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QUESTION BOOKLET NUMBER

0111	2380416	Subject Code **CFA650**

SUBJECT : Mutual and other Funds

DATE : January 23, 2011 — TIMINGS: 10:00 Hrs to 13:00 Hrs

TOTAL MARKS: 100 — DURATION: 3 Hours

To be filled by the Student			
ENROLLMENT NO.	[redacted]	OMR NO.	[redacted]
TEST CENTER	[redacted]	SEAT NO.	[redacted]

Instructions to Students

1. Fill in the required particulars in the Question Booklet and the Answer Booklet. In the absence of this data, the Answer Booklet will not be evaluated.
2. Use the OMR Answer Sheet to mark answers for section A. Use the Answer Booklet to write responses for sections B and C.
3. See the back cover page for instructions on marking answers in the OMR Answer Sheet.
4. Section A should be attempted first. Time allotted to answer section A is 30 minutes. Return the OMR Answer Sheet 30 minutes after commencement of the examination. Return the Answer Booklet at the end of the examination.
5. Students can retain this Question Booklet after the examination.

Answering Materials distributed along with this question booklet:	
★OMR ANSWER SHEET	● ANSWER BOOKLET

Formulae and Tables [FAT] Book issued for reference and collected back

Section A : Basic Concepts (30 Marks)

- **This section consists of questions with serial number 1 - 30.**
- **Answer all questions.**
- **Each question carries one mark.**
- **Maximum time for answering Section A is 30 Minutes.**

1. Which of the following debt portfolio management strategies is/are passive?

   I. Bond Laddering strategy.
   II. Indexing strategy.
   III. Buy and hold strategy.
   IV. Bond swap strategy.

   (a) Only (II) above
   (b) Both (III) and (IV) above
   (c) (I), (II) and (III) above
   (d) (I), (II) and (IV) above
   (e) (II), (III) and (IV) above.

2. Which of the following is **not** an exit strategy available to a venture capital fund?

   (a) Initial public offerings
   (b) Liquidation of the company
   (c) Buy back by promoters
   (d) Merger and Acquisition
   (e) Strategic buy.

3. Prince Mutual Fund has launched a new scheme i.e. Prince Resurgent Ultra Short-Term Fund. For that, a mutual fund officer and an agent approached the prospective customer, who is high net worth investor. They also ensured the client to provide the after sales service. The distribution channel used by Prince Mutual Fund is

   (a) Personal selling
   (b) Direct marketing
   (c) Joint calls
   (d) Distribution companies
   (e) Sales force distribution.

4. In the primary fund of funds selection process, which of the following factors is **not** considered for PE fund selection?

   (a) General partner experience
   (b) Past performance of general partners
   (c) PE fund due diligence
   (c) Past returns of PE fund
   (e) Growth forecast of PE fund

5. Mr. Agarwal is trying to analyze the performance of two mutual funds. He has collected the following information regarding the same:

Fund	1 year Return (%)	Beta	Coefficient of Correlation with the market Index
Comfit Mutual Fund	22.00	1.39	0.90
Dura Mutual Fund	17.32	1.26	0.75

If variance of the returns on the market portfolio is $324(\%)^2$, the total risks for both the funds are respectively

(a) 27.80% and 30.24%
(b) 30.17% and 29.84%
(c) 27.80% and 28.96%
(d) 30.17% and 27.96%
(e) 31.26% and 30.24%.

6. There are different strategic ways by which buyout transactions can build value. In this context, which of the following statements is/are **not true** with respect to recapitalizing?

I. In recapitalizing, LBO funds target low levered high cash flows generating companies to create value for themselves.
II. It focuses on structuring an improved combination of equity and debt in order to restructure the balance sheet to add value.
III. The small equity investment requirement and availability of tax shield on debts are basis for the valuation of company, which attracts LBO Funds for takeover.
IV. In Recapitalizing, the funds exit by relaunch of the company through IPO.

(a) Only (II) above
(b) Only (IV) above
(c) Both (I) and (III) above
(d) Both (II) and (III) above
(e) (I), (II) and (IV) above.

7. According to SEBI circular dated January 04, 2007, the net investment that can be made by the mutual fund in ADRs, GDRs and foreign securities is upto

(a) 5% of net assets managed by mutual fund
(b) 10% of net assets managed by mutual fund
(c) 15% of net assets managed by mutual fund
(d) 20% of net assets managed by mutual fund
(e) 25% of net assets managed by mutual fund.

8. Which of the following statements is **not true** regarding the fundamental traits which a successful financial planner must possess?

(a) Familiarity with taxation and estate planning issues
(b) Familiarity with the appropriate asset allocation strategies
(c) Financial planning at the individual level rather than at the macro level
(d) Linking his remuneration to the overall achievement of the client's goals, ensuring consistency
(e) An understanding of various stages of a client's life and wealth cycle

9. The most common benchmark index for measuring returns of private equity market of real estate assets is

(a) National Association of Real Estate Investment Fiduciaries Property Index NAREIFPI
(b) National Organization of Real Estate Investment Fiduciaries Property Index
(c) National Institute of Real Estate Investment Fiduciaries Property Index
(d) National Council of Real Estate Investment Fiduciaries Property Index
(e) National Academy of Real Estate Investment Fiduciaries Property Index.

10. Prashanti Ltd., offered right shares to its shareholders in the ratio of 4:1 at the rate of ₹150 per share. If the ex-rights price of the share is ₹ 175, the value of each right would be

(a) ₹ 6.25
(b) ₹ 6.75
(c) ₹ 6.95
(d) ₹ 7.05
(e) ₹ 7.25.

11. Which of the following statements is/are **true** with respect to Gold Exchange Traded Funds (GETFs)?

I. The daily price of each unit is linked to the prices of the gold in the physical market.
II. Authorized participants initially buy the units of GETF from the mutual fund in exchange of actual pure gold.
III. The underlying assets are held by a mutual fund house issuing such units in a physical form or through a gold receipt giving right of ownership.

(a) Only (I) above
(b) Only (III) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

12. The shares of Dutch Chemical Industries are currently selling at ₹ 11.44 each. This year the company has earned ₹ 2.80 per share and paid dividend of ₹ 0.68 per share. Earnings are expected to grow at 7% a year forever. The risk-free rate is 6% and an average market return is 14.2%. If the sensitivity of returns of the shares of Dutch Chemical Industry to market returns increases by 40%, the shares price of Dutch Chemical Industries is expected to approximately (all other factors are remaining constant)

(a) Decrease by ₹ 2.41
(b) Increase by ₹ 2.41
(c) Decrease by ₹ 3.62
(d) Increase by ₹ 3.62
(e) Decrease by ₹ 4.00.

13. Mr. Satya and Mr. Sai have a corpus of ₹ 1 lakh each for investment. Hence, both of them decided to invest in security market. However, Mr. Satya is very positive about investing in mutual funds and hence decided to invest his corpus in security markets through mutual funds. Whereas, Mr. Sai wants to invest his corpus directly in the shares of different companies, as he feels that investment in mutual funds involves certain disadvantages. Which of the following is **not** a disadvantage of investment in mutual funds?

(a) The investors face the risk of the Fund Manager not performing well
(b) The investor can not create tailor-made portfolio
(c) A management fee charged by the Fund may reduce the return available to the investors
(d) There is a chance that fund managers may focus on a short-term return ignoring the long-term return of the fund
(e) There is no liquidity facility available in case of mutual fund investment.

14. The following information pertains to Frobisher Pension Fund:

Particulars	Amount in ₹
Fixed assets	7,97,000
Investments	1,39,000
Current assets	2,35,000
Share capital	1,00,000
Reserves	3,45,000
Secured loan	5,15,000
Unsecured loan	2,11,000

The solvency capital of pension fund is

(a) ₹ 8,26,000
(b) ₹ 7,97,000
(c) ₹ 7,26,000
(d) ₹ 5,15,000
(e) ₹ 2,35,000.

15. Which of the following statements is **not true** with respect to the Security Market Line (SML)?

(a) SML represents the normal trade-off between return and risk
(b) The vertical distance of the security's plot on the graph from the SML is called the security's alpha
(c) Validity of the CAPM can be tested by constructing ex-post SML
(d) Ex-post SMLs are used to evaluate the performance of portfolio managers
(e) The slope of the SML is the beta for a particular security involved.

16. Which of the following statements is **not true** with respect to Self-Regulatory Organizations (SROs)?

(a) The Government approved SROs are given powers to regulate its members and set a code of conduct for their activities

(b) SROs can be a valuable component to the regulator in achieving the objectives of securities regulation

(c) Any organization representing a group of market participants can become an SRO

(d) To act as an SRO, it should get Government recognition and approval and it should be granted specific powers of regulatory authority

(e) SRO can be defined as a 'non-government organization which has statutory responsibility to regulate its own members through the adoption and enforcement of rules of conduct for fair, ethical and efficient practices'.

17. The correlation coefficient between the returns on the stock of Drogue Parachute Ltd., (DPL) and the returns on Sensex is 0.85. If risk of DPL's returns is 9% and the risk of Sensex returns is 12%, the stock beta of the DPL is approximately

(a) 0.21
(b) 0.64
(c) 0.82
(d) 1.13
(e) 1.20.

0.85 = 0.09 / 0.12

18. There are many factors that drive the growth of hedge fund industry. In this context, which of the following statements is **not true**?

(a) The compensation structure common to hedge funds attracts and retains investment professionals

(b) Investment professionals are attracted by the freedom to manage assets without any constraints that clients impose

(c) There are few regulatory requirements and relatively low start-up costs

(d) The infrastructure for hedge fund has become more robust in the form of improved fund administration, auditing, prime brokerage and the development of investible benchmarks

(e) The barriers to entry are significant.

19. Mr. Rawat invested in Monthly Income Fund introduced by Daga Mutual Fund Company. The number of units outstanding in the scheme is 12 lakh. If the redemption price of each unit of Monthly Income Fund is ₹ 24.6715 and unamortized initial issue expense is ₹ 5,40,960, the NAV of the mutual fund scheme is

(a) ₹ 24.2207
(b) ₹ 24.4461
(c) ₹ 24.8969
(d) ₹ 25.1223
(e) ₹ 25.5731.

20. Which of the following statements is/are **not true** regarding the business ethics for mutual funds?

I. AMFI is mainly responsible for formulating regulations.
II. Fund structuring and Governance are monitored by SEBI.
III. AMFI would monitor the exercise of voting rights by funds.

(a) Only (III) above
(b) Both (I) and (II) above
(c) Both (I) and (III) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

21. Since US hedge funds are private investment partnerships, the SEC limits the number of investors in such hedge funds and also specifies a minimum number of investors that must be "accredited". In this regard, accredited investors are those investors with a

(a) Maximum net worth of \$ 1 million
(b) Maximum net worth of \$ 10 million
(c) Minimum net worth of \$ 1 million
(d) Minimum net worth of \$ 10 million
(e) Minimum net worth of \$ 100 million.

22. Which of the following statements is/are **true** with respect to Bullet portfolio?

I. It is a portfolio of bonds with short and long-term maturities and interim coupon payments.
II. It is a portfolio that constitutes of bonds maturing very close to the investment horizon and the nominal coupon payments over the investment horizon.
III. It is also called Dumb-bell portfolio.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (III) above
(e) Both (II) and (III) above.

23. Which of the following strategies involves buying or/and selling a security or financial instrument believed to be significantly overpriced or underpriced by the market relative to its potential?

(a) Relative value strategies
(b) Event driven strategies
(c) Directional strategies
(d) Convertible arbitrage strategies
(e) Market neutral strategies.

24. Which of the following is **not true** in the context of style analysis in asset allocation?

(a) It involves the use of quadratic programming
(b) It determines a fund's exposure to the changes in returns of the asset classes
(c) The objective of this analysis is to find the best asset class exposure that sums upto 100%
(d) The goal of this analysis is to select a style that minimizes the variance of the difference between the return of the fund and the active portfolio with the same style
(e) The goal is to infer about the funds exposure as much as possible to variations in returns of the asset classes.

25. Mr. Yadav is holding 10 bonds of Max Ltd. The market price of a bond is ₹ 1,500 and standard deviation in change in the price of the bond is 10.25%. One year future contract on a similar bond is available at ₹ 1,575. For minimizing risk, if Mr. Yadav has taken long position in 7 future contracts on similar bond, the standard deviation of change in future price is approximately

(a) 19.52%
(b) 16.65%
(c) 15.50%
(d) 13.95%
(e) 12.16%.

26. The funds that focus on major market sub-sectors such as new economy and old economy stocks are known as

(a) Growth funds
(b) Value funds
(c) Concentrated specialty funds
(d) Tax saving funds
(e) Broad-based specialty funds.

27. Which of the following statements is/are **not true** with respect to call price?

I. When the debentures are redeemed by call, they are done so at the call price, which is usually above the par value.
II. The call price is minimum at the start of the effective call option period.
III. The call price increases step-wise towards the face value as the call date approaches the maturity date

(a) Only (I) above
(b) Only (III) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

28. Which of the following statements is **not true** with respect to the role of Sponsor?

(a) Sponsor has to appoint the Board of Trustees and incorporate an Asset Management Company

(b) Sponsor has to submit to SEBI the drafts of the Trust Deed for the creation of Mutual Fund Trust with particulars of the persons, from both the Sponsor company and also outsiders, who gave consent to be the Trustees

(c) Sponsor should locate and appoint both the Trustees and the Fund Managers

(d) Sponsor has to suggest the name and particulars of the Custodians to be engaged for the Mutual Fund

(e) Sponsor plays a major role in contributing to the assets growth under the fund houses.

29. Which of the following statements is **not true** with respect to various features of private equity investment?

(a) Private equity investment is a type of investment in listed company

(b) The realization of fund and return on investment often takes a longer time

(c) Angel investors are one of the major categories of private equity investment

(d) Private equity fund issuers are generally those firms that do not have access to conventional source of financing

(e) It is considered as one of the most expensive forms of finance.

30. The following information pertains to Muktha Ltd.:

Adjusted earnings	₹ 452 crore
Current cost of capital	12.50%

According to Graham method, the Earning Power Value (EPV) of the Muktha Ltd., is

(a) ₹ 56.50 crore

(b) ₹ 407.78 crore

(c) ₹ 508.50 crore

(d) ₹ 1,560.00 crore

(e) ₹ 3,616.00 crore.

END OF SECTION A

Sections B&C

Section B : Problems/Caselets (50 Marks)

- **This section consists of questions with serial number 1 – 5.**
- **Answer all questions.**
- **Marks are indicated against each question.**
- **Detailed workings/explanations should form part of your answer.**
- **Do not spend more than 110 - 120 minutes on Section B.**

1. Mr. Goyal wants to invest his money for future. Not just his own future, his retirement or his dream house, but in the future of his community, his environment, his world. Mr. Goyal is at the heart of socially responsible investing, one of the most optimistic emerging trends in the financial world. Socially responsible investing integrates financial goals with positive personal values to give investors a voice in shaping the future of our society.

   The beauty of socially responsible investment is that everyone's vision of a brighter future is not the same. Some investors are more concerned about environmental problems, some feel strongly about how companies treat their employees, while others worry about the societal effects of certain products, such as tobacco, weapons, or alcohol. There are as many angles to socially responsible investing as there are investors, representing a mosaic of social concerns. But all these angles share in common i.e., each respective individual's or institution's highest aspirations for the world.

   As a part of research for finding out an investment avenue which would enable him to satisfy his desire of making socially responsible investment, Mr. Goyal selected the Sustainable Development Fund of BNP Paribas Mutual Fund for analysis. The objective of this fund is to invest in equity shares of the companies which are socially responsible. However, many mutual fund companies, in the name of innovation, come out with attractive advisements to lure the investing community. But, many a time, 'it is old wine in a new bottle'. Hence, he wanted to observe to which extent the investment style of Sustainable Development Fund is different from that of Equity fund of BNP Paribas in true sense. The details of both the schemes are as follows:

   BNP Paribas Sustainable Development Fund

   Objective of this scheme is to generate long-term capital growth from an actively managed portfolio of equity and equity related securities primarily of the Socially Responsible Companies focusing on Sustainable Development. The scheme will aim at identifying investment opportunities in companies across all ranges of market-capitalization, defined as "Socially Responsible Companies". The scheme does not guarantee / indicate any returns.

   BNP Paribas Equity Fund

   The investment objective of the scheme is to generate long-term capital growth from a diversified and actively managed portfolio of equity and equity related securities. The scheme will invest in a range of companies, with a bias towards large & medium market capitalization companies.

Mutual Fund	BNP Paribas Mutual Fund	
Scheme Name	BNP Paribas Sustainable Development Fund	BNP Paribas Equity Fund
Scheme Type	Open Ended	Open Ended
Inception Date	March 5, 2007	August 9, 2004
Minimum Subscription Amount	5,000	5,000
Fund Manager	Karthikraj Lakshmanan	Amit Nigam

BNP Paribas Sustainable Development Fund's holdings as on 29 October 2010 were as follows:

Company Name	% of Net Assets	Company Name	% of Net Assets
ICICI Bank	6.30	Wyeth	1.84
Reliance Industries	5.40	DLF	1.73
Infosys Technologies	4.88	ITC	1.69
Larsen and Toubro	4.33	Exide Industries	1.68
Federal Bank	3.49	Sterlite Industries (India)	1.66
Indian Bank	3.36	Bharti Airtel	1.60
Oil and Natural Gas Corporation	3.21	Sadbhav Engineering	1.51
Tata Consultancy Services	3.11	HDFC Bank	1.50
Bharat Heavy Electricals	3.01	Corporation Bank	1.47
Sintex India	2.68	Tata Steel	1.45
State Bank of India	2.59	Jubilant Life Sciences	1.29
Lupin	2.52	NTPC	1.28
Alstom Projects	2.49	Kotak Mahindra Bank	1.22
CESC	2.44	Jammu and Kashmir Bank	1.20
GAIL India	2.42	Jaiprakash Associates	1.19
Reliance Communications	2.40	United Phosphorous	1.15
Housing Development Finance Corporation	2.26	Jindal Steel & Power	1.15
		Zee Entertainment Enterprises	1.14
Hindustan Unilever	2.18	Power Finance Corporation	0.89
Hindustan Petroleum Corporation	2.00	Reliance Infrastructure	0.85
Chennai Petroleum Corporation	1.98	EID Parry (India)	0.82
HCL Infosystems	1.86	Net Receivable / Payable	4.82
Tata Power Company	1.84	Others / Unlisted	0.12

Sector wise Allocation as on 29 October 2010 were as follows:

Sector	% of Net Assets
Banking & Financial Services	24.27
Oil & Gas	15.02
Information Technology	9.86
Engineering & Capital Goods	9.83

Sector	% of Net Assets
Utilities	6.41
Pharmaceuticals	5.65
Metals & Mining	4.26
Telecommunication	4.00
Cement & Construction	2.69
Conglomerates	2.68
Consumer Non-durables	2.18
Real Estate	1.73
Tobacco	1.69
Automotive	1.68
Chemicals	1.15
Media & Entertainment	1.14
Food & Beverages	0.82
Net Receivable / Payable	4.82
Others / Unlisted	0.12

BNP Paribas Equity Fund's holdings as on 29 October 2010 were as follows:

Company Name	% of Net Assets	Company Name	% of Net Assets
Reliance Industries	9.94	Hindustan Unilever	2.04
Infosys Technologies	9.28	Jindal Steel & Power	1.93
ICICI Bank	8.71	Hindalco Industries	1.88
Larsen and Toubro	7.05	Sterlite Industries (India)	1.65
ITC	6.03	Tata Power Company	1.56
Housing Development Finance Corporation	5.83	Maruti Suzuki India	1.45
State Bank of India	5.76	Wipro	1.39
HDFC Bank	5.49	Cipla	1.26
Tata Consultancy Services	4.04	Hero Honda Motors	1.25
Oil and Natural Gas Corporation	3.61	Reliance Infrastructure	1.04
Bharti Airtel	2.83	DLF	1.02
Bharat Heavy Electricals	2.73	Jaiprakash Associates	0.97
Tata Motors	2.48	Reliance Communications	0.87
Tata Steel	2.44	ACC	0.70
NTPC	2.09	Money Market Instruments	1.04
Mahindra and Mahindra	2.09	Net Receivable / Payable	-0.45

Sector wise Allocation as on 29 October 2010 were as follows:

Sector	% of Net Assets
Banking & Financial Services	25.79
Information Technology	14.71
Oil & Gas	13.55
Engineering & Capital Goods	9.78

 (Please Turn Page)

Sector	% of Net Assets
Metals & Mining	7.90
Automotive	7.27
Tobacco	6.03
Utilities	4.69
Telecommunication	3.70
Consumer Non-durables	2.04
Cement & Construction	1.67
Pharmaceuticals	1.26
Real Estate	1.02
Net Receivable / Payable	-0.45
Money Market	1.04

The NAVs of both the schemes and S&P CNX NIFTY value at the end of every month during the period under consideration are as follows:

Date	NAV of BNP Paribas Sustainable Development Fund (₹)	NAV of BNP Paribas Equity Fund (₹)	S&P CNX NIFTY
30-Oct-09	10.9756	28.72	4711.70
30-Nov-09	11.7306	30.29	5032.70
31-Dec-09	12.0100	31.18	5201.05
29-Jan-10	11.2285	29.33	4882.05
26-Feb-10	11.2461	29.48	4922.30
31-Mar-10	11.9645	30.96	5249.10
30-Apr-10	12.0713	31.74	5278.00
31-May-10	11.6952	30.34	5086.30
30-June-10	12.3569	31.80	5312.50
30-July-10	12.4428	32.11	5367.60
31-Aug-10	12.5281	32.40	5402.40
30-Sep-10	13.7613	36.20	6029.95
29-Oct-10	13.8020	35.98	6017.70

As per historical observation, the average auction price of 182 day T-Bills is ₹96.72 each. You are **required** to:

a. Observe whether the investment criteria of fund manager of BNP Paribas Sustainable Development Fund is different from that of fund manager of BNP Paribas Equity Fund or not, considering the portfolio composition of each fund and also the coefficient of correlation between the returns of both the funds. **(8 marks)**

b. Compare the performance of BNP Paribas Sustainable Development Fund and BNP Paribas Equity Fund:

   I. With respect to the extent of diversification achieved, by observing the proportion of explainable risk to total risk.

   II. By decomposing the differential (excess) return into two parts i.e. the return due to superior stock selection ability of the fund managers and the return due to imperfect diversification. **(10marks)**

Caselet 1

Answer the following questions based on the given Caselet:

2. According to the caselet, the setting up of Real Estate Investment Trusts (REITs) paves the way for wider participation by retail investors in the country's booming real estate sector and ensures that property markets are suitably expanded with proper regulation for benefits of investors in real estate. In this context, explain the advantages of REITs to the retail investors in specific and property markets and economy in general. (8 marks)

3. As mentioned in the caselet, SEBI came out with a number of draft guidelines for setting up and operating of REITs. Interpret the rationale behind the various guidelines highlighted in the caselet. (10marks)

The Associated Chambers of Commerce and Industry of India (Assocham) has proposed creation of Real Estate Investment Trusts (REITs) on the lines of those prevalent in countries such as Singapore, the U.S. and Japan to ensure that property markets are suitably expanded with proper regulation for benefits of investors in real estate. Presently in India, the presence of high stamp duties and capital gains taxes led to high incidences of non registration of property transactions and no proper disclosures. The proposed real estate investment trusts have been existing in several economies with a developed property market since 1960's. Generally, they hold, manage and maintain real estates for investment purposes which are leased to tenants. REITs tend to have a broad shareholder base and are often, but not always, traded on a public stock exchange.

On the basis of proposal made by Assoccham, on December 28th 2007, India's market regulator, SEBI proposed setting up of Real Estate Investment Trusts (REITs), by releasing the draft guidelines, paving the way for wider participation by retail investors in the country's booming real estate sector.

The draft includes various prerequisites for any entity to launch a REIT scheme, including the valuation aspect, which has been considered a key roadblock to the launch. The market regulator said every such scheme should appoint an independent property valuer, who will value all the real estate under the scheme after physical inspection. "The valuation methodology shall follow the 'valuation standards on properties' published from time-to-time by the concerned Indian institute or the international valuation standards issued from time-to-time by the International Valuation Standards Committee," the draft proposal said, while listing the requirements of the independent principal valuer.

One of the proposals is that the REIT should be in the form of a trust created under the Indian Trusts Act. Trustees should be either a scheduled bank, trust company of a scheduled bank, public financial institution, insurance company, or a body corporate. A scheme should be launched by a trust and be managed by a real estate investment management company, with both parties having to register with SEBI. Only close-ended schemes can be launched by the trusts, and these schemes have to be listed on the stock exchanges mentioned in the offer document.

On investment limitations, SEBI said a REIT, under all its schemes, should not have exposure to more than 15% of any single real estate project. While it can buy uncompleted units in a building, which is unoccupied and non-income producing or in the course of development, the aggregate contract value of such real estate should not exceed 20% of the total net asset value of the scheme at the time of acquisition, the market regulator said.

Further, it is said REIT, under all its schemes, should not have exposure to more than 25% of all the real estate projects developed, marketed, or financed by the same group of companies. The scheme is prohibited from investing in vacant land or participating in property development activities.

The market regulator has put some restrictions on the borrowing capabilities of a REIT scheme for funding investments and operating expenses. Accordingly, a scheme cannot borrow more than one-fifth of the value of the scheme's total gross assets. While the scheme can mortgage its assets for such borrowings, the REIT should disclose its borrowing policy in its offer document, including its maximum borrowing limit, the draft said. Even credit rating for the scheme is compulsory.

The market regulator said the scheme shall distribute not less than 90% of its annual net profit after tax as dividends every year to unit- holders. "The real estate investment trust shall determine any revaluation surplus credited to income, or gains on disposal of real estate, which shall form part of net income for distribution to unit-holders," the draft proposal said.

END OF CASELET 1

Caselet 2

Answer the following questions based on the given Caselet:

4. One peculiar quality of the arbitrage strategy which is adopted by SBI-AOF is that it does not participate in the upside or downside of the market, rather it makes a market-neutral investment decision there by bringing a degree of stability in the performance. However, there are various types of risks associated with such fund, which need to be addressed by the investors before investing. In this context, analyse the various risks associated with SBI-AOF. **(7 marks)**

5. Arbitrage opportunities funds usually propose to capitalise on the arbitrage opportunities arising out of mis-pricing of stocks in the equities and derivatives markets. In this regard, explain the conditions for arbitrage and also analyse how identification of arbitrage opportunities helps in bringing in market efficiency. **(7 marks)**

In India, various mutual fund houses such as SBI, JM, Kotak, Lotus launched arbitrage opportunities funds. These funds usually propose to capitalise on the arbitrage opportunities arising out of mis-pricing of stocks in the equities and derivatives (Futures & Options) markets. Equity markets can be volatile over short term, typically generating steady risk adjusted returns only over long term.

Arbitrage Funds, with low risk positioning, are emerging as an attractive investment options for investors seeking higher risk adjusted returns over an investment time period longer than 6 months. Arbitrage Funds, which capture the interest element in the Equity Market, offer an opportunity for investors to earn higher returns without taking an equity market risk. Operating on the concept of "Fully Hedged Equity Exposure", these investment options ensure that investors are not exposed to Equity Market Risk by creating a portfolio where each position in Equity Stock is hedged by an equal & opposite positions in the relevant derivative instrument.

It seeks to exploit differences in prices prevailing for spot transactions in the Stock Market and those prevailing for the same stocks in the F&O Segment. These differences are determined by prevailing interest rate conditions adjusted for volatility conditions in Equity Markets. Experience suggests that these price differences increase with increasing volatility. Normal arbitrage opportunity is described as a situation where price of a particular stock in spot market is lower than the price for the same stock in futures market. Arbitrage Fund would seek to lock in this differential by buying stock in spot market and simultaneously selling its futures. This effectively negates any equity risk immediately and difference in two prices, termed as "carry" would be earned by the Fund.

An opportunity where price of stock in futures market is lower than price in spot market is termed as "Reverse Arbitrage". Until recently, this form of arbitrage could not be exploited as the Indian Equity Markets lacked a systematic Stock Borrowing and Lending mechanism. However, announcements in Union Budget 2007-08, pertaining to such a mechanism being instituted shortly, as well as allowing institutions to take short positions in the F&O segment based on borrowed stock, would serve to make Reverse Arbitrage a reality. Point that deserves attention in both these forms of arbitrage is that at no point of time is the Fund or its investors are exposed to an unhedged equity risk.

For instance, if we consider the Arbitrage Opportunities Fund (AOF) launched by SBI, it is an open-ended equity oriented fund. SBI-AOF seeks to exploit mis-pricing opportunities arising in equities and derivatives markets. In the absence of profitable arbitrage opportunities, the fund will hold its assets in debt and money market instruments.

Besides adopting the most commonly used arbitrage strategy of purchasing stocks in equity markets and simultaneously selling futures contract of the same stocks, SBI-AOF will use other complex strategies as permitted by SEBI. An important feature of an arbitrage strategy is that it can act as a safeguard against market volatility as both the buying and selling legs offset each other. The returns in an arbitrage transaction are locked at the time of the transaction. In that respect, the fund offers a relatively low-risk investment option for investors. SBI-AOF is mandated to invest between 65%-85% in equity and equity related instruments and derivatives. The fund has stated that every derivative position will be backed by an equal and opposite position in equity markets and that the fund will remain hedged at all times under the respective arbitrage strategy. The fund can also park upto 35% of its corpus in money market/debt instruments in the absence of adequate arbitrage opportunities in the market. One peculiar quality of the arbitrage strategy is that it does not participate in the upside or downside of the market, rather it makes a market-neutral investment decision. Thus, even if the market gets corrected to a large extent, the fund is unlikely to get affected. Given that the arbitrage strategy can insulate the fund from the risk of market volatility, one can expect a degree of stability in SBI-AOF's performance.

END OF CASELET 2

END OF SECTION B

(Please Turn Page)

INSTRUCTIONS FOR MARKING ANSWERS ON THE OMR SHEET

1. **Section - I**
   Use **Ball Point Pen** only.
   Fill in all the particulars in the space provided.

2. **Section – II**
   Use **HB Pencil** only.
   Fill in one character/digit per cell and darken the corresponding circle below that cell.
   Details to be filled include enrolment no., question booklet no., test centre code & OMR answer sheet number.
   In case you want to change any of the information in this section, erase completely the pencil marking in the already darkened circle before darkening a new cell.

3. **Section - III**
   (i) Marking the answer
   - Mark your **answers** in this section using **HB Pencil** only.
   - For answering each question five circles marked with options A, B, C, D and E are provided corresponding to the five options given in the question.
   - Mark your answer by darkening completely the circle consisting of the option you think is the right answer.
   - Do not darken more than one circle for any answer.
   - Do not fill the circle by darkening partly or putting a tick mark, cross mark or any other kind of mark.

WRONG METHOD					CORRECT METHOD				
✓	•	×	.	+	A	B	C	●	E

WRONG METHOD					CORRECT METHOD				
●	B	C	●	E	A	B	C	●	E

   (ii) Changing the answer
   - To change your response, erase completely the pencil marking in the circle before darkening a new circle.
     For Example assume that you have marked option (e) as the answer to a question as follows:

     1. (a) (b) (c) (d) (e)

     If you want to change this answer to option (c), erase completely the circle marked earlier i.e., (e) and darken the circle with option (c) as follows:

     1. (a) (b) (c) (d) (e)

4. **DO NOT** fold, tear or crumple the OMR answer sheet.
5. **DO NOT** use the OMR answer sheet for any rough work or scribbling.