Ordinary Investor's Education Series No. 5

MANAGING YOUR WEALTH

- **Guiding principles**
- **Key elements**
- **Life-time optimization**
- **Caution about wealth advisors**
- **Effect of ups and downs**

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PREFACE

Each earlier booklet in the *Ordinary Investor's Education Series* was concerned with a particular type of investment, such as shares, mutual funds, and derivatives. The present one is different as it looks at the problem of managing your *total personal wealth* as best as possible.

We shall consider all the main forms of wealth and attempt to derive the guiding principles as well as a strategy of investment, given the fact that certain forms of wealth are liable to cyclical ups and downs. Wealth management must take into account this fact as part of over-all risk management.

We hope that the present booklet would be found helpful in evolving a more intelligent approach towards wealth management.

MANAGING YOUR WEALTH

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I

IMPORTANCE AND OVER-ALL APPROACH

Meaning and determinants:

1. Wealth management is concerned with choosing investments from a fairly broad array of assets, taking into account the wealth owner's objectives, needs, family circumstances and stage of life cycle. The choice of investments cannot be static because the opportunities as well as risks are liable to change from time to time.

Managing wealth versus managing portfolio:

2. Some people mistakenly regard wealth management as synonymous with portfolio management. Portfolio literally means "list of investments held". For example, we may talk of "equity portfolio", "bond portfolio" or more broadly of "investment portfolio" or still more broadly of "asset portfolio". Wealth management is a far broader term than portfolio management and requires more imaginative, more far-sighted and more flexible approach.

Growing number of millionaires:

3. The importance of wealth management is increasing. An important reason is that the number of millionaires in India has been growing. Hence, there is rise of interest in the subject of wealth management and in the demand for advisory services related to wealth management. This is indicated by the fact that, over the past decade or so, many

professional firms have started the business of providing advisory services to high networth individuals (HNIs) on a fee basis.

4. According to *Asia-Pacific Wealth Report 2008*, prepared by Merrill Lynch and Capgemini, the number of High Net Worth Individuals in India increased by 22.7% during the year 2007. The highest growth (26.6%) took place at the top end (called Ultra HNWI segment).

5. An important reason behind the rising numbers of HNWIs in India is that the Indian economy is the second fastest growing economy in the world, next only to China. The rate of India's annual GDP growth over 2007-08 was around 9% as against less than 2% in most of the developed countries. More recently, the recessionary tendencies in the developed countries have pulled down India's GDP growth rate to around 7% per annum. It is still significantly higher compared to the developed countries.

Usefulness of wealth management concept:

6. Apart from HNIs, the number of middle and upper-middle class investors is also growing fast. Many rich people seek professional advice on payment basis. The middle and upper-middle class investors can benefit by understanding and applying the basic principles of wealth management on their own. We shall attempt to drive home these principles.

II

OPTIMISING THE ASSET ALLOCATION

Wealth owner's aim:

7. The aim of the wealth owner should be to make the most effective use of the wealth held by allocating it optimally among the various asset classes. Optimisation is, more or less, a continuous process. In order to grasp this, ask yourself the following questions:

> Have I really optimized the asset allocation?
>
> How do I go about it?
>
> Can I pinpoint some important deficiency in managing my wealth?

Determinants of allocation:

8. The allocation of wealth among asset-classes should take into account the wealth-owner's personal circumstances, such as age, present income and future expectations in this regard, assets presently held, risk tolerance, time horizon, family responsibilities regarding children's education and marriage, etc. On the other hand, it is necessary also to take into account the external environment, such as investment opportunities available at present and in the foreseeable future, as well as tax implications. (See Exhibit 1)

Exhibit 1

FACTORS TO BE CONSIDERED

- Present and future income level
- Risk-bearing capacity
- Time horizon for investment
- Inherent cyclical risks of asset types
- Your present investments / assets
- Your present life cycle stage
- Your tax status

9. Considering that so many factors are involved, the task may look daunting but human life is like that only.

10. Remember Bill Gates who was a college drop out and built the world-famous Microsoft and became the wealthiest person. Don’t be daunted.

Broad investment objectives:

11. Be clear about the objectives which you want to achieve, such as maximising:

    - Current income
    - Capital appreciation
    - Protection of capital
    - Tax efficiency

    The achievement of the objectives mentioned above depends on the portfolio of assets chosen.

How ups and downs affect choices:

12. Some assets are characterised by significant cyclical ups and downs in their values even over the long term. The contrast is particularly striking between gold and equities (see Tables 1 and 2). It may be noted from Table 1 that gold prices almost always tend to rise over long periods but equity investment is very fickle as brought out by Table 2. The BSE Sensex touched the peak of 21,207 on January 10, 2008 and had dropped to 7697 on October 27, 2008, i.e. within less than a year. It has recovered about half way since then. In June 2009 it has been around 14500.

Main investment types described:

13. **Real estate**: Real estate can be expected to yield long-term capital appreciation but this depends much on the geographic location. Real estate is much more than pure investment for monetary gain. Real estate in the form of a residential house has multiple advantages and is being encouraged by the government by facilitating housing loans repayable in instalments over fairly long periods. You must keep in mind your capacity to service such a loan. The loans can be available on fixed interest rate or on floating interest rate. In the case of floating interest rate system, such rate is re-set by the lending institution periodically. The borrower’s choice between fixed and floating rate systems depends on the outlook for interest rates in the future.

Table 1

AVERAGE PRICES OF GOLD IN MUMBAI

	Month/Year	**Standard Gold** (Rs. per 10 grams)
Yearly average	2000-01	4,474
	2001-02	4,579
	2002-03	5,332
	2003-04	5,719
	2004-05	6,145
	2005-06	6,901
	2006-07	9,240
	2007-08	9,996
	2008-09	12,905
Monthly average	Apr. - 07	9,321
	May - 07	8,878
	June - 07	8,707
	July - 07	8,741
	Aug - 07	8,836
	Sept. - 07	9,311
	Oct. - 07	9,691
	Nov. - 07	10,340
	Dec. - 07	10,311
	Jan. - 08	11,291
	Feb. - 08	11,888
	Mar. - 08	12,632
	Apr. - 08	11,810
	May - 08	12,143
	June - 08	12,369
	July - 08	13,055
	Aug. - 08	11,855
	Sept - 08	12,214
	Oct. - 08	12,766
	Nov - 08	12,207
	Dec. - 08	12,897
	Jan. - 09	13,508
	Feb. - 09	14,781
	Mar. - 09	15,255
	Apr. - 09	14,501

Source: RBI Monthly bulletins

Table 2
EQUITY PRICE BEHAVIOUR
(Based on BSE Sensex)

	Month/ Year	Closing Price
	2004-05	6492.82
	2005-06	11279.96
Year wise	2006-07	13072.00
	2007-08	15644.44
	2008-09	9708.50
	Apr – 08	17287.31
	May – 08	16415.57
	June – 08	13461.60
	July – 08	14355.75
	Aug – 08	14564.53
	Sep – 08	12860.43
Month wise	Oct – 08	9788.06
	Nov – 08	9092.72
	Dec – 08	9647.31
	Jan – 09	9424.24
	Feb – 09	8891.61
	Mar– 09	9708.50
	Apr– 09	11403.25

Source: SEBI Bulletins, specially April and May 2009

Note: According to the *Economic Times*, the 3-year High and Low of Sensex were as follows:

3-Year High 21207 on 10.01.08
3-Year Low 7697 on 27.10.08

14. **Gold:** From the long-term viewpoint, some investment in gold is worth considering. It can yield long-term appreciation but no regular income.

15. Gold units can now be purchased in a convenient demat form through Gold Exchange-Traded Funds. You can purchase gold units of just a few grams periodically. Buying gold in demat form eliminates the risks and costs associated with physical handling of gold, such as storage and transport. It also ensures purity of the metal.

16. Gold attracts a high volume of short-term speculation also. The extent of speculation is indicated by the trading volume in the yellow metal on the commodity exchanges. As the domestic as well as international prices of gold are reported in the daily newspapers, you can know what your gold holding in demat form is presently worth. Gold in the form of jewellery is saleable only at heavy discount and not easily.

17. There is a typical seasonal cycle in gold prices in India due to significant rise in retail demand during the marriage season. The price fluctuation is accentuated by speculation. For example, gold prices have risen as much as 50% between October 2008 and February 2009 (see *The Economic Times,* March 1, 2009). Buying gold at the

peak prices can be disadvantageous from the viewpoint of wealth management.

18. **Equities:** Investing in equities has become fairly widespread among the middle and upper-income groups in India. Investors usually spread such investment over many companies in order to diversify risk. Carefully chosen equity shares can be highly rewarding over the long-term of 5-10 years but such investments are quite risky over the short-term because of market's usually high volatility, as we have brought out earlier in Table 2.The last twelve months have seen violent fluctuations in equity prices.

19. **Corporate bonds:** Bonds carry a fixed rate of interest over the bond's life. The maturity period for such bonds is commonly 3-5 years in India. The interest rate payable is determined at the time of issue of the bond.

20. An important distinction is whether the issuer is a private corporation or a government controlled corporation. A private corporation is not always a safe bet because some of them fail and are wound up. Their bond holders may get nothing, as happened in some cases.

21. The investor has to bear *interest rate risk* in the case of bonds. The longer the maturity period of a bond, the higher is the interest rate risk. In case the general level of interest rates on bonds rise, the market value of the existing bonds will fall. The reason is that when new bonds carrying a higher interest rate are available, no one would like to buy the old bonds at their par value. Hence,

the old bonds will sell in the market at a discount to the issue price.

22. A point worth noting is that most of the corporate bonds *lack market liquidity* because there is very little trading even if they are listed on a stock exchange.

23. Ratings assigned by credit rating agencies to corporate bonds are indicative of their safety. Triple A (i.e. AAA) indicates the highest quality. A bond investor must take into account the rating assigned before deciding to invest.

24. **Treasury bonds:** These are bonds issued by the Government and are considered as very safe and liquid form of investment. Treasury bonds in India have a long duration of 10 years or even more. On the other hand, treasury bills are short-dated instruments, such as 91 days. The bulk of these treasury securities are held by banks, financial institutions, etc. Only a very small proportion is held by individuals.

25. **Bank fixed deposits:** Fixed deposits with banks are a popular form of investment because it combines safety, liquidity and convenience. Such deposits can be made in a nearby branch of a bank and in small amounts. The period of fixed deposit can be chosen by the investor. Banks allow premature withdrawal at a nominal penalty. The rate of interest varies with the duration of the deposit. Normally, the longer the duration of the deposit, the higher is the rate of interest paid by banks.

26. As the future trend of interest rates is uncertain, the term of fixed deposits with banks has shortened to something like 2 years. Banks are reluctant to commit themselves to high interest rate for long periods on fixed deposits.

27. *Bank deposits are guaranteed* by the Deposit Insurance and Credit Guarantee Corporation upto Rs. 100, 000/- per depositor, taking into account all his deposits such as savings, fixed, current, etc. Small investors are thus fully protected.

28. **Mutual funds:** Securities, such as equities and bonds, may be held by investors directly or through mutual funds. Investors, who know how to evaluate these securities and are prepared to devote the time required for selecting them, may invest directly. Others may invest through mutual funds. These funds charge both an "entry fee" and a "management fee". Each investor has to decide whether it will be better for him to invest directly or through a mutual fund. Some investors use both methods.

29. There is a great variety of mutual funds, including equity funds, bond funds, balanced funds and liquid funds. Within each of these broad categories, there are many sub-categories.

30. A convenient from of investing in mutual fund equity schemes is SIP (Systematic Investment Plan) under which the investor invests a fixed sum, say, every month for a pre-determined period (say, one year) and is allotted units at the prevailing market price. The accumulated units are redeemed on the expiry of the plan.

31. Mutual funds are closely regulated by SEBI, which has laid down limits for chargeable expenses.

Diversify over asset classes:

32. A wise philosophy for the wealth owner is to spread his investment over different asset classes because the various asset classes usually move in different directions at different times. This helps to mitigate risk. Of course, as we have stated earlier, the investment strategy adopted by the wealth owner should take into account his personal situation, including age, family obligations, liquidity needs, long-term goals and risk appetite.

Not a one-off job:

33. Really speaking, choosing investments is not a one-off job of placing specific percentages of the available funds in specific investment categories, say, 20% in equities, 15% in bonds, 10% in mutual funds, 25% in bank deposits, etc. The opportunities and risks go on changing. The wealth-owner should be alert to the changes which are taking place. (See Exhibit 2)

Exhibit 2

ALLOCATIONS NEED REVIEWING

> Reshuffling of investments would be needed from time to time because opportunities and risks go on changing. This is specially so during uncertain times, like the present.

III

SOME GUIDING PRINCIPLES

Life-long vision and strategy needed:

34. The wealth-owner's attempt should be to evolve a life-long strategy. The commonly used phrase "long-term" is very vague and understates the kind of vision needed. Adopting a life-long vision does not rule out revising the vision when the revision becomes necessary. The vision should be reviewed if and when there is a fundamental change in one's personal circumstances or in the external environment.

Diversify but not too much:

35. The wealth owner should diversify his/her wealth over several asset types in order to reduce risk. Concentrating most of the wealth in a single asset type, or just a few types, is risky. At the same time dispersing the wealth over too many types of assets makes the task of supervision very difficult. The variety of assets available is very large as may be seen from Exhibit 3. It is not necessary to have all the kinds. Be choosy.

36. Choose some clear broad goals to be achieved in your life-time. For example, owning a house can be among such goals. Children's education and settlement has to be among one's life goals. A plan for ultimate retirement and retirement income should also be part of one's long vision.

Exhibit 3

AVAILABLE ASSET TYPES

- Life insurance policy
- Residential house
- Bank deposits
- Corporate bonds
- Treasury securities
- Equities
- Gold, silver and jewellery
- Foreign exchange holdings
- Business partnerships
- Other types of assets, such as objects of art, paintings, etc.

37. Based on the above reasoning, the choice of asset classes by a young person who has just started his career will be more restricted compared to that of a person at the fag-end of his career.

38. For a young person in our example, the first choice should ordinarily be a life insurance policy in order to ensure a certain minimum of financial security to the family. This is

now-a-days specially important because the traditional joint-family system has, more or less, broken down in the urban areas.

39. Over the initial 10-15 years, the young person may be expected to have gradually accumulated some cushion of reasonably safe and liquid financial assets. Bank fixed deposits belong to this category. On the other hand, deposits with private companies are not safe. Many companies entice investors by promising high interest rates but fail to repay the deposits. There have been many instances of this kind.

Acquiring a house should be a high priority:

40. A fairly high priority should be to acquire a residential house. Housing loans are now being provided by housing societies and banks. Such loans usually have a long repayment period. One has to choose the repayment period most suitable in the particular circumstances. The schedule of repayment is fixed in advance for the entire period.

41. Several variations are available regarding the scheme of repayment. There are basically two alternative schemes, viz. fixed interest rate and floating interest rate. The usual system is that of *equated monthly payments* (including interest and instalments) over the entire loan period. Each monthly payment is split between interest component and instalment component. While the interest component goes on reducing, the instalment component goes on increasing over successive months. The length of the repayment period has to be chosen by the borrower, keeping in view his/her financial capacity. (See Exhibit 4)

Exhibit 4

OWNING A RESIDENTIAL PROPERTY SHOULD BE A PRIORITY

- Such properties normally appreciate over the long term
- Residential houses can be purchased on instalment basis spread over many years
- Income-tax concessions are available on one residential house
- Owning a residential house provides security to the family

Other investment avenues:

42. The wealth owner may consider other avenues of investment, such as mutual fund schemes and direct holding of shares and bonds in selected companies. The risks involved in most such investments have increased considerably in recent times because of certain world-wide events, involving the failure of some of the largest financial institutions. One needs to be choosy and careful.

IV

CHOOSE WEALTH ADVISORS CAUTIOUSLY

Some tricky problems:

43. If the wealth-owner wishes to engage a wealth management advisor, there are some tricky problems. One is that of how to judge the advisor’s competence. Such people are usually smart and have the gift of the gab. You should not be taken in by glib talk.

44. Some wealth advisors are unscrupulous and get secret commissions from sellers of financial products. Their recommendation may be influenced by such commissions and may not necessarily match the wealth owner’s life goals. If the wealth-owner intends to engage a wealth advisor, he should always check up from other people whether the particular advisor is competent and reliable and what has been their experience about the advisory services provided. (See Exhibit 5)

Exhibit 5

**PROBLEMS REGARDING
WEALTH MANAGEMENT ADVISORS**

- Many advisors are not very competent
- Some are unscrupulous
- Caution always needed

One advisor or more:

45. Some wealth-owners use more than one wealth advisor but this is likely to lead to less than optimum result because of over-lapping or duplication. It may create confusion also. Hence, it should ordinarily be avoided.

Getting the best out of your wealth advisor:

46. Managing your own wealth will demand time and attention. As a result, the wealth-owner may not be able to give full attention to his/her normal business, profession or duties. It is for resolving this kind of problem that the wealth-owner may engage a wealth advisory firm but this may often create new problems. For example, the wealth management advisor would be routinely posting to his clients piles of information on changes, developments or opportunities. Sifting through the pile would require time on the part of the wealth-owner.

47. Perhaps the best way for the wealth-owner could be to prepare a list of specific questions on which he/she needs advice from the wealth management advisor. A meeting with the wealth-advisor, say, once a month or so could serve the purpose.

48. One may use the wealth management advisory firm purely for advice or also for implementing the advice. For example, if a property has to be purchased, a lot of information may have to be collected and numerous formalities to be completed, including submission of bids in certain formats. This work can be entrusted to the wealth management advisory firm.

V

THE CHANGING SITUATION

Recent developments in India:

49. Several domestic brokerage houses in India are reported to have started wealth management services during the last few years, specially when the stock market and the economy were booming. One such firm was Motilal Oswal Financial Services Limited which had created a Wealth Management Division with as many as 350 personnel.[1] The business of wealth management slowed down recently because of recessionary trends, but it still has good long-term prospects.

50. The HDFC Bank is also reported to have started wealth management business by making its services available not only to high networth individuals but also to the mass of affluent salaried class. It has divided its target customers into three types, viz. (a) those who delegate the whole investing process to the bank (b) those who take investment decisions themselves but delegate the execution to the bank and (c) those who seek advice only.

51. There are many other relatively recent entrants into wealth management business, such as Ask Investment Holdings, ICICI Bank, Kotak group, Reliance Money and some more. We are mentioning this just to indicate that wealth management is becoming increasingly important.

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[1] See *The Financial Express*, March 7, 2009.

52. India is endowed with a large number of business entrepreneurs as well as highly qualified technical persons. Many of them can benefit from a better understanding of the basic principles underlying wealth management.

Goals keep changing:

53. As life goes on, the objectives and goals of the wealth owner keep changing. This will necessitate the re-setting of the asset portfolio. Some assets may have to be liquidated and others acquired in their place. Wealth management is not a static problem.

Cyclical changes:

54. The reason partly is the cyclical ups and downs which affect certain asset classes much more than others, as we have pointed out earlier.

Choose uncorrelated assets:

55. It will be particularly useful to diversify your wealth among asset classes which are not correlated to each other. Cyclical swings will bring this out. For example, gold prices are generally not correlated to equity prices. Diversifying over both can be particularly useful.

Other factors:

56. There may be important changes within the family, such as children's marriage and settlement. A consequential change may be required in your asset portfolio: you may need a larger house because of larger family.

57. The wealth owner may accept a new job or migrate to a new location. Such changes could sometimes mean reconsideration of the goals and objectives also.

58. Sometimes, there are partitions in joint families, necessitating a fresh look at wealth management by each of the constituents of the erstwhile family.

Involve family members:

59. As the children grow up, it would be advisable to gradually involve them in managing the family's wealth. This is almost a necessity in the case of business families who have a growing business and are diversifying their activities.

Periodical review needed:

60. The spectrum of assets has to be reviewed from time to time both on account of the changes in the market's environment and also due to personal factors.

Summing up:

61. It can be educative to periodically evaluate how well is your own wealth management, focusing on selected aspects (See Exhibit 6).

Exhibit 6

EVALUATING YOUR WEALTH MANAGEMENT

- Identify weaknesses in your wealth management
- Evaluate performance
- Assess past mistakes
- Redefine your future strategy