# Question Paper
# Mutual and other Funds (CFA650) : January 2009

## 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 statements is generally **not true** with respect to the investment in banks and mutual funds? <Answer>

(a) Liquidity is better in mutual funds than in banks
(b) Administrative expenses are higher in banks than in mutual funds
(c) Quality of assets is more transparent in mutual funds than in banks
(d) Investment options are less in banks than in mutual funds
(e) Return on investment in equity schemes of mutual funds is lower than that of banks.

**2.** According to SEBI regulations, which of the following is/are **not true** with respect to the valuation of investments for the purpose of calculation of NAV? <Answer>

I. Traded securities are to be valued at the average closing price of the preceding 30 working days on the stock exchange where they are principally traded.
II. When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.
III. Short-term deposits with the banks are to be valued at cost.
IV. Government securities are to be valued based on the prevailing yield to maturity.

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

**3.** Which of the following statements is/are **not true** with respect to asset allocation? <Answer>

I. Strategic asset allocation is generally undertaken periodically.
II. Tactical asset allocation considers changes in risk tolerance level of the investor.
III. Strategic asset allocation indicates a long term asset allocation policy of the portfolio manager.
IV. Tactical asset allocation is based on the assumption that the markets over-react to the available information.

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

**4.** 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? <Answer>

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

**5.** Mr. Goyal has a portfolio of Rs.10,00,000. He has not marked the portfolio to market. Owing to the marriage of his daughter, he wants to liquidate his portfolio. His portfolio is said to be exposed to <Answer>

(a) Tenure risk
(b) Interest rate risk
(c) Credit risk
(d) Reinvestment risk
(e) Insurance risk.

**6.** The surplus in the balance sheet of pension fund indicates <Answer>

(a) The market value of the assets is more than the market value of the liabilities
(b) The book value of the assets is more than the actuarial value of the liabilities
(c) The market value of the assets is more than the actuarial value of the liabilities
(d) The liquidation value of the assets is more than the actuarial value of the liabilities
(e) The book value of the assets is more than the market value of the liabilities.

**7.** Mr. Rohit, an investor, invested in the units of UTI petro fund which is floated on no load basis. He is planning to redeem his investment from the scheme during the 2$^{nd}$ year of his investment. As per the SEBI guidelines, the maximum percentage of redemption proceeds to be charged by UTI mutual fund as 'contingent deferred sales charge' is <Answer>

(a) 4.0%
(b) 3.0%
(c) 2.0%
(d) 1.0%
(e) 0.5%.

**8.** Escort Ltd. has been operating in the business of financial services for the last four years and is planning to sponsor a mutual fund. It has a sound track record in all its business transactions. In this regard, which of the following statements is **true** regarding its eligibility to sponsor a mutual fund, if its net worth is positive in all the immediately preceding three years and has fulfilled all other requirements to sponsor a mutual fund? <Answer>

(a) It is eligible, as it has fulfilled all requirements to establish mutual fund
(b) It is not eligible, as it is required to have carried out business of financial services at least six years
(c) It is not eligible, as it is required to have positive net worth in all the immediately preceding four years
(d) It is not eligible, as it is required to have carried out business of financial services at least for five years
(e) It is eligible, as it has a sound track record in all his business transactions.

**9.** Which of the following steps of formulation of a scheme generally covers the determination of eligibility of applicants to the scheme, allotment and distribution of income to unit holders, etc.? <Answer>

(a) Conceptualization of the scheme
(b) Drafting of the scheme
(c) Test marketing of the scheme
(d) Approval of the scheme
(e) Authorization of the scheme.

**10.** It is observed that investors require a return of 15% for investing in the stock of Renuka Ltd. The company paid a dividend of Rs.2.75 per share in the recently completed financial year. If the stock is currently available at a price of Rs.52, the implied growth rate in dividends is approximately <Answer>

(a) 6.35%
(b) 7.86%
(c) 8.34%
(d) 9.22%
(e) 10.05%.

**11.** Interest rate anticipation strategy under active bond management requires <Answer>

I. Forecasting the direction and quantum of change in the interest rate.
II. Investing in long maturity and low coupon bonds when interest rates are expected to rise.
III. Investing in short maturity and high coupon bonds when interest rates are expected to rise.
IV. Investing in long maturity and low coupon bonds when interest rates are expected to decline.

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

**12.** Consider the following information pertaining to the portfolio of a Fund Manager: <Answer>

| | |
|---|---|
| **Existing** | |
| Market value (Rs.) | 940 lakh |
| **Futures contracts available on index** | |
| Market value | 3280 |
| Multiple | 100 |
| Present effective duration | 6 months |

The number of futures contracts that the fund manager should buy to achieve his targeted effective duration is 430. To achieve the targeted effective duration, the fund manager has to increase the present effective duration by approximately

(a) 6 months
(b) 7 months
(c) 8 months
(d) 9 months
(e) 10 months.

**13.** Ms. Chitra, invested Rs.97,500 at the per unit purchase price of Rs.15, in the mutual fund scheme offered by SBI Mutual Fund. The scheme provides her the facility to withdraw Rs.3,475 per month. If in the first month of investment, the sales price is Rs.15.50 each, number of units left in the account of Ms. Chitra after first month is approximately <Answer>

(a) 6,290
(b) 6,285
(c) 6,276
(d) 6,270
(e) 6,260.

**14.** The excess return generated by Dolphin equity diversified fund per unit of risk is 4.65 as per Treynor. The systematic risk associated with the returns of the fund is $437.5844(\%)^2$ and standard deviation of market returns is 20%. If 91days treasury bill are priced at 98.16% of the face value, the total return generated by the fund is approximately <Answer>

(a) 11.35%
(b) 12.40%
(c) 13.75%
(d) 14.50%
(e) 15.60%.

**15.** Ms. Ritu, an analyst expects that a favorable change in the tax law will benefit holders of utility company stock. She immediately begins calling her clients and informing them of the upside potential of investing in such assets. According to SEBI, this practice is considered <Answer>

(a) Unethical, as she is trading on the basis of private information available to her and this is the case of 'Insider Trading'
(b) Unethical, as she is giving preferential treatment to her clients
(c) Unethical, as this is personal trading and she is using non-public information for personal gains
(d) Ethical, as she is assessing on the basis of her abilities to analyze the market situation
(e) Ethical, as she is helping other people trade in her personal account.

**16.** Which of the following is/are **not** the assumption(s) of Systematic Asset Allocation? <Answer>

I. The markets cannot provide explicit information regarding the returns available.
II. The relative expected returns reflect consensus.
III. The measurement of potential returns cannot provide useful clues to those returns that are actually realized.

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

**17.** Treynor ratio and Sharpe ratio for market portfolio are 7.1 and 0.9 respectively. T-Bills are trading in the market at 8% p.a. If alpha and beta of the Contra fund are 1.7 and 0.75 respectively, the realized return on the fund is <Answer>

(a) 15.03%
(b) 13.33%
(c) 12.45%
(d) 11.59%
(e) 10.65%.

**18.** Which of the following statements is/are **not true** with respect to Gold Exchange Traded Funds (GETFs)? <Answer>

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. Authorized participants are not eligible to facilitate secondary market of the GETF units through the stock exchange.
IV. 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 (III) above
(b) Both (I) and (III) above
(c) Both (I) and (IV) above
(d) (I), (II) and (III) above
(e) (II), (III) and (IV) above.

**19.** Mr. Umesh is planning to invest in a scheme offered by Lotus mutual fund. His friend suggested him to refer to the offer document before investing. However, for brief information he can also refer to Key Information Memorandum (KIM). Which of the following statements is **not true** with respect to key elements in KIM? <Answer>

(a) It describes the risk associated with the investment in the scheme
(b) It contains the name of the fund manager and name of the trustee company
(c) It states the maximum number of units to be invested
(d) It provides information on the performance of the scheme existing for more than one year
(e) It states when the scheme opens for continuous sale and repurchase, in case of open-ended funds.

**20.** Under which of the following financial planning strategies, mutual fund investor monitors the different market areas or sectors in an attempt to be in the strongest funds of the market or sector at any given time? <Answer>

(a) Power of compounding
(b) Active switching
(c) Drawdowning
(d) Front running
(e) Benchmarking.

**21.** An issuing company is required to create debenture redemption reserve before the date of redemption, out of its profits to the extent of <Answer>

(a) 10% of the amount of debenture to be redeemed
(b) 20% of the amount of debenture to be redeemed
(c) 30% of the amount of debenture to be redeemed
(d) 40% of the amount of debenture to be redeemed
(e) 50% of the amount of debenture to be redeemed.

**22.** There will be no conflict in ranking between Sharpe ratio and Treynor ratio, if the portfolio has <Answer>

(a) Large number of assets
(b) Zero systematic risk
(c) Zero total risk
(d) Zero unsystematic risk
(e) Equal amount of systematic and unsystematic risk.

**23.** Which of the following statements is/are **not true** with respect to ExMark? <Answer>

I. It is a term that defines the relationship between a fund's return and return on market index.
II. An ExMark below 80% indicates more predictability of relative performance.
III. Funds with an ExMark of 95% or above provide more opportunity to add value over and above the market's return.

(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.

**24.** The following is the information pertaining to the portfolio of Dolex Mutual Fund: <Answer>

| Securities | No. of shares | Closing Price (Rs.) |
|---|---|---|
| L&T | 110,000 | 2,685.45 |
| Cipla | 312,000 | 259.95 |
| Wipro | 450,000 | 523.10 |
| HDFC | 390,000 | 883.30 |
| Tata Steel | 299,000 | 502.75 |
| Sinfo Ltd. (Thinly traded) | 10,50,000 | 25.75 |

The balance sheet of Sinfo Ltd. is not made available after nine months from the close of the year. The fund has not borrowed any funds, but its accrued management fee with the portfolio manager currently totals Rs.3,000,000. The number of units outstanding is 107,573,000. The NAV of each unit is

(a) Rs.11.15
(b) Rs.10.51
(c) Rs.10.26
(d) Rs.10.02
(e) Rs.9.50.

**25.** Bond laddering involves buying bonds of different <Answer>

(a) Prices
(b) Durations
(c) Convexities
(d) Coupons
(e) Maturities.

**26.** The type of private equity financing provided to companies for full fledged manufacturing, operations and sales is <Answer>

(a) Start-up stage financing
(b) First-stage financing
(c) Second-stage financing
(d) Third-stage financing
(e) Bridge financing.

**27.** Universe Ltd. is considering India for investment purpose. However, its main concerns are high inflation, high trade deficit, and slowdown in growth being faced by India. In this regard, India is said to be facing <Answer>

(a) Market risk
(b) Country risk
(c) Credit risk
(d) Political risk
(e) Economic risk.

**28.** Mr. Sharma retired from Nath Brothers at the age of 60 years. His last 10 months' monthly average salary is Rs.25,000. After retirement, if he is drawing monthly pension of Rs.11,428 under Employees' Pension Scheme (EPS), the number of pensionable years of service is approximately <Answer>

(a) 30 years
(b) 29 years
(c) 28 years
(d) 27 years
(e) 26 years.

**29.** A Leveraged Buyout (LBO) transaction involves <Answer>

I. The purchase of a target company or division of a company with substantial portion of borrowed funds.
II. Collateralizing the assets of a company that is to be acquired to raise the funds.
III. Selling of unrelated or non-core assets of target firm to repay debts.

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

**30.** Which of the following statements is/are **true** with respect to Barbell portfolio? <Answer>

I. It is a portfolio of bonds with short and long term maturities and interim coupon payments.
II. It is a portfolio that constitute of a couple of bonds maturing very close to the investment horizon and the nominal coupon payments over the investment horizon.
III. It is a strategy of managing the fixed-income investments by building a ladder of investments of certificate of deposits or bonds that mature at regular intervals.

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

**END OF SECTION A**

# Mutual and other Funds (CFA650) : January 2009

## Section B : Problem/Caselets (50 Marks)

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

**1.** The following is the information pertaining to the NAVs of SBI Magnum Nifty based Fund and the values of Nifty for a particular period: <Answer>

| Period | NAVs of SBI Magnum Index Fund (Rs.) | Nifty |
|---|---|---|
| 30/11/07 | 51.3374 | 5762.75 |
| 31/12/07 | 54.2324 | 6138.60 |
| 31/01/08 | 45.3955 | 5137.45 |
| 29/02/08 | 46.0329 | 5223.50 |
| 31/03/08 | 41.5770 | 4734.50 |
| 30/04/08 | 45.1704 | 5165.90 |
| 30/05/08 | 42.4086 | 4870.10 |
| 30/06/08 | 34.9311 | 4040.55 |
| 31/07/08 | 37.1752 | 4332.95 |
| 29/08/08 | 37.3242 | 4360.00 |
| 30/09/08 | 33.5800 | 3921.20 |
| 31/10/08 | 24.8235 | 2885.60 |
| 28/11/08 | 22.6320 | 2635.00 |

You are **required** to compute the annualized tracking error of SBI Magnum Nifty based Fund. **(10 marks)**

### Caselet 1

**Read the caselet carefully and answer the following questions:**

**2.** According to the caselet, India is emerging as an investment destination for global Islamic investors. In this regard, analyze the future potential of Islamic investment in India. <Answer> **(10 marks)**

**3.** As mentioned in the caselet, "Shariah-compliant stocks are 'halal' (permissible) under Islamic finance laws, while non-Shariah compliant companies are 'haram' (prohibited)." In light of this, considering the various criteria highlighted by Taurus Mutual Fund Managing Director, Mr. R.K. Gupta for the selection of stocks to be included in the portfolio of Taurus Mutual Fund scheme, explain the possible conditions for screening the stocks for investment. <Answer> **(10 marks)**

On September 11, 2001, the world changed for almost everybody in the planet. The case of Islamic investors was no different. Changing political situation in America and European countries after the terror attack on World Trade Center and falling GDPs of Europe and North America have forced rich Islamic investors from the Gulf countries to look for investment opportunities in South East Asian countries, including India. According to sources in the industry, Islamic investments close to $750 million have already been made in the capital market and infrastructure sector in the past few months. In fact, India has seen tremendous increase in the investment inflows from Islamic nations in the last few years. However, it is difficult to find out the exact amount of investment flowing into India from the Islamic world so far because most of it is in unorganized sectors like real estate. But

Indian industry sources engaged in promoting Islamic finance and investment expect an investment of at least one billion US dollars in Shariah-compliant Indian companies in the next one year. Shariah is the Islamic legal framework covering all aspects of lives of Muslims - private and public - including trade, commerce and business. Keeping in view the immense opportunities of Islamic investment in India in future, Kuwait-based Khaleej Finance and Investment also invested $250 million in shariah-compliant venture in India and Beary's Investments, a Middle-East investment group, made an investment of over $50 million in real estate in Bangalore. The world's economic centre of gravity is gradually shifting from the established, wealthy economies of Europe, Japan and North America to the emerging economies like China, India and South East Asia, with China and India projected to be the largest economies of the world in the next 50 years. According to Dr Shariq Nisar, an expert on Islamic investment and finance associated with Mumbai-based Idafa Investment Pvt Ltd, a stock brokerage firm adhering to Islamic economic norms, "there is a clear switch of Islamic investors looking for alternate destinations owing to fear of freezing of their accounts in Europe and North America due to political and other developments in the last few years. "Surprisingly, the growth in market capitalization of Shariah-compliant stocks was also found to be better than the rate of growth achieved by non-Shariah-compliant stocks," claims Dr Nisar, "Shariah-compliant stocks are 'halal' (permissible) under Islamic finance laws while non-Shariah compliant companies are 'haram' (prohibited)." This suggests that India is emerging as an investment destination for global Islamic investors.

According to a study conducted by Dr Nisar, a number of Shariah-compliant stocks in India are much higher than in Muslim countries put together. He claims that 61 per cent Indian companies are Shariah-compliant against 57 per cent in Malaysia, 51 per cent in Pakistan and a mere 6 per cent in Bahrain. Giving details, he says that 335 of 1,000 listed firms at National Stock Exchange and 237 out of 500 listed at Bombay Stock Exchange are Shariah-compliant. It will hugely benefit the Indian economy by attracting investments from the cash rich Middle Eastern economies on the lookout for new investment destinations. Five Indian companies, Reliance Industries, Infosys Technologies Wipro, Tata Motors and Satyam Computer Services figure in the Standard & Poor's BRIC Shariah Index.

With Islamic finance industry at its infancy in India, firms and institutions in Islamic investment are facing shortage of qualified Islamic religious scholars as also bankers. "To meet the needs of Islamic finance industry, three institutes offering education in Islamic finance and management have been set up recently in Calicut (Kerala), Hyderabad (Andhra Pradesh) and Bhubaneswar (Orissa), offering postgraduate diploma in Islamic banking and finance," says Dr Nisar.

The country is likely to get its first Islamic mutual fund soon as a Delhi-based asset management company Taurus has approached capital market regulator, SEBI to launch such a product based on the Sharia laws. "Subject to approval from SEBI, we expect to mop up Rs.500 crore from Taurus Parasoli Ethical Fund," Taurus Mutual Fund Managing Director, R K Gupta told media. Detailing the features of the five-year close-ended fund, Gupta said it would invest in stocks that are Shariat-compliant, or in simple terms do not relate to the businesses like liquor, banned by the Islamic laws. Gupta said the product is likely to attract more non- Muslims than Muslims, since the concept is quite business-like. Since interest income is banned under Shariat laws, Taurus would give quarterly disclosure of income to subscribers, breaking them up into interest income and capital appreciation. Those who do not want interest income can donate it to Zakat, which is an obligation on Muslims to pay part of their income to specified charities to uplift poor, the destitute and so on. This break-up would also enable the subscribers to know for better the operating income of companies in the underlying stocks other than the interest income and they would be in more comfortable position to make judgments about the stocks, Gupta said.

The move is expected to pool in untapped funds from the Muslims, who do not invest in securities or other financial products due to personal religious beliefs. The fund intends to draw up a portfolio that will have equities of those companies that delve in services and products, which are considered Halal (legal according to

Islamic law). Thus, the fund will exclude shares of companies that earn profits through interest (banks, insurance), deal in products like liquor, pork meat or offer services like gambling and dance clubs.

The newer financial products will follow the Islamic guidelines too, not investing in companies that have a debt of greater than or equal to 33 percent of market capitalization and companies earning interest income more than five percent of their gross revenue. With 34 offices across India and 30,000 account holders, the company is now eyeing expansion in the eastern states where there is a substantial Muslim population. "Eastern India is very important. West Bengal and Assam have a huge Muslim population. We have started operating in the city and are getting a good response," added Mr.Gupta.

**END OF CASELET 1**

## Caselet 2

**Read the caselet carefully and answer the following questions:**

<Answer>

**4.** According to the caselet, for an investor, who accords greater importance to capital preservation over capital appreciation, CPOSs is the place to be. However, it is essential for investors to be aware of the nuances of investment in such schemes. Explain the nuances associated with such schemes.

**(10 marks)**

<Answer>

**5.** As per the caselet, structurally CPOSs are similar to another existing mutual fund category called Fixed Maturity Plans (FMPs), which has been around for a while and they both have certain dissimilarities as well. Explain the dissimilarities between FMPs and CPOSs.

**(10 marks)**

Recently, a new category named Capital Protection Oriented Schemes (CPOSs) made its debut in the mutual fund industry. As the name suggests, the mainstay of such schemes is to provide capital protection. The risk that market-linked investment avenues (like mutual funds) pose to investors is erosion of capital. Any movement in the stock market is clearly reflected in the performance of an equity fund; the extent to which the fund responds to the movement however depends on various factors like the investment style and underlying investments made.

Adverse market conditions can make investors feel insecure about their investments, leading to distress redemptions (mostly at losses) or even worse it deters them from investing in such avenues. In such a scenario, anything that guarantees the protection of at least the initial invested capital appears to be a good deal.

SEBI has given the go-ahead to mutual funds for the launch of Capital Protection Schemes (CPS). Investments in such schemes come with a guarantee, albeit implicit, that the investor's capital will be safeguarded. Hence, irrespective of the direction in which the market moves or even if the scheme underperforms, the protection of the investor's capital is guaranteed by the AMC.

Capital protection mutual fund scheme is exactly what you wanted -- a mutual fund scheme that promises to protect your initial investment and gives better returns than a bank fixed deposit and other guaranteed products on offer. They target the need for safety of initial investment that has so far kept conservative investors out of the MF ambit and to provide returns attractive enough to lure them away from guaranteed return products.

The performance of existing monthly income plans and hybrid debt oriented schemes show that funds are capable of generating superior returns with a high degree of safety. However, investors need to read the fine print on the protection of capital, liquidity, expected returns and risks before committing to these schemes.

In August, market regulator SEBI issued guidelines permitting fund houses to launch "capital protection-oriented" schemes. SEBI says capital protection should arise from the way in which the portfolio is constructed and not from any guarantee by the asset management company or sponsor.

It also requires that the scheme be rated by a credit rating agency on the ability of the fund to protect the initial investment and to be periodically reviewed on its continued ability to do so. Also, these schemes have to be closed-end, so investors can invest only at the time of the new fund offer and can redeem only on the completion of its term.

Structurally they are similar to another existing mutual fund category called Fixed Maturity Plans (FMPs), which has been around for a while. For investors, the presence of these categories which are structurally similar, yet distinct in terms of positioning can be confusing. FMPs are close-ended debt funds (investments can be made only during the new fund offer period) with a fixed maturity horizon. They can also invest a smaller portion of their corpus in equities. FMPs target a given yield (return), lock-in the same at the time of investment and stay invested till maturity. In turn, investors who stay invested in the fund till its maturity are virtually assured of clocking the designated returns. It should be understood, that being a market-linked investment avenue, the returns aren't assured or fixed. Hence, deviations in the designated returns on account of market fluctuations cannot be ruled out.

Conversely, CPOSs are close-ended debt funds, oriented towards the protection of capital invested. Again, the capital protection is not guaranteed. The portfolio is constructed in a manner to provide the investor with at least the amount invested on maturity.

Both the schemes attempt to combine the stability of debt along with the power of equities. Normally, these funds invest a majority of the corpus (say at least 80%) in debt instruments and the balance (around 20%) in equities. The portfolio is so designed, that the amount of money invested in the debt component is equivalent to the initial investment on maturity. For example, out of Rs.100 invested, the fund invests Rs.80 in debt instruments, which will amount to Rs.100 on maturity. Thus, the debt portfolio attempts to preserve the initial investments made by investors, while the equity portfolio (Rs.20 in this case) is utilised to generate capital appreciation.

Investors would do well to understand that both CPOSs and FMPs cater to the needs of different types of investors. For an investor, who accords greater importance to capital preservation over capital appreciation, CPOSs is the place to be. On the other hand, investors who are looking at clocking a "somewhat" assured income, FMPs should be the chosen investment avenue. It is essential for investors to be aware of the nuances of both the categories, so that they can make more informed investment decisions.

**END OF CASELET 2**

**END OF SECTION B**

## Section C : Applied Theory (20 Marks)

- This section consists of questions with serial number 6 - 7.
- Answer all questions.
- Marks are indicated against each question.
- Do not spend more than 25 -30 minutes on Section C.

**6.** SEBI acts as the watchdog to control any unethical and unfair business practices by the fund managers at the operating level. In this context, elucidate the various practices of fund manager that are considered unethical by the SEBI. <Answer>

**( 10 marks)**

7. The stages of investor life cycle and his wealth status can be considered for developing a suitable model portfolio. In addition to this, an understanding of the various aspects of investor investment profile will allow the advisor to assess the proper balance of model portfolio. In this regard, discuss the various methods which the advisor or investor can look for building a model portfolio. **( 10 marks)**

<Answer>

**END OF SECTION C**

**END OF QUESTION PAPER**

# Suggested Answers
# Mutual and other Funds (CFA650) : January 2009

## Section A : Basic Concepts

| | Answer | Reason | |
|---|---|---|---|
| **1.** | E | The return in mutual funds is higher than in banks. Hence, alternative (e) is false and is answer. All other alternatives are true. | < TOP > |
| **2.** | B | For the purpose of calculation of NAV, the investments are to be valued as follows.<br>i. Traded securities are to be valued at the last quote closing price on the stock exchange where it is principally traded.<br>ii. When on a particular valuation day, a security has not been traded on the selected stock exchange; the value at which it is traded on another stock exchange may be used.<br>iii. While investment in call money, bills purchased under rediscounting scheme and short-term deposits with banks shall be valued at cost plus accrual, other money market instruments are to be valued based on the yield at which they are currently traded.<br>iv. Government securities are to be valued based on the prevailing yield to maturity. | < TOP > |
| **3.** | B | Strategic asset allocation is also referred to as long run asset allocation or policy asset allocation and undertaken periodically. Hence, (I) and (III) are correct. In tactical asset allocation, changes in the risk tolerance of investors are ignored. Hence (II) is wrong. Tactical asset allocation may involve switching fund from one asset to another to benefit from short-term under pricing or over pricing. The tactical asset allocation sometimes is based on the assumption that the markets overreact to the available information. Hence (IV) is also correct. Only (II) is wrong and is therefore answer. | < TOP > |
| **4.** | C | Directional 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. | < TOP > |
| **5.** | B | Interest rate risk is defined as the fluctuations in interest rates that affect the returns of fund and its asset values. Not marking the portfolio to market exposes the fund to interest rate risk, if the portfolio has to be liquidated for some reason. | < TOP > |
| **6.** | C | The surplus is defined as the difference between the market value of the assets and the actuarial value of the liabilities of pension payments. | < TOP > |
| **7.** | B | The management is entitled to charge a 'contingent deferred sale charge' (in other words, a load) on redemptions during the first four years of the scheme, subject to the following limits:<br>During the $1^{st}$ year — Maximum 4% of the redemption proceeds.<br>During the $2^{st}$ year — Maximum 3% of the redemption proceeds.<br>During the $3^{st}$ year — Maximum 2% of the redemption proceeds.<br>During the $4^{st}$ year — Maximum 1% of the redemption proceeds.<br>Therefore, correct answer is option (b). | < TOP > |

**8.** D To be competent to sponsor a Mutual Fund, a sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. SEBI (Mutual Fund) Regulation, 1996, further elaborates the definition of sound record thus: < TOP >

i, The finance company should be carrying on business in financial services for a period of not less than five years.

ii. The net worth is positive in all the immediately preceding five years.

iii. The net worth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company, and

iv. The sponsor has profit after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year.

Escorts Ltd. is not fulfilling the (i) and (ii) condition, therefore it is not eligible to sponsor a mutual fund and correct answer is option (d).

**9.** B It is seen that the format/drafting of the scheme generally covers the following important aspects: Objectives, issue particulars, duration of scheme, eligibility of applicants to the scheme, allotment, distribution of income to unit holders etc. < TOP >

**10.** D < TOP >

$$P_0 = \frac{D_1}{(k_e - g)}$$

$$P_0 = \frac{D_0\,(1+g)}{k_e - g}$$

$$52 = \frac{2.75\,(1+g)}{0.15-g}$$

$$\frac{52}{2.75} = \frac{1+g}{0.15-g}$$

$$18.909 = \frac{1+g}{0.15-g}$$

$$2.836 - 18.909g = 1 + g$$

$$\frac{1.836}{19.909} = g$$

$$g = 9.22\%$$

**11.** E Interest rate anticipation strategy demands forecasting the direction and quantum of change. Hence (I) is correct. Because interest rate sensitivity is related to bond duration, the general rule for interest rate anticipation is to increase your investment in long duration (long maturity and low coupon bond) when interest rates are expected to decline. This enhances the opportunity to increase total return in the short run through price appreciation. On the other hand, if interest rates are expected to rise, moving into shorten duration bonds (i.e. short maturity and high coupon bonds) aids in preserving capital which in turn can stabilize or increase total return in a market with falling prices. Clearly (III) and (IV) are also correct and (II) is wrong. Hence (e) is the answer. < TOP >

**12.** D

$$X = \frac{(D_T - D_I)P_I}{D_F P_F}$$

< TOP >

Where,

X = approximate number of futures contracts;

$D_T$ = target effective duration for the portfolio;

$D_I$ = initial effective duration for the portfolio;

$P_I$ = initial market value of the portfolio;

$D_F$ = effective duration for the futures contract; and

$P_F$ = market value of the futures contract

$$X = \frac{(D_T - D_I)940,00,000}{0.5X3280X100} = 430 \text{ contracts}$$

$$(D_T - D_I) = 0.75021 \text{ or } 0.75 \text{ years or } 9 \text{ months.}$$

**13.** C Number of units purchased = 97,500/15 = 6,500 < TOP >

Number of units withdrawal = 3,475/15.50 = 224.19

Number of units left = 6500 – 224.19 = 6,275.81 ≈ 6,276.

**14.** B The fund is using Treynor ratio as a measure of return per unit of risk. < TOP >

Therefore, Treynor ratio = 4.65

$$\text{Treynor ratio} = \frac{R_p \text{ - } R_f}{\beta}$$

$$Rf = \frac{F-P}{P} \times \frac{365}{d}$$

$$= \frac{100-98.16}{98.16} X \frac{365}{91} X\ 100 = 7.52\%$$

$$\text{Systematic risk} = \beta^2 \text{ X } \sigma^2{}_m$$

$$437.5844 = \beta^2 \text{ X } 20^2$$

$$\beta = 1.05$$

$$\text{Now, } 4.65 = \frac{R_p \text{ - } 7.52}{1.05}$$

$$R_p = 12.40\%$$

**15.** D The situation given in the question is ethical, as she is accessing on the basis of her abilities to analyze the market situations. < TOP >

The practices that are considered unethical by the SEBI are:

- Insider trading.
- Preferential treatment to selected investors.
- Personal trading by fund managers and employees.

'Insider Trading' means buying or selling securities on the basis of privileged information available to the funds by persons regarded as insiders to the company. In normal cases, the fund managers are not insiders; these people collude with other inside people to access private information, which they use to trade on their personal account. Insider trading is likely to impact investors in a very bad way.

Mutual funds are vehicles of collective investments under which investors in a scheme are treated equally. Thus, the concept of preferential treatment is avoided here.

Personal trading, which is done by fund employees, can create conflicting and at times interesting situations. Fund managers buy and sell securities in the market for the mutual fund portfolios; they have access to information that is unavailable to others.

Therefore, correct answer is option (d).

**16.** D The assumptions of Systematic Asset Allocation are as follows: < TOP >

I. The markets provide explicit information regarding the returns available.

II. The relative returns reflect the investor's present perceptions.

III. The measurement of potential returns provides useful clues to those returns that are actually realized.

Hence, statements (I) and (III) mentioned are false and alternative (d) is answer.

**17.** A Treynor's ratio for market portfolio = $(R_M – R_F)/\beta_M$ < TOP >

As $\beta_M$ of market portfolio is 1

Market Risk Premium $(R_M – R_F)$ = 7.1%

Total Return = Alpha + $R_f$ + Beta $(R_m – R_f)$

Kotak Equity Diversified Scheme = 1.7 + 8.0 +0.75 × 7.10 = 15.025% ≈ 15.03%.

**18.** A Under GETFs, investors can buy gold-linked units that would be traded on the stock exchange. One unit of GETF is equal to the value of one gram of gold. The daily price of each unit is linked to the prices of the gold in the physical market. Like any other mutual fund, the investors are able to buy and sell the units of this GETF from the stock market. < TOP >

A mutual fund house launching a GETF appoints authorized participants who initially buy the units of GETF from the mutual fund by exchanging actual pure gold for the units of GETF. These authorized participants facilitate secondary market trading of the GETF units through the stock exchange; where, investors can buy or sell gold units on payment. The underlying asset, i.e., gold, is held by a mutual fund house issuing such units either in a physical form or through a 'gold reciept' giving right of ownership. Authorized participants can go back to the mutual fund house to redeem the GETF units and can demand equivalent value of actual pure gold at any time.

Therefore, statement (III) is not true and correct answer is option (a).

**19.** C The offer document states the minimum number of units to invest not maximum number. All other statements are correct. Therefore, correct answer is option (c). < TOP >

**20.** B Active switching is an investment strategy where by the mutual fund investor monitors the different market areas or sectors in an attempt to be in the strongest funds of the market or sector at any given time. < TOP >

**21.** E The guidelines for protecting the interests of debenture holders requires, among other things, the issuing company to create a debenture redemption reserve out of its profits to the extent of 50% of the amount of debentures to be redeemed before the date of redemption. < TOP >

**22.** D Ranking according to sharpe and Treynor ratio is same if portfolio is completely diversified i.e. total risk = systematic risk or unsystematic risk is zero. Hence (d) is the answer. < TOP >

**23.** D ExMark is a term that defines the relationship between a fund's return and market index. An ExMark below 80% indicates less predictability of relative performance. < TOP >

Funds with an ExMark of 95% or above provide less opportunity to add value over and above the market's return. Since statements (II) and (III) are false, alternative (d) is answer.

**24.** C Sinfo Ltd. is a thinly traded security and its balance sheet is not made available after the nine months from the close of the year. Therefore, share of the company will be valued at zero. < TOP >

Value of the portfolio = 1,10,000 × 2,685.45 + 3,12,000 × 259.95 + 4,50,000 × 523.10 + 3,90,000 × 883.30 + 2,99,000 × 502.75 = Rs.1,106,708,150.

= Rs.1,106,708,150 – Rs.3,000,000 = Rs.1,103,708,150

NAV = Rs.1,103,708,150/ 107,573,000 = Rs.10.26

**25.** E Bond laddering involves buying bonds of different maturities. < TOP >

**26.** B First-stage financing is provided to companies for full fledged manufacturing, operations and sales. < TOP >

**27.** E India is facing economic risk. This risk arises due to change in macro economic conditions of the country. The factors could be weak or negative economic growth, high inflation, high trade deficit, decline in real GDP and per capita income, standard of living, capital flight and indebtedness of the country. These factors determine the future course of a country and helps in risk assessment on investment. < TOP >

**28.** A The amount of monthly pension under EPS is calculated as under: < TOP >

Pension = (Pensionable salary X (pensionable years of service + 2)) /70

Where, Pensionable salary is the last 10 months' average salary.

Therefore,

11,428 = (25,000 X (Pensionable years of service +2)) /70

Pensionable years of service = 29.99 Years = 30 years (app.)

**29.** E A LBO involves the purchase of a target company or division of a company where a substantial portion of funds is borrowed, and the assets of the target company are provided as security. In many cases, non-correlated assets or division of the acquired firm are sold to generate cash for payment of borrowed debts. < TOP >

**30.** A Bullet – Portfolio consisting a couple of bonds maturing very close to the investment horizon and the coupon payments are nominal over the investment horizon. < TOP >

Barbell or Dumb-bell – A bond investment strategy that concentrate holdings in both very short-term and extremely long-term maturities.

Therefore, correct answer is option (a).

# Mutual and other Funds (CFA650) : January 2009

## Section B : Problem/Caselets

< TOP >

**1.**

| | $R_{SBI}$ (%) | $R_{Nifty}$ (%) | ($R_{SBI}$ – $R_{Nifty}$) | $(R_{SBI} - R_{Nifty})-\overline{(R_{SBI} - R_{Nifty})}$ | $[(R_{SBI} - R_{Nifty})-\overline{(R_{SBI} - R_{Nifty})}]^2$ |
|---|---|---|---|---|---|
| 31/12/07 | 5.6392 | 6.5221 | -0.8829 | –0.5724 | 0.3276 |
| 31/01/08 | -16.2945 | -16.3091 | 0.0146 | 0.3251 | 0.1057 |
| 29/02/08 | 1.4041 | 1.6750 | -0.2709 | 0.0396 | 0.0016 |
| 31/03/08 | -9.6798 | -9.3615 | -0.3183 | –0.0078 | 0.0001 |
| 30/04/08 | 8.6428 | 9.1118 | -0.4690 | –0.1585 | 0.0251 |
| 30/05/08 | -6.1142 | -5.7260 | -0.3882 | –0.0777 | 0.0060 |
| 30/06/08 | -17.6320 | -17.0335 | -0.5985 | –0.2880 | 0.0829 |
| 31/07/08 | 6.4244 | 7.2366 | -0.8122 | –0.5017 | 0.2517 |
| 29/08/08 | 0.4008 | 0.6243 | -0.2235 | 0.0870 | 0.0076 |
| 30/09/08 | -10.0316 | -10.0642 | 0.0326 | 0.3431 | 0.1177 |
| 31/10/08 | -26.0765 | -26.4103 | 0.3338 | 0.6443 | 0.4151 |
| 28/11/08 | -8.8283 | -8.6845 | -0.1438 | 0.1667 | 0.0278 |
| Total | | | -3.7263 | | 1.3689 |
| Average | | | -0.3105 | | |

Tracking error = $\sqrt{1.3689/11}$ = 0.3528%

Annualized tracking error = 0.3528 $\times \sqrt{12}$ = 1.22%

**Another Method :**

| | $R_{SBI}$ | $R_{Nifty}$ | $(R_{SBI} - \overline{R_{SBI}})$ | $(R_{SBI} - \overline{R_{SBI}})^2$ | $(R_{Nifty} - \overline{R_{Nifty}})$ | $(R_{Nifty} - \overline{R_{Nifty}})^2$ | $(R_{SBI} - \overline{R_{SBI}})(R_{Nifty} - \overline{R_{Nifty}})$ |
|---|---|---|---|---|---|---|---|
| 31/12/07 | 5.6392 | 6.5221 | 11.6513 | 135.7528 | 12.2237 | 149.4188 | 142.4220 |
| 31/01/08 | -16.2945 | -16.3091 | -10.2824 | 105.7277 | -10.6075 | 112.5191 | 109.0706 |
| 29/02/08 | 1.4041 | 1.6750 | 7.4162 | 55.0000 | 7.3766 | 54.4142 | 54.7063 |
| 31/03/08 | -9.6798 | -9.3615 | -3.6677 | 13.4520 | -3.6599 | 13.3949 | 13.4234 |
| 30/04/08 | 8.6428 | 9.1118 | 14.6549 | 214.7661 | 14.8134 | 219.4368 | 217.0889 |
| 30/05/08 | -6.1142 | -5.7260 | -0.1021 | 0.0104 | -0.0244 | 0.0006 | 0.0025 |
| 30/06/08 | -17.6320 | -17.0335 | -11.6199 | 135.0221 | -11.3319 | 128.4120 | 131.6755 |
| 31/07/08 | 6.4244 | 7.2366 | 12.4365 | 154.6665 | 12.9382 | 167.3970 | 160.9059 |
| 29/08/08 | 0.4008 | 0.6243 | 6.4129 | 41.1253 | 6.3259 | 40.0170 | 40.5674 |
| 30/09/08 | -10.0316 | -10.0642 | -4.0195 | 16.1564 | -4.3626 | 19.0323 | 17.5355 |
| 31/10/08 | -26.0765 | -26.4103 | -20.0644 | 402.5801 | -20.7087 | 428.8503 | 415.5076 |
| 28/11/08 | -8.8283 | -8.6845 | -2.8162 | 7.9310 | -2.9829 | 8.8977 | 8.4004 |
| Total | -72.1456 | -68.4193 | | 1282.1904 | | 1341.7907 | 1311.3060 |
| Average | -6.0121 | -5.7016 | | | | | |
| Variance (Total/11) | | | | 116.5628 | | 121.9810 | 119.2096 |

Beta = 119.2096/121.9810 = 0.9773

Residual Risk = $\sigma^2_{SBI} - \beta^2 \times \sigma^2_{Nifty}$ = 116.5628 – 0.9773$^2$×121.9810 = 0.0569

Tracking error = $[(\beta_{SBI} - 1)^2 \sigma^2_{NIFTY} + \sigma^2_{eSBI}]^{1/2}$ = $[(0.9773 - 1)^2 \times 121.9810 + 0.0569]^{1/2}$ = 0.3461

Annualized tracking error = $0.3461 \times \sqrt{12}$ = 1.20%

The minor deviation in tracking error in both the methods is due to approximation.

**2.** As indicated in the caselet, the world's economic centre of gravity is gradually shifting from the established, wealthy economies to the emerging economies like China, India and South East Asia. India, the world's largest democracy, offers some very clear advantages. It is not only one of the fastest growing economies in the world, but with a population of 1.3 billion, India represents economic opportunities on a massive scale. "India's legal framework, which protects foreign investors, is also the best in the region. There is also an abundance of managerial and technical skills, with international expertise and that is where India enjoys an edge over other Asian countries to attract foreign investors. < TOP >

With such a sound economic base and with hundreds of companies complying to economic laws of Shariah, India offers a huge economic opportunity for Islamic investors, who follow Shariah investment and therefore can't invest in interest-based ventures or in Islamically unethical ventures like tobacco, pornography, alcohol, fashion, gambling, vulgar entertainment and conventional finances like banks and non-banking financial institutions.

As a number of Shariah-compliant stocks in India are much higher than in Muslim countries put together, thus providing immense scope of parking money by Islamic investors. As the growth in market capitalization of Shariah-compliant stocks was also found to be better than the rate of growth achieved by non-Shariah-compliant stocks, Islamic finance is fast becoming a great success story of modern times. Even though Islamic investors turns to Islamic countries like Malaysia, Pakistan and Indonesia, their economies provide limited opportunities and too inadequate to absorb the huge investment potential of the Arab Islamic countries. So, the Islamic investors are now coming forward to invest in India, as it is the best option with a large number of companies qualifying Shariah investment norms. And even Indian Muslim investors show great interest in investing in Shariah-compliant stocks.

**3.** After considering the various criteria, highlighted Mr.Gupta, the possible conditions for investing in shares can be: < TOP >

It may not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, such as companies manufacturing, selling or offering liquors, pork haram (prohibited) meat, or involved in gambling, night club activities, pornography, gold trading, advertising and media (with the exception of newspapers). If the main business of the companies is halal (lawful), like automobiles, textiles etc, but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the shareholder disapprove such dealings. If income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity, and must not be retained by investor. The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money, they cannot be purchased or sold except on par value, because in this case the share represents money only and the money cannot be traded in except at par.

For companies whose main activity is not un-Islamic but a part of their income is not purely Islamic or a minor part of it comes from un-Islamic activities are prohibited, for example hotel, sugar, entertainment etc.

**4. No Guarantees:** SEBI's guidelines do not require the fund house to give any guarantees. In other words, the AMC isn't required to make up the difference in case of capital erosion. They only need to ensure that, as far as possible, the investor's initial investment is safe, by structuring the portfolio in such a way that ensures protection. < TOP >

**Low liquidity:** Capital protection funds are essentially closed-end funds, wherein an investor can't exit during the life of the scheme for any reason, be it need for liquidity or poor performance by the scheme. The experience of closed-end funds listing on stock exchanges has not been happy with the units quoting on the exchanges at heavy discounts to NAV. This makes it essential for the investor to be able to spare the funds for three or five years, as the case may be, for which funds would be locked up.

**Moderate returns:** If you invest in the belief that returns from funds will match that of diversified equity funds when markets go up and reflect a fixed deposit in a bear market, you would be disappointed. A capital protection fund's focus is protecting the capital. Only a portion of the funds will be invested in equity and related instruments and returns to investors are going to be muted to that extent.

**Return and risk**: The risk for an investor in a capital protected fund will not be of losing capital invested. The risk for the investor would be of not getting expected returns. The challenge for fund managers would be to be able to allocate sufficient resources to risky assets to generate returns.

For example, in a phase when interest rates are going down, greater allocation will have to be made to the debt component in order to offset the reinvestment risk and to ensure that the redemption value of the bonds at the time of maturity equals or is greater than the amount invested.

This would mean less exposure to equity products and that would greatly reduce the potential gains that a fund can achieve from subsequent gains in the stock markets. To put things in perspective, a look at the returns from MIPs show that funds that have at least 15 per cent in equity have fared better in all periods.

**5.FMPs and CPOSs have certain dissimilarities as well:**

< TOP >

- CPOSs are oriented towards capital protection; hence the defining feature of schemes from the segment is providing safety of capital. Generating capital appreciation is relegated to second position.

  Conversely, FMPs are return-oriented investment avenues and not inclined towards protection of invested amount. The primary aim of such funds is to generate returns.
- As per SEBI (Securities and Exchange Board of India) guidelines, it is mandatory for all the AMCs (Asset Management Companies) to get the proposed portfolios of their CPOSs rated by a SEBI registered credit rating agency. Also, the rating has to be reviewed on a quarterly basis and AMCs must ensure that the debt component of the portfolio has the highest investment grade rating (AAA or P1+).

  FMPs tend to primarily invest in debt instruments with a high credit rating as well, but they have a free hand in terms of the instruments they can invest in. Similarly, it is not mandatory to get the portfolio rated by any credit rating agency.
- CPOSs are close-ended in nature and don't offer any option to investors for premature withdrawals. Hence investors are advised to park only that portion of their investible surplus, which can be put aside for a longer time frame.

Investors in FMPs have the option of prematurely exiting their investments; however, the same would attract an exit load as specified by the fund house.

## Section C: Applied Theory

**6.** In accordance with the regulations prescribed to Fund Managers, SEBI requires Fund Managers to observe ethical norms in its day-to-day functions. SEBI acts as the watchdog to control any unethical or unfair business practices through the AMC at the operating level. The practices that are considered unethical by the SEBI are: < TOP >

- Insider Trading.
- Preferential Treatment to Selected Investors.
- Personal Trading by Fund Managers and Employees.

The term, '*insider trading'* means buying or selling securities on the basis of privileged information available to the Funds by persons regarded as insiders to the company. In normal cases, the Fund Managers are not insiders; these people collude with other inside people to access private information, which they use to trade on their personal account. Insider trading is likely to impact investors in a very bad way.

In a similar way, Mutual Funds are vehicles of collective investments under which investors in a scheme are treated equally. Thus, the concept of preferential treatment is avoided here. SEBI, as a regulator, keeps a watch on AMCs in order to prevent unethical practices in this regard; for instance, one can take the "Late trading abuses," which discriminate one set of unit holders to others. The circulars SEBI issues prescribe uniform cut-off time to accept application for subscription and to determine applicability of uniform NAVs to all customers. Mutual Funds all over India are required to adhere to these regulations.

*Personal trading***,** which is done by Fund employees, can create conflicting and at times interesting situations. Fund Managers buy and sell securities in the market for the Mutual Fund portfolios; they have access to information that is unavailable to others. An ethical issue that attracted considerable attention and debate in recent times is – whether Fund Managers are to be permitted to trade on their own account in the securities that are present in the Funds they manage. According to one school of thought, the operations of Fund Managers must be barred while they continue as Fund Managers. As per another view, personal trading (for personal investment purposes) may be permitted although there are many restrictions on the timings of the personal traders and on the investments holding period, etc. In essence, SEBI maintains a continuous vigil on Fund Managers and sees that non-public information is not used for personal gains.

At present, SEBI holds the view that Fund employees are not barred from trading or investing at all levels. Fund Managers are also required to disclose the holdings and transactions made during a given period of time. Such disclosure will help the authorities to investigate the activities of the Fund Managers and to capture any wrongdoing that is taking place. SEBI, as a regulatory body, works to attain the objective of investor protection as it restricts the Fund Manager from putting the investors' money at risk or loss. "Front running" is a method of buying and selling securities before doing the same transaction for a Fund which is unethical in nature; front running method is banned all over the world.

**7.** An effective model portfolio for the investor should be based on a balance between the risks the investor is willing to take and the returns he needs to achieve his goals. An understanding of the various aspects of investor investment profile will allow the advisor to assess the proper balance of model portfolio. < TOP >

The methods which the advisor or investor can look for building a model portfolio are:

a. The 100 minus the Investor Age Method.

b. Financial Objectives Method.

c. Cash Flow Needs Method.

d. Risk Tolerance Method.

e. 100% Equity Funds for Long Run.

a. **The 100 Minus the Investor Age Method:** According to this method, the percentage of total investment that can be invested in equities depends on the investor's age and is based on the premise that the investor will live up to 100 years. The method suggests that the proportion of investment to be placed in equities is 100 minus the investor age. The rest may be placed in bonds and other safe investments. Though life expectancy is increasing, the probability of a person living beyond 100 years is still low. As the age increases, the ability to take risk normally declines. This method essentially addresses this issue. The person (who uses this method) reduces his/her allocation to equities, as he/she grows old. This method, while based on the general perceptions about the desirable exposure to equities over the life of a person, suffers from some obvious defects. It does not take into account the life expectancy of a person, the factor of inflation, the wealth to be accumulated or the current financial needs. Over the years, this method results in increase in the current income and decrease in growth, this can be harmful for the financial condition of the person, if factors such as inflation and increasing long life expectancies are taken into consideration.

b. **Financial Objectives Method:** This method is based more on common sense than anything else. It simply says, plan the investor's financial needs in future and invest enough money so that he will be able to realize them. It does not talk anything about how and where and when to invest. If one's goals are short-term, one has to invest in short-term liquid investments and if they are long-term, one has to go in for long-term investments. All that one has to know is what one wants to achieve and how much one can save today for that.

c. **Cash Flow Needs Method:** This method, as the name suggests, involves projecting the cash flows of the future and estimating the deficit, if any. Investments will then be aimed at filling the deficit. The sources of income that a person may have, for example, may be wages and salary, pension payments, interest and dividend income on investments already made, rental income from properties, sale proceeds of properties, inheritance of property, sale of used vehicle, etc. The outflows expected in future should then be reduced from the inflows. If there is a surplus, then one may go in for conservative or safe investments. In case, there is a deficit, investments will have to be aggressive and the degree of aggressiveness depends on the amount of deficit and the amount now available for investment.

d. **Risk Tolerance Method:** This method ignores the financials and focuses on the psychology of the individual. According to this method, a risk-averse person should invest all or most of the money available in low risk investments and a risk-lover may invest in high-risk instruments.

e. **100% Equity Funds for Long Run:** This strategy involves placing all the long-term investments entirely on equity stocks. This method generally gets popular when stock markets are on a high and falls in popularity along with the markets. There is no other basis, scientific or otherwise, for it.

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