mind.

There are two types of cost – transaction cost and tax cost. Transaction costs is the time and money costs like research cost, brokerage etc., for buying and selling securities.

Relatively illiquid investments like private equity and real estate pose challenges in rebalancing as they pose higher transaction costs.

Rebalancing is comparatively easier with relatively more liquid asset like listed equities or government bonds. While rebalancing the portfolio, managers sell assets, usually the appreciated asset and buy usually depreciated assets. Portfolio managers often set price targets for buying and selling securities. Such actions attract tax liability, which also should be kept in mind while deciding the frequency for rebalancing and the tolerance for deviations.

Chapter 9: Sample Questions

- 1) The first step in the investment process is the development of _____.
 - a. Objective statement.
 - b. Investment Policy statement**
 - c. Financial statement.
 - d. Statement of cash needs.

- 2) Which of the following is considered to be an investment objective?
 - a. Capital preservation
 - b. Capital appreciation
 - c. Current income
 - d. all of the above**

- 3) Asset allocation is _____.
 - a. The process of dividing funds into asset classes.**
 - b. Concerned with returns variability.
 - c. Concerned with the risk associated with different assets.
 - d. Concerned with the relationship among investments' returns.

- 4) _____ phase is the stage when investors in their early-to-middle earning years attempt to accumulate assets to satisfy near-term needs, e.g., children's education or down payment on a home.
 - a. Accumulation**
 - b. Spending
 - c. Gifting
 - d. Consolidation

- 5) Which of the following is a step in the portfolio management process?
 - a. Develop a policy statement.
 - b. Study current financial and economic conditions.
 - c. Construct the portfolio.
 - d. All of the above**

CHAPTER 10: PERFORMANCE MEASUREMENT AND EVALUATION OF PORTFOLIO MANAGERS

After reading the chapter, reader should:

- Understand different ways of calculating the return
- Understand different ways of calculating the risk
- Understand different ways of calculating the risk-adjusted return
- The importance of Benchmarking and peer group analysis
- Performance reporting to the Investor by PMS
- Global Investment Performance Standards

10.1 Parameters to define performance – risk and return

The main issue in performance measurement and evaluation is the human tendency to focus on the return, the investment has earned over a period of time with little regard to the risk involved in achieving that return. Proper performance measurement should involve recognition of both return and risk of investments.

10.2 Rate of return measures

The most vital statistic in measuring the performance of a portfolio is the rate of return. Rate of return has many possible definitions. However, there is one possible definition for each purpose. So, one should make effort to obtain clarity about the purpose for which the performance is to be measured and then look at an appropriate return measure.

10.2.1 Holding period return

The most straightforward rate of return is the holding-period-return (HPR), popularly known as total return or point-to-point return. It equals the income generated by an investment plus the change in value of the investment during the period the investment is held, over the beginning value of the investment, expressed as a percentage per annum.

For example, If the market value of an investor's portfolio on 1 April, 2018, is Rs.1,00,000, and on 31 March, 2019 the market value of the same portfolio stands at Rs.1,20,000, the investor would have achieved a holding-period return equal to 20%. In general, we can use Equation (1) to compute holding-period returns.

$$\text{HPR} = (E - B) / B \dots\dots\dots \text{Equation 1}$$

$$\text{HPR} = ((120000 - 100000)) / 100000 = 20\%$$

Further, assume that during the same period the investor has received Rs. 5000 by way of dividend and interest income, then:

$$\text{HPR} = (I + (E - B)) / B \dots\dots\dots \text{Equation 2}$$

$$\text{HPR} = (5000 + (120000 - 100000)) / 100000 = 25\%$$

Where:

HPR = holding-period return

I = Income

E = Ending Value

B = Beginning Value.

This measure assumes that all income distributions are made at the end of the year. In spite of this limitation, total return measure is widely used and generally accepted indicator of performance. This is considered as the starting point of performance measurement exercise.

10.2.2 Time weighted Rate of Return (TWRR) versus Money weighted Rate of return (MWRR)

Let us now consider rate of return over multiple holding periods. Suppose a portfolio has generated the following annual holding period return from 2015 through 2019 (Table 10.1):

Table 10.1: Five year Holding Period returns

Year	HPR for the year
2015	-5.00%
2016	-15.20%
2017	8.10%
2018	30.75%
2019	17.65%

Suppose further that the investor has invested Rs. 75,000 in this portfolio by making contributions at the beginning of the year as follows (Table 10.2):

Table 10.2: Investment Contributions

Year	Investment Amount in Rs.
2015	5000
2016	10000
2017	15000
2018	20000
2019	25000

At the end of 2019, the investments would have grown to the value of Rs. 105,920.31 as shown below:

Table 10.3: Computation of Returns and portfolio value at the beginning and end of the period

A	B	C	D	E	F
	Investment made at the beginning of the year in Rs.	Return generated during the period	Return made during the period in Rs.	Portfolio Value at the beginning of the period in Rs.	Portfolio Value at the end of the period in Rs.
2015	5000	-5.00%	-250	5000	4750
2016	10000	-15.20%	-2242	14750	12508
2017	15000	8.10%	2228.15	27508	29736.15
2018	20000	30.75%	15293.87	49736.15	65030.01
2019	25000	17.65%	15890.3	90030.01	105920.31

What is the rate of return generated during the period of five years?

By discounting the terminal value of the investment i.e. 105,920.31 to cashflow contributions made, internal rate of the return for the same can be calculated.

$$5000 = -\frac{10,000}{(1+r)^1} - \frac{15,000}{(1+r)^2} - \frac{20,000}{(1+r)^3} - \frac{25,000}{(1+r)^4} + \frac{105,920.31}{(1+r)^5}$$

(Internal Rate of Return) IRR = 15.15%

IRR is also referred as MWRR (Money Weighted rate of return). Financial calculators and spreadsheet have inbuilt function for solving the IRR.

MWRR is the annual rate of return at which the cumulative contributions grow over the measurement period. MWRR depends on the timing of the cash flow. If we reverse the order of contributions of the same amount i.e. Rs. 75,000, as shown in Table 10.4, MWRR would change to 10.21%.

Table 10.4: Calculation of MWRR

A	B	C	D	E	F
	Investment made at the beginning of the year in Rs.	Return generated during the period	Return made during the period in Rs.	Portfolio Value at the beginning of the period in Rs.	Portfolio Value at the end of the period in Rs.
2015	25000	-5.00%	-1250	25000	23750
2016	20000	-15.20%	-6650	43750	37100
2017	15000	8.10%	4220.1	52100	56320.1
2018	10000	30.75%	20393.43	66320.1	86713.53
2019	5000	17.65%	16187.44	91713.53	107900.97

$$25000 = -\frac{20,000}{(1+r)^1} - \frac{15,000}{(1+r)^2} - \frac{10,000}{(1+r)^3} - \frac{5,000}{(1+r)^4} + \frac{107,900.97}{(1+r)^5}$$

MWRR or IRR = 10.21%

Alternatively, in order to calculate the underlying investment performance without being influenced by the timing of cash flow, TWRR can be calculated.

The Global Investment Performance Standards (GIPS) glossary defines time-weighted rate of return as a “calculation that computes period by period returns on an investment, and removes the effects of external cash flows, which are generally client driven, and best reflects the portfolio manager’s ability to manage assets according to a specified strategy or objective.”

TWRR is the compound rate of growth over the stated period. In TWRR, portfolio will be valued every time there is an external cash flow. If there is no external cash flow, TWRR is equivalent of HPR. When there is an external cash flow, TWRR requires computing a set of return for each period. These subperiod returns will be linked together to compute TWRR for the evaluation period.

Table 10.5 gives the contribution made by the investor along with the portfolio value for five years period.

Table 10.5: Contributions made by investor and portfolio value

A	B	C
	Investment made at the beginning of the year in Rs.	Portfolio Value at the end of the period in Rs.
2015	5000	4750
2016	10000	12508
2017	15000	29736.15
2018	20000	65030.01
2019	25000	105920.31

In this example, there are five sub periods. First step towards calculating the TWRR is to calculate each period return as shown in Table 10.6 using equation 1 i.e. $(E-B)/B$.

Table 10.6: Calculating returns for each period

A	B	C	D	E
	Investment made at the beginning of the year in Rs.	Portfolio Value at the end of the period in Rs.	Portfolio Value at the beginning of the year in Rs.	Return made during the year
2015	5000	4750.00	5000.00	-5.00%
2016	10000	12508.00	14750.00	-15.20%
2017	15000	29736.15	27508.00	8.10%
2018	20000	65030.01	49736.15	30.75%
2019	25000	105920.31	90030.01	17.65%

The next step is to link these five subperiod return together. For chain linking these subperiod return, we have to calculate wealth relatives. Wealth relative is ending value of one unit of money. Hence, what needs to be done to create wealth relative is to add one to each period return, as shown in Table 10.7.

Table 10.7: Returns made and wealth relative

	Return made during the year	Wealth Relative
2015	-0.05	0.9500
2016	-0.152	0.8480

2017	0.081	1.0810
2018	0.3075	1.3075
2019	0.1765	1.1765

The next step is to create a cumulative wealth relative for the entire evaluation period by multiplying each period wealth relative as shown below.

$$\text{Cumulative wealth relative} = 0.95 \times 0.848 \times 1.081 \times 1.3075 \times 1.1765 = 1.3396$$

Cumulative wealth relative tells us what one rupee has grown over a period of time, in this case five-year period. In this example one rupee has become Rs.1.3396 in a period of five years. The compound annual return can be calculated as:

$$\text{TWRR} = (\text{Cumulative wealth relative}^{(1/n)}) - 1$$

$$\text{TWRR} = (1.3396^{(1/5)}) - 1 = 6.021\%$$

The TWRR is the same as geometric return.

Note that unless the subperiods constitute exactly one year, time-weighted rate of return will not be expressed as an annual rate, and we have to annualize the return.

SEBI (Portfolio Managers) Regulation, 2020 prescribes discretionary portfolio managers to disclose performance using 'Time Weighted Rate of Return' for the immediately preceding three years. For illustration see Box 10.1.

Box 10.1: Calculation of Time-Weighted Rate of Return

Steps to Compute Individual Portfolio TWRR:

1. Begin with market value at the beginning of the period.
2. Move forward through time towards the end of the period.
3. Compute the market value of the portfolio immediately before the contribution to / withdrawal from the portfolio.
4. Calculate a sub-period return for the period between the valuation dates i.e. the dates corresponding to the contribution and / or withdrawal dates using the formula:
$$\frac{(\text{Ending Market Value} - \text{Beginning Market Value} - \text{Contribution} + \text{Withdrawal})}{(\text{Beginning Market Value} + \text{Contribution} - \text{Withdrawal})}$$
5. Repeat steps 3 and 4 for each contribution and / or withdrawals
6. When there are no more contributions and / or withdrawals, calculate a sub- period return for the last period to the end of the period market value.
7. Compound the sub-period returns by taking the product of (1+sub-period returns). This is called geometric linking or chain linking of the sub-period returns.
8. Subtract 1 from the product value as arrived at in step 7 above.
9. Express the result as per 8 above in percentage terms to get the TWRR for the time period under evaluation.

Example:

An account is funded on 1-Jan-2019 by an amount 50,00,000. On 1-Mar-2019, client contributed additional 20,00,000. The market value of the account as on 28-Feb-2019 is 49,00,000. On 1-Oct-2019, the client withdrew an amount of 10,00,000 from the account. The market value of the account on 30-Sep-2019 was 75,00,000. The market value of the account on 31-Dec-2019 was 70,00,000.

Sub-Periods	Sub-period returns	Sub-period returns + 1
1-Jan-2019 to 28-Feb-2019	$\frac{(49,00,000 - 50,00,000)}{50,00,000}$ = -2.00%	$(1 - 2.00\%) = 0.98$
1-Mar-2019 to 30-Sep-2019	$\frac{(75,00,000 - 49,00,000 - 20,00,000)}{(49,00,000 + 20,00,000)} = 8.69\%$	$(1 + 8.69\%) = 1.08$
1-Oct-2019 to 31-Dec-2019	$\frac{(70,00,000 - 75,00,000 + 10,00,000)}{(75,00,000 - 10,00,000)} = 7.69\%$	$(1 + 7.69\%) = 1.07$
TWRR		$\frac{((0.98 * 1.08 * 1.07) - 1) * 100}{1} = 14.71\%$

Source: SEBI FAQs dated October 2020

10.2.3 Arithmetic Mean Return (AMR) vs. Geometric Mean Return (GMR)

Suppose there are two portfolio choices available to invest Rs.100,000. First choice produces a holding-period rate of return of -50 percent in the first year and 100 percent in the second year. Another choice produces holding-period rate of return of 10 percent in the first year and 10 percent in the second year. Which one would you suggest?

In case of first scheme at the end of the second year, the investor will end up with Rs.100,000. The value of the portfolio is the same, as it was two years ago, though the average annual return on the portfolio is 25 percent.

With the second choice the value of the portfolio at the end of the second year is Rs.121,000; an average annual 10 percent gain in value. Clearly, investor is better off with the second scheme, although it produces average annual return lower than the first scheme.

To understand how the outcome in the two cases are so different, it is important to distinguish the two methods of calculating returns. The average annual **arithmetic return** is the simple average of individual total yearly returns.

The yearly return is the sum of :

- (1) the percentage gain (or loss) in the value of your portfolio due to changes in asset prices and
- (2) any dividends or other cash distributions, expressed as the percent of invested assets.

The arithmetic mean is the “simple average” of a series of returns, calculated by summing all of the returns in the series and dividing by the number of values.

$$AMR = \sum_{t=1}^n R_t / n$$

For the first choice the $AMR = (-50\% + 100\%) / 2 = 25\%$

For the second choice the $AMR = (10\% + 10\%) / 2 = 10\%$

The best estimate of a future year's return based on a random distribution of the prior years' returns is the arithmetic average. Statistically, it is our best guess for the holding-period return in a given year. If we wish to estimate the expected return over a multiyear horizon conditioned on past experience, we may use the arithmetic average.

The second method of calculating returns is the average annual **geometric or compound return**. The average geometric return is far more important than the average arithmetic

return if one is analyzing the long-run return on assets. The average annual geometric return is the rate at which the sum you invested at the beginning of the period will accumulate to a given sum at the end of the period by the process of compounding, or continuously reinvesting your dividends and capital gains. A characteristic of the compound return is that it depends only on the initial and final values of the portfolio, not on the path by which that value was realized.

GMR is based on an exponential function, which represents periodic compounding.

$$GMR = \prod_{t=1}^n (1 + R_t)^{1/n} - 1$$

As can be seen in the formula, the process of calculating the GMR is the same as TWRR. We are required to calculate wealth relatives for each HPR. Then we have to link these subperiod returns.

In the above example, the evaluation period is two years. Hence to calculate annualized return, the cumulative wealth ratio is raised to $(1/2)$. n being the number of years.

For the first choice $GMR = (((1+50\%)*(1+100\%))^{(1/2)}) - 1 = 0$

For the second choice $GMR = (((1+10\%)*(1+10\%))^{(1/2)}) - 1 = 10\%$

For a one-year holding period the arithmetic and geometric returns are identical, since both calculate the total return over one year. But over longer holding periods the geometric average return is always less than the arithmetic return except when all the individual yearly returns are exactly the same, in which case the geometric return equals the arithmetic return.

Given the initial and final value of a portfolio, a fund manager can always increase the average annual return by increasing risk. As noted above, a manager who takes your portfolio from Rs. 100 to Rs.50 and back to Rs. 100 again, achieves an average arithmetic return of 25 percent. Yet every investor should prefer the second manager to the first. Geometric return is the only way to compare long-term accumulations. It explains what has really happened to the investments. If, however, we wish to estimate the probability distribution of terminal wealth we should use the geometric average.

10.2.4 Gross versus net return

The gross return is the total return generated on investment before the deduction of any fees, expenses or commissions. Gross return is stated for a specified period of time. Net return is calculated after adjusting gross return for fees, expenses or commissions. Net return is the return investor actually makes, hence focusing on gross return can be misleading though it can be used to evaluate the performance of investments at a broader level.

Let us look at the following example of a portfolio to understand the difference between gross return and net return. Given below is the information about the size of the portfolio, investment period, fees, expenses etc..

1. Size of sample portfolio: Rs. 100 lacs
2. Investment Period: 1 year
3. Profit made during the year: 20% on the capital contribution
4. Hurdle Rate: 10% of amount invested
5. Other Expenses such as Brokerages, DP charges etc., charged on gross value of portfolio (0.50%)
6. Upfront fee – Nil
7. Setup fee-Nil
8. Fixed Management fee charged on average of capital contribution and gross value of portfolio (e.g. 1.5%)
9. Performance fee (e.g. 20% of profits over hurdle rate without catch-up)
10. The frequency of calculating all fees is annual.

What is the gross return and net return on investment?

Capital Contribution made at the beginning of investment period (i)	1,00,00,000
Less: Upfront fees	-
Assets under management (AUM)	1,00,00,000
Add/ Less: Profits/ Loss on investment during the year on AUM at 20%	20,00,000
Gross Value of the Portfolio at the end of the investment period	1,20,00,000
Less: Other Expenses (0.50% of the gross value of the portfolio at the end of the investment period) (a)	60,000
Gross Value of the Portfolio less Other Expenses	1,19,40,000
Less: Fixed Management Fees (1.50%) of $((100,00,000+120,00,000)/2)$ (b)	1,65,000
Portfolio Value after charging Fixed Management Fees	1,17,75,000
Required Portfolio Value @ Hurdle Rate (i) * $(1.10)^1$ ie. $100,00,000 * (1+10\%)^1$	1,10,00,000
Less: Performance Fee @ 20% of the Profits over Hurdle Level (c) $20\% * (117,75,000 - 110,00,000)$	1,55,000
Portfolio Value after charging Performance Management Fees i.e. $(117,75,000 - 1,55,000)$	1,16,20,000
Less: Exit Load (2%) (d)	2,32,400

Portfolio Value after charging Exit Load	1,13,87,600
Total Charges (a+b+c+d)	6,12,400
Net Value of the Portfolio	1,13,87,600

Gross return is the total rate of return earned. For the above example it is calculated as follows:

Gross Return = (Gross value of the portfolio – Capital Contribution)/Capital Contribution

Gross Return = (Rs. 1,20,00,000 Lacs. - Rs. 1,00,00,000 Lacs.) / Rs. 1,00,00,000 Lacs.

Gross Return = 20 %

Net Return is the return earned after adjusted for the fees and expenses. It is calculated as follows:

Net Return = (Net value of the portfolio – Capital Contribution)/Capital Contribution

Net Return = (Rs. 1,13,87,600 – Rs. 1,00,00,000) / Rs.1,00,00,000

Net Return = 13.88%

10.2.5. Pre-tax versus post tax return

The pre-tax rate returns are returns before taxes, and post-tax returns are returns after taxes are paid on investment income and realized capital gains. Investors belong to different tax brackets. Hence the performance of the investments is communicated as pre-tax rate of return. Investors or their financial advisors are expected to calculate the post-tax return by adjusting the pre-tax return to the tax rates applicable to the investors.

Pre-tax return = Post Tax Return/ (1-tax rate)

Post-tax return = Pre-Tax Return x (1-tax rate)

Pre-Tax return enables comparisons across different investments and strategies, since different investors may be subject to different levels of taxation. However, what really matters to the investor is post-tax return. Hence, they make investment decision on the basis of post-tax performance.

An example of post-tax return calculation is given below:

An individual achieves a 5% pre-tax rate of return for stock XYZ and is subject to a capital gains tax of 15%. The post-tax rate of return is:

Post-tax return = Pre-tax return x (1-tax rate)

Post-tax return = $5\% \times (1-15\%) = 4.25\%$

10.2.6. Compounded Annual Growth Rate

Compounded Annual Growth Rate is a measure of an investment's annual growth rate over time, with compounding. It assumes that the any dividend/income/rent declared by the investment is re-invested in the same investment on that day's market price.

Here is the compound interest formula to determine the CAGR between the opening and closing wealth.

The formula is:

$$(A / P)^{(1 / t)} - 1,$$

Where

'A' is the closing wealth,

'P' is the opening wealth and

't' is the time period in years

Suppose an investment has invested Rs. 100,000 in an investment for five years. The year on year return is given as follows:

Year	Return
2015	-5.00%
2016	-15.20%
2017	8.10%
2018	30.75%
2019	17.65%

For calculating the CAGR, we need to calculate the terminal wealth i.e. the end of the period value of the investment.

Year	Return	Investment value at the end of the year in Rs.
2015	-5.00%	95,000
2016	-15.20%	80,560
2017	8.10%	87,085
2018	30.75%	1,13,864
2019	17.65%	1,33,961

As can be seen, Rs. 100,000 has grown to Rs. 1,33,961 in five years. Using the formula for compound interest, CAGR can be calculated as:

$$\text{CAGR} = (1,33,961/1,00,000)^{(1/5)} - 1 = 6.02\%$$

As demonstrated below, CAGR is the constant rate of growth to reach the same terminal value.

Year	Return	Investment value at the end of the year in Rs.	Investment value at the end of the year growing at the rate 6.0622% in Rs.
2015	-5.00%	95,000	1,06,020
2016	-15.20%	80,560	1,12,410
2017	8.10%	87,090	1,19,180
2018	30.75%	1,13,860	1,26,350
2019	17.65%	1,33,960	1,33,960

10.2.7. Annualizing return

For facilitating comparison, rate of return is reported on annualized basis. The annualized return represents the compound average annual return of the investment. The calculation is same as the calculation of CAGR or geometric mean return. Return are annualized by following the same chain linking method and the product of the linking is raised to the reciprocal of the number of years in the evaluation period.

For example, a portfolio has generated the following return in the last three years.

Year	Return
2017	15.5%
2018	9.50%
2019	-6.90%

First step in annualizing the return is to calculate the wealth relative:

Year	Return	Wealth Relative
2017	15.5%	1.1550
2018	9.50%	1.0950
2019	-6.90%	.9310

Next step is to take the product of the wealth relative:

$$1.1550 \times 1.1950 \times .9310 = 1.1775$$

Next is to raise it to the reciprocal of the number of years:

$$1.1775^{(1/3)} = 1.0559$$

Final step is to subtract 1:

$$1.0559 - 1 = 0.0559 \text{ or } 5.56 \%$$

If the measurement year is less than a year, it is inadvisable to calculate annualized return, as it means extrapolating the return to a full year. Particularly for those investments where returns can fluctuate significantly during the remaining period.

10.2.8. Cash drag adjusted return

Portfolio managers may not invest the entire capital contribution made by investors for variety of reasons. However, while computing return, for the investment period, the capital contribution made by investors need to be taken into consideration. It has been observed that portfolio managers were not taking into account the cash component in computing returns (i.e. ignoring the drag that cash exerts on returns). This practice mis-states the return as shown in the example below.

An investor has invested Rs. 100 lacs in an equity investment portfolio. The manager has invested only Rs. 75 Lacs in the equities and Rs. 25 lacs are lying in the liquid funds. For the period, the equity exposure has generated a return of Rs. 7.5 Lacs, while the liquid fund has given 4% return.

Return on investment (ignoring the drag cash has exerted) = Rs. 7.5 lacs / Rs. 75 lacs = 10%

Return on investment (adjusting the drag cash has exerted) in Rs. = $(10\% \times \text{Rs.}75 \text{ lacs}) + (4\% \times 25 \text{ lacs})$ = Rs. 85,000 or 8.5% on Rs. 100 lacs

10.2.9. Alpha and Beta return

Most investment portfolios tangle alpha and beta decisions together. The returns from such portfolios can be decomposed into alpha and beta return by using asset pricing models. The most popular asset pricing model is Capital Asset Pricing Model (CAPM).

The CAPM theorizes that risk consists of a systematic component (that is non-diversifiable) and a unsystematic (idiosyncratic or unique) component that is diversifiable. Risk that is unsystematic can be diversified away hence an investor should not expect compensation for

bearing this type of risk. As per this model, investments are to be priced for their market risk i.e. non-diversifiable risk. Market risk as discussed in 10.3.3 is measured by Beta. Under CAPM, the required return on a security or portfolio is computed as:

$$\text{Required return} = R_f + \beta (R_m - R_f)$$

R_f = Risk free return

β = Beta of the security/portfolio

R_m = Return on a Market Portfolio (A popular broad market index is a good proxy)

Alpha is the return generated by the portfolio over the over the required rate of return as per CAPM.

For understanding decomposition of return, look at the following example.

Example:

A portfolio has generated a return of 25%. The market benchmark return for the same period is 15%. The beta of the portfolio is 1.5. Treasury bond yield is 5%.

The return of the portfolio has three components:

Risk free return = 5%

Beta return = Beta * ($R_m - R_f$) = 1.5 x (15% - 5%) = 15%

Alpha return = Actual Return – Required rate of return

Alpha return = 25% - {5% + 1.5 x (15% - 5%)}

Alpha Return = 5%

This is also referred as Jensen alpha.

Alpha return is a reward for bearing non-market risk. Beta return is a reward for bearing market risk.

Some professionals make a distinction between alpha and Jensen alpha. They refer to the excess return over the market benchmark return as alpha.

In the above example, excess return is 25% - 15% = 10%

10.2.10 Portfolio Return

The return of the portfolio is the weighted average return of individual securities in it. The following example, gives the weight (proportion) of four securities in the portfolio and their return.

Security	Return	Weight in the portfolio
A	15%	30%
B	10%	20%
C	12%	20%
D	18%	30%

The weighted average return of the securities is the return of the portfolio, calculated as follows:

$$\text{Portfolio Return} = (15\% \times 30\%) + (10\% \times 20\%) + (12\% \times 20\%) + (18\% \times 30\%) = 14.30\%$$

10.3. Risk measures

Risk is the key dimension of performance measurement, and a decisive factor in selecting a portfolio manager.

10.3.1. Total risk and downside risk

Risk in a generic sense is the possibility of loss, damage, or harm. For investments more specific definitions of risk can be given.

It can be defined as variability in the expected return - total risk. Or, it can be limited to losses or worse than expected outcomes only – downside risk.

Two possible measures of risk have received support in theory to capture total risk: the variance and the standard deviation of the estimated distribution of expected returns. Whereas downside risk includes concepts such as semi-variance/standard deviation and target semi variance/standard deviations.

Standard deviation as a measure of total risk

Standard deviation and variance are measures of dispersion in return. Standard deviation is the square root of variance. It quantifies the degree to which returns fluctuate around their average. A higher value of standard deviation means higher risk.

Standard deviation is used probably more than any other measure to describe the risk of a security (or portfolio of securities). In any academic study on investment performance; chances are that standard deviation will be used to gauge risk. It's not just a financial tool, though. Standard deviation is one of the most commonly used statistical tools in the sciences and social sciences. It provides a precise measure of the amount of variation in any group of

numbers - the returns of a mutual fund, rainfall in Mumbai, or the weight of professional cricket players.

$$SD = \sqrt{\frac{\sum_{i=1}^n (x_i - \bar{x})^2}{n}}$$

One of the strengths of standard deviation is that it can be used across board for any type of portfolio with any type of security. The calculation is the same for a portfolio of bonds as it is for a portfolio of growth stocks or any other type of investments.

Standard deviation is interpreted as follows:

Suppose the investment portfolio has a monthly standard deviation of 3.27%. Suppose the expected return for the same is 2%. This means in future there is 66.7% probability that the portfolio return would be between mean return + and – 1 Sigma i.e. 2% -3.27% to 2% +3.27%, where 3.27 is 1 * 3.27%

There is 95% probability that the portfolio return would be between mean return + and – 2 Sigma i.e. 2% -6.54% to 2%+6.54%, where 6.54 is 2 * 3.27%

There is 99% probability that the portfolio return would be between mean return + and – 3 Sigma 2% -9.81% to 2%+9.81%, where 9.81 is 3 * 3.27%

Standard deviation allows portfolios with similar objectives to be compared over a particular time frame. It can also be used to gauge how much more risk a fund in one category has versus the other.

Semi variance / Semi Standard deviation as a measure of downside risk

Semi variance measures the dispersion of the return below the mean return. Target Semi variance measures the dispersion of the return below the target return. In case of symmetrically distributed return, semi variance will be proportional to variance and provides no additional insight. Forecasting asymmetrical distribution of return is very difficult and may not be a good forecast of future risk. Due to these reasons' semi variance is not so popularly used in practice.

10.3.2. Portfolio risk versus individual risk

Standard deviation or variance of the returns is used as measure of risk. While computing portfolio risk, it is to be borne in mind that portfolio standard deviation is not the weighted average standard deviation of individual investments in a portfolio (except when these

investments have perfect positive correlation with each other, which is practically an impossibility). Portfolio risk depends on the weights of the investments, their individual standard deviations and more importantly the correlation across those investments as shown in the formula below:

$$\sigma_{\text{port}} = \sqrt{\sum_{i=1}^n w_i^2 \sigma_i^2 + \sum_{i=1}^n \sum_{j=1}^n w_i w_j \text{Cov}_{ij}}$$

Where:

σ_{port} is the risk (standard deviation of portfolio return) of the portfolio;
 w_i, w_j are the weights of individual assets in the portfolio, that determined by the proportion of money invested in each of the asset in the portfolio;
 σ_i^2 is the variance of returns of the individual assets in the portfolio;
 cov_{ij} is the covariance of the returns of individual assets. Covariance is a product of coefficient of correlation between the assets returns and their individual standard deviations. Poorer the correlation across investments, lower would be the portfolio risk.

10.3.3. Systematic Risk and Unsystematic Risk

Systematic risk is defined as risk due to common risk factors, like interest rates, exchange rates, commodities prices. It is linked to supply and demand in various marketplaces. All investments get affected by these common risk factors directly or indirectly. Systematic risks cannot be diversified away, though it can be hedged. Systematic risk is measured by Beta.

Risks due to sector specific/company specific factors is referred as unsystematic risks. These risks can be diversified away. Alpha return is a reward for bearing unsystematic risk.

Beta

Systematic risk is measured by Beta. Beta relates the return of a stock or a portfolio to the return on market index. It reflects the sensitivity of the fund's return to fluctuations in the market index. Beta calculation requires two series of values for a reasonably long period of time, say 3 to 5 years. First series is your portfolio's daily/weekly/monthly prices. The second series would be the market index on all the dates for which the market prices of your portfolio has been considered.

$$\text{Beta} = \text{Cov}(M_r, P_r) / \text{Var}(M_r)$$

Where

$\text{Cov}(M_r, P_r)$ = Covariance between the market's return and the portfolio return

$\text{Var}(M_r)$ = Variance in the Market return

The relationship between the Beta of an individual security with portfolio of securities is linear. Beta of the portfolio can also be calculated by taking the weighted average beta of the individual securities/investments in the portfolio. Thus, if stock A has a beta of 1.2 and stock B has a beta of 1.1 and they make up the portfolio in the ratio of 60:40, the Beta of the portfolio (β_p) would be:

$$\beta_p = 0.60 \times 1.2 + 0.40 \times 1.1 = 1.16$$

Beta is fairly easy to interpret. A beta that is greater than one means that the portfolio or stock is more volatile than the benchmark index, while a beta of less than one means that the security is less volatile than the index.

10.3.4. Tracking error

Tracking error is the standard deviation of the difference between the portfolio and its target benchmark portfolio total return. Generally indices are used to benchmark portfolios.

Lower the tracking error, closer are the returns of the portfolio to the target Index. If the benchmark portfolio is the market portfolio, tracking error measures deviations from the market return. Tracking Error is always calculated against the Total Returns Index which shows the returns on the Index portfolio, inclusive of dividend. Tracking errors primarily arises due to mismatches between portfolio's risk profile and the benchmark's risk profile.

10.4 Risk-adjusted return

The differential return earned by the portfolio manager may be due to difference in the exposure to risk. Hence it is imperative to adjust the return for the risk. The following are popularly used risk-adjusted return measures. These risk-adjusted performance measures assess the performance of a fund in terms of return per unit of risk.

10.4.1 Sharpe Ratio

One approach is to calculate portfolio's return in excess of the risk-free return and divide the excess return by the portfolio's standard deviation. This risk adjusted return is called Sharpe ratio. This ratio named after William Sharpe. It measures Reward to Variability.

$$S = \frac{(R_p - R_f)}{\sigma_p}$$

Here,

R_p = Return of the portfolio

R_f = Risk-free return

σ_p = Standard deviation of return on the portfolio

It is to be noted that these three variables should be for the same period. Generally, annualized return and annualized standard deviation is taken for computing Sharpe ratios of the portfolio, for easy comparison across portfolios.

Suppose the annualized standard deviation of the portfolio is 6.50%. Suppose that the annualized return for the same portfolio is 10.50%. The risk-free rate of return is 5.50%.

Then the Sharpe ratio for the portfolio is:

$$(10.50\% - 5.50\%) / 6.50\% = 0.7692$$

This suggests that the fund has generated 0.7692 percentage point of return above the risk-free return for each percentage point of standard deviation.

The Sharpe ratio is a measure of relative performance. It enables investors to compare across investment opportunities. Higher the Sharpe ratio, better is the portfolio's risk adjusted performance. A fund with a higher Sharpe ratio in relation to another is preferable as it indicates that the fund has generated return for every unit of risk.

As can be noted Sharpe ratio adjusts return to the total portfolio risk. Hence it is a useful measure of performance for several mutually exclusive portfolios.

The Sharpe ratio is the simplest measure to compute and that is why it is the most widely used risk-adjusted return measure. However, it has a disadvantage: It ignores diversification potential of portfolio.

10.4.2 The Treynor Ratio

The Treynor measure adjusts excess return for systematic risk. It is computed by dividing a portfolio's excess return, by its beta as shown in equation:

$$T = \frac{(R_p - R_F)}{\beta_p}$$

where

T = the Treynor measure,

R_p = portfolio return,

R_f = riskless return and

β_p = portfolio beta.

As can be seen the numerator of the equation remains the same as in case of Sharpe ratio. The denominator standard deviation is replaced by Beta.

Suppose in the above case, beta of the fund is precisely 1. The Treynor ratio of the funds would be:

$$\text{Treynor Ratio} = \frac{(10.50\% - 5.50\%)}{1} = 0.05$$

This indicates that the fund has generated 0.05 percentage point excess returns for every unit of systematic risk.

Like Sharpe ratio, it is a measure of relative performance. It enables investors to compare across investment opportunities. A fund with a higher Treynor ratio in relation to another is preferable as it indicates that the fund has higher risk premium for every unit of market risk.

As Treynor ratio indicates return per unit of systematic risk. Hence it is a useful measure of performance if an investor wishes to evaluate a portfolio in combination with other actively managed portfolios.

10.4.3 Sharpe versus Treynor Measure

The Sharpe ratio uses standard deviation of return as the measure of risk, whereas Treynor performance measure uses Beta (systematic risk).

For a completely well-diversified portfolio, the two measures give identical ranking, because total risk and systematic risk would be the same. However, for a poorly diversified portfolio, the ranking based on Treynor Ratio could be higher than that on Sharpe ratio as Treynor ratio, ignores unsystematic risk.

Thus, any difference in rankings based on Sharpe Ratio and Treynor ratio is due difference in portfolio diversification levels.

The Sharpe Ratio is more suitable to evaluate a portfolio performance for an investor who has not achieved adequate diversification on his wealth as a whole, and Treynor Ratio should be used for investors who hold their wealth in well diversified portfolios

10.4.4 Sortino Ratio

For computing Sortino Ratio, portfolio's return in excess of the risk-free return is divided by the portfolio's semi-standard deviation. Thus, Sortino Ratio adjusts portfolio's excess return to the downside risk.

This ratio may be very appealing to some investors who view risk as chances of losing money, rather the uncertainty around expected return.

Sortino Ratio = $(R_p - R_f) / \text{Semi Standard deviation of the portfolio}$

R_p = Return of the portfolio

R_f = Risk-free rate

Like Sharpe and other risk adjusted return ratio, higher level of Sortino Ratio indicates superior performance.

10.4.5 Information Ratio (Appraisal ratio)

If we wish to determine whether or not an observed alpha is due to skill or chance, we can compute information (appraisal) ratio.

$$IR = (R_p - R_b) / \text{Stdev} (R_p - R_b)$$

Where:

IR = the information ratio,

R_p = Return on the portfolio

R_b = Return on the benchmark

$\text{Stdev} (R_p - R_b)$ = Standard deviation of the difference between the return of the portfolio and return of the benchmark

The numerator in the ratio represents the fund manager's ability to use his skill and information to generate a portfolio return that differs from the benchmark (e.g. BSE Sensitive index or Nifty 50) against which his performance is being measured. The denominator measures the amount of residual (unsystematic) risk that the investor incurred in pursuit of those excess returns. The numerator is often referred to as the active return on the portfolio whereas denominator is referred to as the active risk. The point to be noted is that active risk is nothing but tracking error of the portfolio.

10.4.6. M² Measure:

Franco Modigliani and his granddaughter Lea Modigliani (1997) derived another risk-adjusted performance measure. They adjusted the risk of the portfolio to match the risk of the market portfolio. For such a risk adjusted portfolio, they calculated the return, and compared it with the market return to determine portfolio's over or underperformance. To adjust the risk of the portfolio, they resorted to leveraging or de-levering.

After the standard deviations have been equalized, return can be directly compared with the return in the market. A high (low) indicates that the portfolio has outperformed (underperformed) the market portfolio.

Illustration:

Suppose the portfolio has generated a return of 35%. The market (benchmark) portfolio has generated a return of 28%. The treasury bill rate is 6%. The standard deviation of the portfolio is 42%. The standard deviation of the market portfolio is 30%.

Hypothetical Portfolio's volatility = Market's volatility

$30/42 = 0.714$ in P; $(1-0.714) = 0.286$ in T-bills

$$r_p^* = (0.714)(0.35) + (0.286)(0.06) = 26.7\%$$

Since return on the hypothetical portfolio is less than the market by 1.3%, (28%-26.7%) the managed portfolio under performed.

10.5 Performance Evaluation: Benchmarking and peer group analysis

Performance evaluation is a relative concept. After measuring the performance, next important step is to evaluate it against some suitable benchmark or similar portfolios to address more important issues like how the returns measure up to the comparable investment opportunities.

Performance evaluation also enable the investors to determine if the portfolio manager has enhanced the portfolio's value beyond what could be obtained from a passive indexed strategy, and whether the portfolio management fees are justified.

Performance evaluation involves benchmarking and peer group analysis.

10.5.1 Characteristics of indices for Benchmarking

GIPS defines Benchmark as an independent rate of return (or hurdle rate), forming an objective test of the effective implementation of investment strategy. It is a standard or point of reference. It is a collection of investment opportunities or securities or risk factors which represent the investment characteristics and investment approach of the portfolio being evaluated against it.

Indices make popular choices for benchmarking portfolio. The number and variety of available indices make selection of suitable benchmarks a daunting task. A good benchmark increases the proficiency of performance evaluation hence while choosing an index as benchmark, care should be taken to ensure that it is representative of the portfolio.

A good benchmark should be able to satisfy the following criteria:

- The identity of constituents and their weights in the benchmark are clearly defined.
- The benchmark is investable, in other words it is possible to have a passive exposure to the same.
- The benchmark is consistent with the portfolio's investment approach. For example, if the portfolio's investment approach is to invest in blue-chip stocks, the benchmark should also consist of blue-chip stocks. If the investment style of the portfolio is value investing, the benchmark should be of the same orientation.
- The benchmark is having the same risk-return profile as the portfolio.
- The performance of the benchmark is measurable.

10.5.2 Customized Benchmark

Sometimes market based indices may not meet the above criteria of a good benchmark, given the portfolio manager's investment strategies and style. Such situation demands for appropriate customized benchmark. When the portfolio managers follow a certain type of investment strategy and style, they create an investment universe reflecting the same to focus their research activities. The portfolio managers then select the most attractive securities from the investment universe. Such investment universes can act as benchmarks for portfolio evaluation when market-based indices are not found to be valid. The advantage of such benchmarks is that they meet the requirement of valid benchmarks. The disadvantage is that the costs of construction and maintenance of these benchmarks would be much higher than the fee paid for using market-based indices.

10.5.3 Managers' universe analysis

Managers' universe analysis or peer group analysis is also a very popular way of conducting performance evaluation. The median portfolio or the universe of the portfolio managers with the similar investment approach and strategies can be taken as the yardstick to evaluate the performance of the portfolio. Investors have a natural interest in knowing how their portfolio managers are performing compared to others. Portfolio tracking firms have developed databases to facilitate managers' universe analysis. They rank the portfolios with similar investment characteristics and risk-return profile on some risk-adjusted return measure.

10.6. Performance attribution analysis

The second phase of performance evaluation is performance attribution. There are different ways of doing the attribution analysis, but the one propounded by Fama remains the dominant framework.

The underlying theme behind various attribution analysis approaches is to dissect the return into majorly two components: return driven by the benchmark and the differential return. And then identifying and quantifying the sources of differential return to primarily establish whether it was driven by skill of the portfolio manager or some random factors (in layman terms luck).

10.6.1. Assets and Sector Allocation

Differential return can be achieved by choosing to over-invest in (or overweight) a particular economic sector that outperformed the total benchmark (sector allocation) for that period or to underinvest in or avoid (or underweight) an asset category that underperformed the total benchmark (*asset allocation*). It may be noted here that we are assuming that a particular sector is performing better or worse than the overall return of the benchmark portfolio.

$$\text{Allocation effect} = \sum_i [(W_{ai} - W_{pi}) \times (R_{pi} - R_p)]$$

W_{ai} and W_{pi} = the investment proportions of the i^{th} market segment (i.e. asset sector / industry group) in the active manager's portfolio (W_{ai}) and the benchmark policy portfolio (W_{pi}) respectively

R_{pi} = the investment return to the i^{th} market segment in the benchmark portfolio

R_p = Total return of the benchmark portfolio

Allocation Effect can also be extracted by another approach also, where there is no need to assume whether a particular sector or asset class is generating superior returns than the overall benchmark portfolio return. Under these circumstances, the Allocation Effect can be extracted as follows

$$\text{Allocation Effect} = \sum_{i=1}^n [(R_{pi}) \times (W_{ai} - W_{pi})]$$

The terms used in the above equations have the same definitions as described above.

10.6.2. Selection

Differential return can also be achieved by selecting securities that performed well relative to the benchmark or avoiding benchmark securities that performed relatively poorly.

$$\text{Selection Effect} = \sum_i [W_{ai} \times (R_{ai} - R_{pi})]$$

W_{ai} = the investment proportions of the i th market segment (i.e. asset class, sector / industry group) in the active manager's portfolio

R_{ai} and R_{pi} = the investment return to the i th market segment in the active manager's portfolio (R_{ai}) and the benchmark portfolio (R_{pi}), respectively

One may note that the actual weights assigned by the fund manager have been taken, here to weight on the excess returns generated due to selection. This is logical, because the actual investment has been made in the actual proportion only.

10.6.3. Local currency versus foreign currency denominated investment return

An Indian investor who buys and sells securities that are denominated in currencies other than the Indian rupee need to calculate the return after adjusting the fluctuation in Indian rupee against those foreign currencies, as the return earned on investments denominated in foreign currencies would not be the same when converted back to rupee term. The fluctuations in currency values can either enhance or reduce the returns associated with foreign investments. This is called currency risk.

Consider the following scenario:

An Indian investor has invested Rs. 50 lacs in a US equity fund when Rupee was 70 per US dollar. The fund has generated a return of 15%. During the period rupee appreciated to 65 per US dollar. What is the return investor has made?

Capital investment in US based Equity fund (t_0) = \$ 71,428.57

Investment Value (t_1) = $(71,428.57 \times 15\%) + 71,428.57 = 82,142.86$

Investment value in Indian Rupee = $82,142.86 \times 65 = 53,39,285.62$

Return in Rupee term = Rs. 53,39,285.62 – Rs. 50,00,000 = Rs. 3,39,285

i.e. Return made is 6.79 % and not 15%

10.7 Performance reporting to the Investor

SEBI Portfolio Managers regulation state the following regarding performance reporting to the investors:

The portfolio manager shall furnish periodically a report to the client, as agreed in the contract, but not exceeding a period of three months and as and when required by the client and such report shall contain the following details, namely: -

(a) the composition and the value of the portfolio, description of securities and goods, number of securities, value of each security held in the portfolio, units of goods, value of goods, cash balance and aggregate value of the portfolio as on the date of report.

(b) transactions undertaken during the period of report including date of transaction and details of purchases and sales.

(c) beneficial interest received during that period in the form of interest, dividend, bonus shares, rights shares, etc.

(d) expenses incurred in managing the portfolio of the client.

(e) details of risk foreseen by the portfolio manager and the risk relating to the securities recommended by the portfolio manager for investment or disinvestment.

(f) default in payment of coupons or any other default in payments in the underlying debt security and downgrading to default rating by the rating agencies, if any.

(g) details of commission paid to distributor(s) for the particular client.

Portfolio Manager shall present the Time weighted rate of return (TWRR) of the Investment Approach along with the trailing return of the selected benchmark when communicating/advertising/publishing/mentioning performance of an investment approach. Portfolio Manager shall present the Extended Internal Rate of Return (XIRR) for each investment approach the investor invests in when reporting performance to an investor. This shall be accompanied by the minimum, maximum and median XIRR return generated across all investors in each of the IA, the investor has invested in. The TWRR of the respective IA(s) and the trailing return of the benchmark(s) selected shall also be presented separately. The disclosure should also be accompanied by the following disclaimer:

“Please note that performance of your portfolio may vary from that of other investors and that generated by the investment approach across all investors because of (a) the timing of inflows and outflows of funds and (b) difference in the portfolio composition because of restrictions and other constraints.”³⁵

10.8 Valuation of Securities by Portfolio Managers

APMI shall prescribe standardized valuation norms for Portfolio Managers. Valuation of the portfolio debt and money market securities by portfolio managers shall be carried out in accordance with these standardized valuation norms prescribed by APMI.

³⁵ Candidates are advised to read SEBI Circular (SEBI/HO/IMD/IMD-PoD/P/CIR/2022/172) dated December 16, 2022.

APMI shall empanel valuation agencies for the purpose of providing security level prices to Portfolio Managers. Portfolio Managers shall mandatorily use valuation services obtained only from one or more of such empanelled valuation agencies for the purpose of valuation of debt and money market securities in portfolios managed by them. The ultimate responsibility for fair valuation shall be that of the Portfolio Manager.

10.9 Due Diligence and Portfolio Manager selection

Selecting a portfolio manager is a complex process. It involves analysing a lot more than just returns. Investors are expected to carry out a detailed due diligence process before selecting their portfolio managers. Due diligence involves thorough quantitative and qualitative analysis of the portfolio manager's reputation, key personnel and operations.

Investors should understand the investment process, investment strategies, investing styles to appreciate how the investment returns are generated and gauge the likelihood of the performance persisting in future for the given investment process.

The first step in selecting the portfolio manager is to draft the investment policy statement and determine the asset allocation. Then it becomes easier to select the portfolio manager who offers the "best" means to implement or express those decisions.

Portfolio Managers can be evaluated on the basis of their investment philosophy, investment approach, investment process, strategies, styles and past performance compared against a benchmark or managers' universe. Attention can also be paid to the major provisions in the contract with the portfolio managers. Of course the management fees and the cost, will be a crucial factor too in evaluating the portfolio managers.

10.9 Global Investment Performance Standards (GIPS®)³⁶

The Global Investment Performance Standards (GIPS®) provide the investment community with a set of ethical standards for investment management firms to follow when presenting their performance results to potential clients. The standards serve to provide greater uniformity and comparability among investment managers, without regard to geographic location, and to facilitate a dialogue between investment managers and their prospective clients about the critical issues of how the manager achieved historical performance results and future investment strategies.

Firms that claim compliance with GIPS standards must adhere to rules governing not only rate of return calculation but also the way returns are displayed in performance communications.

³⁶ GIPS® is a registered trademark owned by CFA Institute. The GIPS standards are a set of standardized, industry-wide ethical principles that guide investment managers and asset owners on how to fairly calculate and present their investment results, with the goal of promoting performance transparency and comparability.

These standards have evolved over a period of time to improve reliability of performance information and standardize calculation methodology.

These standards are broadly accepted and endorsed by the investment management industry. For example GIPS mandates use of time weighted rate of return. SEBI Portfolio Managers Regulation 2020 has also prescribed the use of TWRR for communicating the past performance.

10.10 GIPS Advertisement Guidelines

The GIPS Advertising Guidelines attempt to serve as industry global best practice for the advertisement of performance results. The GIPS Advertising Guidelines do not replace the GIPS standards nor do they absolve firms from presenting performance presentations that adhere to the requirements of the full GIPS standards. The Guidelines only apply to firms that already satisfy all of the requirements of the Standards on a firm wide basis and claim compliance with the Standards. Firms that claim compliance can choose to advertise that claim using the GIPS Advertising Guidelines.

The Guidelines represent the minimum disclosure and presentation requirements for firms that include a claim of compliance in their advertisements

All advertisements that include a claim of compliance must include the following:

1. A description of the firm.
2. How an interested party can obtain a presentation that complies with the requirements of GIPS and/or a list and description of all firm composites.
3. The GIPS Advertising Guidelines Compliance Statement.
4. A description of the strategy being advertised.
5. Period-to-date composite performance results
6. Composite results for either or both of the following time periods:
 - a. 1-, 3-, and 5- year annualized composite performance returns with the end-of-period date clearly identified (or annualized period since composite inception if inception is greater than 1 or less than 5 years). Periods of less than one year must not be annualized. The annualized returns must be calculated through the same period of time as presented in the corresponding compliant presentation.
 - b. 5 years of annual composite performance returns (or since composite inception if inception is less than 5 years). The annual returns must be calculated through the same period of time as presented in the corresponding compliant presentation.
7. Whether performance is shown gross and/or net of investment management fees.

8. The appropriate composite benchmark total return for the same periods for which the composite return is presented. Firms must also disclose the name and a description of the benchmark. (The appropriate composite benchmark return is the same benchmark total return as presented in the corresponding compliant presentation.) If no benchmark is presented, the advertisement must disclose why no benchmark is presented.
9. The currency used to express performance.
10. The description of the use and extent of leverage and derivatives, if leverage or derivatives are used as an active part of the investment strategy (i.e., not merely for efficient portfolio management) of the composite. Where leverage/derivatives do not have a material effect on returns, no disclosure is required.
11. When presenting non-compliant performance information for periods prior to 1 January 2000 in an advertisement, firms must disclose the period(s) and which specific information that is not compliant as well as provide the reason(s) the information is not in compliance with the GIPS standards.

Chapter 10: Sample Questions

1. The measure of performance which divides the portfolio's risk premium by the portfolio's beta is the _____.

- a. Sharpe measure
- b. Jensen measure
- c. Fama measure
- d. Treynor measure**

2. What is the expected return of the three stock portfolio described below?

	<u>Common Stock</u>	<u>Weight</u>	<u>Expected Return</u>
Ando Inc.		25%	12%
Bee Co.		50%	10%
Cool Inc.		25%	16%

- a. 12.44%
- b. 12.22%
- c. 12.33%
- d. 12%**

3. Sharpe's performance measure divides the portfolio's risk premium by the _____.

- a. Standard deviation of the rate of return**
- b. Variance of the rate of return
- c. Slope of the fund's characteristic line
- d. Risk free rate

4. Portfolio performance measure of "Information Ratio" _____.

- a. adjusts portfolio risk to match benchmark risk.
- b. compares portfolio returns to expected returns under CAPM.
- c. evaluates portfolio performance on the basis of return per unit of risk.
- d. calculates average differential return per unit of variability of differential return.**

USE THE FOLLOWING INFORMATION FOR THE NEXT TWO PROBLEMS

The data presented below has been collected at this point in time.

Fund	Beta	Standard		Return (%)	R_f (%)
		Deviation (%)			
AAA	1.00	5.02		17	6
BBB	1.05	4.04		14	6
CCC	0.89	3.02		10	6
Market	1.00	3.50		12	6

5. Compute the Sharpe Measure for the AAA fund.

- a. 4.49
- b. 2.74
- c. **2.19**
- d. 1.70

6. Compute the Jensen Measure for the BBB fund.

- a. 4.49
- b. 2.74
- c. 2.19
- d. **1.70**

CHAPTER 11: TAXATION³⁷

LEARNING OBJECTIVES:

After reading this chapter, the reader should be familiar with:

- Taxation of investors
- Taxation of various streams of Income
- Section 9A of Income Tax Act, 1961

11.1 Taxation of investors

The provisions of Income-tax are contained in the Income-Tax Act, 1961 ('the ITA') which extends to the whole of India. The Income-Tax Act comprises of Chapters I to XXIII which include provisions relating to the determination of the residential status of a person in India, exemptions, computation of total income, deductions, determination of tax liability, filing of income tax return, the procedure for assessments, etc.

Section 2(31) of the ITA provides an inclusive definition of a person. It provides that a person includes:

- a) an Individual;
- b) a Hindu undivided family (HUF);
- c) a Company;
- d) a firm;
- e) an Association of Person (AOP) or Body of Individual (BOI), whether incorporated or not;
- f) Local authority and
- g) every artificial juridical person, not falling within any of the above categories.

Persons referred under clause (e), (f) and (g) shall be deemed as a person even if it is not formed or established or incorporated with the object of deriving income, profits or gains.

³⁷ This chapter has incorporated updated provisions from the Finance Act, 2022.

11.1.1. Residential status

Income-tax liability of an assessee is calculated on basis of his 'Total Income'. What is to be included in the total income of assessee is greatly influenced by his residential status in India and his citizenship is of no consequence. For example, a person resident in India is liable to pay tax in India on his total world income. On the other hand, a person, who is a citizen of India but non-resident in India during the year, is liable to pay tax only on his Indian income. Total Income of an assessee cannot be computed unless his residential status is determined.

Hitherto, the residential status of an Individual was determined on the basis of his period of stay in India. However, with effect from Assessment Year 2021-22, the residential status of an Individual is determined on basis of his citizenship, period of stay in India and total income from Indian sources.

An assessee can be categorized into following residential status during the previous year:

- a) Resident in India
- b) Non-Resident in India

A resident individual and HUF are further sub-classified into the following status:

- a) Resident and Ordinarily Resident
- b) Resident but Not-ordinarily Resident

A new category of 'deemed resident' has been introduced in clause (1A) of Section 6 of the ITA with effect from Assessment Year 2021-22. As per Section 6(1A) of the ITA, an Indian citizen is deemed as resident in India irrespective of his stay in India if his total income, excluding income from foreign sources, [hereinafter referred to as 'Indian Income'] exceeds Rs. 15 lakhs during the previous year and he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature. Here, 'income from foreign sources' means income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India). Since it is a deeming fiction created by law without reference to stay in India, a deemed resident is always treated as Not-Ordinarily Resident.

11.1.1.1 Residential status of an Individual

The residential status of an Individual as inferred from provisions of Section 6 of the ITA can be categorised into the following categories:

1. Ordinary Resident in India
2. Resident But Not Ordinarily Resident in India
3. Deemed resident

4. Non-resident

An individual is treated as **resident in India** if he stays in India for:

- (a) 182 days or more during the relevant previous year; or
- (b) 60 days or more (but less than 182 days) during the relevant previous year and for 365 days or more in the last 4 years.

The condition (b) is not applicable in case of an Indian citizen or a person of Indian Origin in the following circumstances.

Exception 1: '60 days' to be replaced with '182 days' for the following categories:

- a) Indian citizen or Person of Indian Origin, who being outside India, comes on a visit to India during the previous year and having his Indian income during the previous year of less than Rs 15 lakhs;
- b) Indian citizen who leaves India during the previous year for the purpose of employment; or
- c) Indian citizen who leaves India during the previous year as a member of the crew of an Indian Ship.

Exception 2: '60 days' to be replaced with '120 days' for the following categories:

- a) Individual is an Indian Citizen or a Person of Indian Origin; and
- b) His Indian income during the previous year exceeds Rs. 15 lakhs

The individual, in this situation, is deemed as Not Ordinarily Resident in India.

Deemed Resident

In view of Section 6(1A) of the ITA, an Indian Citizen is deemed as resident in India during the previous year if his Indian income during that year exceeds Rs. 15 lakh and he is not liable to pay tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature. Such individual is deemed as 'Not Ordinarily Resident' in India. These provisions are applicable notwithstanding the number of days of stay in India during the previous year.

As per clause (29A) in section 2 of the ITA, liable to tax in relation to a person, means that there is a liability of tax on such person under any law for the time being in force in any

country, and shall include a case where subsequent to imposition of tax liability, an exemption has been provided.

However, it is clarified that if an individual is said to be a resident in India, then the provisions of deemed residency will not apply in its case.

Not Ordinarily Resident

Where an individual is treated as resident in India, he will be treated as Not Ordinarily Resident (NOR) in India if he satisfies any one condition specified below:

- a) He has been a non-resident in India for at least 9 out of 10 years immediately preceding the relevant previous year; or
- b) He has been in India for 729 days or less during the period of 7 years immediately preceding the previous year.
- c) He is an Indian Citizen or a Person of Indian Origin having Indian total income during the previous year exceeding Rs. 15 lakhs and present in India for a period of 120 days or more but less than 182 days during the previous year.
- d) He is a citizen of India who is deemed to be a resident in India under Section 6(1A) of the ITA.

If he does not satisfy any of the above-mentioned conditions, he is treated as Ordinarily Resident (ROR) in India.

Non-resident

An individual is treated as non-resident in India if he does not satisfy any of the conditions required to be fulfilled to become a resident.

11.1.1.2 Residential Status of HUF

The residential status of a HUF depends upon its place of control and management and residential status of its manager.

Resident in India

A HUF is said to be resident in India in any previous year in every case except where during that year the control and management of its affairs are situated wholly outside India. If principal decision-makers of the HUF take even a single decision in India, the HUF will be considered a resident as 'part of its control and management' will be deemed to be situated in India.

Example, if regular accounts and reports of the foreign HUF are forwarded to the coparceners in India from time to time by the employees, instructions are sought from the coparcener regarding the conduct of the foreign business and such instructions are duly sent, these are substantial indications of the control and management situated in India.

Non-Resident

A HUF is deemed as a non-resident in India if during the previous year, the control and management of its affairs are situated wholly outside India.

Resident and Not-Ordinarily Resident

A resident HUF is further categorised into Not-Ordinarily Resident in India if any of the following conditions are satisfied:

1. The manager of the HUF has been a non-resident in India for at least 9 years out of 10 years preceding the previous year; or
2. The manager of the HUF has been in India for 729 days or less during the period of 7 years preceding the previous year.

If the above conditions are not satisfied, the HUF will be categorised as Ordinarily Resident in India.

11.1.1.3 Residential status of a company

Indian Company

An Indian Company means a company formed and registered under the Companies Act. Indian companies are always treated as resident in India. Even if an Indian company is a subsidiary of a foreign company or it is controlled from a place located outside India, the Indian company is considered as resident in India. An Indian company can never be a non-resident person.

Foreign Company

A foreign company is treated as resident in India if during the relevant previous year its Place of Effective Management is in India.

Residential Status of Firm or AOP or BOI or Local Authority or Artificial Juridical Person

To determine the residential status of a firm or AOP or BOI or Local Authority or Artificial

Juridical Person, the residential status of partner or member during the previous year is not relevant.

A firm or AOP or BOI or Local Authority or Artificial Juridical Person is said to be resident in India in a previous year if any part of the control and management of its affairs is situated in India during that year. If principal decision-makers take even a single decision in India relating to the control and management of its affairs, the firm or AOP or BOI or Local Authority or Artificial Juridical Person will be considered a resident as 'part of its control and management' will be deemed to be situated in India. In other words, it is not necessary that substantial control and management should be situated or exercised in India.

A firm or AOP or BOI or Local Authority or Artificial Juridical Person is said to be non-resident in India in a previous year if the control and management of its affairs are situated wholly outside India during that year.

11.1.2. Place of Effective Management (POEM)

The Finance Act, 2015 amended the residency test for a company, wherein a company would be considered as resident in India if it is an Indian company, or if the company's POEM is in India during the relevant year. The POEM was defined as "a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made."

A foreign company is treated as resident in India if during the relevant previous year its Place of Effective Management is in India. For determination of Place of Effective Management, the Central Board of Direct Taxes (CBDT) has issued the guidelines in Circular No. 6/2017, dated January 24, 2017. These guidelines apply to a foreign company whose gross turnover or receipts during the year exceed Rs. 50 Crores.

11.1.3. Scope of total income

Scope of total income according to the residential status of an assessee shall be as under:

Resident and Ordinary Resident

A resident assessee shall be liable to pay tax in India on the following incomes:

- a) Income received or is deemed to be received by him in India in the previous year;
- b) Income accrues or arises or is deemed to accrue or arise to him in India during such year; and
- c) Income accrues or arises to him outside India during such year.

Resident but not Ordinary Resident

A resident but not ordinarily resident individual and HUF shall be liable to pay tax in India on the following incomes:

- a) Income received or is deemed to be received by him in India in the previous year;
- b) Income accrues or arises or is deemed to accrue or arise to him in India during such year; and
- c) Income accrues or arises to him outside India during such year if it is derived from a business controlled in India or a profession set up in India.

Non-Resident

In case of a non-resident assessee being an individual, HUF, firm, company or other person, following incomes shall be taxable in India:

- a) Income received or is deemed to be received in India by such person in the previous year; and
- b) Income accrues or arises or is deemed to accrue or arise to such person in India during such year.

Summary

Nature of income	Resident and ordinarily resident	Resident but not ordinarily resident	Non-resident
Income received or is deemed to be received in India	Taxable	Taxable	Taxable
Income accrues or arises or is deemed to accrue or arise to him in India	Taxable	Taxable	Taxable
Income accrues or arises outside India if it is derived from a business controlled in India or a profession set up in India	Taxable	Taxable	Not-taxable
Income accrues or arises outside India (from a business controlled from outside India or from a profession set up outside India)	Taxable	Not-taxable	Not-taxable

11.1.4 Characterisation of income

Gains arising from the transfer of securities held in the investee company or portfolio company may be treated either as 'Capital Gains' or as 'Business Income' for tax purposes, depending upon whether such securities were held as a capital asset or a trading asset (i.e., stock-in-trade).

Following are the key illustrative factors indicative of Capital Gains characterisation (not Business Income): -

- (a) Intention at the time of acquisition - capital appreciation;
- (b) Low transaction frequency;
- (c) Long period of holding;
- (d) Shown as investments in books of accounts (not stock in trade);
- (e) Use of owned funds (as opposed to loan) for acquisition; and
- (f) Main object in constitution document is to make investments.

Depending on the characterisation of income, the income and taxes would be computed accordingly.

11.2 Taxation of various streams of income

In the Income-tax Act, 1961, the income is computed under five heads of income, namely, salaries, income from house property, profits and gains of business or profession, capital gains and income from other sources. Total income is the aggregate of income computed under these heads. In case of PMS, the investor is investing in the underlying securities through the PMS, and not investing in the PMS per se. A PMS Client may earn:

- Income from dividend on shares and units of mutual funds
- Income from interest on Fixed Income Securities
- Short-term and/or long-term capital gains (or losses) on sale of Securities (shares, debentures, rights renunciations, units, etc.), if gains are categorized as capital gains
- Business Income (loss) from purchase and sale of Securities (shares, debentures, rights renunciations, units, etc.), if gains are categorized as business income

Each such income has a separate tax treatment in the hands of the PMS Client as discussed in the following sections.

11.2.1. Capital Gains

Any profits or gains arising from the transfer of a capital asset is taxable under the head 'capital gains' in the previous year in which such transfer takes place. However, every transfer

of a capital asset does not give rise to taxable capital gains because some transactions are either not treated as 'transfer' under Section 47 of the ITA or they are excluded from the meaning of a capital asset (i.e., rural agricultural land), or they enjoy exemption under Sections 54 to 54GB of the ITA. Determination of income taxable under the head capital gains depends upon various factors such as period of holding, cost of acquisition, full value of consideration, etc. The nature of capital gain, that is, short-term or long-term, is determined on the basis of period of holding of the capital asset. This distinction is important as the incidence of tax is higher on short-term capital gains as compared to the long-term capital gains. Generally, the period of holding of a capital asset is calculated from the date of its purchase or acquisition till the date of its transfer.

In general, a capital asset is deemed as 'short-term' if it is held by an assessee for a period of not more than 36 months, immediately preceding the date of its transfer. The general rule has a few exceptions wherein an asset, held for not more than 12 months or 24 months, are treated as short-term capital asset.

Following capital assets are treated as short-term capital asset if they are held for not more than 24 months immediately preceding the date of transfer:

- a) Unlisted shares of a company (equity shares or preferences shares);
- b) An immovable property, being land or building or both.

If they are held for more than 24 months immediately preceding the date of transfer, they are termed as long-term assets.

Following capital assets are treated as short-term capital asset if they are held for not more than 12 months immediately preceding the date of transfer:

- a) Listed Shares of a company on recognised stock exchange (equity shares or preference shares)
- b) Listed securities (Debentures, Bonds, Derivatives, Government securities etc.)
- c) Units of UTI (Listed or Unlisted)
- d) Units of Equity Oriented Fund (Listed or Unlisted)
- e) Zero Coupon Bonds (Listed or Unlisted)

If they are held for more than 12 months immediately preceding the date of transfer, they are termed as long-term assets.

As per the amendments in the Finance Act 2023, capital gains on redemption/ transfer of units of Specified Mutual Fund (i.e. a mutual fund where not more than 35% is invested in equity shares of an Indian company) acquired on or after 1 April 2023 or Market Linked Debentures shall be deemed to be capital gains arising from a Short-Term Capital Asset, irrespective of the period of holding.

Any profits or gains arising from transfer of a capital asset is taxable during the previous year in which such transfer takes place. The mechanism for computation of capital gains from transfer of a short-term capital asset is different from the one applicable in case of long-term capital asset.

Computation of short-term capital gain	
Full value of consideration	XXX
Less:	
a) Expenditure incurred wholly and exclusively in connection with the transfer	(XXX)
b) Cost of acquisition	(XXX)
c) Cost of improvement	(XXX)
d) Exemption under Sections 54B, 54D, 54G and 54GA of the ITA	(XXX)
Short-term capital gain or loss	XXX

Computation of long-term capital gain	
Full value of consideration	XXX
Less:	
a) Expenditure incurred wholly and exclusively in connection with transfer	(XXX)
b) Indexed cost of acquisition	(XXX)
c) Indexed cost of improvement	(XXX)
d) Exemption under Sections 54 to 54GB of the ITA	(XXX)
Long-term capital gain or loss	XXX

For computation of long-term capital gains, the assessee has to compute indexed cost of acquisition as explained below.

The Indexed Cost of acquisition shall be calculated in a two-step process. The first step is to calculate the cost of acquisition of capital asset. In the second step, such cost of acquisition is multiplied with the Cost Inflation Index (CII) of the year in which capital asset is transferred and divided by CII of the year in which asset is first held by the assessee or CII of 2001- 02, whichever is later.

$$\text{Indexed Cost of Acquisition} = \frac{\text{Cost of Acquisition} \times \text{CII of the year in which asset is transferred}}{\text{CII of the year in which asset is first held by assessee or CII of 2001-02, whichever is later}}$$

The benefit of indexation shall not be available in the respect of following long-term capital assets:

- a) Listed equity shares, units of equity oriented mutual funds or units of business trust, if the resultant capital gain is taxable under Section 112A of the ITA;
- b) Bond or debenture, except Capital Indexed Bonds issued by the Government and Sovereign Gold Bond issued by RBI under the Sovereign Gold Bond Scheme 2015;
- c) Slump sale;
- d) Units purchased in foreign currency by offshore funds;
- e) Securities as referred to in Section 115AD of the ITA purchased by FPIs/ specified funds;
- f) GDRs purchased in foreign currency; and
- g) Unlisted securities referred under Section 112(1)(c)(iii) of the ITA purchased by a non-resident.

Short-term Capital Gains

Short-term capital gain is chargeable to tax at the rate of 15% (plus applicable surcharge and cess) if such capital gain arises from transfer of securities, being listed equity shares, units of equity oriented fund or units of business trust, and such transaction is chargeable to Securities Transaction Tax (STT). If STT is not applicable, the short-term capital gain shall be taxable at applicable rate.

Long-term Capital Gains

Long-term capital gain in excess of Rs. 1 lakh shall be chargeable to tax at the rate of 10% (plus applicable surcharge and cess) if such capital gain arises from transfer of securities, being listed equity shares (STT is paid on acquisition and transfer), units of equity oriented fund (STT is paid on transfer) or units of business trust (STT is paid on transfer). The CBDT has issued a notification no. 60/2018/F. No. 370142/9/2017-TPL dated 1 October 2018 clarifying that condition of paying STT at time of acquisition shall not apply for all transactions of acquisition of equity shares other than the specified negative list.

The cost of acquisition of equity shares or units of an equity oriented mutual funds or units of business trust acquired before 1 February 2018, should be higher of:

- the actual cost of acquisition; and
- Lower of:
 - Fair market value as on 31 January 2018, determined in the prescribed manner; and
 - Value of consideration received or accruing upon transfer.

Table 11.1 provides tax rates on income earned by assessee on various long term and short term capital assets.

Table 11.1: Tax Rates

Sr. No	Particulars	Resident investors	Non-resident investors	FPI
		Tax rate (%) excluding applicable surcharge and health and education cess		
1	Short-term capital gains on transfer of listed equity shares, to be listed shares sold through offer for sale and units of an equity oriented mutual fund on which securities transaction tax ('STT') has been paid	15%	15%	15%
2	Any other short-term capital gains	30% [Note 1]	30% (in case of firms/ LLP/ foreign non-corporates)/ 40% (in case of foreign company)	30%
3	Long-term capital gains on	10%	10%	

	transfer of: (i) listed equity shares on which STT has been paid both at the time of acquisition and sale of such shares; and (ii) units of equity oriented mutual fund on which STT has been paid on transfer [Note 2]	[Note 3] [on income in excess of INR 1 lakh]	[Note 3] [on income in excess of INR 1 lakh]	10% [Note 3] [on income in excess of INR 1 lakh]
4	Long term capital gains on sale of listed bonds or listed debentures	10% (without indexation)	10% (without indexation)	10% (without indexation) [Note 3]
5	Long-term capital gains on transfer of unlisted bonds or unlisted debentures	20% (without indexation)	10% [Note 3]	10% [Note 3]
6	Long-term capital gains on transfer of unlisted securities (other than unlisted bonds and unlisted debentures)	20% (with indexation)	10% [Note 3]	10% [Note 3]

Note 1:

Assuming highest slab rates for individual investors.

In the case of domestic companies having total turnover or gross receipts not exceeding INR 400 crores in the FY 2021-2022 (AY 2022-23), the tax rate would be 25% (plus surcharge and health and education cess).

As per section 115BAC of the ITA, Individuals, AOPs, BOIs and HUF will have an option to pay tax on its total income at the reduced tax rates. The total income would, however, have to be computed without claiming prescribed deductions or exemptions. Further, the Finance Act, 2023, has provided that the rates under sub-section (1A) of section 115BAC (i.e. the reduced rates) shall be applicable unless an option is exercised under the sub-section (6) of section 115BAC to opt out of the regime. Further, the option of opting back to the regime under sub-section (1A) of section 115BAC can be exercised only once by a taxpayer earning income from business or profession. However, a person not having income from business or profession shall be able to exercise this option every year.

Note 2:

The cost of acquisition of equity shares or units of an equity oriented mutual funds acquired before 1 February 2018, shall be higher of:

- the actual cost of acquisition; and
- Lower of:
 - Fair market value as on 31 January 2018, determined in the prescribed manner; and
 - Value of consideration received or accruing upon transfer.

The CBDT issued a notification dated 1 October 2018, wherein the list of transactions has been specified in respect of which the provision of sub-clause (a) of clause (iii) of sub-section (1) of section 112A of the ITA shall not apply i.e. payment of STT on acquisition of equity shares.

Note 3:

Without considering indexation and foreign exchange fluctuation benefit.

11.2.2. Dividend income

The income in the nature of dividend on securities is taxable in the hands of the assessee under the head 'income from other sources'.

'Dividend' usually refers to the distribution of profits by a company to its shareholders. However, certain receipts are also deemed as a dividend under the provisions of the Income-tax Act, 1961. The deemed dividend, as defined in Section 2(22) of the ITA includes the following:

- a) Distribution of accumulated profits to shareholders entailing release of the company's assets;
- b) Distribution of debentures, debenture-stock or deposit certificates to shareholders out of the accumulated profits of the company and issue of bonus shares to preference shareholders out of accumulated profits;
- c) Distribution made to shareholders of the company on its liquidation out of accumulated profits;
- d) Distribution to shareholders out of accumulated profits on the reduction of capital by the company; and

e) Loan or advance made by a closely held company to its shareholder out of accumulated profits (subject to conditions).

Dividend declared at an annual general meeting is deemed to be the income of the previous year of the shareholder in which it is declared, distributed or paid. The interim dividend is deemed to be the income of the previous year in which the amount of such dividend is unconditionally made available by the company to the shareholder. In other words, it is chargeable to tax on accrual basis.

Up to Assessment Year 2020-21, domestic companies and mutual funds were liable to pay Dividend Distribution Tax (DDT) on the dividend. Therefore, shareholders or unit-holders were exempt from paying tax on the dividend income. After the abolition of dividend distribution tax by the Finance Act, 2020 with effect from Assessment Year 2021-22, if a company, mutual fund or business trust distributes dividend to its shareholders or unit-holders then such dividend income is taxable in the hands of such shareholders or unit-holders. The taxability of dividend and tax rate thereon shall depend upon the residential status of the shareholders and quantum of income. The company, mutual fund or business trust will be required to withhold appropriate taxes on payment of dividend income to investors. Further, interest expenditure (incurred in relation to such dividend income) up to 20% of the dividend income shall be allowable as a deduction from such dividend income earned by the investors.

11.2.3. Interest income

The income in the nature of interest on securities is taxable in the hands of the assessee under the head 'income from other sources'. This income is taxable as other sources if it is not in the nature of business income.

As per Section 2(28B) of the ITA, 'interest on securities' means:

- a) Interest on any security of the Central Government or a State Government;
- b) Interest on debentures/other securities for money issued by or on the behalf of a local authority or a company or a corporation, established by a Central or State or Provincial Act.

The word 'security' is not defined under the ITA. Therefore, the reference can be taken from Section 2(h) of the Securities Contracts (Regulation) Act, 1956. Thus, the interest on securities can arise from the following securities:

1. Bonds;
2. Debentures or debenture stock;
3. Government securities.

The tax is required to be deducted from interest on securities in accordance with Section 193 of the ITA for resident investors. In case of non-resident investors, appropriate tax deduction would be required under certain other provisions of the ITA.

11.2.4. Business income

When an assessee carries on any business or profession, the income arising from such business or profession shall be calculated and taxed under the head 'Profit and Gains of Business or Profession'.

ITA provides an inclusive definition of a business under Section 2(13) of the ITA that is "Business includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce or manufacture."

However, the term business does not necessarily mean trade or manufacture only. The word 'business' has a comprehensive meaning and may be used in many different connotations. It means an activity carried on continuously and systematically by a person by the application of his labour and skill to earn an income. In taxing statutes, it is used in the sense of an occupation or profession, which occupies time, attention and labour of a person, generally with the object of making a profit. Though the element of profit is usually present in 'business' but the motive of making a profit or actual earning of profit is not a necessary ingredient of business.

While computing the income under the head 'profits and gains of business or profession', a business transaction has to be classified into 'speculative' and 'non- speculative'. As per Section 43(5) of the ITA a transaction of purchase or sale of any commodity (including stocks and shares) is considered as a 'speculative transaction' if it is settled otherwise than through the actual delivery except where transaction is entered into to safeguard against losses (i.e., hedging transaction). Transaction in derivatives (including commodity derivatives) carried out in a recognised stock exchange are not considered as a speculative transactions.

Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, such business is treated as speculative business. The provisions for computation of business profits and tax rates are the same in case of a speculative and non- speculative business except treatment of losses. If any loss is suffered from a speculative business, it cannot be set off or adjusted against any profit from the non-speculative business. Further, such losses can be carried forward for 4 years only in contrast to 8 years allowed for non-speculative business losses.

11.2.5 Entitlement of benefit under Double Tax Avoidance Agreement (DTAA)

As per the provisions of the ITA, a non-resident shall be governed by the provisions of the applicable Double Taxation Avoidance Agreement (DTAA) or the provisions of the ITA, whichever are beneficial to such non-resident.

Non-residents who are eligible to avail the benefits of the relevant DTAA may opt to be taxed as per such DTAA on its income earned in India to the extent that they are more beneficial than the provisions of the ITA. The non-residents, however, will be required to obtain a Tax Residency Certificate and also submit a duly completed Form No. 10 F along with supporting documents, to the extent applicable.

The benefit under relevant DTAA will be subject to Indian General Anti-Avoidance Rules (GAAR) and Multilateral provisions.

11.3 Section 9A of ITA

SEBI (Portfolio Managers) Regulations, 2020 provides for an enabling framework for fund managers desirous of providing their services to overseas funds. In the Union Budget 2015-16, the Finance Minister announced amendments in the ITA. These changes were aimed at developing and promoting fund management industry in India. Section 9A was inserted in the ITA to provide a 'safe harbour' to overseas funds availing fund management services from India based managers, provided the fund and the manager comply with the requirements specified in the section.

Section 9A of the ITA provides that in case an eligible investment fund, established or incorporated or registered outside India, collects funds from its members and invests in India then such fund shall not be deemed to have a business connection nor will be regarded as resident in India just because fund management activity is carried out through a eligible fund manager located in India. However, this provision shall apply only when investment fund, as well as fund manager, comply with the conditions as prescribed under section 9A of the ITA.

The conditions which an eligible investment fund has to comply with are as follows:

- a. the fund is not a person resident in India;
- b. the fund is a resident of such country with which India has a tax treaty or the investment fund is established or incorporated in a specified country notified by the Central Government;
- c. the aggregate participation or investment in the fund by person resident in India shall not exceed 5% of the corpus fund. However, for the purpose of calculation of said aggregate participation or investment in the fund, any contribution made by eligible fund manager

during the first three years of the operation of the fund, not exceeding INR 25 crore, shall not be taken into account;

- d. the fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;
- e. the fund should have a minimum of 25 members who are, directly or indirectly, not connected persons;
- f. Any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding 10%;
- g. The aggregate participation interest, directly or indirectly, of 10 or less members along with their connected persons in the fund, shall be less than 50%.
- h. The fund shall not invest more than twenty per cent of its corpus in any entity
- i. the fund shall not make any investment in its associate entity;
- j. the monthly average of the corpus of the fund shall not be less than INR 100 crore. However, in case the fund is established or incorporated in the previous year then the corpus of fund shall not be less than INR 100 crore at the end of period of 12 months from the last day of the month in which the fund was established or incorporated;
- k. the fund shall not carry on or control and manage, directly or indirectly, any business in India;
- l. the fund is neither engaged in any activity which constitutes a business connection in India nor has any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf;
- m. the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken by him on its behalf is not less than the amount calculated in the prescribed manner.

The conditions specified in (e), (f) and (g) above shall not apply in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund or Category I FPI registered under SEBI (FPI) Regulations, 2019.

The conditions which eligible fund manager has to comply with are as follows:

- (a) the person is not an employee of the eligible investment fund or a connected person of the fund;
- (b) the person is registered as a fund manager or an investment advisor in accordance with the either SEBI (Portfolio Managers) Regulations, 2020, SEBI (Investment Advisers) Regulations, 2013 or SEBI (Mutual Fund) Regulations, 1996;
- (c) the person is acting in the ordinary course of his business as a fund manager;
- (d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than 20% of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager.

Chapter 11: Sample Questions

1. Commission received from business forms part of income from_____.
 - a. **Business and profession**
 - b. Capital Gains
 - c. Salary
 - d. Other sources

2. For a person to be qualified as a NRI, he must have stayed outside India for more than _____days in a previous financial year.
 - a. 365
 - b. 280
 - c. **182**
 - d. 150

3. In respect of investments in the debt securities, the foreign portfolio investors need not comply with any conditions or directions given by Reserve Bank of India, as long as it is meeting the restrictions and conditions as specified by SEBI in its SEBI (FPI) Regulations. State whether True or False.
 - a. True
 - b. **False**

CHAPTER 12: REGULATORY, GOVERNANCE AND ETHICAL ASPECTS OF PORTFOLIO MANAGERS

LEARNING OBJECTIVES:

After studying this chapter, the candidates should know about:

- Prevention of Money Laundering Act, 2002
- SEBI (Prohibition of Insider Trading) Regulation 2015
- SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003
- SEBI (Portfolio Managers) Regulations, 2020
- Best practices for Portfolio Managers

The Prevention of Money Laundering Act, 2002 (PMLA) forms the core of the legal framework put in place in India to combat money laundering. The provisions of PMLA came into force on July 1 2005. The objective of PMLA is, “to prevent money-laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for matters connected therewith or incidental thereto.”

Provisions of the PMLA stipulate that every banking company, financial institution and intermediary shall maintain a record of all transactions, the nature and value of which may be prescribed, whether such transactions comprise a single transaction or a series of transactions integrally connected to each other, and where such series of transactions take place within a month and furnish information of transactions and verify and maintain the records of the identity of all its clients. Such transactions include:

- All cash transactions of the value of more than Rs. 10 lakh or its equivalent in foreign currency.
- All series of cash transactions integrally connected to each other which have been valued below Rs. 10 lakh or its equivalent in foreign currency where such series of transactions take place within one calendar month and the aggregate value of such transaction exceeds Rs. 10 lakh.
- All suspicious transaction whether or not made in cash. For the purpose of suspicious transactions apart from ‘transactions integrally connected’, ‘transactions remotely connected or related’ shall also be considered.

The records which have been referred to in the above paragraphs have to be maintained for a period of 10 years from the date of cessation of the transactions between the clients and the banking company or financial institution or intermediary, as the case may be.

Section 3 of the PMLA 2002, defines offence of money laundering as:

"Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting and claiming it as untainted property shall be guilty of offence of money laundering."

Any person found indulging in any offence of money laundering as defined in section 3 of the PMLA, shall be punished as per provisions mentioned in section 4 of the Act.

The Obligations on banking companies, financial institutions and intermediaries has been specified in Section 12 of the PMLA 2002:

1. Every reporting entity shall –
 - a. maintain a record of all transactions, including information relating to transactions covered under clause (b) in such manner as to enable it to reconstruct individual transactions. This records shall be maintained for a period of five years from the date of transaction between a client and the reporting entity.
 - b. furnish to the Director within such time as may be prescribed, information relating to such transactions, whether attempted or executed the nature and value of which may be prescribed.
 - c. maintain record of documents evidencing identity of its clients and beneficial owners as well as account files and business correspondence relating to its clients. This records shall be maintained for a period of five years after the business relationship between a client and the reporting entity has ended or the account has been closed whichever is later.
2. Every information maintained, furnished or verified, save as otherwise provided under any law for the time being in force, shall be kept confidential.

Section 12 AA of PMLA stipulates enhanced due diligence by reporting entities. The details are given below:

1. Every reporting entity shall, prior to the commencement of each specified transaction:
 - (a) verify the identity of the clients undertaking such specified transaction by authentication under the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016 (18 of 2016) in such manner and subject to such conditions, as may be prescribed, provided that where verification requires authentication of a person who is not entitled to obtain an Aadhaar number under the provisions of the said Act, verification to authenticate the identity of the client undertaking such specified transaction shall be carried out by such other process or mode, as may be prescribed.

(b) take additional steps to examine the ownership and financial position, including sources of funds of the client, in such manner as may be prescribed.

(c) take additional steps as may be prescribed to record the purpose behind conducting the specified transaction and the intended nature of the relationship between the transaction parties.

The information obtained while applying the enhanced due diligence measures shall be maintained for a period of five years from the date of transaction between a client and the reporting entity.

(2) Where the client fails to fulfil the above conditions, the reporting entity shall not allow the specified transaction to be carried out. Specified transaction means:

- any withdrawal or deposit in cash, exceeding such amount;
- any transaction in foreign exchange, exceeding such amount;
- any transaction in any high value imports or remittances;
- such other transaction or class of transactions, in the interest of revenue or where there is a high risk of money-laundering or terrorist financing, as may be prescribed.

(3) Where any specified transaction or series of specified transactions undertaken by a client is considered suspicious or likely to involve proceeds of crime, the reporting entity shall increase the future monitoring of the business relationship with the client, including greater scrutiny or transactions in such manner as may be prescribed.

As per provisions of PMLA, intermediaries registered under SEBI Act, shall have to adhere to the provisions as given in the PMLA. A 'Principal Officer' needs to be designated who shall be responsible for ensuring compliance of the provisions of the PMLA. SEBI has issued necessary directives vide circulars from time to time, covering issues related to Know Your Client (KYC) norms, Anti-Money Laundering (AML), Client Due Diligence (CDD). These directives lay down minimum requirements and it is emphasised that the intermediaries may, according to their requirements specify additional disclosures to be made by the clients to address the concerns of money laundering and suspicious transactions undertaken by the clients.

12.2 SEBI (Prohibition of Insider Trading) Regulations 2015³⁸

Any dealing/trading done by an insider based on information which is not available in public domain, gives an undue advantage to insiders and affects market integrity. This is not in line with the principle of fair and equitable markets. In order to protect integrity of the market, the SEBI (Prohibition of Insider Trading) Regulations have been put in place.

³⁸ "the Board" refers to SEBI and Act refers to the SEBI Act.

Schedule C of the regulation specifies the minimum standards for code of conduct for intermediaries and fiduciaries to regulate, monitor and report trading by Designated Persons. The details are given below:

1. The compliance officer shall report to the board of directors or head(s) of the organisation (or committee constituted in this regard) and in particular, shall provide reports to the Chairman of the Audit Committee or other analogous body, if any, or to the Chairman of the board of directors or head(s) of the organisation at such frequency as may be stipulated by the board of directors or head(s) of the organization but not less than once in a year.
2. All information shall be handled within the organisation on a need-to-know basis and no unpublished price sensitive information shall be communicated to any person except in furtherance of legitimate purposes, performance of duties or discharge of legal obligations. The code of conduct shall contain norms for appropriate Chinese Wall procedures, and processes for permitting any designated person to “cross the wall”.
3. Designated persons and immediate relatives of designated persons in the organisation shall be governed by an internal code of conduct governing dealing in securities.
4. Designated persons may execute trades subject to compliance with these regulations. Trading by designated persons shall be subject to pre-clearance by the compliance officer(s), if the value of the proposed trades is above such thresholds as the board of directors or head(s) of the organisation may stipulate.
5. The compliance officer shall confidentially maintain a list of such securities as a “restricted list” which shall be used as the basis for approving or rejecting applications for pre-clearance of trades.
6. Prior to approving any trades, the compliance officer shall seek declarations to the effect that the applicant for pre-clearance is not in possession of any unpublished price sensitive information. He shall also have regard to whether any such declaration is reasonably capable of being rendered inaccurate.
7. The code of conduct shall specify any reasonable timeframe, which in any event shall not be more than seven trading days, within which trades that have been pre-cleared have to be executed by the designated person, failing which fresh pre-clearance would be needed for the trades to be executed.
8. The code of conduct shall specify the period, which in any event shall not be less than six months, within which a designated person who is a connected person of the listed company and is permitted to trade in the securities of such listed company, shall not execute a contra trade. The compliance officer may be empowered to grant relaxation from strict application of such restriction for reasons to be recorded in writing provided that such relaxation does not violate these regulations. Should a contra trade be executed, inadvertently or otherwise, in violation of such a restriction, the profits from such trade shall be liable to be disgorged for remittance to the Board for credit to the Investor Protection and Education Fund administered by the Board under the Act.

Provided that this shall not be applicable for trades pursuant to exercise of stock options.

9. The code of conduct shall stipulate such formats as the board of directors or head(s) of the organisation (or committee constituted in this regard) deems necessary for making applications for pre-clearance, reporting of trades executed, reporting of decisions not to trade after securing pre-clearance, and for reporting level of holdings in securities at such intervals as may be determined as being necessary to monitor compliance with these regulations.

10. Without prejudice to the power of the Board under the Act, the code of conduct shall stipulate the sanctions and disciplinary actions, including wage freeze, suspension, recovery, clawback etc., that may be imposed, by the intermediary or fiduciary required to formulate a code of conduct under sub-regulation (1) and sub-regulation (2) of regulation 9, for the contravention of the code of conduct. Any amount collected under this clause shall be remitted to SEBI for credit to the Investor Protection and Education Fund administered by SEBI under the SEBI Act.

11. The code of conduct shall specify that in case it is observed by the intermediary or fiduciary required to formulate a code of conduct under sub-regulation (1) or sub-regulation (2) of regulation 9, respectively, that there has been a violation of these regulations, such intermediary or fiduciary shall promptly inform the stock exchange where the concerned securities are traded, in such form and such manner as may be specified by SEBI from time to time.

12. All designated persons shall be required to disclose name and Permanent Account Number or any other identifier authorized by law of the following to the intermediary or fiduciary on an annual basis and as and when the information changes:

a) immediate relatives

b) persons with whom such designated person(s) shares a material financial relationship

c) Phone, mobile, and cell numbers which are used by them

In addition, names of educational institutions from which designated persons have graduated and names of their past employers shall also be disclosed on a one time basis.

Explanation – the term “material financial relationship” shall mean a relationship in which one person is a recipient of any kind of payment such as by way of a loan or gift from a designated person during the immediately preceding twelve months, equivalent to at least 25% of the annual income of such designated person but shall exclude relationships in which the payment is based on arm’s length transactions.

13. Intermediaries and fiduciaries shall have a process for how and when people are brought ‘inside’ on sensitive transactions. Individuals should be made aware of the duties and responsibilities attached to the receipt of Inside Information, and the liability that attaches to misuse or unwarranted use of such information.

12.3 SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003

SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 prohibits fraudulent, unfair and manipulative trade practices in securities.

Regulation 2(1)(c) defines fraud as inclusive of any act, expression, omission or concealment committed to induce another person or his agent to deal in securities.

Chapter II of the regulations prohibits certain dealings in securities covering buying, selling or issuance of securities. The regulations prohibit a person to, directly or indirectly:

- buy, sell or deal in securities in a fraudulent manner.
- use or employ in connection with issue, purchase or sale of any security listed or proposed to be listed, any manipulative or deceptive device or contrivance in contravention of the provisions of SEBI Act or rules or regulations made thereunder.
- employ any device, scheme or artifice to defraud in connection with dealing in or issue of any security listed or proposed to be listed.
- engage in any act, practice, course of business which would operate as a fraud or deceit in connection with any dealing in or issue of securities, which are listed or proposed to be listed.
- indulge in a fraudulent or an unfair trade practices in securities.

Dealing in securities shall be deemed to be a manipulative, fraudulent or an unfair trade practice if it involves any of the following:

- a) knowingly indulging in an act which creates false or misleading appearance of trading in the securities market;
- b) dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;
- c) inducing any person to subscribe to an issue of the securities for fraudulently securing the minimum subscription to such issue of securities, by advancing or agreeing to advance any money to any other person or through any other means;
- d) inducing any person for dealing in any securities for artificially inflating, depressing, maintaining or causing fluctuation in the price of securities through any means including by paying, offering or agreeing to pay or offer any money or money's worth, directly or indirectly, to any person;
- e) any act or omission amounting to manipulation of the price of a security including, influencing or manipulating the reference price or bench mark price of any securities;

- f) knowingly publishing or causing to publish or reporting or causing to report by a person dealing in securities any information relating to securities, including financial results, financial statements, mergers and acquisitions, regulatory approvals, which is not true or which he does not believe to be true prior to or in the course of dealing in securities;
- g) entering into a transaction in securities without intention of performing it or without intention of change of ownership of such security; selling, dealing or pledging of stolen, counterfeit or fraudulently issued securities whether in physical or dematerialized form.

12.4 SEBI (Portfolio Managers) Regulations, 2020

The following section gives a summary of the SEBI (Portfolio Managers) Regulations, 2020. Major parts of the regulation have been covered in the previous chapters as and where required.

As per the Regulation:

Portfolio means the total holdings of securities and goods belonging to any person;

Principal officer means an employee of the portfolio manager who has been designated as such by the portfolio manager and is responsible for (i) the decisions made by the portfolio manager for the management or administration of portfolio of securities or the funds of the client, as the case may be; and (ii) all other operations of the portfolio manager.

Registration as Portfolio Manager

No person shall act as portfolio manager unless he holds a certificate granted by SEBI under SEBI PMS Regulations.

Conditions of registration

The certificate of registration granted under Portfolio Managers Regulations is subject to the following conditions, namely: -

- a) the portfolio manager shall abide by the provisions of the SEBI Act and SEBI Portfolio Managers regulations;
- b) the portfolio manager shall obtain prior approval of SEBI in case of change in control in such manner as may be specified by SEBI.

(b) the portfolio manager shall forthwith inform SEBI in writing, if any information or particulars previously submitted to SEBI are found to be false or misleading in any material particular or if there is any material change in the information already submitted;

(c) the portfolio manager shall pay the fees for registration in the manner provided in SEBI PMS regulations;

(d) the portfolio manager shall take adequate steps for redressal of grievances of the investors within the time stipulated by SEBI and keep SEBI informed about the number, nature and other particulars of the complaints received;

(e) the portfolio manager shall maintain the net worth specified in PMS Regulations at all times during the period of the certificate. (This is not applicable in case of co-investment portfolio manager). (This is not applicable in case of co-investment portfolio manager).

Management or administration of clients' portfolio

The money or securities accepted by the portfolio manager shall not be invested or managed by the portfolio manager except in terms of the agreement between the portfolio manager and the client. Any renewal of portfolio on maturity of the initial period shall be deemed as a fresh placement.³⁹

Notwithstanding anything contained in the agreement as referred in the PMS regulation, the funds or securities can be withdrawn by the client before the maturity of the contract under the following circumstances, namely;

- a) voluntary or compulsory termination of portfolio management services by the portfolio manager or the client;⁴⁰
- b) suspension or cancellation of the certificate of registration of the portfolio manager by SEBI;
- c) bankruptcy or liquidation of the portfolio manager.

The discretionary portfolio manager shall invest funds of his clients in the securities listed or traded on a recognized stock exchange, money market instruments,⁴¹ units of Mutual Funds and other securities as specified by SEBI from time to time, on behalf of their clients.

The portfolio manager offering non-discretionary or advisory services to clients may invest or provide advice for investment up to 25% of the assets under management of such clients in unlisted securities, in addition to the securities permitted for discretionary portfolio management

The portfolio manager may offer discretionary or non-discretionary or advisory services for investment upto 100 % of the assets under management of the large value of accredited

³⁹ This is not applicable to co-investment portfolio manager.

⁴⁰ Not applicable to co-investment portfolio manager.

⁴¹ "Money market instruments" includes commercial paper, trade bill, treasury bills, certificate of deposit and usance bills.

investors in unlisted securities, subject to the appropriate disclosures in the disclosure document and the terms agreed between the client and the portfolio manager.

The portfolio manager shall segregate each clients' funds and portfolio of securities and keep them separately from his own funds and securities and be responsible for safekeeping of clients' funds and securities.

The portfolio manager shall not hold the securities belonging to the portfolio account, in its own name on behalf of its clients either by virtue of contract with clients or otherwise.

The portfolio manager may, subject to authorization by the client in writing, participate in securities lending.

Foreign portfolio investors may avail of the services of a portfolio manager. Every portfolio manager shall appoint a custodian in respect of securities managed or administered by it, however, this regulation shall not apply to a) portfolio manager who provides only advisory services b) co-investment portfolio manager.

Submission of networth certificate

Every portfolio manager shall furnish to SEBI a net worth certificate issued by a chartered accountant as and when required by SEBI.

Reports to be furnished to the client

(1) The portfolio manager shall furnish periodically a report to the client, as agreed in the contract, but not exceeding a period stipulated by SEBI and as and when required by the client and such report shall contain the following details, namely:⁴²

(a) the composition and the value of the portfolio, description of securities and goods, number of securities, value of each security held in the portfolio, units of goods, value of goods, cash balance and aggregate value of the portfolio as on the date of report;

(b) transactions undertaken during the period of report including date of transaction and details of purchases and sales;

(c) beneficial interest received during that period in the form of interest, dividend, bonus shares, rights shares, etc.;

(d) expenses incurred in managing the portfolio of the client;

⁴² The report referred to in sub-regulation may be made available on the website of the portfolio manager with restricted access to each client.

(e) details of risk foreseen by the portfolio manager and the risk relating to the securities recommended by the portfolio manager for investment or disinvestment;

(f) default in payment of coupons or any other default in payments in the underlying debt security and downgrading to default rating by the rating agencies, if any;

(g) details of commission paid to distributor(s) for the particular client.

On termination of the contract, the portfolio manager shall give a detailed statement of accounts to the client and settle the account with the client as agreed in the contract.

The client shall have the right to obtain details of his portfolio from the portfolio managers.

The portfolio manager shall take steps to rectify the deficiencies made out in the auditor's report within two months from the date of the auditor's report as specified.

Disclosures

A portfolio manager shall disclose to SEBI as and when required the following information namely:

- (i) particulars regarding the management of a portfolio;
- (ii) any change in the information or particulars previously furnished, which have a bearing on the certificate granted to him;
- (iii) the names of the clients whose portfolio he has managed;
- (iv) particulars relating to the net worth requirement.

Exemption from strict enforcement of regulations in special cases:

SEBI has allowed exemptions from enforcement of SEBI Portfolio Managers Regulations for promoting innovation relating to testing new products, processes, services, business models, etc. in live environment of regulatory sandbox in the securities markets. The exemption may be given to any person or class of persons from the operation of all or any of the provisions of Portfolio Managers Regulations for a period not exceeding 12 months, subject to satisfying specified eligibility conditions prescribed by SEBI from time to time.⁴³

⁴³ Regulatory Sandbox means a live testing environment where new products, processes, services, business models, etc. may be deployed on a limited set of eligible customers for a specified period of time, for furthering innovation in the securities market, subject to such conditions as may be specified by SEBI.

Prior consent of client in regarding investments in the securities of associates/related parties⁴⁴

The portfolio manager may make investments in the securities of its related parties or associates only after obtaining the prior consent of the client in such manner as may be specified by SEBI from time to time. The consent form shall have an option to indicate dissent in case the client does not want to undertake any investment in the securities of associates/related parties of the Portfolio Manager. The client can even specify a limit on investment in such securities. The portfolio managers are required to maintain records and documents pertaining to prior positive consent or dissent as the may be; instances of the passive breach of investment limits (if any), steps taken to rectify the passive breach of investment limits; waiver obtained from the client regarding rebalancing in the event of a passive breach of investment limits.

The portfolio manager shall ensure compliance with the prudential limits on investments as specified by SEBI.

Portfolio Manager shall invest upto a maximum of 30 percent of their client's portfolio (as a percentage of client's asset's under management) in the securities of their own associates/related parties. Further the portfolio manager has to ensure the following limits:

Limits on investment in securities of associates/ related parties of Portfolio Managers

Security	Limit for investment in single associate/related party (as percent of client's AUM)	Limit for investment across multiple associates/related parties (as percent of Client's AUM)
Equity	15 %	25 %
Debt and Hybrid securities	15 %	25 %
Equity+Debt+Hybrid securities [Hybrid securities includes REITs, InvITs, convertible debt securities and other securities of like nature)	30 %	

Note: These limits are applicable to direct investments by Portfolio Managers in equity and debt/hybrid securities of their own associates/related parties and not to any investments in mutual funds.

⁴⁴ Regulation 22 (1A) and SEBI Circular SEBI/HO/IMD/IMD-I/DOF1/P/CIR/2022/112 dated August 26, 2022
https://www.sebi.gov.in/legal/circulars/aug-2022/circular-for-portfolio-managers_62374.html

Exemption from strict enforcement of regulations in special cases:

SEBI has allowed exemptions from enforcement of SEBI Portfolio Managers Regulations for promoting innovation relating to testing new products, processes, services, business models, etc. in live environment of regulatory sandbox in the securities markets. The exemption may be given to any person or class of persons from the operation of all or any of the provisions of Portfolio Managers Regulations for a period not exceeding 12 months, subject to satisfying specified eligibility conditions prescribed by SEBI from time to time.⁴⁵

12.4.1 Code of conduct for portfolio manager

The Code of conduct for the portfolio manager is specified in the Schedule III of the SEBI PMS Regulation.

1. A portfolio manager shall, in the conduct of his business, observe high standards of integrity and fairness in all his dealings with his clients and other portfolio manager.
2. The money received by a portfolio manager from a client for an investment purpose should be deployed by the portfolio manager as soon as possible for that purpose and money due and payable to a client should be paid forthwith.
3. A portfolio manager shall render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgement. The portfolio manager shall either avoid any conflict of interest in his investment or disinvestment decision, or where any conflict of interest arises, ensure fair treatment to all his customers. It shall disclose to the clients, possible source of conflict of interest, while providing unbiased services. A portfolio manager shall not place his interest above those of his clients.
4. A portfolio manager shall not execute any trade against the interest of the clients in its proprietary account.
5. A portfolio manager shall not make any statement or indulge in any act, practice or unfair competition, which is likely to be harmful to the interests of other portfolio managers or is likely to place such other portfolio managers in a disadvantageous position in relation to the portfolio manager himself, while competing for or executing any assignment.

⁴⁵ Regulatory Sandbox means a live testing environment where new products, processes, services, business models, etc. may be deployed on a limited set of eligible customers for a specified period of time, for furthering innovation in the securities market, subject to such conditions as may be specified by SEBI.

6. A portfolio manager shall not make any exaggerated statement, whether oral or written, to the client either about the qualification or the capability to render certain services or his achievements in regard to services rendered to other clients.

7. At the time of entering into a contract, the portfolio manager shall obtain in writing from the client, his interest in various corporate bodies which enables him to obtain unpublished price-sensitive information of the body corporate.

8. A portfolio manager shall not disclose to any clients, or press any confidential information about his client, which has come to his knowledge.

9. The portfolio manager shall where necessary and in the interest of the client take adequate steps for the transfer of the clients' securities and for claiming and receiving dividends, interest payments and other rights accruing to the client. It shall also take necessary action for conversion of securities and subscription for/renunciation of rights in accordance with the clients' instruction.

10. A portfolio manager shall endeavour to (a) ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims and are made aware of attendant risks before any investment decision is taken by them; (b) render the best possible advice to the client having regard to the client's needs and the environment, and his own professional skills; (c) ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

11. A portfolio manager shall not be a party to (a) creation of false market in securities; (b) price rigging or manipulation of securities; (c) passing of price sensitive information to brokers, members of the recognized stock exchanges and any other intermediaries in the capital market or take any other action which is prejudicial to the interest of the investors.

No portfolio manager or any of its directors, partners or manager shall either on their own or through their associates or family members or relatives enter into any transaction in securities of companies on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment.

12. (a) A portfolio manager or any of its employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real time, unless a disclosure of his long or short position in the said security has been made, while rendering such advice.

(b) In case an employee of the portfolio manager is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

13. (a) The portfolio manager shall abide by the SEBI Act, Rules, and regulations made thereunder and the Guidelines/Schemes issued by SEBI.
- (b) The portfolio manager shall comply with the code of conduct specified in the SEBI (Prohibition of Insider Trading) Regulations, 2015.
- (c) The portfolio manager shall not use his status as any other registered intermediary to unduly influence the investment decision of the clients while rendering portfolio management services.

Eligible Fund Managers

The overseas funds availing fund management services from India based managers is designated as 'Eligible Investment Funds' and the India based fund manager providing such fund management services is designated as 'Eligible Fund Managers'. One of the requirements for a fund manager to become 'Eligible Fund Manager' is to be registered with SEBI under specified regulations.

SEBI (Portfolio Managers) Regulations, 2020 has a separate Chapter III for 'Eligible Fund Managers'. These regulations permit existing portfolio managers as well as new applicants, compliant with requirements specified under Section 9A of Income Tax Act, 1961, to act as 'Eligible Fund Managers'. Existing portfolio managers desirous of providing fund management services to overseas funds, if compliant with requirements specified in Section 9A of Income Tax Act, 1961, may pursue this activity on intimation and submission of declarations to SEBI. A new applicant desirous of providing fund management services to overseas funds, and compliant with the requirements specified in Section 9A of Income Tax Act, 1961, may seek registration with SEBI, as laid out in the Chapter III. Further, Chapter III also defines the obligations and responsibilities of such fund managers. Recognizing the different business requirements of such fund managers, as compared to the existing Portfolio Managers, SEBI has also identified certain provisions of the Portfolio Managers Regulations which would not be applicable to Eligible Fund Managers pertaining to their activities as fund manager to Eligible Investment Funds. Some of the provisions are listed below:

- (a) High Water Mark Principle regarding calculation of fees, disclosure of fees;
- (b) Obligation to act in a fiduciary capacity;
- (c) Audit of overseas fund;
- (d) Entering into agreement between the portfolio manager and overseas fund;
- (e) Reporting requirements in respect of overseas fund;
- (f) Minimum investment requirements (i.e. INR 50 Lakhs), etc.

Obligation and Responsibilities of Eligible Fund Managers

An eligible fund manager shall be required to:

- (a) comply with the requirements specified under Section 9A of the Income-tax Act, 1961 or any amendment, notification, clarification, guideline issued thereunder;
- (b) offer discretionary or non-discretionary or advisory services or a combination thereof to eligible investment funds;
- (c) operate in accordance to its mutually agreed contract with the eligible investment funds
- (d) provide all material disclosures to eligible investment funds;
- (e) segregate funds and securities of each eligible investment fund;
- (f) segregate the funds and securities of eligible investment funds from those of its other clients
- (g) maintain and segregate its books and accounts pertaining to its activities as a portfolio manager to eligible investment funds and other clients;
- (h) appoint a custodian:

Provided that the requirement of compliance with this sub-regulation would not arise in case an eligible investment fund has already appointed a custodian under the applicable act or regulations

- (i) keep the funds of eligible investment funds in scheduled commercial banks.

Provided the requirement of compliance with this sub-regulation would not arise in case an eligible investment fund does not intend to invest in Indian securities.

- (j) maintain any additional records as may be specified by SEBI and disclose the same to SEBI as and when required;
- (k) provide quarterly reports to SEBI;
- (l) ensure compliance with the Prevention of Money Laundering Act, 2002 and rules and regulations made thereunder;
- (m) abide by the provisions in these regulations and circulars / guidelines issued by SEBI from time to time.

12.4.2. Code of conduct for PMS Distributors⁴⁶

The code of conduct requires all PMS distributors to:

⁴⁶ https://www.sebi.gov.in/legal/circulars/feb-2020/guidelines-for-portfolio-managers_45981.html
https://www.sebi.gov.in/sebi_data/commondocs/feb-2020/Ann_c_p.pdf

- i. Adhere to SEBI (Portfolio Managers) Regulations, 2020 and circulars issued from time to time related to distributors, distribution, advertising practices of Portfolio Management Services, etc.
- ii. Maintain high standards of integrity, promptitude and fairness in the conduct of all their business.
- iii. Act with due skill, care and diligence in the conduct of all their business.
- iv. Consider investor's interest, risk profiling and suitability to their financial needs while marketing Portfolio Management Services.
- v. Take necessary steps to ensure that the clients' interest is protected.
- vi. Ensure that commission or incentive shall never form the basis for recommending Portfolio Management Services.
- vii. Be fully conversant with the Disclosure Document, Investment Approaches, fees and charges and the terms of agreement to be entered between the client and the Portfolio Manager.
- viii. Disclose to the clients all material information including the details of distribution commissions for various investment approaches.
- ix. Assist clients in completing KYC and In-Person Verification related procedures.
- x. Provide full and latest information about investment approaches and also highlight the assumptions made in performance calculations, risk assessments, performance projections etc., if any, for such investment approaches.
- xi. Inform the clients about the risks and level of control over the administration of Portfolio associated with the type of Portfolio Management Services offered (i.e. Discretionary, Non-discretionary or Advisory).
- xii. Abstain from assuring returns in any type of Investment Approach and from any kind of mis-representation.
- xiii. Abstain from attracting clients through unethical means such as offer of rebate/gifts etc.
- xiv. Maintain necessary infrastructure to provide support to clients in timely receipt of disclosure document, statement of portfolio and performance, statement of fees, audit report, etc.
- xv. Maintain confidentiality of clients' details, deals and transactions, which they come to know in their business relationship.
- xvi. Abstain from making negative statements about other Portfolio Managers or Investment Approaches. Make comparisons, if any, only with the similar and comparable products along with complete facts.
- xvii. Not indulge in any manipulative, fraudulent or deceptive practices or spread rumours with a view to make personal gain.
- xviii. Hold valid Certification, as specified by SEBI, at all times.

[Distributors have to mandatorily obtain registration from APMI]

12.5 Best practices for portfolio managers

In the following section some good practices to be followed by investment management professionals are discussed:

12.5.1 Research objectivity

Objectivity and independence of analysts doing research is an important attribute to strengthen investor confidence in the financial markets.

The CFA Institute has developed standards for research objectivity. These standards are intended to be specific, measurable norms for managing and disclosing conflicts of interest that may impede a research analyst's ability to conduct independent research and make objective recommendations. Firms that adopt the CFA Institute-Research Objectivity Standards (ROS) demonstrate their commitment to manage conflicts of interest effectively and to provide full and fair disclosure of these conflicts to all investors who have access to their research.

A fundamental principle of ethical investment practice is that the best interests of the investing client must always take precedence over the interests of investment professionals and their employers. Every investment professional is personally responsible for ensuring that his or her independence and objectivity is maintained when preparing research reports, making investment recommendations, and taking investment action on behalf of clients.

The key requirements for firms adopting the ROS are given below:

1. Developing a formal written research objectivity policy.
2. Employees of the firm who present and discuss their research and recommendations in public appearances to fully disclose personal and firm conflicts of interest to the host or interviewer and, whenever possible, to the audience.
3. Firms must require research reports and recommendations to have a basis that can be substantiated as reasonable and adequate.
4. Firms that engage in, or collaborate on, investment banking activities must segregate research analysts from the investment banking department
5. Firms must establish and implement salary, bonus, and other compensation for research analysts that align compensation with the quality of the research and the accuracy of the recommendations over time and do not directly link compensation to investment banking or other corporate finance activities on which the analyst collaborated.

6. Firms must implement policies and procedures that manage the working relationships that research analysts develop with the management of subject companies.
7. Firms must have policies and procedures that manage covered employees' "personal investments and trading activities" effectively.
8. Firms must provide full and fair disclosure of all conflicts of interest to which the firm or its covered employees are subject.
9. Firms must establish a rating system that is useful for investors and for investment decision-making; and provides investors with information for assessing the suitability of the security to their own unique circumstances and constraints.

12.5.2 Soft dollar practices

Investment management firms pay commission to brokerage firms for executing trades. Soft dollar arrangements are the one where investment managers pay a higher commission to the brokerage firm in lieu of enjoying additional services like access to their research reports, hardware, software or even non-research-related services, etc..

In portfolio management services, the investor is charged the brokerage fee. Soft dollar arrangement must be avoided as it is abusive in nature. There should be transparency with regard to the services availed by the buy side firm such as portfolio manager and the charges paid towards them.

For the mutual fund industry, SEBI has stated through a circular in 2016 (SEBI/HO/IMD/DF2/CIR/P/2016/42) that such arrangements between AMCs and brokers should be limited to only benefits (like free research report, etc.) that are in the interest of investors and the same should be suitably disclosed. The portfolio managers may also follow the same as a matter of good ethical practice.

12.6 Investor Charter for Portfolio Management Services

With a view to enhancing awareness of investors about the various activities which an investor deals with while availing the services provided by the portfolio managers, an investor charter has been issued by SEBI. The investor charter details different services provided by the portfolio managers to the investors along with estimated timelines, like account opening, agreement with the portfolio manager, periodic statements to the investors, investor grievance redressal mechanism, responsibility of investors at one single for ease of reference. All registered portfolio managers have to notify the same to their clients and also are required to prominently display on their websites.⁴⁷

⁴⁷ Candidates are advised to read Investor Charter for PMS in more details: https://www.sebi.gov.in/legal/circulars/dec-2021/publishing-of-investor-charter-and-disclosure-of-investor-complaints-by-portfolio-managers-on-their-websites_54546.html

Chapter 12: Sample Questions

1. Record of transactions to be maintained under the Prevention of Money Laundering Act includes Cash transactions of the value of more than _____.
 - a. **Rs.10 lakh**
 - b. Rs. 20 lakh
 - c. Rs. 25 lakh
 - d. Rs. 1 crore

- 2.A foreign portfolio investor can invest in the following securities?
 - a. Domestic Mutual Fund Schemes
 - b. Derivatives traded on a recognised stock exchange
 - c. Rupee denominated credit enhanced bonds
 - d. **All of the above**

- 3.The objective of the SEBI (Prohibition of Insider Trading) Regulations is to prohibit insider from _____ on matters relating to insider trading.
 - a. Dealing
 - b. Communicating
 - c. Counselling
 - d. **All of the above**

- 4.The SEBI Fraudulent and Unfair Trade Practices Regulations prohibit a person to, directly or indirectly _____ securities in a fraudulent manner.
 - a. Buy
 - b. Sell
 - c. Deal In
 - d. **All of the above**

SAMPLE CASE STUDY QUESTIONS

Case Study 1:

You are an PMS distributor. You are comparing the performance of various funds. The following table gives you the performance of two funds. Comment on their performance by ranking them on various risk and return measures and ratios.

The yield on government bond is 5 percent.

	Large Cap Fund A	Large Cap Fund B
CAGR - GMR	9.97%	9.39%
Standard Deviation	10.26%	14.89%
Beta	1.05	0.29
Semi Standard Deviation	7.53%	11.46%
Tracking Error	3.17%	16.07%
Information Ratio	48.24%	21.39%

- Rank the funds on the basis of Sharpe Ratio:
 - Rank 1 – Fund A & Rank 2 – Fund B**
 - Rank 1 – Fund A & Rank 2 – Fund B
 - Both the funds have generated the same risk-adjusted return
 - Cannot calculate the Sharpe Ratio with the given information
- Calculate the Sharpe Ratio of Fund A
 - 0.4844**
 - 0.2948
 - 0.4048
 - 0.5467
- Calculate the Treynor Ratio of Fund A
 - 0.0473**
 - 0.0948
 - 0.0048
 - 0.0467
- Calculate Sortino ratio for Fund A
 - 0.6600**
 - 0.09867
 - 0.9845

- d. Cannot calculate Sortino Ratio with the given information
5. Calculate the Alpha for Fund A⁴⁸
- 0.01529208**
 - 0.00029208
 - 0.00529208
 - 0.09529208

Case Study 2:

You are provided with following information about ten funds.

	AUM (Rs. Cr)	Benchmark	Alpha	Tracking Error
1	11234	SENSEX	0.21	0.0124
2	10980	SENSEX	0.56	0.0098
3	5670	SENSEX	0.76	0.0087
4	12050	SENSEX	0.98	0.1245
5	680	Nifty 50	0.29	0.0012
6	1180	Nifty 50	0.54	0.0211
7	1250	Nifty 50	0.43	0.2341
8	13400	Nifty 50	0.98	0.4598
9	9870	Nifty 50	0.35	0.5431
10	2400	Nifty 50	0.26	0.0012

- How would you rank these funds on performance if they are passively managed?
 - On the basis of information ratio
 - On the basis of Alpha
 - On the basis of Tracking error**
 - On the basis on AUM
- Suppose these funds are index funds, which fund has performed the best?
 - Fund no. 5 & 10 as they have the lowest tracking error**
 - Fund no. 9 as it has the highest tracking error
 - Fund no. 8 as it has the highest AUM
 - Fund no. 8 and 4 as they have generated the highest alpha
- Calculate the information Ratio for Fund no. 1:
 - 16.93**
 - 0.002604
 - 0.5904

⁴⁸ Explanation: To calculate Alpha for Fund B, we need to know the market return. Using Information Ratio and Tracking Error, Market Return can be calculated easily as $\text{Information Ratio} = (\text{portfolio return} - \text{market return}) / \text{Tracking Error}$.

$48.24\% = (9.97\% - \text{MR}) / 3.17\%$

$\text{Information Ratio} = \text{Alpha} / \text{TE}$

$48.24\% = \text{Alpha} / 3.17\%$

- d. Information ratio can't be calculated as the information provided is not sufficient
4. What is the best way of ranking these funds for performance if they are actively managed?
- a. **On the basis of information ratio**
 - b. On the basis of Alpha
 - c. On the basis of Tracking error
 - d. On the basis on AUM
5. Which of the ten funds have generated highest "beta adjusted excess return".
- a. Fund no. 9
 - b. Fund no. 8
 - c. Fund no. 4
 - d. **Fund 8 & 4**

Case Study 3:

You are provided with the expected return and standard deviation on the following four assets:

	Expected Mean Return	Standard Deviation
Treasury bond (A)	5%	0
Asset B	10%	10%
Asset C	12%	15%
Asset D	7%	17%

1. If you are a portfolio manager and could invest in only one of the three assets i.e. A, B or C, which one would you pick?
 - a. A
 - b. B
 - c. C
 - d. **Any of them depending upon the risk profile of the investor and investment objectives**
2. If you could combine any of the other three assets with Asset A, which one would you choose?⁴⁹
 - a. **A with B**
 - b. A with C

⁴⁹ Explanation: A with B because of highest slope line i.e. risk-adjusted return ratio.

- c. A with D
 - d. Any of the above
3. Which of the three assets i.e. B,C & D has the highest Sharpe Ratio?
- a. **B**
 - b. C
 - c. D
 - d. B&C
4. Within the framework of portfolio theory, would you automatically rule out asset D by dominance, if you could combine it with asset B&C.
- a. Yes, as D has the lowest Sharpe ratio
 - b. Yes, as D has highest standard deviation
 - c. Yes, as D has lowest return
 - d. **No, information on correlation would be needed before any decision can be made**
5. In what proportion would you combine asset B & C, if you can invest in both of them along with asset A.
- a. More than 50 % of asset C as it has higher return
 - b. More than 50 % of asset B as it has lower standard deviation
 - c. **Depending upon the investment objective**
 - d. Combining B with C will be suboptimal

Case Study 4:

A portfolio manager invested Rs. 100 lakhs of an investor's wealth in equity shares of 4 companies, A, B, C, and D, and as per the mandate he had to invest equal amounts in each of the stock.

The prices of each of the stock at the time of investment was Rs.1000, Rs.500, Rs.200, and Rs.2000.

The investor wanted to liquidate the investment at the end of first year.

During the year, each of the stocks A,B,C, and D, paid a dividend of Rs.20, Rs.10, Rs.4, and Rs.40 respectively.

The prices at which the portfolio manager liquidated the stocks were 1100, 700, 400, and 1600 respectively.

The investor has been educated by the Portfolio Manager that he needs to develop his expected return based on CAPM. So the investor collects the necessary information for the estimation.

The Betas of the stocks A, B, C, and D are 2.5, 1.2, 1.5, and 2 respectively. The relevant risk free rate for one year investment horizon is 8%, and the market premium is 12%

1. What is the expected rate of return on stocks C and D?

- a. 26 percent and 32 percent**
- b. 14 percent and 16 percent
- c. 24 percent and 20 percent
- d. 14 percent and 32 percent

2. By how much did stock B exceed the expected return? [Calculate simply based on the return number.]

- a. 22.40 percent
- b. 19.60 percent**
- c. 87.50 percent
- d. 40 percent

3. What is the expected return of the investor on the entire portfolio, once the investor comes to know about the stocks which the portfolio manager has selected? Round off the answer to two decimal points.

- a. 29.10 percent

- b. 22.40 percent
- c. 29.60 percent**
- d. 15.20 percent

4. Stock B surpassed the expected rate of return because of?

- a. The proportion of wealth allocated to each asset it in
- b. The beta of the portfolio
- c. Market Premium used in the CAPM
- d. The market price of its stock**

5. During market boom, which of the above stocks will generate highest return?

- a. A and D
- b. A and B
- c. B and D
- d. Can't Say**

About NISM

National Institute of Securities Markets (NISM) is an educational institution established by the Securities and Exchange Board of India (SEBI), the securities market regulator, in 2006. The Institute was established in pursuant to the Union Finance Minister's proposal, in his 2005-06 Budget Speech, to set up an institution 'for teaching and training intermediaries in the securities markets and promoting research'.

NISM is committed to its vision 'to lead, catalyze and deliver educational initiatives to enhance the quality of securities markets'. The Institute conducts a wide range of capacity building programmes in securities markets - from basic financial literacy to full-time post-graduation programmes. The Institute's six Schools of Excellence, viz., School for Certification of Intermediaries, School for Securities Education, School for Investor Education and Financial Literacy, School for Regulatory Studies and Supervision, School for Corporate Governance and School for Securities Information and Research upholds NISM's vision and works in synergy towards professionalizing the markets.

NISM is mandated by SEBI (Certification of Associated Persons in the Securities Markets) Regulations, 2007 to conduct certification examinations and continuing professional education programs for associated persons engaged by an intermediary. NISM also conducts certification examinations for other regulators like IBBI and PFRDA. NISM's certifications establish a single market-wide knowledge benchmark for different functions in the Indian securities market and enable the associated persons to advance their knowledge and skills.

About the Workbook

This workbook has been developed to assist candidates in preparing for NISM-Series-XXI-A: Portfolio Management Services (PMS) Distributors Certification Examination. This examination seeks to create a common minimum knowledge benchmark for distributors of PMS and aims to enhance the quality distribution and related support services in the PMS.

The book covers about basics of investments, securities markets, investing in stocks, fixed income securities, derivatives and mutual funds. This book also provides an understanding about the role of portfolio managers, operational aspects of portfolio management services, the portfolio management process, performance measurement and evaluation of portfolio managers. The taxation, regulatory, governance and ethical aspects of portfolio managers have also been discussed in this workbook.

NATIONAL INSTITUTE OF SECURITIES MARKETS

NISM Registered Office

5th floor, NCL Cooperative Society,
Plot No. C-6, E-Block, Bandra Kurla Complex,
Bandra East, Mumbai, 400051
Tel: +91-22-41738811

NISM Campus

Plot No. IS 1 & 2, Patalganga Industrial Area,
Mohopada, District Raigad,
Maharashtra-410222
Tel: +91-2192-668300/01

NISM Bhavan

Plot No. 82, Sector-17,
Vashi, Navi Mumbai, Maharashtra-400703
Tel: +91-22-66735100/5101
Fax: 022-66735110

www.nism.ac.in