

Question Paper

Portfolio Management and Mutual Funds – II (252) : April 2003

Part D : Case Study (50 Points)

- This part consists of questions with serial number 1 - 6.
- Answer all questions.
- Points are indicated against each question.
- Do not spend more than 80 - 90 minutes on Part D.

Case Study

Read the case carefully and answer the following questions:

1. Prepare a comprehensive investment strategy for Mr. Sharma clearly stating the investment objectives and constraints.

(10 points)
2. Construct an investment plan using strategy of dedication with zeros (Zero coupon bonds) so that funds requirement of Mr. Sharma can be met. Estimate the duration of the resulting portfolio of zero coupon bonds as on April 01, 2003.

(10 points)
3. The risk-free rate of return is 5% and variance of the market index return is $20(\%)^2$. Using Sharpe optimization model, construct an optimal stock portfolio for Mr. Sharma.

(12 points)
4. Using the results obtained by you in question numbers (2) and (3) above, calculate duration of the savings portfolio of Mr. Sharma.

(5 points)
5. Would you advise Mr. Sharma to invest in J.M. Momentum and Income Fund? Justify.

(6 points)
6. Briefly discuss advantages and limitations of portfolio dedication.

(7 points)

Mr. Praveen Sharma is planning to invest his savings to meet his future needs. He consulted Star Advisors Ltd., a firm offering portfolio management services. Star Advisors Ltd. manages the portfolios of high net worth investors. The track record for Star Advisors Ltd. is quite impressive.

A portfolio manager of the company met Mr. Sharma to assess the needs and limitations of the later's requirement. The salient observations made by the portfolio manager are as follows:

- Mr. Sharma (42) is working as Manager (Finance) of a multimedia company. His wife, Seema is a housewife. They have two children – a son and a daughter. His son is presently in XI standard and wants to go abroad for his higher education. His daughter is in IX standard and wants to become a doctor. Mr. Sharma earns Rs.50,000 per month and receives Rs.1.6 lakh every year as bonus. Total monthly expenses of Mr. Sharma are Rs.30,000.
- The total amount in the saving portfolio of Mr. Sharma is Rs.50 lakhs. His total investment needs are expected to be Rs.80 lakhs and he wants at least 50% of this requirement from his saving portfolio. Mr. Sharma plans to obtain substantial capital gains from his investment to finance construction of a hospital after 10 years. He wants substantial portion of services of the hospital to be offered to poor people and wants to build an endowment for which he requires an additional Rs.20 lakhs.
- The portfolio manager of the Star Advisors advised Mr. Sharma that in view of his essential requirements for education of his children, he should invest in bonds and for capital appreciation he should also invest in stocks. The ideal proportion suggested by the portfolio manger requires 60% of his savings portfolio should be in fixed income securities and balance should be dedicated to equities.

The above case is prepared only for the purpose of examination and not to illustrate either effective or ineffective performance of the fund. The case contains real information adapted and combined with other information to generate discussion or analysis on the desired topics.

Year-wise fund requirement of Mr. Sharma is as follows:

Year ending March 31	Liability (Rs. lakhs)
2004	3.00
2005	3.00
2006	4.00
2007	4.00
2008	4.00
2009	5.00
2010	5.00
2011	4.00
2012	8.00
2013	15.00

Portfolio managers generally advise investors to invest in debt instruments of different credit qualities to increase the return but, for Mr. Sharma the portfolio manager suggested high rated debt instruments. Portfolio manager advised Mr. Sharma to use dedication strategy using zero coupon bonds. The following zero coupon bonds are selected for the dedication strategy:

Days/Years	Yield	Years	Yield
0-91 days	5.15%	5 years	8.10%
91-180 days	5.75%	6 years	8.35%
181-360 days	6.25%	7 years	9.25%
2 years	6.75%	8 years	10.05%
3 years	7.20%	9 years	11.15%
4 years	7.80%	10 years	11.85%

The portfolio managers also suggested the following stocks after considering his risk tolerance level:

Stocks	Beta	Unsystematic risk (%)²	Expected utility (%) at risk tolerance level of 50%	Expected Dividend (Rs.)	Price (Rs.)
Temple Ltd.	1.25	18.75	12.50	7.50	80
Omni Corp.	1.10	15.80	11.00	6.25	90
Dollex Ltd.	0.92	13.07	9.25	11.00	100
Alpha Ltd.	0.75	8.75	9.00	9.80	120
Shilpa Oil	1.02	11.20	10.21	7.50	140
Stanley Ceramics	0.89	9.16	9.50	11.25	150

Mr. Praveen Sharma is also analyzing the possibility of investing in mutual funds and has selected the J.M. Momentum and income fund. The essential details of this scheme are as follows:

JM MOMENTUM & INCOME FUND

TYPE OF THE SCHEME

Open Ended Income scheme seeking to generate regular income, primarily through investments in fixed income securities. The fund may also invest a part of its assets in equity and equity related securities.

INVESTMENT PLANS

The Scheme offers investors three investment plans,

- Dividend – Monthly, Quarterly, Half Yearly
- Growth
- Bonus Plan

INVESTMENT OBJECTIVES

The primary investment objective of the scheme is to generate regular income by way of investments in fixed income securities so as to make monthly, quarterly and half yearly dividend distribution, declare bonus in the growth option. The fund would also aim to achieve capital appreciation through investing a portion of its assets in equity and equity related securities.

ASSET ALLOCATION PATTERN

Under normal circumstances the Investment Pattern of the fund would be as follows.

Sl. No	Type of Security	Indicative allocation (% of corpus)	Risk Profile
1.	Debt securities, Money Market Instruments, Securitized Debt, Cash and Call	85%-100%	Low to Medium
2.	Equity and Equity related securities	Upto 15%	Medium to High

INVESTMENT PATTERN

The corpus of the Scheme will be invested in high quality debt and money market instruments. Subject to the Regulations, the corpus of the Scheme can be invested in any (but not exclusively) of the following securities:

- Securities created and issued by the Central and State Governments and/or repos/reverse repos in such Government Securities as may be permitted by RBI (including but not limited to coupon bearing bonds, zero coupon bonds and treasury bills).
- Securities guaranteed by the Central and State Governments (including but not limited to coupon bearing bonds, zero coupon bonds and treasury bills).
- Debt obligations of domestic Government agencies and statutory bodies, which may or may not carry a Central/State Government guarantee.
- Corporate debt and securities (of both public and private sector undertakings) including Bonds, Debentures, Notes, Strips, etc.
- Obligations of banks (both public and private sector) and development financial institutions.
- Money market instruments permitted by SEBI/RBI.
- Certificate of Deposits (CDs).
- Commercial Paper (CPs).
- Securitised Debt
- The non-convertible part of convertible securities.
- Any other domestic fixed income securities including Structured Obligations.
- Any international fixed income securities.
- Pass through, Pay through or other Participation Certificates representing interest in a pool of assets including receivables.
- Any other like instruments as may be permitted by RBI/SEBI/ such other Regulatory Authority from time to time.
- Equity and Equity related securities including convertible bonds and debentures and warrants carrying the right to obtain equity shares
- ADR's, GDR's issued by Indian companies subject to condition issued by RBI and SEBI.
- Derivative instruments like Interest Rate Swaps, Forward Rate Agreements, Stock Index Futures and such other derivative instruments permitted by SEBI and RBI.

The securities mentioned above and such other securities the scheme is permitted to invest could be listed, unlisted, IPO's, secondary market operations, privately placed, rights offers or negotiated deals, secured, unsecured, rated or unrated and of any maturity.

The fund can invest in securities that are rated by CRISIL and ICRA and other independent credit rating agencies.

END OF PART D

Part E : Caselets (50 Points)

- This part consists of questions with serial number 7 - 13.
- Answer **all** questions.
- Points are indicated against each question.
- Do not spend more than 80 - 90 minutes on Part E.

Caselet 1

Read the following caselet carefully and answer the following questions:

7. The caselet states that large returns demand investment strategies that can work only if returns are kept confidential. Discuss.

(8 points)
8. What is alternative investment? Apart from investing in private equity, what are the other instruments available under this type of investments?

(7 points)
9. How do you think CALPERS can standardize its measurement of IRR?

(5 points)

How much detail should pension funds give about their ventures into alternative investments? In the case of private-equity investments with no quoted market value, disclosure can be misleading – and embarrassing. So argues the California Public Employees' Retirement System (CALPERS), the largest public pension fund in America, which has invested almost \$20 billion of its \$129 billion assets in the alternative instruments.

The strategy may have been good for CALPERS itself – but so far it adamantly refuses to tell. This reticence has prompted the San Jose Mercury News to file a lawsuit with wide implications.

The newspaper is suing CALPERS for access to the fund-by-fund performance data of its private-equity investments, claiming that this should be a matter of public record. CALPERS argues that it is trade secret and large returns demand investment strategies that can work only if returns are kept confidential. Last week, the San Francisco Superior Court ruled tentatively that at least some performance data falls into the public domain, but it gave CALPERS, and the private equity funds in which it invest, three weeks to make their case.

Private-equity funds, unlike publicly traded stocks with returns that can be easily measured, report an internal rate of return (IRR), a fuzzy concept for which no standardized measure exists and which can easily be manipulated to boost results. CALPERS itself recently launched an initiative to standardize its measurement of IRR, even as it awaits the judge's decision.

Any move by CALPERS is likely to be followed elsewhere. In September the University of Texas pension fund willingly made public its private-equity performance, amid a hail of lawsuits from private-equity firms. The Massachusetts pension trust is considering a similar step. Private-equity funds fear the effect that disclosure might have on reputations. But these days the pressure for more transparency is hard to resist.

Caselet 2

Read the following caselet carefully and answer the following questions:

10. According to the caselet, ETFs are appropriate tools with which asset allocation models get a good compliment. Do you agree? Justify.

(7 points)

11. Even though ETF involves paying commissions, how do you think that it involves lower cost compared to other funds?

(7 points)

The Exchange Traded Funds (ETFs) have become immensely popular among the investor community. They provide the much-needed diversification to the portfolio. By providing the correlation of assets to the minimum levels, the ETFs have passed a big hurdle on the road towards popularity.

Even the ETFs have several advantages to tell; they are mainly picked up for the benefits of diversification that they provide. ETFs can combine assets in a judicious proportion to introduce the much-needed diversifying effect to the portfolio. Exchange Traded Funds tend to capture the performance of the entire basket therefore it becomes handy for the investor to have the benefit of a diversified portfolio by including few ETFs in the portfolio. Mutual funds also offer diversification, but they are always prone to the temptation of shifting in style by the manager. ETFs, in these times promise the purity of asset class with a totally transparent holding of the assets with a daily disclosure.

Time and again, the contribution of the asset allocation towards the final outcome of a portfolio has been stressed upon several times. Thus, asset allocation models have been designed to produce efficient portfolios with an expected rate of return and a pre-targeted variability of returns; all with the assumption that long-term returns are approximated with long-term historical returns. It has been seen that ETFs are appropriate tools with which asset allocation models get a good compliment.

Another great advantage that the ETFs bring to the table is the cost advantage. Traditionally, the Exchange Traded Funds have found to be the ones with the lowest expense ratios of as compared to any other competitor. They definitely have a cost advantage over the actively managed mutual funds. Costs associated with the portfolio can reduce the returns generated by the portfolio significantly over a longer investment horizon of one to two decades. But it may also be noted that a transaction in ETF involves paying of commissions on the part of the investor.

It is generally observed that the investors tend to be more observant towards the cost of investment when the returns generated by their portfolios are low or negative. Nevertheless, despite of their magnitude, costs associated with the investments are to be kept in mind. In this case, the ETFs can provide an opportunity to register higher returns by reducing investment expenses incurred.

Caselet 3

Read the following caselet carefully and answer the following questions:

12. The caselet strongly suggests that separate account products would dominate mutual funds in future. Do you agree? Discuss.

(8 points)

13. Briefly discuss the important reasons behind the lower returns provided by mutual funds compared to the returns actually generated in the stock market, bond market and the money market.

(8 points)

A report prepared by the respected Forrester Research organization predicts that by 2004 – right around the corner, really—mutual fund assets will grow by 26%, while separate account assets will grow by 400%. By then, they predict the end of mutual fund dominance will be well underway:

"By 2006, large fund firms will emphasize separate accounts at the expense of mutual funds . . . By 2010, assets in separate accounts will exceed \$2.6 trillion, at least 30% of retail assets managed."

And that's not all. "The end of mutual fund dominance will accelerate as fund families create their own separate account products," and financial advisers will construct their own client portfolios with stock baskets.

If separate accounts will continue to dominate mutual funds, a dark era for the mutual fund industry lies close at hand. *Or does it?* One need only recall Mark Twain's famous comment, "the reports of my death are greatly

exaggerated." If it merely chooses to do so, the mutual fund industry can continue its dominance on the balance sheets of individual investors for as far ahead as the mind can imagine. For America's families have spoken, and mutual funds have emerged as their investment of choice to an astonishing—and often unrecognized—degree.

Consider American historical savings flow patterns. As the 1970s turned to the 1980s, US families were investing about 20% of their capital into mutual funds. By the turn to the 1990s, the rate had risen to 25%. But by 1996 it had risen to 60%. And by the turn of the millennium, it had soared to 82%. Yes, on average during 1999-2001, US families—the very backbone of the U.S. economy—saved \$385 billion per year . . . and placed \$320 billion of it in mutual funds.

This powerful increase in market penetration says something very simple about mutual funds: They are popular with investors who use them. But it also says something else: Today's fund dominance comes because of the remarkable flexibility of the fund industry and the wide span of financial instruments that mutual funds comprehend. Lest we forget, this industry includes not only *equity* mutual funds (the apparent focus of the Forrester study), but *bond* funds and *money market* funds. When you think about it, mutual funds are the investment of choice in each asset class, and will continue to grow—no matter what the course of the financial markets, no matter what the emotional state of the American investor.

In the soaring stock prices of 1999 and the first half of 2000, for example, when fund cash flows from individual investors were \$400 billion, the mix was 90% stock funds and 20% money market funds, with 10% actually *withdrawn* from bond funds. Then, when the stock market reversed course over the next year and one-half, industry cash flows remained strong at \$290 billion, but the mix was 30% bond funds, 30% money market funds, and only 40% equity funds.

Clearly, mutual funds have successfully made the transition from the old equity-oriented industry that people knew from 1924 (when the first U.S. fund was formed) right up to 1975, when the money market fund was introduced. Shortly thereafter, in that seemingly ancient era of the early 1980s when yields were at double digit levels and investors wanted, of all things, *income*, from their investments, money market funds dominated the industry, with bond funds not far behind.

But the tragic flaw of this industry is that mutual funds have failed to give our investors an adequate share of the returns actually generated in the stock market, the bond market, and the money market. During the two decades ending December 31, 1999, these returns were at the highest levels in U.S. history: 18% per year for stocks, 10% for bonds, 7% for the money markets. As a result, despite *relative* returns that significantly lagged those of the markets in which they invested, fund investors enjoyed good *absolute* returns.

END OF PART E

END OF QUESTION PAPER

Suggested Answers

Portfolio Management and Mutual Funds – II (252) : April 2003

Part D : Case Study

1. Investment Policy

Returns Required:

- Mr. Sharma's salary is sufficient to meet regular expenditures of his family and therefore, he does not require any monthly return to meet his household expenditure. He has good surplus earning which he can invest in fixed income securities as well as equity. Investments in debt securities gives more safety to his investment portfolio and equity investment gives chance for capital appreciation.
- Very high returns are not required from the equity investment of Rs.20 lakhs. Equity portfolio should at least produce Rs.40 lakh in 10 years i.e. 7.17% yearly return is required. As Mr. Sharma is contented with just 50% of the amount coming through equity portfolio even debt investment can provide it. As higher risks are involved with equity, it should provide the entire investment needs of Mr. Sharma i.e. 80 lakhs at a return of about 14.87%.
- Ideally, equity portfolio should provide his fund need, and also money for establishing an endowment fund. For generating this money also the expected return from equity portfolio goes upto 17.46%.
- As there is a substantial monthly surplus, no additional yearly investments are being planned for the post retirement requirement and marriage expenses of his daughter.

Risk Tolerance:

- The risk tolerance is low for the funds required for the higher education of Mr. Sharma's children.
- Risk tolerance level is moderately high for the funds required for the hospital and endowment fund as they are not as important as the education of his children. High level of risk tolerance is required to achieve a return of 17.46% p.a.
- Reduction in the risk tolerance level will demand additional investments from Mr. Sharma.

Constraints:

- Liquidity: Liquidity requirements are almost nil.
- Investment Horizon: The time period of investment is medium to long term (10 years).
- Taxes: Mr. Sharma falls into high tax bracket due to his high salary. Investment in tax saving instrument should be made to lower down the tax burden.
- Other circumstances: Additional fund of Rs.25 lakhs is required for the establishment of the endowment fund. The additional requirement demands a higher return at of course, higher risk tolerance level.

2.

Year	Liabilities	Current Purchases	Maturity value	Yield locked
1	3.00	2.823	3.00	6.25%
2	3.00	2.633	3.00	6.75%
3	4.00	3.247	4.00	7.20%
4	4.00	2.962	4.00	7.80%
5	4.00	2.709	4.00	8.10%
6	5.00	3.0903	5.00	8.35%
7	5.00	2.692	5.00	9.25%
8	4.00	1.8593	4.00	10.05%
9	8.00	3.0896	8.00	11.15%
10	15.00	4.8948	15.00	11.85%
		30.00		

The duration can be calculated as follows

Duration of Zero coupon bond	Amount	Proportion	Weighted duration
1	2.823	0.0941	0.0941
2	2.633	0.088	0.176
3	3.247	0.1082	0.3246
4	2.962	0.0987	0.3948
5	2.709	0.0903	0.4515
6	3.0903	0.1030	0.6180
7	2.692	0.0897	0.6279
8	1.8593	0.0620	0.496
9	3.0896	0.1030	0.927
10	4.8948	0.1632	1.632
	30.00		5.7419

3. As utility is given for four stocks we need to first calculate expected return

$$= \text{Utility} + \text{Risk Penalty}$$

$$= \text{Utility} + \frac{\sigma_i^2}{t_k}$$

$$\sigma_i^2 = \text{Systematic risk} + \text{Unsystematic risk}$$

$$= \beta_i^2 \sigma_m^2 + \text{Unsystematic risk.}$$

Temple Ltd.	$(1.25)^2 \times 20 + 18.75$	50
Omni Corporation	$(1.10)^2 \times 20 + 15.80$	40
Dollex Ltd.	$(0.92)^2 \times 20 + 13.07$	30
Alpha Ltd.	$(0.75)^2 \times 20 + 8.75$	20
Shilpa Oil	$(1.02)^2 \times 20 + 11.20$	32
Stanley Ceramics	$(0.89)^2 \times 20 + 9.16$	25

Expected return of the stock

	Utility (%)	Risk Penalty $\frac{(\sigma_i^2)}{t_k}$	Expected return (%)
Temple Ltd.	12.50	50/50 = 1.00	13.50
Omni Corporation	11.00	40/50 = 0.8	11.80
Dollex Ltd.	9.25	30/50 = 0.60	9.85
Alpha Ltd.	9.00	20/50 = 0.40	9.40
Shilpa Oil	10.21	32/50 = 0.64	10.85
Stanley Ceramics	9.50	25/50 = 0.50	10.00

	R_i	β_i	$\left(\frac{R_i - R_F}{\beta} \right)$	Rank
Temple Ltd.	13.50	1.25	$\frac{13.50-5}{1.25} = 6.8$	1
Omni Corp.	11.80	1.10	$\frac{11.80-5}{1.10} = 6.19$	2
Dollex Ltd.	9.85	0.92	$\frac{9.85-5}{0.92} = 5.27$	6
Alpha Ltd.	9.40	0.75	$\frac{9.40-5}{0.75} = 5.87$	3
Shilpa Oil	10.85	1.02	$\frac{10.85-5}{1.02} = 5.74$	4
Stanley Ceramics	10.00	0.89	$\frac{10-5}{0.89} = 5.62$	5

Rank	Stock	β_i	σ_{ei}^2	$\left(\frac{R_i - R_F}{\hat{\alpha}} \right)$	$\left[\frac{R_i - R_F}{\sigma_{ei}^2} \right] \hat{\alpha}$	$\frac{\beta_i^2}{\sigma_{ei}^2}$	$\sigma \left[\frac{R_i - R_F}{\sigma_{ei}^2} \right]$	$\sum \frac{\sigma_{ei}^2}{\beta_i^2}$	C
1	Temple	1.25	18.75	6.8	0.567	0.083	0.567	0.083	4.263
2	Omni	1.10	15.80	6.19	0.474	0.077	1.041	0.160	4.957
3	Alpha	0.75	8.75	5.87	0.377	0.064	1.418	0.224	5.175
4	Shilpa	1.02	11.20	5.74	0.533	0.093	1.951	0.317	5.316
5	Stanley	0.89	9.16	5.62	0.486	0.087	2.437	0.404	5.368
6	Dollex	0.92	13.07	5.27	0.341	0.065	2.778	0.469	5.352

All the stocks; except dollex should be selected as $\left(\frac{R_i - R_F}{\beta} \right) > C$ and $C^* = 5.368$.

$$Z_p = \frac{\beta}{\sigma_{C_i}^2} \left(\frac{R_i - R_F}{\beta} - C^* \right)$$

$$Z_T = \frac{1.25}{18.75} (6.8 - 5.368) = 0.0955$$

$$Z_O = \frac{1.10}{15.80} (6.19 - 5.368) = 0.0572$$

$$Z_A = \frac{0.75}{8.75} (5.87 - 5.368) = 0.0430$$

$$Z_S = \frac{1.02}{11.20} (5.74 - 5.368) = 0.0338$$

$$Z_{ST} = \frac{0.89}{9.16} (5.62 - 5.368) = 0.0245$$

$$\Sigma Z = 0.2540$$

Weights

$$\begin{aligned}
 W_T &= 0.0955/0.254 = 0.376 \text{ i.e., } 37.6\% \\
 W_O &= 0.0572/0.254 = 0.2252 \text{ i.e., } 22.52\% \\
 W_A &= 0.0430/0.254 = 0.1693 \text{ i.e., } 16.93\% \\
 W_s &= 0.0338/0.254 = 0.01330 \text{ i.e., } 13.30\% \\
 W_S &= 0.0245/0.254 = 0.0964 \text{ i.e., } 9.64\%
 \end{aligned}$$

4. Duration of bond portfolio = 5.7419 years

For calculation of Duration of equity we should calculate dividend yield of the equity portfolio which includes all stocks except Dollex.

Individual dividend yield of stocks Div / Price

Temple	–	7.50/80	=	0.09375
Omni	–	6.25/90	=	0.0694
Alpha Ltd	–	9.80/120	=	0.0817
Shilpa oil	–	7.50/140	=	0.0536
Stanley Ceramics	–	11.25/150	=	0.075

Weighted dividend yield

$$\begin{aligned}
 &= 0.09375 \times 0.3760 + 0.0694 \times 0.2252 + 0.0817 \times 0.16935 + \\
 &\quad 0.0536 \times 0.1330 + 0.075 \times 0.0964 = 0.07907
 \end{aligned}$$

$$\begin{aligned}
 \text{Duration of equity portfolio} &= \frac{1}{\text{Dividend yield}} \\
 &= \frac{1}{0.07907} \\
 &= 12.6470 \text{ years}
 \end{aligned}$$

Duration of the savings portfolio

$$\begin{aligned}
 &= 12.6470 \times 0.40 + 5.7419 \times 0.60 \\
 &= 8.5039 \text{ years i.e., } 8.5 \text{ years.}
 \end{aligned}$$

5. Investment in J.M momentum income fund is advisable for Mr. Sharma .The asset allocation pattern of J.M momentum & Income fund indicates that at least 85% of the fund will be invested in the fixed income securities and rest of the money can be devoted to the equity and equity related securities. As most of the fixed income securities selected by the fund is of secured nature there is no threat to the capital and selective stocks can produce extra return to the investors who select this fund for investment. As per investment policy 7.17% of annual return is required by Mr. Sharma and mixture of govt. securities and corporate bonds can definitely produce this much return. Again three types of plan are available under this scheme which also gives him the flexibility to choose appropriate scheme which meets Mr. Sharma's criteria.

6. Advantages and Limitations of Portfolio Dedication:

The primary advantage of the dedicated portfolio strategy, when compared to other techniques used to accumulate value, is that it minimizes price (volatility) risk and reinvestment risk because it is typically structured to require a minimum amount of rebalancing and reinvestment income. However, because the technique focuses primarily on matching investment and liability flows, little attention is given to the total return potential of the portfolio. Furthermore, to the extent that securities with maturities comparable to the dates needed for cash are not available, the portfolio is exposed to the risk that the cash supplement provided by reinvestment income may be insufficient. This can occur because the portfolio manager is unable to accurately assess the future reinvestment rates.

Part E: Caselets

Caselet 1

7. Investors who invest in alternative instruments are different from normal investors who invest in equity or fixed income securities. A forced disclosure of returns of these instruments may witness erosion in their investment base. If best funds shun these investments expected returns would see a southward movement. Again, investment strategies involving illiquid assets can produce volatile return which can be tolerated by sophisticated investors, such as, big pension funds and insurance companies. Clearly, investment strategies which can give exceptionally high returns require confidentiality about return and risk involved in it.
8. Loosely speaking all kinds of investment that do not fall in the traditional investment instrument category can be named as alternative investments. In a study published in 1997, Goldman Sachs and Frank Russell defined alternative investments as private, non-traditional, illiquid investments. The instrument covered in the study include venture capital, leveraged buyouts, distressed securities, private equity, oil and gas programs, mezzanine financing, economically targeted investments and timber lands or farmland. Apart from these instruments, managed futures, hedge funds and private debt can also be included in the alternative investment category.
9. Calculation of IRR requires projection of future cash-inflows and the discounting factor to be used for discounting these cash flows. Private equity funds are not as liquid as publicly traded stocks. Illiquidity of private equity investment makes the cash-inflows uncertain and also risk is higher compared to traded stocks. Standardization of IRR involves deciding the conditions in which future cash-inflows can be realized and for every cash-inflows discounting factor should be decided based on its uncertainty level.

Caselet 2

10. Asset allocation becomes very easy if an investor can match the required asset class with the ETF that replicates the asset class. The benefit attached with this type of asset allocation is that any probable error of stock selection can be overcome effectively. Again ETFs can be bought and sold on the exchange at a price that are usually close to the actual intraday NAV of the scheme. Because of this buying and selling facility any change in asset allocation can be executed very fast.
11. Like any other index fund, ETFs are usually passive managed funds but ETF's unit can be bought and sold directly on the exchange. As an ETF is listed on the exchange cost of distribution are much lower. These savings in costs are passed to the investors in the form of lower costs. Further, the structure of ETF also helps reduction in collection disbursement and other processing charges. Long-term investor's inflows and short-term investor's outflow are protected by ETFs. This happens because the fund does not bear extra transaction costs when buying/selling is done due to frequent subscriptions and redemption.

Caselet 3

12. Separate accounts can deliver what investors want: Customized money management. Other benefits that may occur if an individual is using a separate account, higher tax efficiency, ability to structure investor's portfolios around large individual holdings (e.g., company stocks). Real time disclosure of portfolio holdings and the ability to avoid investment that have moral or sentimental importance to them.

However, the benefits mentioned above are doubtful. For example, taxes are not a particular issue for bond and money market funds which account for 40% of industry assets. Infact, regular index funds and tax managed funds offer readily available tax relief. Separate accounts do not necessarily offer investment advantage over mutual funds. Some times they may be disadvantageous to investors. Any investor would like to earn as much as market. This can be easily achieved through low-cost index funds. Actually there is no historical records of separate account managers. Above all, managing a separate account is a challenging task. Only few registered advisers and brokers are having ample resources and technology at par of mutual

funds. Clearly, it is very premature to say that separate account products would dominate mutual funds.

- 13.** Market timing is very important for any mutual fund manager. Although most of the managers had no problem in beating the various market for small period. However during a long investment horizon, they failed to recognize the market tops and bottoms for selling and buying the securities. Even a best performing fund can give negative returns if its timing is not appropriate.

Even a better selection of securities will not fetch the ideal return if timing is not appropriate. Infact, a wrong timing may wash out all the benefits of stock selection. Wrong market timing or not sustaining the timing criteria on a regular basis is the main reason behind the lower returns provided by mutual funds compared to the return provided by individual securities.