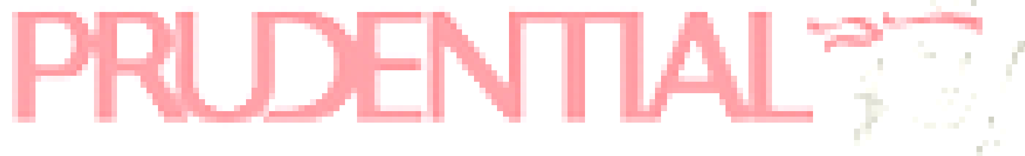
Revision and Practice Test Kit Version 3

For AMFI Mutual Fund (Advisors) Certification Examination

June 2007

ICICI PRUDENTIAL ASSET MANAGEMENT COMPANY LTD.

Revision and practice test kit 3



ASSET MANAGEMENT

Chapters 1 & 2 : Introduction & Mutual Fund Products

Approximate Weightage: 6 questions, 7 marks

- A mutual fund is a pool of money collected from investors and is invested according to stated investment objectives.
- Mutual fund investors are like shareholders and they own the fund.
- Mutual fund investors are not lenders or deposit holders in a mutual fund.
- Everybody else associated with a mutual fund is a service provider, who earns a fee.
- The money in the mutual fund belongs to the investors and nobody else.
- Mutual funds invest in marketable securities according to the investment objective.
- The value of the investments can go up or down, changing the value of the investors' holdings.
- The net asset value (NAV) of a mutual fund fluctuates with market price movements.
- The market value of the investors' funds is also called as net assets.
- Investors hold a proportionate share of the fund in the mutual fund. New investors come in and old investors can exit at prices related to net asset value per unit.
- Advantages of mutual funds to investors are:
  - Portfolio diversification
  - Professional management
  - Reduction in risk
  - Reduction in transaction cost
  - Liquidity
  - Convenience and flexibility
- Disadvantages of mutual funds to investors are:
  - No control over costs
  - No tailor made portfolios
  - Problems of managing a large portfolio of funds
- UTI was the only mutual fund during the period 1963-1988.
- UTI was the only fund for a long period and enjoyed monopoly status.
- UTI is governed by the UTI Act, 1963.
- In 1987 banks, financial institutions and insurance companies in the public sector were permitted to set up mutual funds.
- SEBI got regulatory powers in 1992.
- SBI Mutual Fund was the first bank-sponsored mutual fund to be set up.
- The first mutual fund product was UTI's Master Share in 1986.
- The private sector players were allowed to set up mutual funds in 1993.
- In 1996 the mutual fund regulations were substantially revised and modified.
- In 1999 dividends from mutual funds were made tax exempt in the hands of investors.
- Mutual fund assets in mid-2002 were approximately Rs. 1,00,000 crore.
- Mutual funds can be open ended or closed end, Load or No-Load, Taxable or Tax exempt, commodities and Real Estate.
- In an open-ended fund, sale and repurchase of units happen on a continuous basis, at NAV related prices, from the fund itself.
- The corpus of open-ended funds, therefore, changes everyday.
- A closed-end fund offers units for sale only in the NFO. It is then listed in the market.
- Investors wanting to buy or sell units have to do so in the stock markets. Usually closed-end funds sell at a discount to NAV.
- The corpus of a closed-end fund remains unchanged.
- Mutual funds also offer equity linked savings schemes (ELSS) that have the following features:
  - 3 year lock in
  - Minimum investment of 90% in equity markets at all times
  - Open ended or closed end
  - Rebate of 20% under section 80C for investments up to Rs. 10,000.

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- Gilt funds are funds that invest only in government securities
- Sectoral funds are also called as specialty funds.
- Equity funds are risky; liquid funds have the lowest risk.
- Equity funds are for the long term; liquid funds are for the short term.
- Investors choose funds based on their objective, risk appetite, time horizon and return expectations.

Chapters 3 & 4 : Sponsor, Trustee, AMC and Other Constituents
Approximate Weightage: 2 questions; 3marks

- Mutual funds in India have a 3-tier structure of Sponsor-Trustee-AMC.
- Sponsor is the promoter of the fund.
- Sponsor creates the AMC and the trustee company and appoints the boards of both these companies, with SEBI approval.
- The mutual fund is formed as trust in India, and not as a company.
- In the US mutual funds are formed as investment companies.
- The AMC's capital is contributed by the sponsor.
- Investors' money is held in the Trust (the mutual fund). The AMC gets a fee for managing the funds, according to the mandate of the investors.
- The trustees make sure that the funds are managed according to the investors' mandate.
- Sponsor should have at least a 5-year track record in the financial services business and should have made profit in at least 3 out of the 5 years.
- Sponsor should contribute at least 40% of the capital of the AMC.
- Trustees are appointed by the sponsor with SEBI approval.
- At least 2/3 of trustees should be independent.
- At least ½ of the AMC's Board should be of independent members
- An AMC cannot engage in any business other than portfolio advisory and management.
- An AMC of one fund cannot be Trustee of another fund.
- AMC should have a net worth of at least Rs. 10 crore at all times.
- AMC should be registered with SEBI.
- AMC signs an investment management agreement with the trustees.
- Trustee company and AMC are usually private limited companies.
- Trustees are required to meet at least 4 times a year to review the AMC.
- The investors' funds and the investments are held by the custodian, who is the guardian of the funds and assets of investors.
- Sponsor and the custodian cannot be the same entity.
- R&T agents manage the sale and repurchase of units and keep the unit holder
- accounts.
- If the schemes of one fund are taken over by another fund, it is called as scheme take over. This requires SEBI and trustee approval.
- If two AMCs merge, the stakes of sponsors changes and the schemes of both funds come together. High court, SEBI and Trustee approval needed.
- If one AMC or sponsor buys out the entire stake of another sponsor in an AMC, there is a take over of AMC. The sponsor who has sold out, exits the AMC. This needs high court approval as well as SEBI and Trustee approval.
- Investors can choose to exit at NAV if they do not approve of the transfer. They have a right to be informed. No approval is required, in the case of open-ended funds.
- For closed-end funds, investor approval is required for all cases of merger and takeover (as per the curriculum).
- Closed end fund investors also do not have exit option.

Chapter 5 : Legal and Regulatory Framework

Approximate Weightage: 4 questions; 4 marks.

- Mutual funds are regulated by the SEBI (Mutual Fund) Regulations, 1996.
- SEBI is the regulator of all funds, except offshore funds.
- Bank-sponsored mutual funds are jointly regulated by SEBI and RBI.
- If there is a bank-sponsored fund, it cannot provide a guarantee without RBI permission.
- RBI regulates money and government securities markets, in which mutual funds invest.
- Listed mutual funds are subject to the listing regulations of stock exchanges.
- Since the AMC and Trustee Company are companies, any complaints against their board can be made to the CLB.
- Investors cannot sue the trust, as they are the same as the trust and cannot sue themselves.
- UTI does not have a separate sponsor and AMC.
- UTI is governed by the UTI Act, 1963 and is voluntarily under SEBI Regulations.
- SROs are the second tier in the regulatory structure.
- SROs get their powers from the apex regulating agency, act on their instructions and regulate their own members in a limited manner.
- SROs cannot do any legislation on their own.
- All stock exchanges are SROs.
- AMFI is an industry association of mutual funds. AMFI is not yet a SEBI registered SRO.
- AMFI is regulated by its own board made up of its members.

Chapter 6 : Offer Document and Key Information Memorandum

Approximate Weightage: 7questions; 12 marks

- Offer Document (OD) is the most important source of information for investors.
- Abridged version of the OD is called as Key Information Memorandum (KIM).
- Investors are required to read and understand the offer document.
- No recourse is available to investors for not reading the OD or KIM, as they sign the form stating that they have read the OD.
- The cover page contains the details of the scheme being offered and the names of sponsor, trustee and AMC.
- Mandatory disclaimer clause of SEBI should also be on the cover page of the Offer document.
- OD is issued by the AMC on behalf of the trustees.
- KIM has to be compulsorily made available along with the application form.
- Closed end funds issue an offer document at the time of the NFO.
- Open ended funds have to update OD at least once in 2 years.
- Trustees approve the contents of the OD and KIM.
- The format and content of the OD has to be as per SEBI guidelines.
- The AMC prepares the OD and is responsible for the information contained in the OD.
- The Compliance Officer has to sign the due diligence certificate. He is usually an AMC employee.
- The due diligence certificate states that:
  - Information in the OD is according to SEBI formats
  - Information is verified and is a true and fair representation of facts
  - All constituents of the fund are SEBI registered

- SEBI does not approve or certify the contents of the OD.
- Factors common to all funds are called as standard risk factors. These include market risk, no assurances of return, etc.

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- **Factors specific to a scheme are scheme-specific risk factors in the Offer Document. These include restrictions on liquidity such as lock-in period, risks of investing in the first scheme of a fund, etc.**
- **Fundamental attributes of a scheme include its basic features.**
- **For any change in fundamental attributes, investor approval is not needed. Trustees and SEBI should approve the change.**
- **Each investor should be informed through a communication and given the option to exit without paying any exit load.**
- **A scheme cannot make any guarantee of return, without stating the name of the guarantor, and disclosing the net worth of the guarantor. The past performance of the assured return schemes should also be given.**
- **Information on existing schemes and financial summary of existing schemes to be given for 3 years.**
- **Information on transactions with associate companies to be provided for the past 3 years.**
- **If any expense incurred is higher than what was stated in the OD, for past schemes, explanations should be given.**
- **There is no information on other mutual funds, their product or performance in the OD.**
- **Investors' rights are stated in the OD.**
- **The borrowing restrictions on the mutual fund should be disclosed. This includes the purposes and the limits on borrowing.**
- **Investors have the right to inspect a number of documents. These are:**
  - **Trust deed**
  - **Investment management agreement**
  - **SEBI (MF) Regulations**
  - **AMC annual reports**
  - **Unabridged offer document**
  - **Annual reports of existing schemes**

- **3 years track record of investors' complaints and redressal should be disclosed in the OD.**
- **Any pending cases or penalties against sponsors or AMC should be disclosed in the OD.**
- **The offer document contains detailed information, while the KIM is a summary form of the OD. If any information is crucial to the investor, it will be found in both KIM and OD. For example, the details of guarantee if the scheme is an assured return scheme.**
- **The name and addresses of trustees and AMC directors will be found in the KIM, but the details of their role, responsibilities and duties will not be found in the KIM, but only in the OD.**
- **The OD and KIM are documents of a mutual fund and there will be no information about other mutual funds in an OD. There will be no comparisons are data on performance of other mutual funds.**
- **The OD and KIM will not contain names of securities in which the mutual fund plans to invest. Only broad allocation will be given.**

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Chapter 7 : Processes, rights and obligations for investors

Approximate Weightage: 4 questions; 5 marks

- Categories of investors eligible to apply is stated in the offer document.
- Whether a certain class of investor, such as a trust or a company can invest in a fund, depends on the list of eligible investors in the OD.
- Non-resident Indians (NRIs) and overseas corporate bodies (OCBs) are eligible to invest in mutual funds.
- Foreign nationals and entities cannot invest in mutual funds.
- Any investor who becomes a foreign citizen after investing in a fund, has to compulsorily redeem the units after obtaining foreign citizenship.
- The curriculum does not explicitly recognise a Person of Indian Origin (PIO).
- Therefore any Indians seeking foreign citizenship should redeem their units. This is not the case in reality, but is the expected answer in the examination.
- FIIs can invest in mutual funds. They invest through the Non-resident rupee account.
- RBI permission for NRIs, OCBs and FIIs is a blanket permission. Every investment does not need RBI approval.
- Prospective investors have no legal remedies.
- Investors have "Proportionate Beneficial Ownership" in MFs.
- Agents can sell products of multiple mutual funds.
- Agents are appointed after they clear the AMFI exam and sign an agreement with the AMC on non-judicial stamp paper.
- Fees and commissions are decided by the AMC and not subject to any regulation.
- Investors have the right to receive redemption proceeds within 10 days.
- Investors have the right to sue the AMC, Trustees or Sponsor.
- Investors cannot sue the Trust as they are the Trust and can't sue themselves.
- An open ended fund opens for sale and repurchase within 30 days from the date of closure of the NFO.
- Investors do not have any remedy for performance of the fund being below the investors' expectations.
- If investors representing 75% of the unit capital approve, the AMC's services can be terminated, or the scheme can be wound up.
- The Unit holders can claim unclaimed redemption proceeds or dividends due within a period of 3 years of the due date at the prevailing NAV. After 3 years he/she will be paid at NAV applicable at the end of the third year.
- The first right of the investor is towards the trustees.
- If a fund does not redress their complaint they can go to SEBI.
- AMFI does not require that every investment decision must be approved by an investor.

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Chapter 8 : Tax Aspects

Approximate weightage 1 question; 2 marks

- Mutual funds themselves pay no tax on the incomes they earn. They are fully exempt from tax.
- If an investor holds units for 12 months or less, any gain from selling the units is called as short-term capital gain.
- Short-term capital gains are taxable at the marginal rate of taxation of the investor.
- If an investor's holding period is more than 12 months, any gain or loss from sale is called as long-term capital gain.
- Long-term capital gain can be indexed for inflation.
- Indexing refers to updating of the purchase price, based on the cost of inflation index published by the CBDT. The formula for indexation is purchase price X (index in the year of sale/index in the year of purchase).

- Investors can pay either 10% tax (plus surcharge) on the capital gain tax without indexation or 20% (plus surcharge) on capital gains after indexation, which ever is lower.

Example:

An investor invests Rs. 4,00,000 in a mutual fund. He sells his investments after 2 years for Rs. 6,00,000. What is the capital gains tax payable, without indexation? (Ignore surcharge).

In the above case the capital gain is Rs. 2,00,000, on which 10% is payable as capital gains tax, without indexation. This amounts to Rs. 20,000.

	Equity Schemes					Other Schemes					
	STCG	LTCG	Dividend	DDT	TDS	STCG	LTCG	Dividend	DDT		TDS
									Liquid	Others	
Resident /HUF	10%	Nil	Tax free	Nil	Nil	As per Slab	10% (20% with indexation)	Tax free	28.325% (25%+ 10%+3%)	14.1625% (12.5%+ 10%+3%)	Nil
Partnership firms	10%	Nil	Tax free	Nil	Nil	30%	10% (20% with indexation)	Tax free	28.325% (25%+ 10%+3%)	22.66% (20%+ 10%+3%)	Nil
AOP/BOI	10%	Nil	Tax free	Nil	Nil	As per Slab	10% (20% with indexation)		28.325% (25%+ 10%+3%)	14.1625% (12.5%+ 10%+3%)	
Domestic Cos	10%	Nil	Tax free	Nil	Nil	30%	10% (20% with indexation)	Tax free	28.325% (25%+ 10%+3%)	22.66% (20%+ 10%+3%)	Nil
NRIs	10%	Nil	Tax free	Nil	STCG- 11.33% (10%+10%+ 3%)	As per Slab	10% (20% with indexation)	Tax free	28.325% (25%+ 10%+3%)	22.66% (20%+ 10%+3%)	STCG- 30%
					LTCG-NIL		10% (20% with indexation)		28.325% (25%+ 10%+3%)	14.1625% (12.5%+ 10%+3%)	LTCG- 20%

Chapter 9 : NAV and Pricing

Approximate Weightage: 2 questions; 3marks.

- Load is charged to the investor when the investor buys or redeems (repurchases) units.
- Load is an adjustment to the NAV, to arrive at the price.
- NAV = Net Assets of the scheme / Number of Units Outstanding, i.e. Market value of investments + Receivables + Other Accrued Income +Other Assets = Accrued Expenses – Other Payable – Other Liabilities No. of Units Outstanding as at the NAV date
- Load that is charged on sale of units is called as entry load.
- An entry load will increase the price, above the NAV, for the investor.
- Load that is charged when the investor redeems his units is called an exit load.
- Exit load reduces the redemption proceeds of the investor.

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- Load is primarily used to meet the expenses related to sale and distribution of units.
- An exit load that varies with the holding period of an investor is called a (contingent deferred sales charge) CDSC.
- To arrive at the sale price, given NAV and load (%), we have to calculate the amount of load and add it to the NAV. The amount of load will be = NAV x (entry load/100).
- To arrive at the sale price, given NAV and load (%), we have to calculate the amount of load and reduce it from the NAV. The amount of load will be = NAV x (exit load/100).
- Load is subject to SEBI regulations
- SEBI has stipulated that the maximum level of entry or exit load cannot be higher than 7%.
- SEBI also stipulates that the repurchase price cannot be less than 93% of the sale price.
- Minimum repurchase price, given sale price is = NAV X (1 – 7%)
- For closed end funds, the maximum entry of exit load cannot be higher than 5%.
- The repurchase price cannot be less than 95% of the sale price.

Chapter 10 : Equity Markets and Mutual Funds

Approximate Weightage: 2 questions; 3 marks.

- The investment pattern of the fund is primarily dictated by the fund objectives.
- A fund manager whose style is value investing, will prefer to invest in established profit making companies, and will buy only if the price is right. He will look for “undervalued” shares, which have a value proposition that is yet to be recognized by the market.
- A fund manager, whose style is growth, is more aggressive and is willing to invest in companies with future profit potential. He is willing to buy even if the stock looks expensive. He focuses on sectors that are expected to do well in future, and will be willing to buy them even at higher prices.

- Equity stocks can be classified as large cap and small cap stocks.
- Large cap stocks are liquid and trade every day. They are established companies offering normal profit potential.
- Small cap stocks provide higher return potential. But they are generally not very liquid.
- Cyclical stocks are those whose performance is closely linked to macro economic factors.
- P/E ratio is the ratio of earnings per share (EPS) to market price per share. Growth shares sell at higher P/E ratios than value shares.
- Dividend yield is the ratio between the dividend per share and market price per share. Growth shares have lower dividend yields than value shares.
- If the market prices move up, P/E ratios are higher and dividend yields are lower.
- If the market prices move down, P/E ratios are lower and dividend yields are higher.
- An active fund manager hopes to do better than the market by selecting companies, which he believes, will outperform the market.
- A passive fund manager simply replicates the index, and hopes to do as well as the index.
- A passive fund manager tries to keep costs down and has to rebalance his portfolio if the composition of the index changes.
- Fundamental analysis is the analysis of the profit potential of a company, based on the numbers relating to products, sales, costs, profits etc, and the management of a company.
- Technical analysis is an analysis of market price and volumes, to identify clues to the market assessment of a stock.
- A fund manager focuses on asset allocation; a dealer buys and sells shares; and an analyst researches companies and recommends them for buy and sell.

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Chapter 11 : Debt Markets and Mutual Funds

Approximate Weightage: 2 questions; 3marks.

- **Debt Instruments are issued by government, banks and companies.**
- **They can pay interest on fixed rates, floating rates or on discounted basis.**
- **If no interest is paid, such an instrument is a zero coupon instrument.**
- **Debt markets are wholesale markets in which large institutional investors operate. Banks are the largest players in debt markets.**
- **About 96% of secondary market trading happens in government securities.**
- **Basic characteristics of bonds are as follows:**
  - **Principal value, par value, or face value is the amount representing the principal borrowed and the rate of interest is calculated on this sum. On redemption this amount is payable.**
  - **Coupon is the interest paid periodically to the investor.**
  - **Maturity date is the date on which a bond is redeemed. Term to maturity or tenor is the period remaining for the bond to mature.**
  - **Put option refers to the option to the investor to redeem the bond before maturity. Call option is the option to the borrower to redeem before maturity.**
  - **If interest rates go up, above the coupon rate, investors may exercise the put option. If interest rates fall below the coupon rate, issuers may exercise the call option.**

- **Current yield is the ratio of coupon amount to market price of a bond. If a bond, paying coupon at 8% is selling in the market for Rs. 105, the current yield is 8/105 = 7.62%.**
- **Changes in interest rates impacts bond values, in the opposite direction. An increase in interest rates leads to a fall in bond values; a decrease in interest rates leads to an increase in bond values.**
- **Duration of a bond helps measure the interest rate risk of a bond. It is the weighted average maturity of a bond.**
- **Credit risk refers to the risk of default.**
- **The base rate or benchmark rate in the bond market is the rate at which the government borrows in the market. All other borrowers pay a rate that is higher, due to the presence of credit risk.**
- **The difference between the benchmark rate and the rate that is paid by other borrowers is called the credit spread. (Called as yield spread in the AMFI book).**

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Chapter 12 : Restrictions on Investment

Approximate Weightage: 3 questions; 4 marks.

- **Mutual funds can invest only in marketable securities.**
- **A mutual fund, under all its schemes, cannot hold more than 10% of the paid-up capital of a company.**
- **Except in the case of sectoral funds and index funds, a mutual fund scheme cannot invest more than 10% of its NAV in a single company.**
- **Investments in rated investment grade issues of a single issuer cannot exceed 15% of the net assets and can be extended to 20%, with the approval of the trustees.**
- **Investment in unrated securities cannot exceed 10% of the net assets for one issue and 25% of net assets for all such issues.**
- **Investment in unlisted shares cannot exceed 5% of net assets for an open-ended scheme, and 10% of net assets for a closed end scheme.**
- **Invest abroad in ADR/GDR's within an overall limit of US $ 500 millions for all funds put together. There is a sub ceiling for individual MFS which should not exceed 10 % on net assets managed by them as on date of last audited Balance Sheet, subject to maximum of US $ 50 million per MF.**
- **Inter scheme transfers are allowed by the SEBI regulations, provided:**
    - **Such transfers happen on a delivery basis, at market prices.**
    - **Such transfers do not result in significantly altering the investment objectives of the schemes involved.**
    - **Such transfer is not of illiquid securities, as defined in the valuation norms.**

- **A mutual fund can borrow a sum not exceeding 20% of its net assets, for a period not exceeding 6 months. This facility is clearly designed as a stopgap arrangement, and is not a permanent source of funds for the scheme.**
- **A fund can borrow only to meet liquidity requirements for paying dividend or meeting redemptions.**
- **All investment made in the marketable securities of the sponsor and its associated companies must be disclosed by the mutual fund in its annual report and offer document.**
- **A mutual fund scheme cannot invest in unlisted securities of the sponsor or an associate or group company of the sponsor.**
- **A mutual fund scheme cannot invest in privately placed securities of the sponsor or its associates.**
- **Investment by a scheme in listed securities of the sponsor or associate companies or group companies of sponsor cannot exceed 25% of the net assets of the scheme.**
- **Mutual Funds were allowed to make use of Futures & Option contracts in Equities for Portfolio risk management Portfolio Rebalancing**
- **Since September 2005 SEBI has** also **allowed Mutual Funds to trade in Derivative Contracts.**
    - **To enhance portfolio returns**
    - **To launch schemes which invest mainly in Futures & Options**
- **What are Equity Derivatives?**
    - **Equity derivatives instruments are specially designed contracts**
    - **They derive their value from an underlying asset**
    - **They are traded separately in F & O segment of Exchange**
- **Main derivative instruments are**
    - **Futures**
    - **Options**
- **In a future contract you can buy & sell the underlying equity at a specified future date at agreed price. Contract can be liquidated before maturity date without taking or giving delivery of underlying asset**

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- In option contract:
  - the buyer of option contract gets the right to buy or sell
  - the underlying equity
  - at agreed price
  - on a future date
  - only if he exercises the option &
  - for this right he pays a price called Premium.
  - Option contracts are of two types
- If Fund manager expects the equity market to decline :
  - he may not sell the equity in the Cash Market.
  - But can sell the Index Future at the current price for future delivery.
- If markets fall the equity portfolio value will decline,
  - but future contract will show a corresponding profit,
  - since fund manager has sold future contract at a higher price.
  - If market rises equity portfolio value will rise but future contract will show corresponding loss, since fund manager has sold future contract at lower price
  - This is called Hedging Portfolio Risk
- Other method of hedging investment portfolio risk is by buying a Put Option (an option to sell the underlying equity at an agreed price) by paying premium.
  - A fund manager can execute the option only if the price falls, since he has right to sell at a higher price.
  - If the price rises he will not execute the option and forgo the premium

Chapter 13 & 14 : Accounting and Valuation

Approximate Weightage: 4 questions; 6 marks.

- Investor's subscriptions to the mutual fund are accounted as unit capital, and not as liabilities or deposits.
- Assets of a mutual fund are the investments made by the fund.
- Liabilities of a mutual fund are strictly short term in nature.
- The unit capital account is maintained at face value.
- NAV is the net assets per unit, computed as net asset divided by number of units outstanding.
- The day on which NAV is calculated is called as the valuation date.
- All mutual funds have to disclose their NAV everyday, by posting it on the AMFI web site by 8.00 p.m.
- Open-ended funds have to compute and disclose NAVs everyday.
- Closed end funds can compute NAVs every week, but disclosures have to be made everyday.
- Initial issue expenses of a scheme cannot exceed 6% of funds mobilised. Any amounts above this have to be borne by sponsors or AMC.
- For a closed end fund, initial issue expenses are charged over the life of the scheme, on a weekly basis.
- For an open-ended scheme, the initial issue expenses are carried in the balance sheet of the fund as "deferred revenue expenses". They are written off over a period not exceeding 5 years.
- The maximum limit on the expenses that can be charged to an equity mutual fund are:
  - For net assets up to Rs. 100 crore: 2.5%
  - For the next Rs. 300 crore of net assets: 2.25%
  - For the next Rs. 300 crore of net assets: 2%
  - For the remaining net assets: 1.75%

- These limits are lower by 0.25% for debt funds

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- These regulatory ceilings are applied on the weekly average net assets of the mutual fund scheme.
- The investment management fees are regulated by SEBI as follows:
  - For the first Rs. 100 crore of net assets: 1.25%
  - For net assets exceeding Rs. 100 crore: 1.00%

- Valuation of equity shares is done on the basis of traded price; provided that price is not more than 30 days old.
- Debt securities with less than 182 days to maturity are valued on accrual basis. The accrual is calculated as follows:
- A t-bill is issued at Rs. 80 and redeemed at Rs. 100 after 364 days. The accrual per day is = 20/364 = 0.5494
- Illiquid securities cannot be more than 15% of the portfolio's net assets. Any illiquid assets above this limit have to be valued at zero.
- Mutual Funds value their investments on a "mark to market" basis; on the date of valuation; eg – if it's a daily NAV, the portfolio is valued daily.

- Valuation of Traded Securities
  - Where a security is traded on Stock Exchange (SE): valued at the last quoted closing price where it is "principally traded".
  - If the security is not traded on the valuation day, take the value at which it was traded on other SE on the earliest previous day, but not more than 30 days prior to valuation.

- Value of traded securities = Market price of traded securities x It's no. of shares or bonds

- Thinly Traded Equity/ Equity Related Securities :-
  An equity /equity related instruments is thinly traded if :-
  - Monthly trading value is less than Rs. 5 lacs and value less than 50,000 share volume
  - When trading is suspended up to 30 days take the last traded price
  - Trading is suspended for more than 30 days AMC/Trustee to make valuation.

- Thinly Traded Debt Securities :-
  - Traded value (other than g-sec) is less than Rs. 15 crore for a period of 30 days prior to valuation date.
  - Add value traded on all exchanges
  - Such security to be valued using the method for non-traded debt.
- Non-Traded Securities :-
  - When not traded on any Stock Exchange for 30 days prior to valuation date
  - Non-traded/thinly traded securities shall be valued "in good faith" by AMC.

- Non Traded/ Thinly Traded Equity Securities :-
  - Net worth per share should be calculated.
  - The value per share should be calculated on the basis of capitalization of earnings.
  - Capitalization rate will be determined by referring to P/E ratio of comparable traded securities with an appropriate discount for lower liquidity to be used.
  - If an individual security accounts for more than 5% of the total assets of the scheme, shall be valued by an independent valuer. The proportion while it bears to the total net assets. The scheme on date of valuation of non traded, non-govt. debt with less than 182 days for maturity.

- Non traded thinly traded debt securities
  - Upto 182 days maturity: valued as money market securities.

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- Over 182 days: would be classified as follows:
  All Non Traded debt Securities

  - All Non-govt., investment grade debt securities to be valued on YTM (Yield to Maturity) basis
  - All Non-govt., non-investment grade performance assets would be valued at a discount of 25 % of the face value
  - All Non-govt. non-investment grade based on provisioning norms.
  - Call money, bills purchased under rediscounting and short term deposits with banks are valued at (cost + actual)
  - Convertible debentures and bonds: Non-convertible component is to be valued as a debt instrument, and convertible as any equity instrument.

Chapter 15 & 16 : Risk, Return and Performance
Approximate Weightage: 7 questions; 11 marks.

- Rate of return is computed as: (Income earned/Amount invested)*100.

  This number can be annualised by multiplying the result by the factor 12/n, where n is the number of months in the holding period. If the holding period is in days, the above factor will be 365/n, where n is the number of days in the holding period.

- Change in NAV method of calculating return is applicable to growth funds and funds with no income distribution.

- Change in NAV method computes return as follows:
  (NAV at the end of the holding period – NAV at the beginning of the holding period)/NAV at the beginning of the period. Return is then multiplied by 100 and annualised.

- The total return with re-investment method or the ROI method is superior to all these methods. It considers dividend and assumes that dividend is re-invested at the ex-dividend NAV.

- Total Return or ROI Method computes return as follows:
  [(Value of holdings at the end of the period - value of holdings at the beginning of the period)/ value of holdings at the beginning of the period] x 100
  - Value of holdings at the beginning of the period = number of units at the beginning x begin NAV.
  - Value of holdings end of the period = (number of units held at the beginning + number of units re-invested) x end NAV.
  - Number of units re-invested = dividends/ex dividend NAV.

- Expense ratio is an indicator of efficiency and very crucial in a bond fund.

- Income ratio is the ratio of net investment income by net assets. This ratio is important for fund earning regular income, such as bond funds, and not for funds with growth objective, investing for capital appreciation.

- Portfolio turnover rate refers to the ratio of amount of sales or purchases (which ever is lesser) to the net assets of the fund.

- Higher the turnover ratio, greater is the amount of churning of assets done by the fund manager.

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- High turnover ratio can also mean higher transaction cost. This ratio is relevant for actively managed equity portfolios.
- If the turnover of a fund is 200%, on average every investment is held for a period of 6 months.
- Risk arises when actual returns are different from expected returns.
- Standard deviation is an important measure of total risk.
- Beta co-efficient is a measure of market risk. The quality of beta depends on exmarks.
- If ex-marks are high beta is more reliable.
- Ex-marks are an indication of extent of correlation with market index. Index funds have ex-marks of 100%.
- Comparable passive portfolio is used as benchmark.
- Usually a market index is used as a benchmark.
- Compare both risk and return, over the same period for the fund and the benchmark.
- Risk-adjusted return is the return per unit of risk.
- Comparisons are usually done
  - With a market index
  - With funds from the same peer group

- With other similar products in which investors invest their funds
- When comparing fund performance with peer group funds, size and composition of the portfolios should be comparable.
- Treynor and Sharpe ratios are used for evaluating performance of funds.
- The quality of beta depends on ex-marks.

Chapter 17 : Financial Planning Process

Approximate Weightage: Chapters 17 – 22: 25 questions; 37 marks

- Financial planning comprises
  a. Defining a client's profile and goals
  b. Recommending appropriate asset allocation
  c. Monitoring financial planning recommendations

- Financial planning helps a mutual fund distributor to establish long-term relationships and build a profitable business.
- Financial planning is a very profitable business in the US.
- Steps in financial planning are:
  a. Asset Allocation
  b. Selection of fund
  c. Studying the features of a scheme

- Financial planning is concerned only with broad asset allocation, leaving the actual selection of securities and their management to fund managers.
- Investors delegate the task of investing in securities to the fund manager.
- The financial planner can only work with defined goals and cannot take up larger objectives that are not well defined.
- The client is responsible ultimately for realising the goals of the financial plan.
- The basis of genuine investment advice should be financial planning to suit the investor's situation
- Risk tolerance of an investor is not dependent on the market, but his own situations.

Chapter 18 : Life Cycle and Wealth Cycle Stages

- The life cycle stages of an investor can be classified as follows:
  - Childhood stage
  - Young unmarried stage
  - Young married with children stage

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- Married with older children stage
- Pre-retirement stage
- Retirement stage

- The income level of investors, the saving potential, the time horizon and the risk appetite of an investor depend on his life cycle.
- Younger investors have higher income and saving potential, take longer-term view and may be willing to take risks.
- Older investors may have limited income and saving, shorter time horizon, and unwilling to risk their savings.

- There are 3 wealth cycle stages for investors:
  - Accumulation stage is when investors are earning and have limited need for investment income. They focus on saving and accumulating wealth for the long term. Equity investments are preferred in this stage.
  - Transition stage is when financial goals are approaching. Investors still earn incomes, but have also draw on their earnings. Investors choose balanced portfolios that have both debt and equity.
  - Reaping stage or distribution stage in when investors need the income from their investment, and cannot save further. They reap the benefits of their savings. They prefer debt investments and preserving of capital at this stage.

- Inter-generational fund transfer refers to transfer of wealth to an investor. The preferred investment avenue will depend on the life cycle and wealth cycle stage of the beneficiaries.
- These investors who transfer wealth do not require financial planning.
- Sudden wealth surge refers to winnings in games and lotteries. Investors should be advised to temporarily park their funds in money market investments and create a long-term plan after thinking through the plan. They must also take into account the impact of tax.
- Affluent investors are of two types:
  - Wealth preserving investors who are risk-averse and like to invest in debt.
  - Wealth creating investors who prefer growth and are willing to take the risk of equity investments.

Chapter 19 : Investment Products

- Key features of all investment options should be remembered. Please note that the questions are based on the date of the curriculum, which is December 2001. Any changes in rates and other features after that date are not included in the examination. For example, rate on the RBI Relief Bond, for the exam, is 8.5% and not 8%.
- Physical assets like gold and real estate are preferred by investors who like physical ownership. These investments are not liquid.
- Physical assets are perceived to be a hedge against inflation.
- Real estate investment requires high initial investments.
- Bank deposits are preferred by a large number of investors due to the perception of bank deposits being safe and free of default.

- Features of PPF
  - 15-year deposit product made available through banks
  - Risk-free government obligation
  - Open to individuals and HUFs
  - Only one account permitted per entity
  - Offers tax-free interest of 8% p.a. and contribution up to Rs. 70,000 (min Rs. 500) are eligible for deduction under sec 80C

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- Option to withdraw 50% of 4th year balance in the 7th year
- Restriction on withdrawal reduces liquidity.
- Interest receipt and withdrawal of principal exempt from tax.
- Only individuals and HUFs are eligible to invest

➢ Features of RBI Relief Bonds
- Issued by RBI on behalf of the Government of India
- A 5-year investment product with 8% interest offering
- Interest is currently taxable (used to be tax-free earlier) & payable semi-annually
- Free of risk of default

➢ Government Securities
- Long-term government paper
- Risk-free government obligation
- Low-return and define the benchmark rate of return on the yield curve
- Specially appointed Primary dealers deal in G-Secs
- Generally high ticket investments
- Best accessible to small investors through mutual funds.

➢ Features of other government schemes
- Indira Vikas Patra and KVP issued by central government and sold by post offices.
- Current yield on IVP is 8%
- Interest is taxable.
- Investor identity is protected and investment in cash is possible.

➢ Features of instruments issued by companies
- Commercial Paper: Short term (90days) unsecured instrument. Credit rated.
- Debentures: Secured fixed income instruments with credit rating.
- Equity Shares – Liquidity through listing.
- Preference Shares – Fixed rate of dividend.
- Fixed Deposits – Unsecured deposits with credit risk.
- Bonds of FI – Unsecured fixed income securities issued by public financial institutions.

➢ Features of insurance policies

- Investors buy due to tax concessions, while they should buy for the insurance cover.
- With profit policy provides bonus along with sum assured.
- Without profit policy only provides insurance cover.

➢ Why MF is the best option
- Mutual funds combine the advantages of each of the investment products.
- Dispense the shortcomings of the other options.
- Returns get adjusted for the market movements.

Chapter 20 : Investment Strategies

➢ Investors should choose to allow their investment to compound over the long run.

➢ This can be achieved by choosing the growth or re-investment option of mutual funds. Automatic reinvestment plans can also be used.

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- Buy and hold strategy which is preferred by many investors, may not be beneficial because investors may not weed out poor performing companies and invest in better performing companies.

- Rupee-cost averaging (RCA) involves the following:
  - A fixed amount is invested at regular intervals.
  - More units are bought when price is low and fewer units are bought when price is high.
  - Over a period of time, the average purchase price of the investor's holdings will be lower than if one tries to guess the market highs and lows.
  - RCA does not tell indicate when to sell or switch from one scheme to another. This is a disadvantage.
  - Investors use the systematic investment plan or automatic investment plan to implement RCA.

- Value averaging involves the following:
  - A fixed amount is targeted as the desired value of the portfolio at regular intervals.
  - If markets have moved up, the units are sold and the target value is restored.
  - If markets move down, additional units are bought at the lower prices.

- Over a period of time, the average purchase price of the investors' holdings will be lower than if one tries to guess the market highs and lows.

- Value averaging is superior to RCA, because it enables the investor to book profits and rebalance the portfolio.

- Investors can use the systematic withdrawal and automatic withdrawal plans to implement value investing.

- Investors can also use a money market fund and an equity fund to implement value averaging.

Chapter 21 : Asset Allocation and Model Portfolios

- Asset allocation is about allocating money between equity, debt and money market segments.

- Asset allocation varies from one investor to another depending on their situation, financial goals and risk appetite.

- A model portfolio creates an ideal approach for the investors' situation and is a sensible way to invest.

- The asset allocation for an investor will depend on his life cycle and wealth cycle.

- Investors can have two strategies:
  - Fixed asset allocation
  - Flexible asset allocation
  - Fixed asset allocation means
  - Maintaining the same ratio between various components of the portfolio
  - Re-balancing the portfolio in a disciplined manner

- Fixed allocation means a periodical review and returning to the original allocation. If equity is going up, such investors would book profits. They are disciplined.

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- Flexible allocation means allowing the portfolios profits to run, without booking them.

- If equity market appreciates, flexible asset allocation will result in higher percentage in equity than in debt.

- Graham recommends that most investors should choose a 50:50 allocation that is 50% in equity and 50% in debt.

- Bogle recommends that age, risk profile and preferences have to be combined in asset allocation

- Older investors in distribution phase - 50% equity; 50% debt
- Younger investors in distribution phase - 60% equity; 40% debt
- Older investors in accumulation phase - 70% equity; 30% debt
- Younger investors in accumulation phase - 80% equity; 20% debt

- Steps in developing a model portfolio for the investors:
  - Develop long term goals
  - Determine asset allocation
  - Determine sector distribution
  - Select specific fund schemes for investment

- Jacob's Model Portfolios
  Accumulation phase
    - Diversified equity: 65 - 80%
    - Income and gilt funds: 15 - 30%
    - Liquid funds: 5%

  Distribution phase
    - Diversified equity: 15 - 30%
    - Income and gilt funds: 65 - 80%
    - Liquid funds: 5%

Chapter 22 : Fund selection

- Fund selection refers to the actual choice of funds according to the chosen model portfolio for the investor.

- Equity funds: Characteristics:
  - Fund category – the fund chosen should be suitable to investor objective
  - Investment style – Choose between growth and value depending on investor's risk
  - perception
  - Age of the fund – Experienced funds are preferred to new funds
  - Fund management experience –Track record of the fund managers is important
  - Size of the fund – Larger funds have lower costs
  - Performance and risk – risk adjusted performance matters

- High beta means higher risk.

- High turnover means high transaction costs.

- Equity Funds: Selection Criteria
  - Percentage holding in cash should be low – Funds can always sell liquid stocks for liquidity requirements.
  - Concentration in portfolio should be low – An equity fund should be well diversified.

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- Market capitalization of the fund – High capitalization means better liquidity
- Portfolio turnover – Higher turnover means more transactions and costs, but exploitation of opportunities. Low turnover represents patience and stable investments.

➢ Risk Statistics
- Beta – represents market risk, higher the beta higher the risk.
- Ex-Marks – represents correlation with markets – higher the ex-marks, lower the risk. A fund with higher ex-marks is better diversified than a fund with lower ex-marks.
- Gross dividend yield represents return. Funds with higher gross dividend yield should be preferred.
- Funds with low beta, high ex-marks and high gross dividend yield are preferable

➢ Debt Funds: Selection Criteria
- A smaller or new debt fund may not necessarily be risky.

➢ For debt funds expense is important.

➢ For short-term investors, load is more important than expense ratio.

➢ For long-term investors, expense ratio is more important than expense ratio.
- Total return rather than yield to maturity (YTM) is important.
- Expenses are very important, because high expense ratios lead to yield sacrifice.
- Credit quality - Better the rating of the holdings, safer the fund.
- Average maturity - Higher average maturity means higher duration and interest rate risk.

➢ Funds with higher average maturity are more risky than funds with lower average maturity.

➢ Money Market Funds
- Liquidity and high turnover rate is high.
- Shorter-term instruments are turned over more frequently.
- Protection of principal invested is important.
- NAV fluctuation limited due to low duration and lack of interest rate risk.
- Credit quality of portfolio should be high.
- Low expense ratio is important.

CHAPTER 23 : BUSINESS ETHICS

➢ The term refers to rules of acceptable and good conduct in business.

➢ All those persons who are engaged in business should comply with rules of good conduct.

➢ Those who own and manage the business may set the business ethics. These may also be made and imposed by agencies that regulate the business. Many countries have made laws for protection of consumers and investors. However, laws cannot help in eliminating the potential malpractices in businesses. Therefore, it is desirable, probably required that the business ethics be made and adopted by those who are engaged in and involved with the business themselves.

➢ Business ethics are self imposed and adopted, whereas laws are enforced.

➢ Need of business ethics:
- These are required to have honest and fair business practices.

- These are required to insure that the business is not done dishonestly and false promises are not made to the investors.
- From social angle, business ethics are required to protect the consumers.
- From the angle of business itself, good ethics mean good business. Honest and fair practices will insure that the customer remains satisfies, will not feel cheated and the loyalty will increase.
- They are also required to have transparency in business dealings and insuring that both the existing as well as potential clients and, or consumers are treated at par

➢ Mutual funds are vehicles of collective investments, which are managed by asset-management companies. AMC manages this money to earn a fee. In this process the AMC take the help of many other entities including distributors and individual financial advisors. All these need to abide by the rules of good conduct.

➢ In this process, the following points are important:
  - The rules of conduct for distributors and employees are set by trustees, and directors of Asset Management Companies.
  - AMFI has also set rules of good conduct for AMC's, its employees and distributors.

➢ Objectives of business ethics
  - The major objective is to have honest and transparent dealing with existing and potential consumers.
  - Another objective is protection of consumers or clients from being cheated or exploited
  - We also require business ethics to ensure level playing field among all the business participants.
  - Business ethics also help in ensuring healthy competition for the benefit of all consumers

➢ GoI and SEBI both are concerned with the protection of investor interests.

➢ SEBI has incorporated the rules of good conduct in MF regulations. It has also issued guidelines to AMFI and mutual funds to develop codes of conduct for fund distributors, fund managers and all employees and associates of AMC and Trustee Company.

➢ The following areas are monitored by SEBI
  - Fund structure: In India, trustees have fiduciary responsibility towards investors in mutual funds. Mutual funds are a trust and the trustees hold investors money in trust. The money continues to belong to the investors and fund managers only manage it. Indian mutual funds structure is made on the principal of Independence in the legal structure.
    - This independence is achieved in the following three ways:
      - Separation of functions: The ownership, management and custody of the assets of mutual funds lie with different entities. No one constituent has total control of the assets of the mutual funds.
      - Independence of organizations: Mutual funds are trusts, which are, manage by "board of trustees" and AMC is a company, which is run by its "board of directors". Trustees are given the overall role of independent supervision of all AMC personal including the directors.
      - Independence of personal: Both the trusts and AMC should have a prescribed level of independent personnel. Two-third of the board of trustees has to be independent and 505 of the board of directors of AMC have to be independent. Further, a trustee cannot serve as a Director on the AMC he supervises or even any other AMC.

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- Fund governance: The mutual fund structure has been designed to protect the investor through a system of checks and balances on the observation of ethical standards.
- Exercise of voting rights by funds: Mutual funds hold shares in various companies as a part of their investment portfolio. The shares are in the name of trustees, who also receive the right to vote as investors. Ethical norms require that the trustees exercise these rights in the interest of fund investors. There is no law that places a specific responsibility on trustees to vote in a particular way; however, SEBI is empowered to investigate any case in this regard.
- Fund operations: Even at operating level, SEBI expects that AMC's observe ethical norms in day-to-day exercise of their functions. Some of the practices, which SEBI considers unethical are:
    - Insider trading: Fund managers should not collude with insiders of various companies and use information for their own benefit.
    - Preferential treatment to selected investors: Mutual funds being vehicles of collective investment, all investors should be treated equally. The regulators keep check to see that no discrimination is in favor of any investor.
    - Personal trading by fund managers and employees: The objective is the fund managers and other fun employees do not use any no public information for personal gains. SEBI has taken a view that not all fund employees at all levels should be barred from personal trading, however they should disclose their holdings and transactions made during a given period.

➢ The following are the main regulations /guidelines of SEBI in this regard:

- Guidelines for good conduct of AMC and Trustee company- personal trading: SEBI has indicated some minimum requirements that have to be followed by employees of AMC and Trustees. AMC's and TC's can set rules that are more stringent in this regard. The responsibility to ensure ethical compliance by AMC's is set on trustees.
- Regulations of personal trading:
    - AMC is required to file a quarterly statement of dealings in securities by key personal of AMC.
    - The trustees are also required to file details of security transactions where they exceed Rs.1 lakh.
    - The regulations require that trustees certify that the AMC employees do not indulge in front running or self-dealing.
- Regulations on insider trading: SEBI has instructed that SEBI (insider trading) (Amendment) regulations 2002 shall be followed by AMC, TC, their directors and employees.
- Regulations on fund advertisement: SEBI has issued detailed guidelines that mutual funds have to follow while advertising their products.

- Compliance officer: SEBI has made it mandatory for every AMC to have a compliance officer who would be responsible for implementation of all laws, guidelines and voluntary codes of conduct. Compliance officer not only reviews but can also give approval to personal trading and investment transactions.

- Code of conduct for distributors: All the distributors and agents have to follow the code of conduct laid down in the fifth schedule of the SEBI MF Regulations (1996) as well as AGNI. Mutual funds have to monitor and report any violation of these guidelines to SEBI and AMFI.