Association of International Wealth Management of India

C.P.B.M®

Certified Private Banking Manager

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MODULE I
INTRODUCTION

1.1 DISCUSS BRIEFLY THE PRIVATE BANKING SERVICES PROVIDED GLOBALLY.

Banking sector is responsible for handling the financial assets under any economy. The banking sector can be divided into two parts: traditional and private.

Traditional Banking: Traditional banking is the basic form of banking which involves savings account and current accounts, which an average earning individual requires. Traditional banks deal more with the basic forms of savings which includes bonds and interests. Also, nowadays many banks handle equity portfolios of individuals in their Demat accounts.

Private Banking: Private banking deals with taking the money one has and investing it wisely so as to preserve, protect and grow it. Private banking is appropriate for those individuals who are thinking about huge amounts of solid long term investments and need personalized attention for investment advice, legal and regulatory advice.

High Net worth Individuals (HNIs) refer to an individual or a family with high net worth compared to the average person. There is no specific definition of how wealthy somebody must be to fit into this category as the exact amount differs from one financial institution to another.

Private banking is personalized banking, investment and financial services that are offered to bank's wealthy high net worth individual (HNI) clients. Since, HNIs are richer than the average persons; they have the ability to invest in traditional as well as alternate investments. The aim of private banking is to cater to the needs of the HNIs with the most appropriate investment options and variety of choices.The term "private" refers to the personal customer service rendered to the HNIs by the bank's financial advisors rather than in mass-market retail banking. Private wealth management services are provided by larger corporations, such as Goldman Sachs, but they may also be provided by independent financial advisors or portfolio managers multi-licensed to offer multiple services and who focus on high-net-worth clients.

Wealth management is a professional investment advisory service which provides services on financial planning, portfolio management, accounting and tax services and legal planning. The investment advice is provided by professional money managers who have expertise and experience in growing and managing the money of investors. These professional wealth managers have educational qualifications such as Chartered Financial Consultants, Certified Financial Planners, Chartered Financial Analysts (in the United States), Chartered Strategic Wealth Professionals (in Canada), Chartered Financial Planners (in the UK), or any other credentialed money manager (such as a MBA).

Generally, people are under the impression that HNIs are people without problems as they are living a life of luxury. But, owning a lot of wealth means taking care of it. This can be achieved by the help of wealth management, which provides proper tax planning, creation of a successful investment plan and proper management of their wealth.The most important use of wealth management is in the planning of retirement. The cost of living has been rising steadily in the world. In these changing times, it is important for aging people to park their wealth with professional money managers who can protect and grow their funds so that they can have a safe and secured retired life.

The services provided through private banking and wealth management differ slightly. Wealth management is a broader service which includes management of a client's portfolio according to the objectives and constraints of the client, on the other hand, private banking involves envelope solutions for HNI clients. Private banking does not necessarily involve actual buying of assets on the client's behalf.

Wealth management vs. Financial planning

Wealth management and financial planning are on the ground level the same thing as they both deal with wealth and finances. But they are different from one another. Management of wealth is done by wealthy people as they need a wealth manager who takes care of their wealth and manages it properly. While, financial planning deals more with structuring out a plan as to how one deals with his expenses over time in comparison to the income.

As the name suggests, wealth management is all about managing one's wealth. Wealth management is more inclined towards preservation of current wealth and accumulation of further wealth. Wealth management services are undertaken by wealthy people as; one needs to be wealthy to get their assets managed.

Financial planning is the discipline of handling money. It involves the practices of saving, earning, investing and spending on the basis of matters of one's personal life. Planning of finances according to the future outflow and inflow of cash is very necessary in one's life Financial Planning is done by everyone, which includes HNIs as well as people with average earnings. Planning of finances does not require existing wealth like in the case of wealth management.

1.2 DISCUSS THE OPPORTUNITIES AND CHALLENGES IN THE PRIVATE BANKING SECTOR.

Opportunities in the private banking sector

The wealth management pools across the globe have seen a significant growth in both developed as well as emerging markets. The HNI households tend to grow faster than the average households in an economy due to their high investment in risky assets and access to better financial services. According to the McKinsey European Private Banking Survey 2016, the assets held by HNW investors will exceed $100 trillion by 2025, up from $63.5 trillion in 2016. In 2016, HNW wealth grew 8.2% as the number of high net worth individuals (HNWI) globally topped 16.5 million.

High Net-Worth Individuals by Region, 2016

Region	Wealth in USD (Trillions)	2015-2016 % Change	# Of HNWI (Millions)
Africa	$1.5	10.7%	0.2
Middle East	$2.4	5.0%	0.6
Latin America	$8.0	8.9%	0.6
Europe	$14.7	8.2%	4.5
North America	$18.0	8.1%	5.2
Asia Pacific	$18.8	8.2%	5.5

Region	Wealth in USD (Trillions)	2015-2016 % Change	# Of HNWI (Millions)
Total	$63.5	Avg. 8.2%	16.5
Source: Capgemini Financial Services Analysis, 2017			

In the emerging market economies, the wealth created by the first generation families gets compounded as the economy becomes more mature. It leads to the rise in need for wealth management services. The emerging market economies are a very crucial source of expansion for the wealth management industry in the years to come.

Challenges in the private banking sector

There is a barrier to entry for the average earning individuals, as only HNIs can afford the costs of a personalized banking service. After the Global financial crisis in 2008, U.S. Department of Homeland Security closely monitor offshore private banking for illegal activity. Hence, the strict legal and tax systems can affect the overall growth of the private banking industry. The licensing of the private banking institutions and individuals has become further restrictive which has reduced the number of players in this sector. The services provided by these institutions have also been made restrictive.

Lead acquisition is another challenge faced in this industry. Private Banks are always in search of new clients and generally adapt to age old methods of referrals from corporate marketing and wholesale divisions. These methods do provide these institutions with valuable clients but they are also trying to adapt sophisticated multi-channel approaches that use social networking and event marketing.

The current growth rate in the financial markets has been very weak and the overall investor sentiment is bearish. Due to these reasons the clients are unwilling to invest and thus a lot of the time of the banking professionals is spent in discussing and analyzing the investing strategies with the clients.

Recruitment and training is a very expensive and time taking process. To gain trust of its clients private banking professionals have to undergo rigorous training and the institutions have to go through a very careful and thorough process of recruitment. The professionals need to have deep understanding of the markets and also must have strong interpersonal skills along with high level of ethics. Incentive programs for banking professionals is a common practice throughout the industry.

1.3 EXPLAIN THE BUSINESS MODEL OF THE PRIVATE BANKING SECTOR.

The overall private banking and wealth management sector has seen a steady decline in the profitability margins. The core business model on which this business has been operating primarily focuses on domestic businesses and high net-worth clients with an international footprint. They provided standardized advisory and brokerage services with limited investment products being available to the clients. There was not much focus on establishing and improving client-manager relationship and the profits of the manager depended on the transaction volume rather than profitability. These organizations had highly complex IT infrastructures and were unable to provide a user friendly interface to their clients.

There has been a fundamental shift in the business model. The new business model is based on four important pillars: innovation, digitization, industrialization and disruption.

Innovation is the creation of a new and viable business offering (ideally going beyond products to platforms, business models and client experience).

Digitization is the transformation of business activities by the introduction and use of information technology.

Pillars of the Model

Industrialization is the concept of reducing the cost base and re-thinking the value creation process through the elimination of redundancies, smart sourcing, automation and standardization.

Disruption is a process whereby a smaller company with fewer resources is able to successfully challenge incumbent businesses.

In an environment of stiff competition and growing technology, mind shift was necessary. With clients having access to myriad alternatives they can shift to another organization if they find better services. Organizations providing technology based banking services have grown manifold in the past few years and with millennials being the rising prospective client segment tech savvy alternatives have become essential. The new business models are client focused and personalized.

Banking professionals have identified the importance of client engagement and are resorting to new methods of networking for better client manager relationships.

They are adapting a proactive rather than a reactive attitude towards the client. Instead of being vendors of investment products, private banks are now providers of financial solutions. Client preferences have also changed with clients now being more socially aware and desiring to invest in unique channels, for example, a client could wish to invest in an innovative start-up aiming at curbing carbon emissions. The relationship between banking professionals and clients has evolved to become more spontaneous rather than structured. The client meetings are more focused on client aspirations, circumstances and priorities.

1.4 DISCUSS CLIENT NEED ANALYSIS IN PRIVATE BANKS.

The investment plans for the clients are made in accordance with the needs of the client. The first few meetings are just about understanding the client and listing out the needs according to priority. Needs also include the goals or dreams he wishes to achieve in life, for example, starting his own venture or a family vacation. The aspiration of clients may vary with their lifestyle. The client is required to specify the amount of money that he would like to spend on the particular aspiration and what is the expected time by which he wants to fulfill the particular aspiration. The time is a crucial factor as the banking professional needs to ensure that the client has the required amount of money at the appropriate time.

Client needs change with time. For instance, at a younger age client might need to buy a house or fund his child's education however, with time retirement planning might be another aspect on which the banking professional might need to focus.

Needs are also affected by client's behavioral traits. An investor with very low risk tolerance level would not prefer to invest in products like hedge funds as they carry high risk even if along with high returns. Similarly, the entrepreneur segment, will be willing to take high risk for high returns and would require a broader product range, like private investment and real estates, at different moments in time and through different channels. Private Banks needs to put in an effort to capture and analyze these needs.

1.5 DISCUSS THE BEST PRACTICES IN THE PRIVATE BANKING SECTOR.

In the wake of changing paradigm of the private banking industry, the banking professionals are looking towards purpose along with profits. The change in client segment from baby boomers to millennials requires for the implementation of best practices in this industry. The investment ideology must be a blend of profit and purpose.

The best practices are:

Clean Technology Portfolio

Business Intelligence

Making Impact Investments

Clean Technology Portfolios

Clients are becoming increasingly socially aware and thus the banking professionals should be aware of this shift and build their client's portfolios around this purpose.

Business Intelligence

If the high net worth clients require holistic advice, banking professionals could pursue appropriate certifications to identify and manage the challenges face by the clients and design strategies to better suit the client goals, protect client's assets and reduce tax liabilities.

Making impact investments

Impact investments refer to investing with the purpose of generating high returns and also making a measurable and purposeful environmental impact. Impact investment reduce portfolio volatility and address market inefficiencies through capitalization of social trends.

Sustainable growth allows private banks to prosper in the long run. These three practices can provide private banks with sustainable growth along with reputation.

A recent example of this is Capricorn Investment Group. This group shifted their investment to Elon Musk's renewable energy project called Solar City. They were rewarded for this shift by a 400% increase in stock price within 12 months.

The idea is to generate positive returns alongside giving a positive impact. By understanding these new paradigms, it is possible for budding entrepreneurs, private banks and wealth management enterprises to make financially sound decisions.

1.6 DISCUSS TALENT MANAGEMENT IN PRIVATE BANKING SECTOR.

A thorough analysis of talent management is based on the fact that talent can be found across an organization at all levels. The most basic definition of talent management is that it is the assessment, evaluation and development of the talent of all employees within an organization. Talent is not limited to senior level employees or certain technical skills. Organizations usually have limited resources for talent management and they utilize these resources completely if they believe that they can get good returns.

Due to the 2008 subprime crisis, private banks are under heavy scrutiny i.e. both official and unofficial. Unofficial scrutiny is done by the public at large who is analyzing the bank's every move. Thus, the banks are heavily focused on reducing costs and in turn increasing their profits. These organizations are thus working on utilizing their internal talents to their full capacity as hiring is a very challenging task. There is no dearth of people with the required technical expertise but the problem is two-fold. First, hiring the talented people before their competitor makes a more attractive offer, second, retaining the existing employees and making ample use of their skill set.

Whenever the future of the business is in jeopardy, training and development for the employees are the first to be hit by cutbacks. During the process of recruiting new talent and developing the existing ones, organizations can create their own problems. There might be clashes between the values promoted by the organization but it actually rewards its employees.

1.7 LIST THE PRIVATE BANKING LEADERS GLOBALLY.

The private banking industry as a whole manages assets worth USD 21.1 trillion approximately where the top 25 firms manage approximately USD 13.3 trillion worth of assets which is 63.2% of the total market share. The world leaders according to assets under management are:

Sl No.	Private Banks	Asset Under Management (In billions)
1	UBS	$2,035.2
2	Morgan Stanley	$2,025.0
3	BoA Merrill Lynch	$1,984.3
4	Credit Suisse	$883.7
5	Royal Bank of Canada	$704.4
6	Citi	$550.5
7	J.P. Morgan	$428.0
8	BNP Paribas	$370.7
9	HSBC	$365.0
10	Goldman Sachs	$363.0

Being world's largest high net-worth market, banking professionals are of the belief that, Asia will be their prime focus for investments. The top private banking institutions in Asia are UBS, Credit Suisse, Citi, BNP Paribas, May bank, Agricultural Bank of China and China Merchant Bank. More specifically, China Merchant Bank and Kotak Mahindra were leaders in China and India respectively.In Europe, the leading institutions are UBS, JP Morgan, Pictet and Credit Suisse.

The prime bullish markets are believed to be Middle East, Africa and the Nordic and Baltic region whereas Latin America and North America are believed to be the least bullish markets.

1.8 DISCUSS THE INDIAN PRIVATE BANKING LANDSCAPE.

The private banking sector in Asia has seen tremendous growth in the recent years. The regulations in this region is not fully updated giving private banks greater margins and thus profitability is not a challenge. However, there are certain banks which provide great personalized experience and have better access to technology and resources due to which survival of middle-tier players is difficult.

India's private banking industry has been growing at a healthy pace with assets under management growing from USD 77.5 billion in 2015 to USD 103.7 billion in

2016 that is a growth rate of 33.8%. Buoyant economic growth, low interest rates and declining inflation all contributed to the sector's strong gains.

The table below lists the top ten players in this market:

Sl No	Private Bank	Assets Under Management (in USD billions)
1	Kotak Wealth Management	15.3
2	IIFL Wealth and Asset Management	14.8
3	ICICI Private bank	8.5
4	Standard Charted Private bank	7.8
5	Edelweiss wealth management	7.4
6	BNP Paribas wealth management	7.3
7	Julius Baer	7.0
8	Citi Private Bank	7.0
9	HDFC Private Bank	6.5
10	Barclays Wealth	4.3

At the top of the table is Kotak Wealth Management with assets under management USD 15.3 billion. Its AUM has risen by 59.3% in one year. Second on the list is IIFL wealth management with AUM of USD 14.8 billion. IIFL was restructured in the year 2016 with its asset management arm and wealth management arm merging to form IIFL wealth and asset management. Third is ICICI, with a growth of 11.8% its AUM is USD 8.5 billion. The largest growth in assets under management was seen by Edelweiss of 138.7%.

Domestic private banks seem to have a dominance over the international private banks in the Indian market. Among top 20 players in the market 13 are domestic with a market share of 64%. Over the past few years, some notable private banks have exited the Indian market, for example, HSBC private bank, UBS wealth management, Morgan Stanley private wealth management, etc. These private banks are now focused on the 'global Indians' i.e. NRI clients and their onshore Indian footprints.

SUMMARY

1. Discuss briefly the private banking services provided globally.
   - Traditional Banking: Traditional banking is the basic form of banking which involves savings account and current accounts.
   - Private Banking: Private banking deals with taking the money one has and investing it wisely so as to preserve, protect and grow it. It is suitable for HNIs.
   - High Net worth Individuals (HNIs)-HNIs refer to an individual or a family with high net worth compared to the average person.
   - Private banking is personalized banking, investment and financial services that are offered to bank's wealthy high net worth individual (HNI) clients.
   - Wealth management is a professional investment advisory service which provides services on financial planning, portfolio management, accounting and tax services and legal planning.
   - Financial planning deals more with structuring out a plan as to how one deal with his expenses over time in comparison to the income.
2. Discuss the opportunities and challenges in the private banking sector.
   - The global wealth is rising and thus the private banking sector has a great scope of growth ahead.
   - Emerging market economies are a crucial sector for expansion as the economies are advancing towards maturity.
   - The challenges in the private banking sector are:
     i. Barrier to entry for average earning individuals
     ii. Lead acquisition
     iii. Negative market sentiment
     iv. Expensive recruitment and training
3. Explain the business model of the private banking sector.
   - There has been a shift in the model used by this industry. The new model is based on four pillars:

i. Innovation
ii. Digitalization
iii. Industrialization
iv. Disruption

- The millennials comprise of a significant portion of client segment thus the services provided by private banks must be customized, client focused and tech savvy.
- The relationship between banking professionals and clients has evolved to become more spontaneous rather than structured.

4. Discuss client need analysis in private banks.
   - Client needs are of prime importance in the formation of investment plans.
   - Needs include goals, dreams and aspirations.
   - Time is a very crucial factor as with time dreams and aspirations change.
   - The psychological make-up of the client also affects needs.
5. Discuss the best practices in the private banking sector.
   - The investment ideology must be a blend of profit and purpose.
   - The best practices are:

     i. Clean technology portfolio
     ii. Business intelligence
     iii. Making impact investments
6. Discuss talent management in private banking sector.
   - Talent can be found at all levels across an organization.
   - Talent management is the assessment, evaluation and development of the talent of all employees within an organization.
7. List the private banking leaders globally.
   - UBS, Morgan Stanley, Merrill Lynch, Credit Suisse are among the global leaders in the private banking sector according to assets under management.
   - Asia is the prime focus for investments.

- The prime bullish markets are believed to be Middle East, Africa and the Nordic and Baltic region whereas Latin America and North America are believed to be the least bullish markets.

8. Discuss the Indian private banking landscape.
   - India's private banking sector assets under management have grown from USD 77.5 billion in 2015 to USD 103.7 billion in 2016 that is a growth rate of 33.8%.
   - As per AUM, the biggest player in the market is Kotak Wealth Management.
   - The largest growth in assets under management was seen by Edelweiss.
   - India's private banking industry is dominated by domestic players with a market share of 64%.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	I	1	Which of the following includes savings accounts for individuals?	Traditional banking	Private banking	Corporate banking	Individual banking	**A**	Traditional banking is the basic form of banking which involves savings account and current accounts, which an average earning individual requires.
2	I	4	Which of the following aspects does not impact client's asset management strategy?	Age of client	Financial goals	Psychological make up	None of the above	**D**	All of the above mentioned factors impact a client's asset management strategy.
3	I	8	Which of the following private banks in India has seen the highest annual growth in assets under management?	Edelweiss Wealth Management	Kotak Wealth Management	Julius Baer	Barclays Wealth	**A**	The largest growth in assets under management was seen by Edelweiss of 138.7%.
4	I	1	Which of the following services is provided by wealth management advisory firms?	Legal advice	investment advice	tax planning	All of the above	**D**	Wealth management is a professional investment advisory service which provides services on financial planning, portfolio management, accounting and tax services and legal planning.
5	I	5	What does impact investment mean?	Investing for high returns	Investing with environmental purpose	Investing in high risk avenues	Both A and B	**D**	Impact investments refer to investing with the purpose of generating high returns and also making a measurable and purposeful environmental impact.
6	I	6	The skills of which level employees is referred to as talent for the organization?	Senior level	Administrative level	Supervisory level	All of the above	**D**	Talent is referred to as the skills at all levels of the organization.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
7	I	2	Which of the following is not a challenge for the private banking sector?	Barrier to entry for average earning individuals	Rising global wealth	Lead acquisition	Recruitment and training	**B**	Rising global wealth management is an opportunity and not challenge for the private banking sector.
8	I	3	Which of the following is not a pillar for the client based business model?	Innovation	Industrialization	Standardization	Digitalization	**C**	The four pillars of the client based model are innovation, digitization, industrialization and disruption.
9	I	6	Which of the following is a challenge faced in talent management?	hiring the talented people before their competitor makes a more attractive offer	lack of talented people	retaining the existing employees	Both A and C	**D**	Challenges faced in talent management are hiring the talented people before their competitor makes a more attractive offer and retaining the existing employees and making ample use of their skill set.
10	I	5	Best practices in private banking result in:	Better reputation	Sustainable growth	Both A and B	None of the above	**C**	Best practices in private banking can provide private banks with sustainable growth along with reputation.
11	I	1	Financial planning is required by:	Average earning individuals	Below average earning individuals	Extremely rich individuals (HNIs)	All of the above	**D**	Planning of finances is the management of future outflow and inflow of cash, it is necessary in everyone's life
12	I	7	Which of the following is considered to be the least bullish market?	Middle East	North America	Africa	Baltic Region	**B**	Latin America and North America are believed to be the least bullish markets.
13	I	2	Which of the following methods are used for acquisition of new clients?	Social networking	Client referrals	Event marketing	All of the above	**D**	All of the above mentioned methods are used by private banking professionals for client acquisition.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
14	I	3	Which of the following processes involves reducing cost based and revaluating value creation?	Industrialization	Innovation	Disruption	Digitization	**A**	Industrialization is the concept of reducing the cost base and re-thinking the value creation process through the elimination of redundancies, smart sourcing, automation and standardization.
15	I	8	Which of the following factors does not have a positive impact on private bank gains?	High economic growth	Low interest rate	High inflation	None of the above	**C**	Low inflation results in higher profitability for private banks.
16	I	1	Wealth management is required by:	Average earning individuals	Below average earning individuals	Extremely rich individuals (HNIs)	All of the above	**C**	Wealth management investment advice is provided by professional money managers who have expertise and experience in growing and managing the money of investors who are already rich.
17	I	4	Is time an important factor in investment management?	Yes	No	Varies according to client	None of the above	**A**	Time is a crucial factor in investment management.
18	I	7	Which of the following regions has the highest net wealth?	Africa	Asia	North America	Middle East	**B**	Asia has the highest net wealth of $18.8 trillion.
19	I	3	________ is a process whereby a smaller company with fewer resources is able to successfully challenge incumbent businesses.	Industrialization	Standardization	Innovation	Disruption	**D**	Disruption is a process whereby a smaller company with fewer resources is able to successfully challenge incumbent businesses.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
20	I	1	Private banking is suitable for what kind of clients?	Average earning individuals	Below average earning individuals	Extremely rich individuals (HNIs)	All of the above	C	The aim of private banking is to cater to the needs of the HNIs with the most appropriate investment options and variety of choices. Private banking deals with taking the money one has and investing it wisely so as to preserve, protect and grow it.

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MODULE II
INVESTMENT PRODUCTS

2

Learning Outcome Statements

1. Discuss investment in fixed income sector.
2. Discuss corporate finance and advisory.
3. Discuss investment in real estate.
4. Discuss investment in Equities.
5. Discuss investment in Exchange traded funds/mutual funds.
6. Discuss investment in alternative investments.
7. Discuss investment in commodities.
8. Case study on REIT

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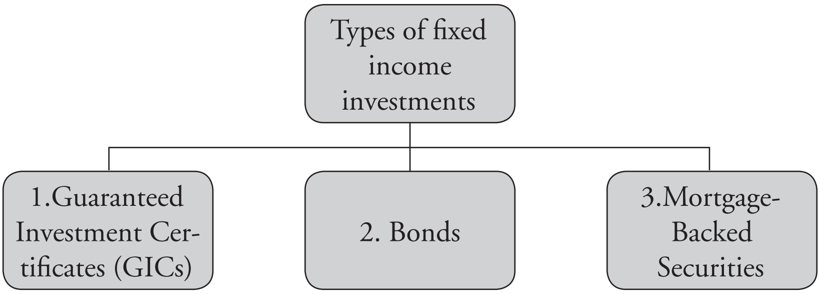
MODULE II
INVESTMENT PRODUCTS

2.1 DISCUSS INVESTMENT IN FIXED INCOME SECTOR

In capital markets, there are primarily two types of investments: debt and equity. Having equity investment is considered as having ownership in the company. Equity investors receive a return which is based on the appreciation of share price or the dividends they receive. But as the name suggests, in a fixed income investment a pre-determined amount is earned by the investor which is paid out by the issuer of the fixed income security. Fixed income security holders do not have an ownership stake in the company; instead they are lenders of capital to the company in exchange for interest on their capital. This interest that they receive on a regular basis is called 'fixed income'. Also note, since they are considered as creditors of the company, they generally have a priority claim (over the equity investors) to the firm's assets in case of bankruptcy.

Why fixed income?	**Diversification** - Fixed income securities help in smoothening out the ups and downs in a stock portfolio. This is because stock and bond prices have historically tended to move independently and with different magnitudes at any given time.
	Capital preservation - In fixed income securities, principal is returned at maturity. Hence, the capital is preserved. But, there is a risk that the issuer of the bond may default.
	Regular Income Generation - Fixed income securities are typically designed to provide a regular, predictable stream of interest payments on set dates.

Yield to maturity (YTM) is the total return anticipated on a bond if the bond is held until its maturity. It is a long-term bond yield, but is expressed as an annual rate. In simpler words, it is the internal rate of return (IRR) of an investment in a bond if the investor holds the bond until maturity and if all payments are made as scheduled. Yield to maturity is also referred to as book yield or redemption yield.



1. Guaranteed Investment Certificates (GICs): Guaranteed Investment Certificates (GICs) are notes which have a fixed yield and term and are issued by a trustworthy company. For example, The Canada Deposit Insurance Corporation (CDIC) insures many GICs for interest and principal totaling up to $100,000. Generally GICs are non-redeemable before the term is over.
2. Bonds: A bond is an obligation or loan taken by the issuer (e.g. a government or a company) of the bond, which is towards the investors. The issuer of the bond promises to payback the face value (principal) of the bond on a fixed maturity date and to make regular scheduled interest payments (usually semiannually). Bonds can be issued by government and companies, which are known as government bonds and corporate bonds respectively.
3. Mortgage-Backed Securities: A mortgage-backed security (MBS) is an asset-backed security which is backed by mortgage or mortgage pools. These mortgage back securities generally pay periodic payments (which are the rental income) that are similar to coupon payments. MBS are generally issued by either a federal government agency company, government-sponsored enterprise (GSE), or private company.

Importance of credit rating on a fixed income security:

The credit rating on a fixed income security is an important determinant of the yield of the bond and the amount of risk associated with the bond. Credit ratings for fixed income securities are issued by credit rating agencies. Standard & Poor's (S&P), Moody's and Fitch are the most well-known credit rating agencies that issue hundreds of thousands of new credit ratings every year. The credit ratingsthey issue are based on the ability of the issuer to meet its financial obligations and the issuer's overall credit quality. The credit rating affects the yield of the security as investors demand a higher yield for a bond with a lower credit rating as the risk is higher.

Risks associated with fixed income securities:

Fixed income is generally considered to be a more conservative and less risky investment than stocks, but bonds and other fixed income investments still carry a variety of risks that investors need to be aware of. The various risks of fixed income include:

1. Interest rate risk - Since, bonds are bought and sold in the secondary market, the prices of bond may fluctuate due to the economic environment which is affected by the change in interest rates. If interest rates rise, bond prices usually decline because new bonds are likely to be issued with higher yields which make the old or outstanding bonds less attractive. Hence, the prices of bonds are subject to interest rate risk.
2. Credit Risk - As bonds can be issued by corporate, they carry the risk of default which means that the issuer may be unable or unwilling to make further interest or principal payments. In addition, bonds carry the risk of being downgraded by the rating agencies which could have implications on price. Credit yield is high for non-investment grade bonds which have very low ratings.
3. Inflation Risk - Inflation risk is a major concern for investors who are planning to live off their bond income as there is a risk that inflation will rise, thereby lowering the purchasing power of one's income. To combat this risk, one may want to consider U.S. Treasury Inflation-Protected bonds (TIPS). The TIPS principal is adjusted for any rise in the Consumer Price Index, so when the bond matures and the principal is returned, that amount will be higher to correspond with the amount of inflation.
4. Liquidity Risk - Liquidity risk is the risk of not being able to sell off one's asset at its fair value immediately. Hence, if fewer people are willing to buy a certain bond, the owner of the bond may have to sell it off at a lower price than its fair value. This is liquidity risk.

2.2 DISCUSS CORPORATE FINANCE AND ADVISORY.

High net worth individuals investment in companies and also lend their expertise to the management. This type of investment provides huge return but also is associated with high risk. This investment relates to corporate finance which aims at maximizing shareholder value. Corporate finance involves the management of financial activities of a corporation. It tries to pre-empt the company's financial troubles.

Corporate finance is often confused with business finance. Business finance refers to financing of every kind of business such as partnership firm, joint venture, etc whereas corporate finance aims at achieving the financial goals of an organization by the way of planning, raising, investing and monitoring of the organization's finances.

Investment and Capital Budgeting	It includes the planning and decision of where the organization will place its long term capital assets in order to generate the highest risk-adjusted returns. This mainly consists of deciding whether or not to pursue an investment opportunity through extensive financial analysis. Financial modeling is used to estimate the economic impact of an investment opportunity and compare alternative projects.
	Capital Financing It includes decisions on how to optimally finance the capital investments through the business' equity, debt, or a mix of both. Balancing the two sources (equity and debt) should be closely managed because having too much debt may increase the risk of default in repayment, while depending too heavily on equity may dilute earnings and value for original investors.
	Dividend and Return of Capital Management of an organization is required to decide of they wisk to retain the business' earnings or distribute it in the form of dividends. Retained earnings can often be the best source of funds, without incurring additional debts or diluting the value of equity by issuing more shares. If management is of the belief that they can earn a rate of return on a capital investment that's greater than the company's cost of capital, they should pursue it, otherwise, they should return that capital to shareholders via dividends or share buybacks.

2.3 DISCUSS INVESTMENT IN REAL ESTATE.

Investment in properties in the form of purchase, ownership, management or rentals is all a part of Real Estate Investments. Real Estate investments provide both rental income and also provide capital gains. Diversification benefits and also inflation hedge are the prime reasons to add real estate in a portfolio.

Real Estate investments have become a popular means of investment and after globalization the investments have also increased due to free trade and owning properties outside one's country have become much easier.

However in 2007-2008 real estate was the primary reason for the global economic crisis as everyone thought that the prices of properties can never fall, emphasizing the need for due diligence while investing in real estates.

Investment in real estate is an important part of portfolio management, as empirical evidence shows that real estate prices have soared over the past decades as they hedge the investors against inflation. Real estate investments also provide rental income. Real estate investments can be privately held or publically held.

Private Real Estate Investments	Public Real Estate Investments
◆ One directly owns property (which is private equity) or gives loan to someone else to own a property (private debt). ◆ On owning the property, one has direct control over the property. ◆ A diversified portfolio of real estate is not possible as one cannot have the capital to invest everywhere. ◆ Huge investments are required to own real estate because of its high value and indivisibility. ◆ Private real estates are generally less liquid. ◆ NCREIF index, which is an index of appraisal values of real estate reports- (*i*) Low standard deviation (*ii*) Low correclation with Equity and Bond (*iii*) High correlation with CPI index	◆ One can easily invest in real estate by buying Real estate investment trusts i.e (REITs) or Real estate operating companies i.e. (REOCs) (which is public equity), or by buying mortgage back securities (MBS)(which is public debt). ◆ The management of REITs, REOCs, MBS is going to contol the real estate and manage the property. ◆ A diversified portfolio of real estate is possible as REITs, REOCs, MBS invest in several different properties. ◆ Small investment is required as ownership is divisible even though the real estate itself is not divisible. ◆ REITs, REOCs, MBS are relatively more liquid as they are publically traded. ◆ REITs and REOCs realtively have- (*i*) Higher standard deviation (*ii*) Higher correlation with equity and debt. (*iii*) Low correlation with the CPI index.

Types of real estate

- **Residential real estate investing** -Investments in real estate involving apartments, houses, etc. where individuals reside or live is known as residential real estate investing. Residential Real estate investing is used for capital appreciation and for earning rental income from the property. It is one of the most common types to start investing in real estates. Generally, leverage is taken to finance the purchase in such cases.
- **Commercial real estate investing** - Real estate investing dealing in commercial properties like office buildings, malls, shops, etc. are included in commercial real estate investing. Commercial Real estate investing is costlier than other forms and require high due diligence before investment. Also the income generation from commercial properties is higher than other real estate investments. Rent generated is higher in case of commercial properties.
- **Industrial real estate investing** - Properties such as warehouses or factories which are related to the industrial sector or are used for industrial purpose fall into this category. Investments are high as cost for acquiring such properties is huge.
- **Retail real estate investing** - Investments in shopping malls, traditional shopping center are examples of retail real estate investing. The rental income received is very high from such investments. The cost of acquisition of such properties is also very high. Such properties also include lease payments.

Role of real estate in portfolio

Real Estate investments can have a great impact on a portfolio. Portfolio managers should consider it while constructing portfolio for their clients because of the following advantages:

1. **Steady income**: After investing in real estates, the properties provide constant and fixed returns in the form of rents on a monthly or quarterly basis. This is one of the biggest advantages and reasons for investing in real assets.
2. **Tax benefits**: In some places, owning a rental property has advantages in calculation of taxes as they are exempted. For example rental income is not subject to self-employment tax. Even if some countries don't exempt it, the percentage of tax is low compared to other sources of tax.

3. **Appreciation:** Apart from providing constant rental incomes real-estate also provides rise in value helping investors to earn capital gains. This combination of constant returns and appreciation makes real estate investments attractive to investors.
4. **Inflation Hedge**: Investments in real estate acts as a hedge against inflation. There is high correlation between inflation and value of real assets. Not only does it increase property value but also increases the rental income over time due to inflation.
5. **Benefit of using leverage:** Real estate is supported by using debt. In most of the cases they are purchased taking loans. The interest payments are usually less when compared to asset appreciation and rental income. This is a win for the investor and helps recovering investments faster.
6. **Diversification benefits:** Real estate investments have low correlation with other asset classes. This helps in better diversification of portfolio and achieving higher risk adjusted returns.

Risks of real estate investments:

- Huge Lead time- On direct investment in real estate, there is a significant risk of changes in the property market by the time the construction is over. Hence, real estate investments face a risk of a huge lead time.
- Cost and availability of debt capital- Huge investments in real estate are mostly partly financed by debt. If the debt market gets poor and worsens i.e. debt is not easily available, the cost of debt is high, then it will be more difficult for investors to purchase real estate, hence prices and rents of real estate will decline.
- **Market risk-** Real estate investments are known for their up and down market cycles. During good markets there are strong occupancies and steady rent growth. When the real estate market is down, there are lower occupancies and discounted rents. Hence, real estate prices are subject to market risk.
- Liquidity Risk- It is the risk of not being able to sell off the property into cash at its fair value immediately due to the lack of counterparty. Real estate investments require huge amounts of capital, hence finding the buyer of the property who pays its fair value is a time consuming task which cannot be done immediately.

- Valuation Difficulty: Valuation of real estate is not an easy task as properties don't exchange hands everyday like the shares of the company does; hence the perceived value for different investors is different.

Valuation techniques of Real Estate

Real estate valuation or property valuation is the process of ascertaining the value or price of the property (market value). The biggest problem while valuing real estate's is illiquidity. Properties are not sold every day like stocks or bonds as they are purchased for a long term horizon. This makes calculating the value of real estate more complex.

There are three main methods to calculate the real estate values:

- Income Approach
- Cost approach
- Sales comparison approach

The income approach or the income capitalization approach is more often used to value commercial and investment properties. The net operating income of the rent collected is taken and divided with the capitalization rate. This calculation method causes an inverse relationship between capitalization rate and value of property. In other words, higher the capitalization rate, lower the value of the property. The capitalization rate is nothing but the discount rate minus the growth rate. The other way to calculate value using income approach is to discount expected future cash flows and calculating its present value.

The cost approach considers that the value of a property should be equal to the cost it will take to construct the property. The cost is calculated by adding cost of land and construction and subtracting depreciation from it. Cost approach assumes that if the property is being built now what will its value be. It gives a very recent value and removes the bias of historical values.

There are two cost approach appraisal methods:

- Reproduction method- This method assumes that the duplicate of existing property is built at current market prices and calculates the total value.
- Replacement method- This method assumes that the property will be reconstructed with the same structure but with certain updates.

The sales comparison approach measures the value of property based on the sale price of certain other property sold during recent times in similar areas. The adjustments are made in prices based on the additional features. The sales comparison is based on the law of one price. The law of one price states that two identical products should have the identical price. Properties are not same, which causes the introduction of price adjustments.

Using this method, the following points should be considered:

The properties should be as similar as possible-

- No. of bedrooms
- Square feet
- No of bathrooms
- The properties should be in the same locality or as close as possible for better valuation
- Their sales date should be as recent as possible as values of property change in short periods.

Real Estate Investment Trust

Real Estate Investment Trust or REIT's are instruments that give investors the privilege and opportunity to invest in a professionally managed real estate fund which will be managed by a skilled and experienced manager. REIT's may be described as shares of the fund that are now a very growing form of investment in the real estate industry. The investors contribute money to the fund and make a pool of investment. The manager then buys property through this fund he considers can earn profits in the future. The rental income received from such properties is distributed to the investors in the form of dividend. This structure helps investors to be a part of a large investment which they might not have able to afford.

REITs' are often compared to mutual funds. The reason them being compared to mutual funds is that Dwight D. Eisenhower created the REITs with the motive of replicating the structure in the real estate industry. REIT's are now a widely used toll to invest in real estates. There are many types of REITs' based on the property including retail REIT's, Commercial REIT's and Residential REIT's.

The benefits of investing in REIT are:

Liquidity: The biggest drawback of real estate is illiquidity. However REITs' remove this issue as they are traded on exchange like any other equity shares

Affordability: Real estate investments are very costly and require a large fund. REITs' remove this problem too as an investor willing to invest in real estate but is short of funds can invest in the REITs. They are available at a very nominal amount.

Tax Benefits: Investors enjoy a tax-exempt distribution which comes in the form of dividends in the REITs structure.

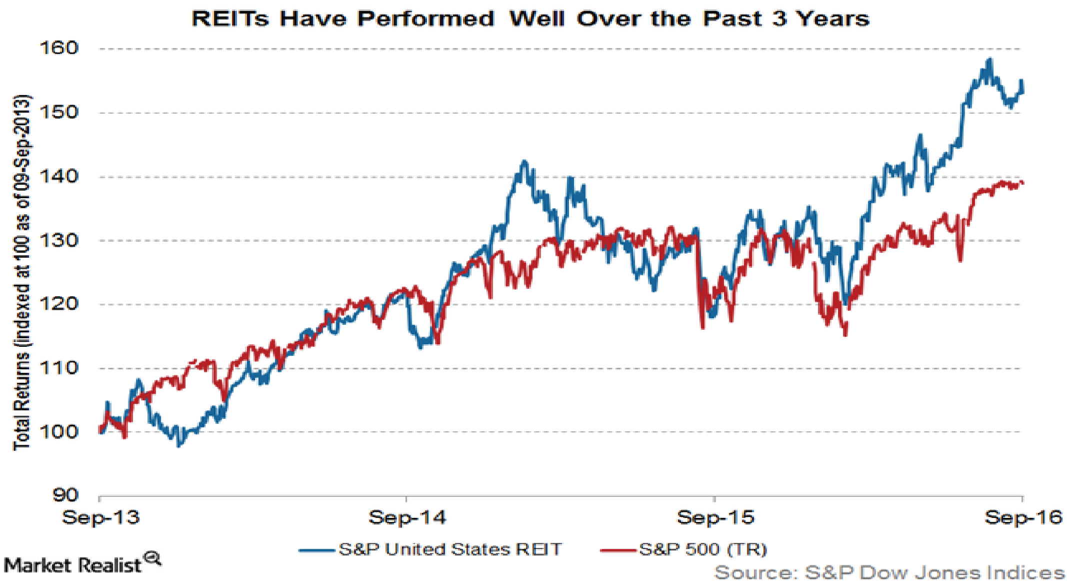
Diversification: REITs usually own a lot of properties which gives them diversification benefits. This feature of REITs reduces the risk as an investor need not rely on a single property.

However there are certain risks associated with REITs namely:

- Market risk
- Income risk
- Concentration risk
- Refinancing risk
- Leverage risk

Before investing in REITs, the investor must check his ability to bear the risk and then only proceed to invest. The risks mentioned above are broad. There might be some specific risk with REITs too. Those risks must also be assessed.

Correlation refers to the co movement of one asset class to another asset class and is considered while creating a diversified portfolio. The correlation between REITs and equity is high. Dow Jones Global Ex-U.S. Select RESI and the S&P 500 had a correlation of 0.66 from December 1992 to June 2016. The degree of correlation might differ in short term due to cyclical fluctuations. For example, during the last recession cycle the correlation between REITs and equity was about 0.8.However in long term the correlation smoothens out.



Over the years the performance of REITs has been exceptional. It has generated more returns than both equity and bonds.

Due Diligence in Real Estate

Real Estate has many advantages but has a lot of risk involved too. The real estate investment manager needs to hold proper knowledge and needs to have the necessary skills before investing in real estates.

Real estate is dependent on a various number of factors which need to be analyzed before investing them. Value of properties fluctuates due to factors related to economy or factors which are global in nature, conditions of the market a rate of interests. In real estate investments the manger plays a key role as selection of properties is the most important determinant apart from rules, regulations which affect the value of the property. Factors like management, finance and selection directly affect the returns from real estate investments. Although leverage is useful, it also magnifies loss apart from profits.

Apart from these risks there is governmental risk too. Some of the barriers are zoning, permitting and environmental laws by which government may intervene.

Large investments like commercial properties also have the risk of not getting enough loans to finance the properties. If interest rates increase, the real estate properties will become more costly. This will lead to a fall in the demand for real estate causing the value of real estate's to also fall.

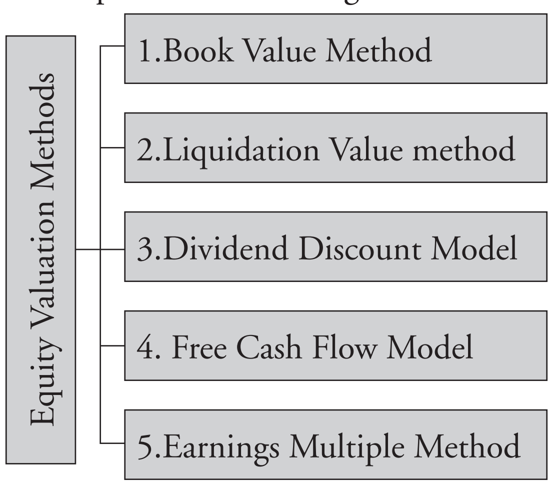
2.4 DISCUSS INVESTMENT IN EQUITIES

Equity investments generally refer to investments in shares of stocks of the companies. The motive of investors to buy and hold on to stocks is to gain income from dividend and also to realize capital gain from the sale of the stocks.

Equity risk premium refers to the excess return over and above the risk-free rate that the stock market provides. This additional return is what persuades the investors to take on additional risk over and above the risk free rate. This additional premium varies across different stocks and also changes over time as market risk fluctuates. Higher the risk, higher the reward!

Risk-Return

The risk return tradeoff is a basic principle which mentions how higher level of risk accounts to higher potential reward and vice-versa. Hence, if there is low level of uncertainty about a stock's potential returns, it means that the stock is not so risky, hence the returns that the investors will demand from it is also low. But, if there is a high level of uncertainty around a stock's possible returns, then the investors will ask for a higher amount of premium for taking that risk.



1. Book Value Method:

   This is a method of Equity valuation where book value as per the balance sheet of thecompany is considered to be the value of equity of the company.

Net-worth of the company is the book value of the company. It is calculated as-

Net Worth = Equity Share capital + Preference Share Capital + Reserves & Surplus - Miscellaneous Expenditure (as per B/Sheet) - Accumulated Losses.

2. Liquidation Value Method:

   In this way of Equity valuation, liquidation value of a firm is considered to be the value of the equity of the firm. Liquidation value refers to the value realized if the firm liquidatestoday.

   Liquidation Value = Net Realizable Value of All Assets - Amounts paid to All Creditors including Preference Shareholders.

3. Dividend Discount Model:

   This model of dividend discount model helps in equity valuation by finding the present value of all the future dividends of the company. There are a various number of assumptions made in this method about period of dividends and growth in dividends.

4. Free Cash Flow model:

   This valuation model is based on the free cash flows of the company, in this method, free future cash flows of the company are discounted to find out the present value of the company today. Also note, to find the value of the equity, debt is deducted from enterprise value.

5. Earnings multiple method:

   Earnings multiple or Relative Valuation methods are also called comparable methods because they use peers or competitors value to derive the value of the equity. The importance here is of deciding which factor to be considered for comparison and which companies should be considered peers.

Security Market Index

A security market index is the aggregate value produced by the combination of several stocks and other investment vehicles together and expressing their total values against a base value from a specific date in the past. The intention of security market index is to represent an entire stock market and thus track the market's changes over time. Basically, a security market index works as a proxy for how the entire market is performing. These index values are useful when investors want to track changes in market values over long periods of time. For example, Standard and Poor's 500 Index is computed by combining 500 large-cap U.S. stocks together into one index value. Investors use the value of this index as a benchmark to measure their performance.

A portfolio can be managed actively or passively.

Active management: Active management is done by portfolio managers. These managers have a goal to beat the average market returns by making use of the short term fluctuations in prices. They do not follow the buy and hold strategy, instead they use buying, short selling or even leverage to actively use their expertise to manage the portfolio. Active management costs more than passive management as high level of expertise and transaction costs are involved.

Passive Management: Passive management is done by investors who want a cost effective strategy and are willing to buy and hold. It is done by investors who personally do not have the time to track the market; hence they are not tempted by short term fluctuations in the market.

A company's stock prices are affected mainly by three important factors-

- Fundamental Factors
- Technical Factors
- Market Sentiments

Fundamental Factors:

In markets where the stocks of various companies are fairly priced, the price of a stock is determined by its fundamentals. The price of a stock is either based on the multiple of value (for instance, P/E ratio) or is based on the earnings of a company (for instance, EPS). Stock prices generally fairly reflect what the fundamentals of the company are, how strong the balance sheet is, and the amount of leverage taken by the company, company's expected cash flows and dividends.

Technical Factors:

Technical factors that determine a stock's price focus on the externalities of the stock which affect the supply and demand for the stock which in turn influences the price. Important technical factors are-

- Market's performance
- How strong are the competitors

- How easily are substitutes available
- Inflation in the economy
- Liquidity in the market
- Demographics of the market being catered to
- Trend of the market

Market Sentiments:

Market sentiments refers to the psychology of the investors. Markets are based on greed and fear. While, the fundamental and technical factors can be estimated and foreseen, but the sentiments of players in the market is very difficult to predict.

Investment in unlisted shares

Unlisted shares are not traded on an exchange. This means that, these shares are not available for the general public to buy easily in a standardized way through a clearing house. Instead, these shares are traded in over-the-counter (OTC) market. Due to this reason, these unlisted shares are also called over the counter shares. Also, because these shares are not exchange traded, the liquidity in the OTC market is low. Obviously, unlisted shares have greater amount of risk as they aren't exchange traded, so the investors demand higher return for investment in unlisted shares.

2.5 DISCUSS INVESTMENT IN EXCHANGE TRADED FUNDS/MUTUAL FUNDS.

A mutual fund is a pooled investment vehicle that offers instant diversification benefit. It is a fund where small retail investors pool together their capital to hire professional managers who manage their money in the best possible way so as to get diversification benefit. Mutual funds are heavily regulated as they deal with the commingled funds of the small retail investors, they have management fees, advertisement charges, and sales charge. Mutual funds can be open ended and close ended.

Open ended:Buying and selling of shares takes place directly from the mutual fund. Open ended mutual funds always transact at the next available Net Asset Value (NAV).The number of shares increases as new investors buy and number of shares go down as investors withdraw.

Close ended:Buying and selling of shares of mutual funds takes place in the secondary market amongst the buyers and sellers themselves. The shares of the close ended mutual funds trade either at a discount or a premium to its actual NAV. The number of shares remain constant as the buyers and sellers transact amongst themselves.

Exchange traded funds has the features of both an open ended fund as well as a close ended fund. They provide instant diversification benefit like the open ended mutual funds, but they are exchange traded which means that buyers and sellers can directly transact with one another. Since these funds are exchange traded, investors can use 'stop and limit orders' and even short sell in some cases. Majority of the ETFs currently in the world are passively managed, which means that they follow the buy and hold strategy for the long haul, hence they have a lower management fees compared to an open ended mutual funds. ETFs are required to disclose their holdings twice each day which makes them subject to a high level of transparency.

Diversification of investment is a technique in risk management which is applied by investors or their portfolio managers to minimize the unsystematic risk. It involves investing in a variety of different asset classes so as to not get affected by the systematic risk of a specific asset class. Mutual funds and exchange traded funds invest in various securities, such as cash, bonds and stocks. These funds also invest in several asset categories and in different securities within each category, due to which these funds enjoy diversification benefit. Due to diversification of investments across various asset classes, if one asset class performs poorly, then the portfolio as a whole does not suffer because there are other asset classes present in the portfolio that might have outperformed the market.

Fund of Funds:

Fund of fund (FOF) is a strategy of investment where the investor holds a portfolio of other investment funds rather than himself directly investing in one particular fund or in stocks, bonds or other securities. The benefit of such a fund is that there is multi manager expertise involved, hence there is also a drawback of double layered fees. But, by investing in fund on funds, the investor does not have to do much due diligence of the individual funds in the FOFs. Also, the investor gets better diversification benefit.

2.6 DISCUSS INVESTMENT IN ALTERNATIVE INVESTMENTS.

Few years ago, investors just used to invest in stocks, bonds or cash equivalents. However as the time has changed, investors have also started diversifying their portfolios through investments in other asset classes. These asset classes apart from equity, bonds and cash are known as Alternative Investments. They differ from traditional investments in terms of both the structure of investment and the type of asset class including securities included. Use of derivatives and leverage is very common in alternative investments.

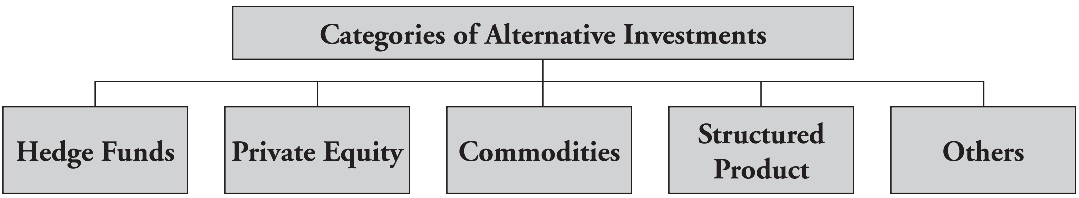
Generally, the fees structure in managing the alternative investments is higher than traditional investments. There is an incentive fees included apart from the higher management fees.

When compared to traditional investments, alternative investments are:

1. Less liquid than traditional investments
2. There is need for more specialization in management of asset class
3. There is less regulation and transparency when compared to traditional investments
4. There is a difference in taxation policies
5. There is less availability of returns from the past

However investments in asset class apart from traditional investments is now increasing due to high returns and diversification benefits.

Types of Alternative investments



Benefits of Alternative Investments as Part of Your Portfolio

Diversification Potential of Alternative Investments: Although alternate investments are risky investments if we see them alone; they help in diversification of a portfolio if we include them in the portfolio. Alternative Investments have a great diversification benefit. Their returns have been less correlated with the traditional investments like equity and bonds. Diversification is the biggest benefit of investing in alternative asset classes.

Hedge against Inflation: Some alternate investments are highly correlated with inflation. This feature makes alternate investments as a hedge against inflation. For example Real estate provides real growth in long term.

Higher returns: The high risk taken by investors is rewarded with high returns too. Returns on alternate investments are dependent on the market conditions and economic cycle.

Drawbacks of Alternative Investments

Complexity: Alternative investments are more complex than traditional investments. They require more due diligence and need to be watched continuously.

Higher Fees: The fees charged by managers managing alternative investments is much higher than the fees charged by the managers of traditional investments including equity, bonds and mutual funds.

Illiquidity: When compared to alternative forms of investment, traditional investments are more liquid. It is difficult to exit in alternative forms of investment.

Higher Risk: Higher returns are always accompanied with higher risk. The volatility and risk factors are higher in alternative investments.

2.7 DISCUSS INVESTMENT IN COMMODITIES.

A commodity refers to a useful or valuable thing. Commodities also include primary agricultural product or a raw material that is used as input in the manufacturing of other goods and services. Commodities are usually homogenous; though there may be different grades of quality for the same commodity.

What should one do to gain exposure to fluctuation in price of the commodity?

a. By physically owning the commodities (this is not recommended for small investors due to high storage costs and transportation costs).

b. By owning financial derivatives of commodities.

c. By owning the equity of companies in the commodity business.

d. By investing in Commodity ETFs.

e. By investing in managed futures.

f. Individual investor account (which is suitable for high net worth clients)

Factors that affect the price of commodities are -

(1) Demand- demand of commodities primarily depends upon the economic cycle.

(2) Supply- supply of commodities primarily depends upon production, inventory, storage costs and extraction costs.

Potential Risks of investing in commodities are -

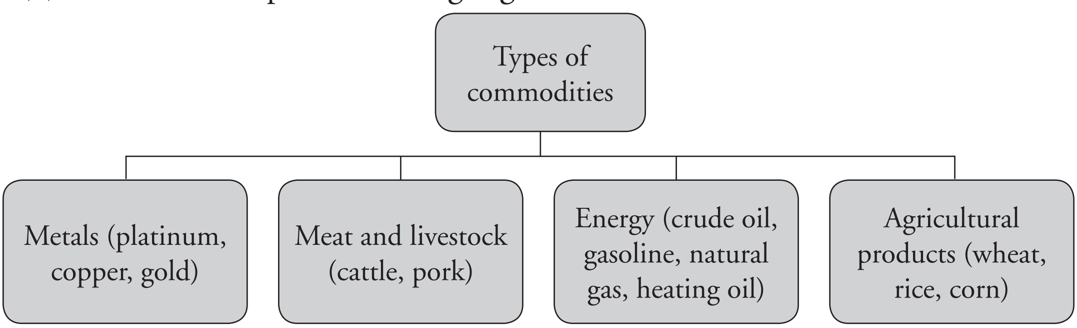
(1) High volatility - The prices of commodities can be extremely volatile as the prices are heavily dependent on various world events, import controls, competition worldwide, legal regulations and economic conditions. There is always uncertainty regarding these events which makes investing in commodities highly risky.

(2) Commodity funds may not track the underlying- Commodity funds track the underlying commodity using complex derivatives like futures contracts. These futures contracts are highly speculative in nature, hence volatile and risky, which may cause the fund's performance to significantly differ commodity's performance.

Benefits of investing in commodities are-

(1) Correlation of commodities is low compared to other asset classes, hence commodities provide a significant diversification benefit from a portfolio perspective.

(2) Commodities provide a hedge against inflation.



Rather than directly owning the commodities, one can still invest in commodities by investing in commodity futures.

A futures contract is an agreement to buy or sell a specific quantity of a commodity in the future at a fixed price (decided today), so mainly institutional investors and speculators participate in futures contract.

Advantages of commodity futures are-

1. Leverage can be taken easily on an exchange, hence if one is on the winning side of the trade, his gains can be magnified.
2. It is easy to go long (buy) or short (sell) on a commodity because of higher liquidity on an exchange.

Disadvantages of commodity futures are-

1. Leverage magnifies financial consequences as well, so if one is on the losing side of the trade, losses are also magnified.
2. One does not have the convenience of using the product while he's entered into a futures contract.

2.8 CASE STUDY OF REIT

Company: Omega Healthcare Investors (Ticker: OHI)

Recommendation: Short Equity

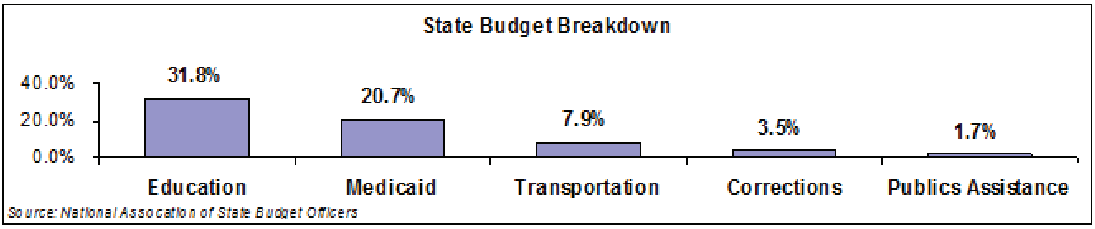
Catalyst: U.S. Federated States Balancing Budgets, May 2011

COMPANY DESCRIPTION

Omega Healthcare Investors is a Real Estate Investment Trust (REIT). The Company invests in and provides financing to the long-term care industry.

SITUATION

States were facing huge budget gaps in the year 2012—Medicaid was at the top of the list to get cut. Since October 2008 states had been getting stimulus monies from the ARRA, mostly in the form of Medicaid and State Stabilization Funds. States had \$40bn to use for 2011 while it was granted \$140bn. That amount entirely ended on June 30, 2011. The states had a hard enough time balancing their budgets under the current stimulus, and aggregate state Budget Deficits were projected to be \$144bn (FY11) and \$119bn (FY12) - those were very large holes to fill.



CATALYST

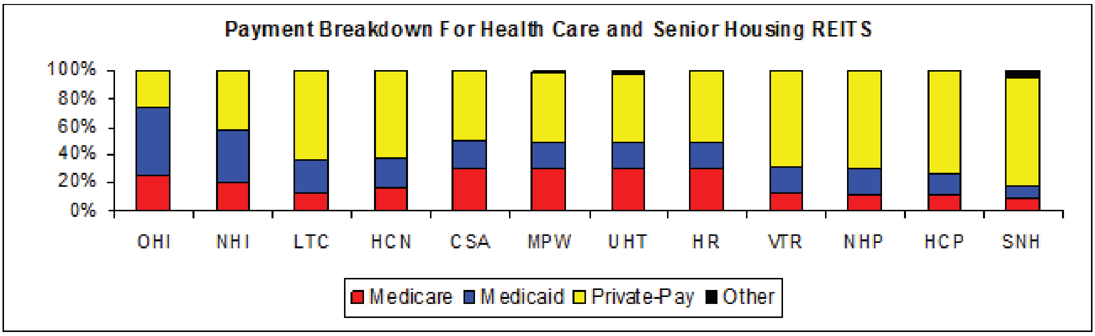
May 2011: As per the Constitution every state has to balance their budget at the beginning of the year, which takes place during May (for fiscal year 2011 budget). Medicaid is 21% of each state's budget, so it is very large. Industry experts believed that if the economy did not recover, states will have to start cutting budgets next year when state stimulus wears off. Medicaid was at the top of the list for most budget cuts.

RISKS

- A second extension of the FMAP Medicaid stimulus measures (there did not seem to be political will).
- RUGS IV Implementation on October 31st, which is expected, could give a quick relief rally signaling an end to the healthcare overhaul (as we've seen with the banks and Basel III).

WHY OHI?

- Taking a bottom-up approach, OHI has the best risk/reward of the group with significant credit risk to Medicaid cuts.
- OHI portfolio consists of 98% Skilled Nursing - one of the first groups for Medicaid reimbursement cuts.
- 72% of OHI's revenue consists of ten large Skilled Nursing Providers.
- OHI's top two states by revenue Florida (21%) and Ohio (15%) are currently facing FY11 state budget shortfalls of $4.7bn and $3.0bn per the Center on Budget and Policy Priorities.
- OHI has by far the highest exposure to government reimbursement levels - approximately 73% of their revenue comes from Medicare and Medicaid funding, much higher than the group at 39%.



VALUATION

OHI was trading at a discount to the HC REITs at 13.6X in year 2011 FFO vs. group at 15.9X

On EBITDA, OHI was trading at 13.9X.The year estimates vs. was at 14.6X.

SUMMARY

1. Discuss investment in fixed income sector
   - Fixed income security holders do not have an ownership stake in the company; instead they are lenders of capital to the company in exchange for interest on their capital.
   - Why fixed income? - (1) Diversification (2) Capital preservation (3) Regular income
   - Yield to maturity (YTM) is the total return anticipated on a bond if the bond is held until its maturity. It is the internal rate of return (IRR) of an investment in a bond.
   - Types of fixed income investment- 1) Guaranteed Investment Certificates (GICs) (2) Bonds (3) Mortgage back securities
   - Importance of credit rating on a fixed income security - The credit rating on a fixed income security is an important determinant of the yield of the bond and the amount of risk associated with the bond. & Poor's (S&P), Moody's and Fitch are the most well-known credit rating agencies
   - Risks associated with fixed income securities - (1) Interest rate risk (2) Credit risk (3) Inflation Risk (4) Liquidity Risk

2. Discuss corporate finance and advisory.
    - Corporate finance involves the management of financial activities of a corporation. It tries to pre-empt the company's financial troubles.
    - It aims at maximizing shareholder value.
    - Components of corporate finance are:
        i. Investment and capital budgeting
        ii. Capital Financing
        iii. Dividend and Return of Capital
3. Discuss investment in real estate.
    - Real estate investments include residential properties or commercial properties, as well as real estate backed debt.
    - Investment in real estate is an important part of portfolio management, as empirical evidence shows that real estate prices have soared over the past decades as they hedge the investors against inflation.
    - Private Real Estate Investments - One directly owns property, has direct control over the property, diversified portfolio of real estate is not possible, huge investments are required, less liquid.
    - Public Real Estate Investments- One can easily invest in real estate by buying Real estate investment trusts i.e. (REITs) or Real estate operating companies i.e. (REOCs) or Mortgage back securities (MBS), the management of REITs, REOCs, MBS is going to control the property, diversified portfolio of real estate is possible, REITs, REOCs, MBS are relatively more liquid as they are publically traded.
    - Risks of real estate investments - 1) Huge Lead time 2) Cost and availability of debt capital 3) Market risk 4) Liquidity risk
4. Discuss investment in Equities.
    - Equity investments generally refer to investments in shares of stocks of the companies. The motive of investors to buy and hold on to stocks is to gain income from dividend and also to realize capital gain from the sale of the stocks.

- The risk return tradeoff is a basic principle which mentions how higher level of risk accounts to higher potential reward and vice-versa.
- Equity Valuation methods:
  - *i*. Book Value Method
  - *ii*. Liquidation Value method
  - *iii*. Dividend Discount Model
  - *iv*. Free Cash Flow Model
  - *v*. Earnings Multiple Method
- A security market index is the aggregate value produced by the combination of several stocks and other investment vehicles together and expressing their total values against a base value from a specific date in the past. For example, Standard and Poor's 500 Index is computed by combining 500 large-cap U.S. stocks together into one index value.
- Active management: Active management is done by portfolio managers. These managers have a goal to beat the average market returns by making use of the short term fluctuations in prices.
- Passive Management: Passive management is done by investors who want a cost effective strategy and are willing to buy and hold. It is done by investors who personally do not have the time to track the market.
- A company's stock prices are affected mainly by three important factors-
  - *i*. Fundamental Factors
  - *ii*. Technical Factors
  - *iii*. Market Sentiments
- Unlisted shares are not traded on an exchange. These shares are traded in over-the-counter (OTC) market, hence have lower liquidity and also have a default risk.

5. Discuss investment in Exchange traded funds/mutual funds.
   - A mutual fund is a pooled investment vehicle that offers instant diversification benefit. It is a fund where small retail investors pool together their capital to hire professional managers who manage their money. Mutual funds can be open ended or close ended.

- Exchange traded funds have the features of both an open ended fund as well as a close ended fund. They provide instant diversification benefit like the open ended mutual funds, but they are exchange traded which means that buyers and sellers can directly transact with one another.
- Due to diversification of investments across various asset classes, if one asset class performs poorly, then the portfolio as a whole does not suffer because there are other asset classes present in the portfolio that might have outperformed the market.
- Fund of fund (FOF) is a strategy of investment where the investor holds a portfolio of other investment funds rather than himself directly investing in one particular fund or in stocks, bonds or other securities.

6. Discuss investment in alternative investments.
   - This is an asset classes apart from equity, bonds and cash, i.e. traditional instruments, known as Alternative Investments.
   - They differ from traditional investments in terms of both the structure of investment and the type of asset class including securities included.
   - Use of derivatives and leverage is very common in alternative investments.
   - Investments in asset class apart from traditional investments is now increasing due to high returns and diversification benefits
7. Discuss investment in commodity.
   - A commodity refers to a useful or valuable thing. Commodities also include primary agricultural product or a raw material that is used as input in the manufacturing of other goods and services.
   - One can gain exposure in commodities by -
     (*a*) By physically owning the commodities (this is not recommended for small investors due to high storage costs and transportation costs).
     (*b*) By owning financial derivatives of commodities.
     (*c*) By owning the equity of companies in the commodity business.
     (*d*) By investing in Commodity ETFs.

(*e*) By investing in managed futures.

- Factors that that affect the price of commodities are: 1) Demand 2) Supply
- Potential Risks of investing in commodities are: 1) High volatility 2) Commodity funds may not track the underlying
- Benefits of investing in commodities are: 1) diversification benefit 2) Hedge against inflation
- Types of commodities: 1) Metals (platinum, copper, gold) 2) Meat and livestock (cattle, pork) 3) Energy (crude oil, gasoline, natural gas, heating oil) 4) Agricultural products (wheat, rice, corn)
- Advantages of commodity futures: 1) Leverage can magnify gains 2) Liquidity
- Disadvantages of commodity futures are: 1) Leverage can magnify losses 2) No convenience yield.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	II	3	Under which approach to valuing real estate properties is an analyst most likely to estimate a capitalization rate?	Comparable sales approach	Income approach.	Cost approach.	A & C	**A**	The income approach estimates values by calculating the present value of expected future cash flows from property ownership or by dividing the net operating income (NOI) for a property by a capitalization rate. The comparable sales approach estimates a property value based on recent sales of similar properties. The cost approach is based on the estimated cost to replace an existing property.
2	II	6	An investor is most likely to consider adding alternative investments to traditional portfolio because:	of their historically higher returns	of their historically lower standard deviations	their inclusion will reduce Sharpe Ratio	of their guaranteed returns	**A**	Historical results have shown that as an asset class alternative investments have higher returns than traditional asset classes
3	II	3	Which of the following is not a type of real estate investment?	Industrial real estate investing	Exchange traded funds	Residential real estate investing	Commercial real estate investing	**B**	Exchange traded fund is not a part of real estate asset class.
4	II	2	Which of the following is not a component of corporate finance?	Capital Budgeting	Capital Structure	Dividend decision	Ratio Analysis	**D**	Ratio analysis is not a component of corporate finance.
5	II	1	Fixed income investments don't provide?	Diversification	Capital Preservation	Regular income	Share in profits	**D**	Fixed income investments do not provide a share in profits as such investors are lenders of the company and not the equity holders
6	II	1	Which one is not a type of fixed income investment?	Guaranteed Investment Certificates (GICs)	Bonds	Mortgage-Backed Securities	Swaps	**D**	Swaps are derivatives

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
7	II	1	What is the credit rating of a bond based on?	Credit Quality of the issuer	Amount of the Coupon payments	Maturity period of the bond	IRR of the bond	**A**	The credit ratings they issue are based on the ability of the issuer to meet its financial obligations and the issuer's overall credit quality
8	II	1	Generally, which is the most risky investment?	Derivatives	Equity	Corporate Bonds	Government Bonds	**A**	Derivatives are the riskiest as they use leverage
9	II	1	If interest rate rises, then the price of bonds are?	unaffected	falls	Rises	Cant say	**B**	If interest rates rise, bond prices usually decline because new bonds are likely to be issued with higher yields which make the old or outstanding bonds less attractive.
10	II	1	To protect yourself from inflation, what will one buy?	TIPs	Corporate bonds	S&P500 index fund	Government Bonds	**A**	Treasury Inflation-Protected bonds (TIPS),In TIPS principal is adjusted for any rise in the Consumer Price Index, so when the bond matures and the principal is returned, that amount will be higher to correspond with the amount of inflation.
11	II	5	Which of the following is not a type of real estate investment?	Residential Real estate investing	Commercial real estate investing	Industrial real estate investing	None of the above	**D**	Residential Real estate investing, Commercial real estate investing and industrial real estate investing are types of real estate investment.
12	II	6	Which one of the following is not a part of alternative investments?	Hedge Funds	Private Equity	Real Estate	Bonds	**D**	Bonds is a part of traditional investments.
13	II	3	Which of these investments is a good hedge against inflation?	Real estate	Equity investments	Bonds	Distressed investments	**A**	empirical evidence shows that real estate prices have soared over the past decades as they hedge the investors against inflation

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
14	II	3	REITS/REOCs are advantageous over direct investment in real estate because?	they are more expensive	they are publically traded, hence more liquid	they require more number of investors	they are less diversified	**B**	REITs, REOCs, MBS are relatively more liquid as they are publically traded compared to direct investment in real estate
15	II	3	Investment in real estate does not have which of the following?	Liquidity risk	Market risk	Window dressing of accounts	cost of debt	**C**	Real estate investments do not have the problem of window dressing of accounts like equity investments.
16	II	7	Which of this is a type of a commodity?	Gold ETF	Private equity of a company dealing in gold	Fossil fuels	MBS	**C**	fossil fuel is a form of energy, which is a commodity
17	II	7	Commodity futures are better than physically holding the commodity as:	they have convenience yield	they have leverage which has consequences too	they are easier to buy/sell	they need storage	**C**	It is easy to go long (buy) or short (sell) on a commodity because of higher liquidity on an exchange.
18	II	4	If there is a high level of uncertainty about a stock returns, then investors will want:	higher return	lower return	return on the benchmark	cannot say	**A**	if there is a high level of uncertainty around a stock's possible returns, then the investors will ask for a higher amount of premium for taking that risk.
19	II	4	Passive management is better than active management as:	it costs less	it takes advantage of short term fluctuations in the market	it requires a lot of high level expertise and management	it is done frequently	**A**	Passive management is done by investors who want a cost effective strategy and are willing to buy and hold instead of hiring managers who actively manage their portfolios
20	II	3	Which method considers that the value of a property should be equal to the cost it will take to construct the property?	Income Approach	Cost Approach	Sales Comparison Approach	All of the above	**B**	The cost approach considers that the value of a property should be equal to the cost it will take to construct the property.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
21	II	6	When compared to traditional investments, alternative investments are :	have different tax treatment	less regulated	more liquid	less transparent	**C**	When compared to traditional investments, alternative investments are less liquid.
22	II	3	Who was the creator of REITs?	Dwight D. Eisenhower	Barley H. Konsie	Blake J. Harvard	Tom L. Richardson	**A**	Dwight D. Eisenhower was the creator of REITs.
23	II	5	About close ended mutual funds, which one is true?	Buying/selling of shares take place directly from the mutual fund	Buying/selling of shares increases/decreases the total number of outstanding shares	The shares of the close ended mutual funds trade either at a discount or a premium to its actual NAV	Close ended mutual funds always transact at the next available Net Asset Value (NAV).	**C**	Open ended mutual funds always transact at the next available Net Asset Value (NAV) while the shares of the close ended mutual funds trade either at a discount or a premium to its actual NAV.
24	II	5	Which one of them do not provide diversification benefit?	Mutual funds	Exchange traded funds	Index fund	Shares of a conglomerate	**D**	Mutual funds, exchange traded funds, index funds invest in a variety of different asset classes so as to not get affected by the systematic risk of a specific asset class. Hence, they provide diversification benefit

MODULE III
ALTERNATIVE INVESTMENTS

3

Learning Outcome Statements

1. Explain Private Equity and its strategies
2. Define commodities and forms of investing in commodities
3. Explain Hedge Funds and Hedge Fund Strategies
4. Explain investments in structured products
5. Discuss the concept of Special Purpose Vehicle
6. Explain use of derivatives

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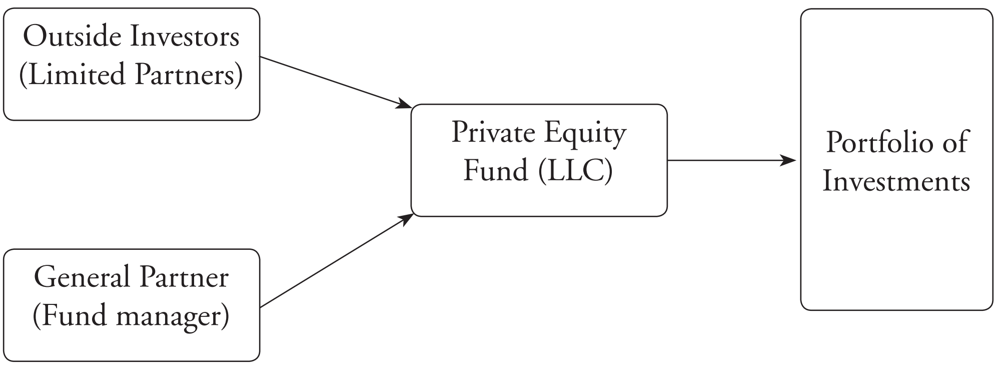
MODULE III
ALTERNATIVE INVESTMENTS

3.1 EXPLAIN PRIVATE EQUITY AND IT'S STRATEGIES

Investments in private companies, public company which intends to be converted to private or in the early stage of company are different forms of Private Equity Investments.

Private Equity Investment- Private Equity generally refers to types of funds organized as limited partnerships which aren't publicly traded. Investors in private equity are typically large institutional investors, university endowments, or HNIs. These private equity investors specialize in buyouts of public companies and getting them delisted. The capital provided by the investors of private equity is utilized for funding new technology, expansion of working capital, for acquisitions and for strengthening the balance sheet.

Private equity firm is set up in the form of Limited Liability Company (LLC). The outside investors are limited partners and provide capital while the general partners manager the capital by deploying it into a pool of investments and charge a management fee for the service.



Private Debt - Private debt is the accumulated debt by individuals or private businesses. It can be of various forms; a personal loan, credit card, corporate bond or business loan for instance. Debt providers may ask for security over an asset or in the form of a guarantee in return for a secured loan. Private debt has a number of risks as; debt incurred with a credit provider may result in high levels of interest, additional charges for missed payments or sometimes even demand for selling off the collateral security. The risk of private debt doesn't only lie with the debtor. If a company liquidates or a person becomes bankrupt, a creditor can lose almost all of their debt investment.

Advantages and Disadvantages of Private Debt:

Advantages:

- ◆ Retention of Equity
- ◆ Easier to obtain debt as compared to equity investors

Disadvantages:

- ◆ Burden of liability on the Balance Sheet
- ◆ Debt investors have lower incentive to grow the business
- ◆ Siphoning of cash flows as interest payments to creditors are on a regular basis

Advantages and Disadvantages of Private Equity:

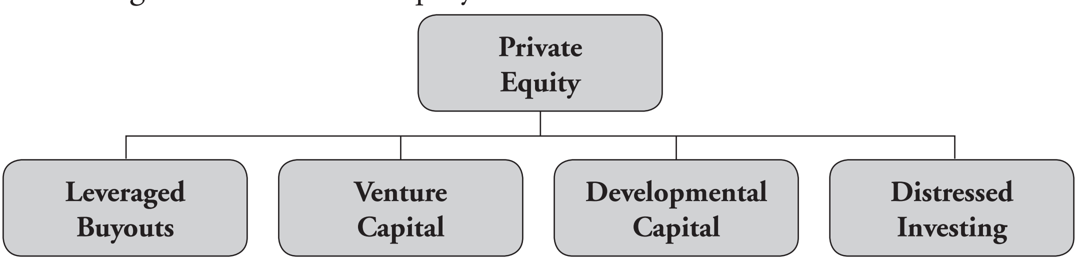
Advantages:

- ◆ No liability burden on the balance sheet
- ◆ Cash flows of the business are not siphoned out as interest payments.
- ◆ Equity investors bring their knowledge, connections and expertise to help and grow the business.

Disadvantages:

- ◆ Dilution of owner's equity stake to investors.
- ◆ Costlier compared to debt as, return on investment for equity investors need to be higher as compared to return on debt investments.

The strategies used in Private equity are:



Leveraged buyouts (LBO's) refer to purchase of an existing private company through use of leverage. Leverage refers to the use of debt. Hence leveraged buy-outs are purchase of companies using loans. The leverage may be bank debt, issue of bonds or issuance of convertible debts or warrants.

Leveraged buyouts can be of two types. Management buyouts involve the existing management team buying the asset and operations of the company while management buy-ins takes place where a new team of management replaces the old one.

The main purpose of a leveraged buyout is to increase the value of the firm through different methods involving new management skills, cost reduction, additional revenue generation. As it requires high amount of debt repayment, companies which have high cash flow are chosen for leveraged buyouts.

Venture capital funds invest in early stages of a company. The investment is in the form of equity but sometimes can also be in form of convertible preference shares or convertible debentures/bonds. As the risk of a new company is very high, returns earned can also be very high if the company is successful. After the company has developed or is successful, venture capital investors book their profits through issuance of IPO's.

The company in which the venture capital investors invest is known as the Portfolio Company. The investors are involved closely in day to day operations of the company and in the development of it, usually by filling the key roles in the board of directors.

We can categorize venture capital investments by the stage of the company when the investment was made. The different stages are:

- **Formative Stage**: The stage where the company has just started and is the earliest stage of investing.
    - Angel Investing- Investments made even before the production has started or the plant or office has been set up; often the stage where there is just an idea for a business is known as Angel Investing. Generally such investments are made by individuals.
    - Seed Stage- It refers to investments which are made for development of the product or service including research and development cost, product development cost, marketing cost, etc. Venture capitals funds usually make investments in this stage.

- Early Stage- Investment to fund the initial production and sale of the goods and services of the company

- **Later Stage**: When a company already is producing and selling goods and services; investment in such stage is known as later stage. The company seeks investments here mainly for expansion and for increasing sales.
- **Mezzanine Stage Financing**: The term refers to the timing of finance; i.e., investment in a private company to make it public. It is provided to prepare a firm for an IPO.

Developmental capital is the capital provided through investment for growth of business and restructuring of the company. The company may be private or public. If it is a public company, the financing is known as private investment in public equities. Developmental capital is also known as minority equity investing.

Private equity investment which involves purchasing debt of mature companies who are going through financial crisis or difficulties is referred to as **Distressed Investing**. Investors in such kind of investments take an active role and help the company to again reorganize and help it to become efficient in order to earn profits. Distressed Investors are called Vulture investors.

Private Equity Due Diligence

Private Equity involves use of high debt in order to invest in the companies. Before investing, investors should take a note of the interest rates and the availability of capital in order to earn maximum return from the portfolio companies.

The factors to be considered while investing in private equity are:

- Investment Process
- Investment Strategy
- Historical returns
- Risk management
- Asset under management
- Growth plans
- Management style
- Skills of manager

- Fees structure
- Valuation methods

Manager plays a very important role in private equity investments. Hence, while choosing private equity managers, special care should be taken.

Exit strategies

There are few methods of exiting private equity investments. Some of them are:

IPO: Selling all the shares or few shares to the general public through initial public offering

Secondary sale: Selling the portfolio company to another private equity firm or to a single investor or to a group of investors

Trade sale: Selling the company to another strategic buyer or to one of its competitor

Recapitalization: When the company issues debt to pay the amount to equity shareholders in the form of dividend. It is a step towards exit.

Liquidation: Selling each and every asset and settling liabilities. It is generally done if there is a loss.

Valuation of private equity companies

The valuation of private equity companies is very similar to valuing a publicly traded company. The difference between their valuations is due to the difference in discount rates or multiples.

Market Comparables approach:

Market values or financial values of publicly traded companies like EBITDA, Revenue, Net income, etc. may be used to calculate the value of a private equity firm. An average is taken of different public companies and is multiplied with the given factor to derive the value of the private company.

Discounted Cash Flow approach:

This category of valuation includes the dividend discount model, free cash flow to equity and even the free cash flow to the firm.

Asset Based approach:

It is calculated using the basic equation- Assets=Liabilities+ equity. The fair value or liquidation value of assets is calculated and subtracted from the total liabilities in order to derive to total value of equity. However if we use liquidation value, the value of equity will be less as liquidation values are amounts which could be realized immediately in a situation of financial distress.

3.2 DEFINE COMMODITIES AND FORMS OF INVESTING IN COMMODITIES

Investors who want to invest in commodities can either have a direct investment, i.e., buying the commodity and holding it or can take the same risk exposure by entering into derivatives. The cost of directly purchasing the commodity is high due to additional costs like storage, transportation, etc. Additionally some commodities are perishable which increases the complexity of direct investments.

Commodities can be differentiated into the following groups:

- Agricultural products like Wheat, Maize, Corn
- Perishable and Non-perishable commodities
- Consumable and Non consumable commodities
- Metals (Bullion and other metals)

Commodities such as wheat, coffee, cocoa, vegetables, etc are known as soft commodities. On the other hands commodities which need to be mined are known as hard commodities, for example, gold, silver, oil, copper, etc.

Commodity derivatives are the most widely used method to take risk exposure in the commodity markets. Investors can enter into forwards, futures, swaps or options. Forwards are traded over the counter while futures are traded on exchange making them standardized. Option gives the investor the right to buy or sell the commodity and not the obligation to do so.

Forms of investing in commodities

As discussed earlier, commodities can be either purchased directly or an investor can use other forms of indirect investments to take risk exposure in the commodity markets. Direct investments in commodities involve costs like storage, transportation, normal loss of commodities while moving them from one place to another, etc. This is why investors hardly use it as a form of investment in commodities.

In the indirect form of investment the most widely used method is derivatives. Most of the investors around the globe use derivatives as a method to invest or trade in commodities. Derivatives involve Forwards, Futures, Swaps and Options. Forwards are contractual obligations to pay a fixed amount in return of a fixed amount of commodity at a particular date and time. The amount and quantity are decided on the day when the forward contract is made.

Futures are very similar to forwards except the fact that they are not traded over the counter. Instead they are traded on exchanges and are hence standardized. In futures the default risk is almost nil. The buyer and the seller of the contract have to deposit a particular amount known as the initial margin. The amount of margin which must be maintained at any time period during the contract is known as maintenance margin. If the margin balance falls below the maintenance margin, the part must deposit additional amount to bring the balance back to initial margin.

Options give the investors the right and not the obligation to buy or sell the commodity. There are two types of options. Call gives the investor the right to buy the commodity but not the obligation to do so. On the other hand, put gives the investor the right and not the obligation to sell the commodity. A call option is exercised when the spot price is above the call price or exercise price while a put option is exercised if the spot price is below the exercise price.

Swaps are agreements to exchange a series of cash flows over a period of time on particular dates known as settlement dates. The most basic type of swap is plain vanilla interest rate swap where one party makes fixed rate interest payments in return for floating rate payments. The principal on which the interest rate is exchanged is notional, i.e. the principal is not exchanged in real terms. At the day of settlement, the two payments are netted and the party having greater liability makes the payment equal to the difference between the interest rate on the principal to the other party. The total period or length of the swap is known as tenor of the swap. The end date is known as the termination date of the swap. Swaps are actually a series of forward rate agreement. However the first payment is already known in case of a swap.

Other methods of investing in commodities are:

Equities: Stocks that are directly related to the commodity markets can be a form of indirect investment to seek risk exposure to the commodity markets. For example, if an investor invests in a company which mines gold and silver, he is exposing himself to the risk in prices of gold and silver.

Exchange traded funds (ETF's): Investors who have limitation in buying equity shares have the option to invest in commodity ETF's. Commodity ETF's invest in both commodities and commodity futures and also track prices of indexes.

Specialized Funds: These funds specialize in a particular sector of the commodity market. For example the fund manager may specialize in agricultural products and hence only concentrate on the prices of agricultural products.

Individual Managed Accounts: High net worth investors have the option to open their own account and have a personal manager to invest in commodities. The specific needs of the investor can be tailored in such type.

Advantages of investing in commodity

1. Diversification

The biggest advantage of investing in commodities is the benefit of diversification. The correlation between commodities and other asset classes is either very low or even negative. This is why when the equity market and the fixed income securities fail; the commodity market will offset the losses from there. The factors affecting commodities is different from the factors affecting the prices of equity or bonds. Hence, a portfolio manager should include and give some weight age to commodities while constructing a portfolio.

2. Inflation protection

The impact of inflation on commodities is very different from the impact on equity and bonds. Due to inflation the value of the currency falls. This causes the real value of financial assets to fall. However commodities maintain their real values as they have almost a perfect correlation or very high correlation with inflation.

3. Hedge against event risk

Natural disasters, economic crisis or periods of recession can have adverse impact on prices of equities and fixed income securities. These events depreciate the value of traditional investment. The risk of prices due to such cases is known as 'Event Risk'. However such events do not have such a harsh impact on commodity prices. In some cases, for example war, the prices of commodities can even rise due to low supply of the commodity. Hence commodities are a hedge against event risk-a buffer against losses.

4. Liquidity

Unlike investment in assets like real estate, investment in commodity futures offers high liquidity. It is easy to go both long and short on commodity futures. An investor can liquidate his position whenever he wants to.

5. Trading on lower margin

In case of commodities futures, an investor can take the same risk but with less capital. Generally, the margin is close to 5-10% of the total value of the contract which is very less when compared to other asset classes. Hence the investor can take large positions with less capital and can magnify the potential of earning profits.

Disadvantages of investing in commodities

1. High Volatility

The prices of commodities are highly volatile due to a lot of global and economic factors. In a recent analysis it was found that commodities are twice a volatile as equity and four times as volatile as bonds. Volatility adds major risk to investments in commodities.

2. Price return

Commodities can only generate price return and can give no extra monetary benefits. For example, equity stocks can give extra monetary benefits in the form of dividends. In commodities, total return is equal to price return.

Explain the determinants of commodity prices

Demand and supply

The most basic determinant of commodity prices is the demand and supply of the commodity. If the demand is greater than the supply, it will cause the price of the goods to increase. If the supply is greater than the demand it will cause the prices of the commodity to fall.

Inflation

The prices of commodities are highly correlated to the rate of inflation in the economy. There is a positive relation between inflation and commodity prices. Hence, if inflation is high it will lead to a greater increase in commodity prices.

Amount of Inventory

If the production of the commodity is high and if its inventory levels are high, it will lead to a greater supply in the market causing the prices to fall and if the inventory levels are low it will cause the demand to be greater causing an increase in the commodity price.

Storage Cost

Commodity prices also depend upon storage costs. A high storage costs have a greater impact in increase in the prices of the commodities than prices of commodities which have low storage cost.

3.3 EXPLAIN HEDGE FUNDS AND HEDGE FUND STRATEGIES

Hedge Funds are pool of investments and are managed by skilled managers. The fund can invest in almost anything including land, stocks, derivatives, currencies and real estate. As these funds are more risky than mutual funds or any other pool of investments, only high networth individuals can invest in it. Hedge funds typically use both long and short strategies and aim at earning a return more than other forms of investment.Hedge funds use a variety of strategies. It can use leverage, can short sell equity stocks and also use derivatives including both- going long and short. Hedge managers are more flexible than traditional managers. However, due to their large structure and complex transactions, hedge fund transactions require prime brokers who provide them services like lending of money, administrative services, custodial services, securities lending for going short, etc.

The return for hedge funds can be stated on actual basis or on a relative basis. Absolute basis is returns in term of percentage, for example 10%. Return on relative basis is return calculated based on a benchmark, e.g. Return 3% above Dow Jones.

Hedge Funds have less regulation when compared to traditional investments. Generally, hedge funds are set up as limited liability partnership with the investors being limited partners. As they are a risky form of investment, everybody cannot invest in them. Only investors who have adequate amount of wealth and sufficient liquidity can invest in hedge funds. The firm managing the fund becomes the General partner and receives incentive fees along with management fees.

Hedge funds are not allowed to advertise themselves.

When compared to traditional form of investments, hedge funds are less liquid. When the returns earned by hedge funds is negative or even low, investors would like to take their investments out of it. This will force the fund manager to sell the shares which will lead to a further decrease in price of the stock. This problem causes fund managers to include lockup period and notice period. The time period during which initial investments are not allowed to be redeemed is the lockup period and the notice period is the time within which the fund manager has to repay the money. Generally, notice periods are for 30 to 90 days.

Some hedge funds may even charge a redemption fees. If the investor wants to redeem his money he needs to pay certain charges or fees for it. Hedge fund managers incur significant transaction cost when they redeem shares. These methods help in prevention of redemption. Redemption increases when the performance of the hedge funds is poor and this leads to further decrease in value of partnership interest. This is an additional risk faced by the hedge funds.

Fund of funds is an investment company which invests in different hedge funds. This helps the small investors to invest in hedge funds and also gives diversification benefits to investors. However, investing in fund of funds causes the investor to pay a double layer of fees. Additional fees are charged by fund of funds apart from different hedge funds.

Hedge Fund Strategies

Hedge funds use a variety of strategies to generate profits for its investors. The Hedge Fund Research, Inc. classifies strategies used by hedge funds into 4 categories:

1. **Macro Strategies**-These strategies are formulated based on global economic events or trends and include taking both long and short position in equity, commodities, currencies, etc.
2. **Event Driven Strategies**-Strategies which are based on certain corporate events like merger or acquisition that create an opportunity for earning profits is known as event driven strategies.
    - Merger Arbitrage: Going long on shares of the Target Company and short on the shares of the company making the acquisition.
    - Activist Shareholder: Purchasing enough equity of a company to influence decisions in order to earn profit

- Restructuring: Buying securities of company which is undervalued due to financial situations which might be resolved
- Special Situations: Investing in situations where there is a potential increase or decrease in price of a security. For example situations like repurchase of securities, company selling assets, etc.

3. **Equity Hedge Fund Strategies**- Strategies which try to earn positive returns from investing in publicly traded securities.
   - Market Neutral: Buying undervalued securities and selling overvalued securities in the same amount to earn exposure to price of the respected securities while reducing market risk
   - Short Bias: Selling overvalued securities with smaller long positions so that net short position is maintained
   - Fundamental Growth: Using fundamental analysis to select stocks which have high growth opportunities in the future.
4. **Relative Value Strategies**-
   - Asset backed fixed income: Exploiting the pricing discrepancies among asset backed securities and mortgage backed securities
   - Convertible arbitrage fixed income: Exploiting the discrepancies in price between a company's convertible bonds and its equity shares
   - General Fixed Income: Taking advantage of pricing discrepancies between fixed income securities available in the market**.**

Due Diligence in Hedge funds

Hedge fund selection is very vital and is complex due to the nature of hedge funds. Hedge funds are less transparent as different funds consider their strategies to be proprietary information. Additionally hedge funds have less regulation which makes it more difficult in selecting them. The following points should be considered while selecting hedge funds:

- Past returns
- Investment process
- Valuation methods
- Hedge fund manager

- Benchmark selected
- Appropriateness of benchmark
- Risk of investments
- Style of management
- Asset under management
- Plans of growth
- Competitive advantages

However it is difficult to analyze the points as hedge funds are not required to report their performances. Also quality aspects like knowledge of hedge fund managers are not measurable in quantitative terms.

3.4 EXPLAIN INVESTMENTS IN STRUCTURED PRODUCTS

Financial instruments issued by banks with varying terms, risk and profile which track the performance of underlying asset are known as structured products. The underlying asset may be equity, commodity, currency, index, ETF's, etc.

Structured products are not standardized and the terms and conditions are decided at the time of issuance. The payment and risk are also different in each case. This makes it more important for investors to be more diligent while choosing the product.

Hence, structured products are investment whose returns depend on the performance of some other investment, like equity stock.

There are two types of structured products:

- Structured Investments- These are issued by banks or insurance companies. The money invested is divided into two parts- one for capital protection and other to earn bonus.
- Structured Deposits-It is very similar to savings account but the difference is that the rate of interest is based on the performance of other asset class. For example, the interest is based on a stock index. If returns are positive, the interest will be given. However, if the index falls then interest will be zero but the principal amount will be safe.

Structured Deposits and structured investments are sold in many names like:

a. Structured Cash ISAs

b. Guaranteed Capital Plans

c. Guaranteed Stock market Bonds

d. Guaranteed Equity Bonds

e. Guaranteed Income Bonds

f. Growth Deposit plans

g. Protected Investment Funds

3.5 DISCUSS THE CONCEPT OF SPECIAL PURPOSE VEHICLE

Securitization refers to the process in which financial assets are purchased by an entity which then issues securities based on cash flows from those financial assets. It is done to convert illiquid assets to liquid assets. The entity which purchases the assets is known as special purpose vehicle or special purpose entity. As the name suggests, the entity is formed for a specific and important reason.

The special purpose vehicle is a legal entity and is separate from the company from which it purchases the assets. Let us take an example to understand this concept.

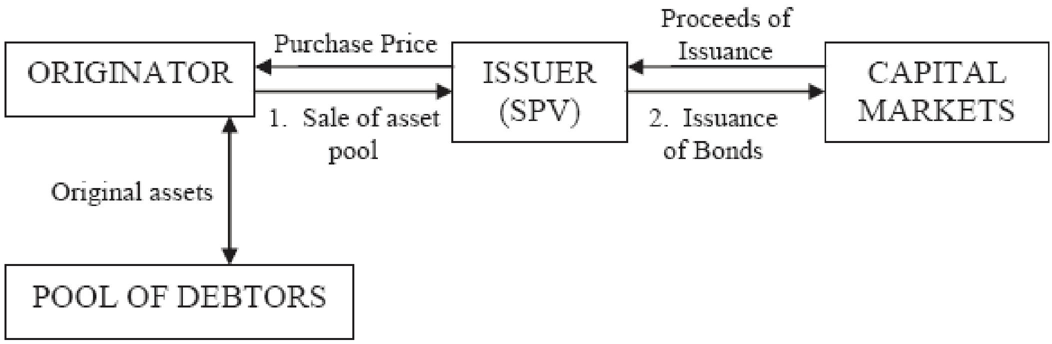
Alpine Construction sells its buildings on an installment basis, i.e., home loans. The customers buy apartments or buildings on loan and Alpine provides them with the loan amount with the buildings being collateral and it receives interest payments and principal for the loan. The loans have maturity of 48-60 months. The interest rates for loans are also different. Alpine is also the servicer of the loan. It collects the payments, sends notices or repossesses properties for which payment has not been made.

Alpine has 5000 home loans. The total amount for the loans including interest yet to be received by Alpine is $ 900 million. It wants to remove this from its balance sheet and wants to issue more home loans which are done by forming a separate purpose vehicle (SPV) which purchase these loans from Alpine at a discount. The SPV which purchases these loans is referred to as the trustee or the issuer.

The SPV then divides these loans and sells it to interested investors. The properties are the collateral in case of defaults from the purchaser of the properties. Hence the loans are collateralized. The SPV is a separate legal entity and is different from Alpine Construction.

The investors who have purchased loans get interest payments which are actually the cash flows received in the form of principal payments and interest payments. As they are securities which are collateralized and are backed by assets they are termed as asset backed securities.

Often there are different classes of ABS issued depending on the risk and time of payment of each class. The riskier the asset classes the higher the return on it. Each class of ABS is known as Tranche and the structure in which an asset class is paid depending upon the timing of the payment is known as Waterfall structure.



Risks associated with SPV

There are various kinds of risks associated with SPV including:

- Issuer default risk
- Uncollateralized product risk
- Expiry risks
- Extraordinary price movements
- Foreign exchange risk
- Credit risk
- Liquidity risk
- Market risk
- Income risk

SPV are non-regulated source of investment. Usually one part of the investment is open to default risk.SPV do not require margin as collateral which makes it more risky during recessions and bankruptcy. After the date of expiry, SPVs are of no value. Extraordinary price movement or interconnection risk is the risk associated due to changes in external factors which may affect the value of the product.

Currency exchange rates are also a very important determinant in the value and price of structured product. The institution selling the structured product should be creditworthy as such investments carry credit risk. There must be a liquidity provider in case of structured products who can help in the running of the products.

The underlying asset is also affected due to many factors. These factors must also be looked into before investing. There is no sure profit in structured products. Before investments, conditions of it should be reviewed.

3.6 EXPLAIN USE OF DERIVATIVES

A derivative is a financial instrument whose value is "derived" from the value of an underlying asset. This underlying asset could be a commodity, foreign exchange, equity, interest rate or an index among others.Derivatives traded on the OTC markets are simply called OTC derivatives and the ones traded on Exchange are Exchange-traded derivatives.

Over the Counter derivatives:

A good example of OTC derivative market is London Bullion Market Association (LBMA). The London bullion market is a wholesale over-the-counter market for the trading of gold and silver. Members of LMBA comprises of central banks; mining companies; investors; refiners; manufacturers of jewelry and industrial products; and other traders. These members trade among themselves or on behalf of their clients.

OTC contracts are not traded on any exchanges. Trades take place over a telephone or online network. Market makers earn out of spreads.

The advantage of OTC derivatives is that they are bilateral contracts and hence, they can be customized. The major advantage of OTC market is that each deal can be customized, subject to regulations of the land. Example the settlement date of the contract can be set as per the production schedule of a manufacturing plant.

The major disadvantage is the counter party risk remains. There is no exchange to reduce the counter party risk. Again, when compared to exchange traded derivative it has lower transparency of last traded price and volumes.

Exchange traded derivatives:

Futures and Options are exchange traded derivatives. Futures are very similar to forwards except the fact that it is standardized. This feature removes default risk and makes futures more creditworthy. An investor needs to deposit an amount known as initial margin in case of futures.

Options give the right to an investor to buy or sell an asset and not the obligation to do so. There are two types of options- call and put. Call gives the buyer the right to purchase the security and put gives the investor the right to sell it. Note that there is no obligation to do so. The call or put writer gets a fixed amount as option premium.

Foreign Exchange Derivatives

A derivative in which the underlying asset is a foreigncurrency is known as foreign exchange derivatives. In International finance, use of currency derivatives means that a person can buy or sell the currency on a future date. Foreign exchange derivatives involve forwards, futures and the use of options.

The following are ways in which a person can use foreign exchange derivatives:

- Basis swap
- Currency future
- Currency swap
- Foreign exchange swap
- Forward exchange rate
- Foreign exchange binary option
- Foreign exchange forward
- Foreign exchange option

Credit Derivative

A credit derivative is a financial instrument whose value is determined by the default risk of the principal asset. These give the advantage to a borrower to be able to mitigate default risk to a third party. Financial assets like forward, options and swaps form a part of Credit derivatives. The price for these instruments changes with change in the credit risk of agents such as investors and government.

Borrowers can default and the lender will need protection against such default and in reality, a credit derivative is a way to insure such losses. The level of risk differs in different cases depending on the third party and a fee is decided based on the appropriate risk level by both the parties.

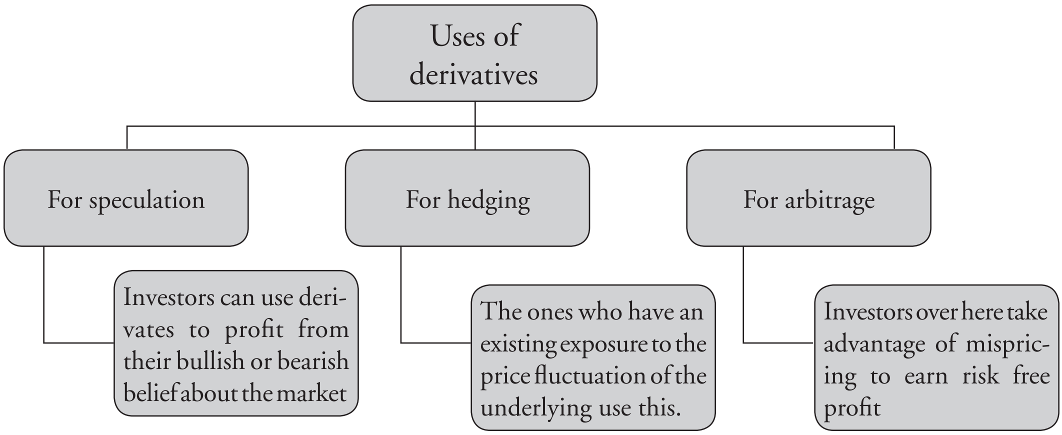
The credit quality of the borrower as well as the third party plays an important role in determining the credit derivative's value. But the credit quality of the third party is more important because if the third party defaults the lender does not receive the payment at all. The third party is known as the counterparty and it plays an important role.

Interest Rate Derivative

Interest rate derivatives are financial instruments used for the purpose of hedging against any unfavorable movement in interest rates. The value of these instruments change according to the change in interest rates. These instruments can also be used to increase or refine the holder's risk profile. Interest rate derivatives market is the largest derivatives market in the world. Interest rate swaps, caps and floors are the most common types of interest rate derivatives.

In interest rate swaps one party receives (pays) a stream of payments on the basis of a floating interest rate and the other partypays (receives) a stream of payments on the basis of a fixed interest rate. The payment streams are based on a notional amount and the payment between both the parties is netted.

In order to protect from rising interest rate one can also buy cap. It sets a ceiling rate which the borrower is willing to pay and if the market rate of interest rises above the ceiling level then the cap buyer receives payment based on the difference between cap rate and market rate. It is like a call option on interest rates. To provide protection against falling interest rate floors are used which are like put option on interest rates. The premium paid on these options depends on the level of protection provided by the options.



Derivatives are of four types: forwards, futures, options and swaps.

Forward Rate Agreements

A derivative contract in which the underlying is interest rates rather than an asset is known as forward rate agreements. The reason for entering a forward rate agreement (FRA) is to lock in a rate of borrowing or lending which will take place at some future date. One party will pay the other party the difference between the interest rate and market rate on the notional profit.

The party which is scared of the situation of the interest going up takes the position of FRA+ while the party which is scared of the interest rate going down takes FRA-.

FRA+ contracts to borrow at the interest rate decided while FRA- contracts to lend money at the pre-determined interest rate. Actually, no amount is borrowed or lent. The amount is notional and hence is known as notional principal.

FRA's are used by firms to hedge the risk of interest rate fluctuation in the future while lending or borrowing. FRA's are very flexible financial instruments and can be used to benefit both the parties when interest rates are volatile.

The main advantages of FRA's are:

- The cost of administration is minimized as there is only one payment and there is no need of daily settlement like future contracts.
- They are customizable financial instruments and can be set according to particular needs
- FRAs are off balance sheet items

- The risk of default by counterparty is limited as no actual amount is exchanged. The principal amount is notional
- A party can exit the contract by taking an opposite position at any time

Forward contracts vs. Futures contract

Forward contracts and Futures contract at the base level serve the same function and are very similar. But, there still are differences between them.

(1) Futures contracts are exchange traded, while on the other hand, forward contract are traded over the counter.

(2) Futures contract have daily re-pricing due to mark to market and forward contracts have a settlement date in the future.

(3) Futures contracts generally have a higher liquidity compared to forward contracts.

(4) Futures contracts are heavily regulated compared to forward contracts.

(5) Futures contact are standardized, while forward contracts are customized.

Options

An option is a financial derivative that represents a contract sold by one party who is known as the option writer or seller, while the other party who buys the financial derivative is called the option buyer. The option buyer has the right, but not the obligation, to buy (call) or sell (put) of a security or other financial asset at an agreed-upon price called the strike price during a certain period of time or on a specific date which is called the exercise price.

Option Buyers:

(1) Call option buyers (C+): call option buyers have the right to buy the share at the strike price if the price goes above the strike price. They have the right to enjoy the upside. For enjoying this right, they have to initially pay a call premium, which is the maximum loss they can have in case the stock price does not touch the strike price. But their profit potential is theoretically unlimited.

(2) Put option buyers (P+): put option buyers have the right to sell the shares at the strike price if the price goes below the strike price. They have the right to enjoy the downside. For enjoying this right, they have to initially pay a put premium, which is the maximum loss they can have in case the stock price

does not touch the strike price. But their profit potential is theoretically up to the value of the stock.

Option Sellers:

(1) Call option sellers (C-): call option sellers have the obligation to sell the share at the strike price if the price goes above the strike price. They have the obligation to sacrifice the upside. For selling their right (to the call option buyer), they charge the call premium. The maximum loss they can theoretically have is unlimited. But their maximum profit can be up to the value of the call premium.

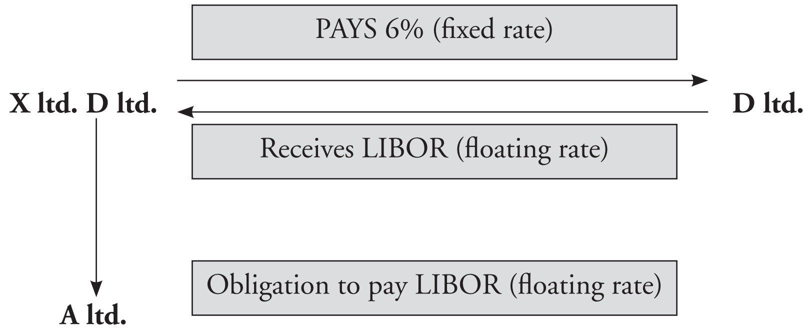
(2) Put option sellers (P-): put option sellers have the obligation to buy the share at the strike price if the price goes below the strike price. They have the obligation to sacrifice the downside. For selling their right (to the put option buyer), they charge the put premium. The maximum loss they can theoretically have is up to the price of the share. But their maximum profit can be up to the value of the put premium

Swaps:

Swaps are a series of forward contacts. It is a derivative contract through which two parties exchange financial instruments. Most swaps involve cash flows based on a notional principal amount that both parties agree to at the start of the swap. The notional principal is not exchanged in reality between the two parties; in fact, the difference in price according to the fluctuation in market value of interest rates, foreign exchange or equity is netted out and paid accordingly.

For instance,

X ltd. has an obligation to pay LIBOR to A ltd for 12 months. Now, LIBOR is a floating interest rate. So, to hedge himself from the risk of interest rate rising, X ltd can enter into an interest rate swap. By entering into an interest rate swap, X ltd. will receive LIBOR from D ltd. (counterparty) and pay a fixed rate of 6% for 12 months.



So effectively, X ltd. receives LIBOR from D ltd. and pays LIBOR to A ltd. So, he is free of the interest rate risk. He only has to pay D ltd. a fixed interest of 6%. Hence, by using an interest rate swap, X ltd. has converted his floating rate into fixed rate.

SUMMARY

1. Explain Private Equity and its strategies.
   - Investments in private companies, public company which intends to be converted to private or in the early stage of company are different forms of Private Equity Investments.
   - The strategies used in Private equity are: leveraged buyouts, venture capital, developmental capital and distressed investing
   - The exit strategies used are: IPOs, trade sale, recapitalization, liquidation and secondary sale
   - The valuation approaches used are: market comparables approach, discounted cash flow approach and asset based approach.
2. Define commodities and forms of investing in commodities
   - Investors who want to invest in commodities can either have a direct investment, i.e., buying the commodity and holding it or can take the same risk exposure by entering into derivatives
   - Commodities such as wheat, coffee, cocoa, vegetables, etc are known as soft commodities. On the other hands commodities which need to be mined are known as hard commodities, for example, gold, silver, oil, copper, etc

- The other methods of investing in commodities are: equity, exchange traded funds, specialized funds and individual managed accounts
- The advantages of investing in commodities are: diversification, inflation protection, liquidity, hedge against event risk
- The disadvantages are: High volatility and Price return only

3. Explain Hedge Funds and Hedge Fund Strategies
   - Hedge Funds are pool of investments and are managed by skilled managers.
   - The fund can invest in almost anything including land, stocks, derivatives, currencies and real estate.
   - As these funds are more risky than mutual funds or any other pool of investments, only high net worth individuals can invest in it.
   - Hedge funds typically use both long and short strategies and aim at earning a return more than other forms of investment.
   - Hedge funds use a variety of strategies-macro strategies, event driven strategies, equity hedge fund strategies, relative value strategies
4. Explain investments in structured products
   - Financial instruments issued by banks with varying terms, risk and profile which track the performance of underlying asset are known as structured products.
   - The underlying asset may be equity, commodity, currency, index, ETF's, etc.
   - Structured products are not standardized and the terms and conditions are decided at the time of issuance. The payment and risk are also different in each case.
   - There are two types of structured products: structured investment and structured deposits
5. Discuss the concept of Special Purpose Vehicle
   - Securitization refers to the process in which financial assets are purchased by an entity which then issues securities based on cash flows from those financial assets. It is done to convert illiquid assets to liquid assets.

- The entity which purchases the assets is known as special purpose vehicle or special purpose entity. As the name suggests, the entity is formed for a specific and important reason.
- The special purpose vehicle is a legal entity and is separate from the company from which it purchases the assets.
- The SPV divides these loans and sells it to interested investors.
- The properties are the collateral in case of defaults from the purchaser of the properties. Hence the loans are collateralized.
- The investors who have purchased loans get interest payments which are actually the cash flows received in the form of principal payments and interest payments.
- As they are securities which are collateralized and are backed by assets they are termed as asset backed securities.

6. Explain use of derivatives
    - A derivative is a financial instrument whose value is “derived” from the value of an underlying asset.
    - This underlying asset could be a commodity, credit, foreign exchange, equity, interest rate or an index among others.
    - Commodity derivatives are either traded on the exchange or are traded over the counter (OTC) market.
    - Derivatives traded on the OTC markets are simply called OTC derivatives and the ones traded on Exchange are Exchange-traded derivatives.
    - OTC derivatives include forwards and swaps.
    - Exchange traded derivatives include futures and options
    - A derivative contract in which the underlying is interest rates rather than an asset is known as forward rate agreements.
    - The reason for entering a forward rate agreement (FRA) is to lock in a rate of borrowing or lending which will take place at some future date.
    - One party will pay the other party the difference between the interest rate and market rate on the notional profit.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	III	1	Young companies receive angel investment from?	Venture capitals	Growth capitals	Mezzanine financing	LBOs	**A**	Venture capital refers to investments that are made in startups and young companies in their initial stage which have little to no track record of profitability.
2	III	4	Which of the following is a bank issued financial instruments with varying terms, risk and profile which track the performance of underlying asset?	Structured products	Hedge funds	Commercial papers	Medium term notes	**A**	Financial instruments issued by banks with varying terms, risk and profile which track the performance of underlying asset are known as structured products.
3	III	2	Which one is not a method of investing in commodities?	ETFs	REITs	Equity	Specialized funds	**B**	REITs are a form of investing in real estate.
4	III	6	Theoretically speaking, which is the riskiest?	C+	C-	P+	P-	**B**	C- means, writing of a call option is the riskiest as, the loss potential theoretically is infinite.
5	III	5	What are the risks associated with special purpose vehicles?	Issuer default risk	Expiry risk	Market Risk	All of the above	**D**	Issuer default risk, expiry risk and market risk are all risks associated with SPEs.
6	III	6	Which one of these have limited risk?	Option buyers	Option sellers	Buyer of futures	Seller of futures	**A**	Option buyer's risk is limited to the amount of their premiums.
7	III	1	The most prevalent type of private equity fund is:	leveraged buyout funds.	venture capital funds.	distressed securities funds	developmental capital	**A**	Leveraged buyout funds comprise the majority of private equity investment funds.
8	III	4	The underlying asset in a structured product can be ____?	Equity	currencies	ETFs	All of the above	**D**	The underlying asset may be equity, commodity, currency, index, ETF's, etc. in case of structured products.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
9	III	3	A portfolio manager who adds hedge funds to a portfolio of traditional securities is most likely seeking to:	increase expected returns only	both increase expected returns and decrease portfolio variance.	decrease portfolio variance only.	take less risk	**B**	For a portfolio of traditional securities, adding alternative investments such as hedge funds can potentially increase the portfolio's expected returns, because these investments often have higher expected returns than traditional investments, and decrease portfolio variance, because returns on these investments are less than perfectly correlated with returns on traditional investments
10	III	6	Which one of these have default risk?	Exchange traded contracts	OTC contracts	Both	none	**B**	OTC contracts do not have a clearing house, hence there are chances of default.
11	III	5	SPV stands for:	Special Purpose vehicle	Specially Priced vehicle	Separate price vehicle	None of these	A	SPV stands for Special Purpose vehicle.
12	III	2	What are the ways an investor can invest in commodities?	Direct Investment	Indirect Investment	Secondary Investment	A & B	**D**	An investor can invest in commodities both directly and indirectly.
13	III	1	Which of the following refers to purchase of an existing private company through use of leverage?	Leveraged Buyout	Venture Capital	Developmental capital	Distressed Investing	**A**	Leveraged buyout refers to purchase of an existing private company through use of leverage.
14	III	6	With respect to risk management for alternative investments, counterparty and liquidity risk are introduced as additional considerations by the use of:	notice period	lockup period	foreign currencies	derivatives	**D**	Use of derivatives introduces operational, financial, counterparty, and liquidity risk.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
15	III	6	_____________ gives the buyer the right to sell the security	Futures	Call	Forwards	Put	D	Put gives the buyer the right to sell the security.
16	III	3	An example of a relative value hedge fund strategy is:	convertible arbitrage	market neutral	merger arbitrage	A & B	**A**	Relative value strategies include convertible arbitrage fixed income, asset-backed fixed income, general fixed income, volatility, and multi-strategy. Market neutral is an equity hedge strategy. Merger arbitrage is an event driven strategy.
17	III	1	Which one of these is an advantage of private debt?	No liability burden on the balance sheet	Debt investors bring their knowledge, connections and expertise to help and grow the business.	Retention of Equity	Cash flows of the business are not siphoned out as interest payments.	**C**	Private debt investments does not lead to dilution of equity.
18	III	4	Which of the following investment is not standardized?	Futures	Call	Structured products	Put	**C**	Structured products are not standardized and the terms and conditions are decided at the time of issuance.
19	III	6	The total period or length of a Swap is known as:	Duration	Tenor	Termination date	Ex dividend date	**B**	The amount of margin which must be maintained at any time period is known as tenor of the swap.
20	III	6	Which of the following are exchange traded derivatives?	Forwards	Futures	Swaps	A & C	**B**	Both forwards and swaps are OTC traded derivatives while futures is traded on a exchange.
21	III	6	Derivatives are not used by:	hedgers	speculators	arbitragers	investors	**D**	Derivatives are used by hedgers, speculators, arbitrageurs

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
22	III	3	Exploiting the discrepancies in price between a company's convertible bonds and its equity shares is a strategy employed by:	Asset backed fixed income	General fixed income	Convertible arbitrage fixed income	Hedge funds	**C**	Exploiting the discrepancies in price between a company's convertible bonds and its equity shares is a strategy employed by convertible arbitrage fixed income
23	III	1	The formative stage of venture capital investing when capital is furnished for market research and product development is best characterized as the:	early stage	angel investing stage	mezzanine financing stage	seed stage	**D**	In the seed stage of venture capital investing, capital is furnished for product development, marketing, and market research. The angel investing stage is when investment funds are used for business plans and assessing market potential. The early stage refers to investments made to fund initial commercial production and sales.

MODULE IV
INVESTMENT ADVISORY

4

Learning Outcome Statements

1. Introduce the concept of financial planning.
2. Discuss the process and components of portfolio management.
3. Explain understanding client's needs and risk appetite
4. Discuss asset allocation - strategic versus tactical
5. Discuss security selection and investment styles
6. Explain separation of Alpha-Beta in Portfolio Construction.
7. Discuss monitoring and rebalancing of portfolio.
8. Explain methods and need of portfolio measurement.
9. Explain the basic concepts of behavioral finance.
10. Discuss psychological profiling of investor personalities.
11. Case Study

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MODULE IV
INVESTMENT ADVISORY

4.1 INTRODUCE THE CONCEPT OF FINANCIAL PLANNING.

Financial planning is a process by which an individual aims at achieving his life goals through proper management of his finances. An individual's goals can include retirement planning, property acquisition, saving for child's education, starting their own venture, etc. This process begins with asking a few important questions to one's own self, they are:

- What is my current net worth?
- What are my goals?
- How much money do i need and when?
- How much risk can i take?
- Where should i invest?

It brings about a discipline in financial decisions of the individual as it highlights the impact of each decision on the individual's life goals. Financial planning does not have a set formula and needs to be customized as per the individual's requirements. Financial plans should also be fluid, with occasional updates when financial changes occur. Financial planning includes tax planning, estate planning and long term investment plans.

The long term investment plans of an individual involves a customized asset allocation strategy based on his investment objectives and constraints. Generally, a portfolio approach to investing is used for this purpose.

4.2 DISCUSS THE PROCESS AND COMPONENTS OF PORTFOLIO MANAGEMENT.

The portfolio approach to investment is when the funds are invested in an assortment of securities and other kinds of investment vehicles to diversify risk and maximize return. Securities traded are divided into equity and debt securities. Equity securities are shares and mutual fund shares. Debt securities include bonds and money market paper. The other form of investment known as alternative investments include commodities, real estate, etc. The composition of investments depends on different factors like investor's risk tolerance, investment horizon, capital asset base and other unique circumstances.

Risk is defined as the variation of the actual return from the expected return, also known as volatility. Risk is measured in terms of standard deviation. There is a possibility for the investor to lose a part or even all of his investment. Thus, the investor needs to assess, given his current circumstances, how much he can afford to lose. Return is what the investor gains or losses as a result of his investment. Generally, at low levels of uncertainty (or risk) the return is also low. A high risk investment may result in a loss of a substantial part of investment but also has a possibility of high return. The risk return trade-off is the balance between the highest possible return at the lowest possible risk. According to the portfolio perspective, risk return trade-off must be analyzed of the portfolio as a whole not the individual investments in isolation.

When an investor holds all his wealth in a single stock it is because he believes it to be the best available stock. However, modern portfolio theory concludes that this risk is not rewarded with the expected high return. Diversification of investment, on the other hand, reduces portfolio risk without necessarily reducing portfolio's expected return. Diversification is achieved through mixing myriad financial instruments within a portfolio. Varying investment across industries helps reduce the industry-specific risk. It can be measured by diversification ratio. It is the ratio of portfolio's weighted average asset volatility to its actual volatility. Since different asset classes are not perfectly correlated to each other, this ratio is generally greater than 1.

Managing a portfolio is a dynamic process and requires continuous planning and monitoring. The steps in portfolio management are:

Planning lays down the foundation of the entire portfolio management process. The foremost task is to analyze the client's investment goals, tax exposure, liquidity needs, income, age and other unique circumstances. This analysis helps in formulating the investment policy statement. It contains the details of the investor's objectives, constraints and benchmark. All the investment decisions are based on the IPS. The next task is to form capital market expectations. Risk and return of different asset classes are analyzed over a long period of time to compose an asset mix that either minimizes the portfolio risk for a given level of expected return or maximizes the expected return for a given level of risk. The long term weights of the target asset classes are then determined, known as the strategic asset allocation. However, due to the changing market circumstances short term changes can be made to the portfolio strategy and is known as tactical asset allocation.

The execution involves an analysis of the risk and return characteristics of various asset classes to determine how funds will be allocated to the various asset types. A top down analysis is performed to identify the most attractive asset classes. Once the asset class allocations are determined, portfolio managers may attempt to identify the most attractive securities within the asset class. Bottom up security analysis performed to evaluate the securities within the asset class. Once the portfolio composition is finalized, the portfolio is executed. It is important as high transaction costs can reduce the performance of the portfolio. Transaction costs can be both implicit and explicit. Explicit costs like taxes, fees, commissions, etc. can be reduced with careful planning but implicit costs like bid-ask spread, opportunity costs, market price impacts, etc require rigorous monitoring and management. Hence, the execution of the portfolio needs to be appropriately timed and well-managed.

The last step is the feedback stage, it requires continuous monitoring of investor's needs and capital market conditions and rebalancing of the portfolio as per the market conditions. Portfolio rebalancing should also consider taxes and transaction costs. The investment performance of the portfolio must be evaluated regularly to measure the achievement of objectives and the skill of the portfolio manager. It is evaluated relative to the benchmark specified in the IPS. Although there is no assurance if the whole process will result in investment success, maintaining a reasonable and disciplined approach to investing increases the likelihood of investment success over time.

4.3 EXPLAIN UNDERSTANDING CLIENT'S NEEDS AND RISK APPETITE.

Risk and return are a very important part of a client's investment portfolio management process. They form his investment goals and objectives and define his asset allocation strategies. Investors are usually risk averse. They are afraid of high volatility in their portfolios and require additional return for an increase in risk. Factors which affect risk are:

- Required spending needs
- Long-term wealth target
- Financial strength
- Liabilities

Risk can be measured in absolute as well as relative terms. Absolute risk is stated in terms of standard deviation of returns, for example, standard deviation of portfolio for Mr. X is 14%. Standalone, the statement can be ambiguous and also confusing for a client who is less aware of the investment jargons. Relative risk is measured in relation to an index. This method of stating risk is better understood by clients and easier to communicate.

The return objectives of a client can be classified as desired and required. Desired return is often specified by the client, it how much the client wants to earn from his portfolio. It is important to educate the client for not having irrational expectations as it gives rise to dissatisfaction and hampers the client-manager relationship. Required rate of return is the amount the portfolio must earn to achieve the investment goals of the client. It must be measured against a benchmark to confirm is the manager performance was satisfactory.

Investment Policy Statement

IPS is a formal written document created between a portfolio manager and client to govern investment decision making. It takes into account the investor's goals and constraints relating to his investments. It needs to be updated regularly as per the changing investor needs and circumstances. The role of IPS is to:

- Having a disciplined approach towards portfolio decisions.
- Easily implemented by both current as well as future investment advisors.
- Protects from impulsive portfolio reallocation in case the changing markets environment or the performance of the portfolio causes overconfidence or panic.

An investment policy statement has a complete client description providing background so that any investment advisor can understand the client's situation. It defines the client's investment goals, constraints and objectives. Along with risk and return, the other components of an IPS are:

- Tax considerations: It includes income and capital gain tax rates, gift tax and taxes on wealth transfer.
- Time horizon: A longer time horizon increases the risk taking ability of the investor as the portfolio has the time to recover any losses incurred. There could also be different stages in the time horizon bifurcated by any life event such as retirement.
- Liquidity: Liquidity is the urgent need for cash. The higher liquidity is required, the lesser risk the portfolio can take and hence, return is also less.
- Legal constraints: Any legal concern must also be specified in the IPS.
- Unique circumstances: An example of unique consideration can be when a socially aware investor does not wish to invest in tobacco or arms and ammunitions companies.

A well-structured IPS also includes the break-down of asset allocations. For example, an IPS specifies investment in equity of 45%. It goes ahead to break down the 45% investment to 15% investment in financial services, 20% in global equity, etc. It provides for the guidelines regarding the rigidity and flexibility when modifying the asset allocation. IPS also identifies the benchmark against which the performance of the portfolio can be evaluated.

T.Rowe Price INVEST WITH CONFIDENCE

Sample Investment Policy Statement

Type of Plan: Defined Contribution (401(k))

Plan Sponsor: XYZ Company. Inc. (Name of Company)

Plan IRS Tax Identification: Plan # 002

Participant Directed Investment Options: Yes.

(The Plan is intended to satisfy the requirements of ERISA Section 404(c).)

Frequency to Change Investment Options: Daily *(certain investments have trading restrictions)*

Record keeper:________________________

Legal Counsel: ________________________

Auditor: ______________________________

Introduction:

XYZ Company, Inc. ("XYZ") sponsors the __________ Savings Plan (the "Plan") for the benefit of its employees. The Plan is intended to provide eligible employees with long-term accumulation of retirement savings through a combination of employee and employer contributions to individual participant accounts. To facilitate this goal for employees who fail to affirmatively sign up to participate in the Plan, XYZ has adopted an automatic enrollment program for the Plan and, pursuant to the Plan, target retirement date investments are provided as the qualified default investment alternative for those eligible participants who arc automatically enrolled.

The Plan is intended to satisfy the requirements of Section 401(a) of the Internal Revenue Code (the "Code") and contains a cash or deferred arrangement that is intended to satisfy the requirements of Code Section 401(k). The Plan also contains an employee stock ownership plan ("ESOP") (as that term is defined in Code Section 4975(c)(7)). The Plan is intended to comply with the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA") including, without limitation, ERISA's requirements relating to the behavior of plan fiduciaries and the requirements of ERISA Section 404(c).

Plan participants have different investment objectives, time horizons, and risk tolerances. To meet these varying investment needs, participants and beneficiaries will be able to direct their account balances among a range of investment options, which span the risk/return spectrum. To the extent consistent with ERISA Section 404(c) and the applicable provisions of the Pension Protection Act of 2006, Plan participants and beneficiaries alone bear the risk of investment results from the investment options and allocations that they select.

Purpose:

This Investment Policy Statement ("IPS") is intended to assist the Plan's fiduciaries in making decisions about the Plan's investments. The IPS outlines the underlying philosophies and processes for the selection, monitoring, and evaluation of investment options and investment managers utilized in the Plan. Specifically, this IPS:

- Defines the roles of those responsible for the Plan's investments;
- Describes the criteria and procedures for selecting and monitoring investment managers/opt ions; and
- Describes the manner in which investment options and investment managers that fail to satisfy established objectives will be managed.

The IPS will be reviewed at least annually, and if appropriate, can be amended to reflect changes in markets, Plan participants' objectives, or other factors relevant to the Plan.

4.4 DISCUSS ASSET ALLOCATION - STRATEGIC VERSUS TACTICAL.

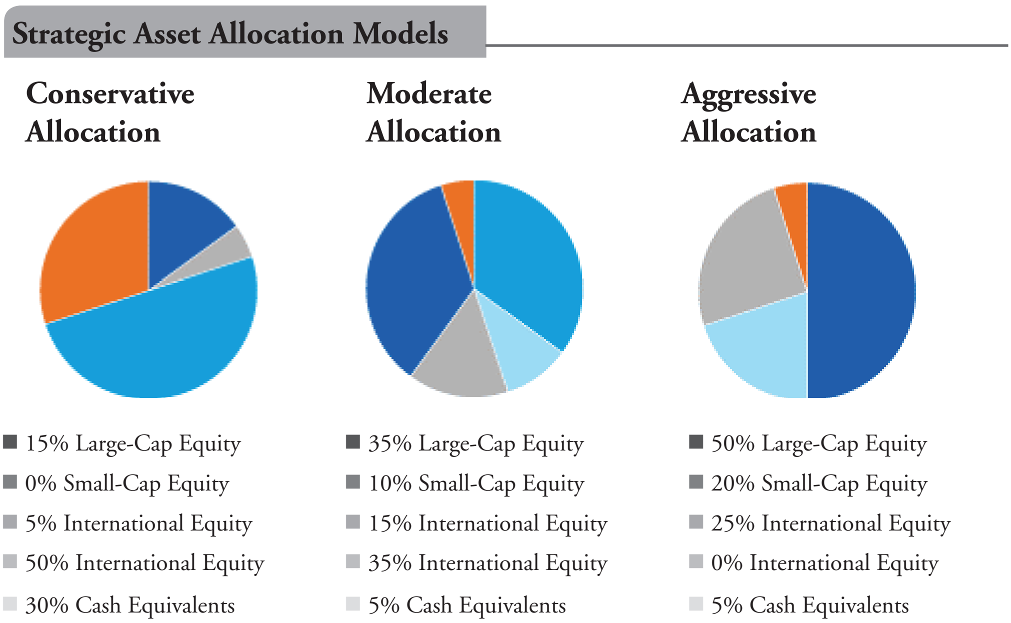
Asset allocation is an investment strategy where the invested funds are divided into different asset categories like stocks, bonds, cash and other alternative investment classes to strike an appropriate balance between risk and reward inclined to the client's investment goals and risk tolerance. There is not set formula for asset allocation which suits everybody rather it is formed as per individual's time horizon and ability to tolerate risk. By investing in asset categories which are negatively correlated an investor can protect himself from incurring significant losses.

Asset allocation is of prime importance as it determines whether an investor would be able to achieve his/her investment goals. For example, Mr. Jones in saving for his retirement which is after 15 years and all his investment is in money market instruments. The asset allocation is not appropriate as money market instruments do not provide high return and are short term investments. However, a balanced investment in bonds and stock would have resulted in a little higher risk for a greater potential return. Risk profiling of an investor depends upon demographics like age, financial goals, personal expenses, number of dependents, stability and predictability of income and profession.

The old rule of thumb for asset allocation used to be subtracting the investor's age from 100 and the resulting figure is the percentage which he/she must invest in stocks. For example, if the client is 45 years old, his asset allocation should be 55% in stocks and 45% in fixed income securities.

Strategic asset allocation (SAA) is a portfolio strategy which determines how much money an investor should be invested in broad categories of investments, such as stocks, bonds and cash. Once this allocation is decided the investor sticks to it for a long period of time. It is static in nature, however, market conditions keep on changing giving the rise to need for tactical asset allocation. Tactical asset allocation (TAA) essentially takes a strategic asset allocation and adjusts it for changing market conditions. It takes an active approach to investing by taking positions in those sectors or securities which have the potential for profit. When portfolio deviates significantly from its strategic asset allocation, it is rebalanced to its original allocations. These are based on modern portfolio theory, which emphasizes diversification to reduce risk and improve portfolio returns.

A disciplined strategic approach prevents investors from making an emotional short-term decision based on current market events. It is assumed that investor's long term objectives and risk tolerance will remain stable over the long term. The allocations are not changed unless there is a significant change in the above mentioned factors. It is referred to as buy-and-hold investing strategy. However, it is inaccurate as great care is exercised to make sure that the asset to asset proportions remain stable despite market fluctuation which requires periodic rebalancing. Buy-and-hold typically suggests that after the initial investments, no changes are made for rebalancing regardless of market price fluctuations. Empirical studies have shown SAA is a dominant determinant of total return and return variability. The below mentioned chart shows general strategic asset allocation models however, no two individuals are the same and there are slight modifications in every case.



Tactical asset allocation relies on forecasting skill and timely execution. Tactical shifts usually range from 5 to 10%. A tactical shift of more than 10% would show a fundamental problem with the construction of the strategic asset allocation.

Let us assume, Mr. Phillip Wheeler is an 80 year old retired individual whose portfolio is being managed by Molly Tanner. As on 31st July, 2017 the value of the portfolio is $ 15 million of which 75% is allocated for equity and 25% for fixed income. By the end of 2017, there was a dramatic decline in equity positions and the portfolio stood at 60% equity and 40 % fixed income. The SAA for the portfolio is 80% equity and 20% fixed income and as per the IPS guidelines the portfolio should be brought back it its initial allocations by selling 20% fixed income and buying 20% equity. However, Molly believes that there will be strong market recovery and temporarily allocates 90% of the funds to equity. This is tactical asset allocation and Molly would go back to the initial levels of 80-20 when the market timing is apt. There are two factors which adversely affect the performance under tactical asset allocation: inaccurate forecast and trading cost.

Consider another portfolio with a target allocation of 65% stocks, 30% fixed income and 5% cash. Assume the market conditions have changed and the bull market is in its maturing stages. The stock are over-valued and a bear market is near. The investor many decide to decide for a more conservative mix reduce his stock allocation to 50% and increase fixed income to 40% and cash to 10%. As the bear market situations become further evident, the investor might decide to switch to fixed income and cash completely. A tactical investor will then start adding stock positions and preparing his portfolio for the next bull market. Tactical allocation is methodical speculative trading but with some buy and hold qualities. The investor does not abandon a specific asset class but plays around with the asset weightages according to his perception of the market conditions.

Tactical asset allocation is based on the assumption that relative returns among asset classes will diverge temporarily from equilibrium levels, allowing the opportunity to earn excess returns. The focus is on asset classes and not on individual securities i.e. forest-before-trees methodology. Index funds and Exchange Traded Funds (ETFs) are good investment options for such an investor. Suppose an investor believes that a bull market is approaching he can simply choose a balanced mutual fund with equity being slightly over weighted. A risk loving investor can pick a mutual fund which invests more in small cap equity than large cap equity.

Suppose a tactical investor feels that FMCG and infrastructure sector would perform better than the other sectors he can choose ETFs within those sectors.

4.5 DISCUSS SECURITY SELECTION AND INVESTMENT STYLES.

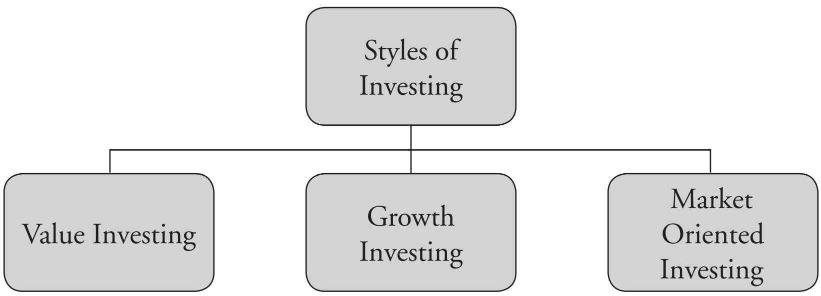
Asset Allocation and Security Selection are quite different from each other but both of them are investment strategy. Security selection is a narrower concept as compared to asset allocation. Asset Allocation is defined as the mix of different assets one should hold in its portfolio to maintain a proper balance between the risk and return. Security selection refers to identifying securities that would help one to make up each asset class.

Asset allocation suffers from more uncertainty as compared to security selection as in asset allocation the future direction of an asset cannot be ascertained while in security selection investor can gather knowledge and information that serves as a guide to determine the future movement of the security.

According to "Efficient Market Hypothesis" the stock prices fully reflect all the available information so according to this theory the investors may sometime try to exploit the mispriced stocks. So, according to this theory, the investors are better off choosing an appropriate asset class and investing in it than doing security selection.

Diversification is considered as one of the most important aspect that must be taken into consideration while investing. During security selection diversification can be achieved by investing in securities which are negatively correlated. For example, consumer utility industries are non-cyclical in nature whereas financial services are cyclical in nature. Investing in both of the sectors improves diversification in a portfolio.

In security selection there are different styles to investing



Value style investing is when the investment is made in securities which have low price multiples (P/E ratio, P/B ratio, etc). The investor is of the belief that the securities are currently under-valued and would eventually rise. Value stocks are typically characterized by high dividend yield.

Growth style of investing involves buying stocks with high price multiples. The rationale behind this style of investing that if the company earning per share of the company is growing but the P/E ratio is consistent, the stock price would rise. Information technology stocks are believed to be growth stocks.

The third style of investing i.e. market oriented investing is a blend of both the above mentioned styles. The focus shifts from value to growth and growth to value according to market conditions.

4.6 EXPLAIN SEPARATION OF ALPHA-BETA IN PORTFOLIO CONSTRUCTION.

Investment can be done in passive or active manner. Passive style of investing is when the fund manager tries to imitate market index. The goal of investing is to earn equal to the market return. However, the actual return is always less than the market return because of the transaction cost involved such as taxes. The passive approach to investing believes in efficient market hypothesis (EMH). According to EMH, the stock prices reflect all the current information thereby stock picking does not involve any extra return.

The opposite of passive style of investing is the active style of investing. Fund managers who follow active style of investing believe that markets are not efficient and can be outperformed by applying different strategies. This excess return is very difficult to earn and thus, active fund managers charge higher fees for the same. Active managers exploit market inefficiencies by buying undervalued stock or short selling over valued stock or simply reducing the risk by use of derivative instruments as hedging tools.

Active management has the following advantages for an investor:

- Active manager invests in his area of expertise.
- Instead of investing in the whole market, the fund manager can pick only high quality company stocks thus providing higher return at a lower risk.
- Active manager can avoid certain sectors or industries as per the market conditions.
- The fund is more aligned with the investment goals of the client.
- Investments which are negatively correlated with the market can be used as a tool for portfolio diversification.

Active management also has certain drawbacks:

- The fund manager might not make the right investment choices.
- The frequent trading could cause higher transaction cost.

- As the investments are not held for long, short term capital gain tax might be applicable causing an increase in tax expenditure.
- Generally, the actively managed funds underperform as compared to their passively managed counterparts.

Some mutual funds follow active portfolio management wherein the fund manager pools the investments of multiple investors and trades according to a certain theme, for example, growth oriented mutual fund, emerging equity fund, gold fund, etc. These managers generally use long only strategy placing their bets on securities which they believe are undervalued. Hedge fund managers also use the active management strategy however, a hedge fund manager is more flexible and uses different strategies to earn excess return.

Active investment returns are the result of market return (beta) and excess return (alpha). The role of a portfolio manager is to outperform the market i.e. to earn alpha. Alpha is the difference between investment return and benchmark return earned due to the skills of portfolio manager. Alpha is earned because of the idiosyncratic risk in a security or asset class. The choice of benchmark is of vital importance in this regard. Suppose an investor has invested 60% in small cap equity and 30% in large cap equity and 10% in cash and has S&P 500 as the benchmark. Here, the alpha does not show the true skills of the manager.

Beta is the systematic risk of a security or portfolio. Regression analysis is performed and the slope of the equitation formed is the beta of the portfolio. It signifies the sensitivity of a portfolio's return to market movements.

It is being increasingly recognized that in order to maximize returns and minimize risk of investment, alpha must be distinguished from beta. For example, an investor invests in S&P 500 index. The investor here has completely abandoned alpha and only earns beta. However, if he invests in an actively managed mutual fund, he earns a combination of alpha and beta wherein the fees paid by the investor is active management level fees even for the beta portion.

Beta investment can be accomplished through index funds or index futures or a combination of both. While index funds require a larger capital base, index futures is for a limited time period and roll over involves significant transaction cost. Beta is usually generated by investing in a large cap fund as the market for large cap securities is highly efficient with respect to information making alpha is hard to generate.

Alpha is hard to find and entirely skills based. Alpha is generated by a portable alpha strategy i.e. earning return without any exposure to market risk. The market exposure in this strategy is usually gained through derivative instruments. This position would only require a small investment and the remaining fund could be invested in money market instruments or other low risk investments. Using portable alpha strategy exposure can be gained to any target market such as real estate, commodity, international equity, etc. This is one of the prime reasons why investors opt for a portable alpha strategy. The investor does not need to alter his/her asset allocation to earn enhanced return and can also diversify the portfolio risk.

The drawback of this strategy is that it may be difficult and costly to implement. Moreover, short selling may not be allowed in certain markets. Some long-short strategies may not be market neutral and could have some systematic risk component.

Alpha or active return is not an appropriate measure of the active fund manager's performance. Information ratio is used for this purpose but first we need to understand the concept of active risk. Active risk also known as tracking risk is the standard deviation of active return. It is composed of deviations of portfolio's factor sensitivities versus benchmark sensitivities and portfolio's individual asset weightings versus benchmark's individual asset weightings. Assume the following situation:

	Fund Manager 1	Fund Manager 2
Active Return	2%	4.25%
Active Risk	2.5%	6%

Here active return of fund manager 2 is more than double of fund manager 1. However, the active risk is also very high. Thus, information ratio needs to be calculated.

Information Ratio (IR) = Average Active Return/Active Risk

In the above example,

IR of Fund Manager 1 = 2/2.5 = 0.8

IR of Fund Manager 2 = 4.25/6 = 0.71

Hence, the performance of fund manager 1 is better.

4.7 DISCUSS MONITORING AND REBALANCING OF PORTFOLIO.

The investment advisor is in a fiduciary relationship with the client. The advisor is expected to monitor the portfolio and ensure it is updated according to changing market circumstances, deviation in asset allocation due to market movement and is aligned towards client's goals and needs. A significant change in the client's situation such as marriage, birth of a child, lottery, inheritance, etc requires the IPS and in turn portfolio to be updated.

Rebalancing is the process of buying or selling of investments to bring the portfolio back to its initial or updated allocation. The cost associated with rebalancing includes transaction cost and capital gains or losses due to sale of investment.

Now the question is, when should the portfolio be rebalanced to initial allocation? There are two methods of deciding this: calendar rebalancing and percentage of portfolio rebalancing. In calendar rebalancing, there is a specified time internal, say monthly, when the portfolio needs to be rebalanced. While this approach is disciplined but the portfolio may suffer severe deviations within the time period and in turn incur huge losses. Percentage of portfolio rebalancing is when a range is set for each asset class and if the range is breached rebalancing is required.

4.8 EXPLAIN METHODS AND NEED OF PORTFOLIO MEASUREMENT.

The process of evaluating the performance of the portfolio is known as portfolio evaluation. It refers to the process by which performance of one portfolio can be compared with the performance of another portfolio i.e. the return earned of the two portfolio can be compared.

It comprises of basically two main functions: Performance Measurement and Performance Evaluation. Performance Measurement is basically an accounting function through which one can measure the return earned during their investment period or holding period of the portfolio. Whereas performance evaluation refers to the process of analyzing whether the performance of the portfolio was superior or inferior as compared to other portfolio or to the benchmark.

When evaluating the performance of the portfolio one should always evaluate it on the basis of risk and return. The return earned on the portfolio should be evaluated with the risk undertaken to earn that return. One should either group portfolios into equivalent risk class or adjust the return for the risk undertaken by developing the risk adjusted return measure.

One can also measure the amount of excess risk undertaken or amount of risk that could be taken by comparing the portfolio beta with the beta of the market portfolio or the benchmark or other similar portfolios.

The first step in evaluating a portfolio is measuring the return earned on the portfolio. The return earned on the portfolio usually refers to the amount of the income which is generally earned during the holding period or the investment period of the portfolio. The return earned on portfolio is nothing but the market value of the portfolio at the end of the investment period minus the value of the portfolio at the beginning and any income earned on the portfolio during the holding period is also added to it. The return earned on a portfolio can be calculated as follows:

$Rp = [(NAV_t - NAV_{t-1}) + D_t + C_t]/NAV_{t-1}$

Where,

NAV_t = NAV per unit at the end of the holding period

NAV_{t-1}= NAV per unit at the beginning of the holding period

D_t= Cash disbursements per unit during the holding period

C_t= Capital gains disbursements per unit during the holding period

Portfolio return is also the weighted average of return of securities. One can also evaluate the portfolio on the basis of risk adjusted return i.e. assessing the portfolio return on the basis of reward earned per unit of risk undertaken. The portfolio should at least earn a risk premium if any risk is undertaken. Risk premium is the reward that one earns for taking extra amount of risk. It is something that is earned over and above the risk free rate. There are several method for measuring the reward per unit of risk. Like the Sharpe Ratio, Treynor Ratio etc.

Sharpe Ratio

This measure was developed by William Sharpe and thus referred to as Sharpe ratio. It is also known as reward to variability ratio. It measure the amount of excess return earned for per unit of risk undertaken. It measures the variability of the return as measured by the standard deviation of return. The formula for measuring the Sharpe ratio is stated as follows:

Sharpe Ratio = $(R_p - R_f)/\sigma_p$

Where

R_p = Realised return on portfolio

R_f = Risk free rate of return

σ_p = Standard deviation of the portfolio

Sharpe Ratio can only be used for those returns that are normally distributed. Returns of many portfolio may not be normally distributed but might be skewed or may have a high degree of kurtosis. The higher the Sharpe ratio the more attractive is the risk adjusted return.

Treynor Ratio

This performance measure was developed by Jack Treynor and thus referred to as Treynor ratio. It is also known as reward to volatility ratio. It measures the risk premium per unit of systematic risk.

Treynor Ratio = $(R_p - R_f)/\beta_p$

Where,

R_p = Realised return on portfolio

R_f = Risk free rate of return

β_p= Portfolio beta

Jensen Measure

This performance measure was developed by Michael Jensen. It measures the difference between the actual return earned on the portfolio and the return expected from a portfolio at a given level of risk. It is based on the Capital Asset Pricing Model.

$E(R_p) = R_f + \beta_p (R_m - R_f)$

Where,

$E(R_p)$ = Expected portfolio return

R_f= Risk free rate

R_m= Return on market index

β_p = Systematic risk of the portfolio

R_m-R_f= Market Risk premium

The differential return is calculated as follows:

$\alpha_p = R_p - E(R_p)$

Where,

α_p = Differential return earned

R_p = Actual return earned on the portfolio

$E(R_p)$ = Expected return

It represent the differential return i.e. the difference between the actual and the expected return. A positive alpha would indicate that the returns were superior to those expected and the same may be because of the manager's skill and a negative would indicate that the performance was worse than that of the market.

Example

Jack Thomas has an investment of $250,000. He is unsatisfied with the performance of his portfolio and wishes to evaluate the performance of his portfolio manager. The following are the details of his portfolio:

Actual Return	9.8%
Standard Deviation	11.6%
Beta of the Portfolio	1.25
Risk free rate of return	4.7%
Market Risk Premium	3.1%

Thomas thus decides to calculate Sharpe Ratio, Treynor Ratio and Jensen Alpha for his portfolio.

Solution

Sharpe Ratio = $(R_p - R_f)/\sigma_p$

= (9.8 - 4.7)/11.6

= 0.44

Treynor Ratio = $(R_p - R_f)/\beta_p$

= (9.8 - 4.7)/1.25

= 4.08

Expected Rate of Return = $R_f + \beta_p (R_m - R_f)$

= 4.7 + 1.25 x 3.1

= 8.6%

Jensen Measure = R_p - $E(R_p)$

= 9.8 - 8.6

= 1.2%

4.9 EXPLAIN THE BASIC CONCEPTS OF BEHAVIORAL FINANCE.

Traditional finance assumes that all investors are rational and thus the markets are highly efficient. It focuses on how individuals "should" behave. In contrast to this, behavioral finance takes into account human sentiments and psychology and attempts to explain the deviation of market from what it must be as per traditional finance. It focuses on why investors behave the way they behave.

Traditional finance is based on the concept of 'Rational Economic Man (REM)'. A REM follows the below mentioned rules while decision making:

Completeness	**Transitivity**
Independence	**Continuity**

According to the concept of completeness, individuals can make a clear choice between two mutually exclusive options. They are aware of their preferences and act according to that. Transitivity translates to consistency i.e. an individual prefers A over B and B over C then he must prefer A over C. Independence means utility is additive and divisible. If we continue with the above example, if Z is added to both A and B, the investor would still prefer A over B. Continuity assumes utility indifference is smooth and unbroken i.e. there would be some combination of A and C where the investor would be indifferent between B and combination of A and C.

Behavioral finance, on the other hand, believes the investor acts normally. Their decisions are based on certain biases known as cognitive and emotional biases. Human beings make decisions make on their emotions and limited understanding. They do not attempt to gather complete information rather satisfice with the available information. Investors do not perform complete analysis before investing instead they take shortcuts and make a decision they think is suitable for them. Also, they prioritize their short term needs over their long term goals.

Cognitive biases

Cognitive biases are caused because of faulty reasoning of the investors. Investors may make statistical errors or process information incorrectly or might even have faulty memory. These biases can be removed by educating the investors. The following are different of cognitive biases found among investors:

- Conservatism bias: Investors usually hold on to their prior views and do not adapt to the changing circumstances.
- Confirmation bias: Investors might notice information that agrees with their views and tend to ignore the remaining information.
- Representative bias: Investors have very small data available based on which they make larger decisions. They ignore the fact that their sample size is too small. They also tend to believe that the classification of assets done by them is 100% correct.
- Control bias: Investors have the illusion that they have the ability to control outcomes.
- Hindsight bias: Investors tend to remember the occasions when their forecasts where correct and ignore the times when they went wrong. This makes them overconfident in their future decision makings.
- Anchoring and adjustment bias: Investors apply mental shortcuts while making decisions and remain fixated on their initial forecast or the price of any security which they perceived to be correct.
- Mental accounting bias: Individuals tend to create separate mental accounts for separate purposes.
- Framing bias: The way the information is presented to them affects their decision making. This leads them to focus more on short term price changes.
- Availability bias: It is when investors give more importance to the information which is easily available.

Emotional biases

Emotional biases are caused by feelings and sentiments of an individual. These are caused due to psychological beliefs. These are not easy to correct and thus are required to be incorporated in the portfolio. The following are the emotional biases from which investors usually suffer:

- Loss aversion: Investors are loss averse and not risk. They see investments in terms of potential profit and loss and not risk. They always give more importance to avoiding loss than earning profits.
- Overconfidence: Sometimes investors think that they have complete knowledge on an investment or the whole market an in turn over state their probability of success. They think that they are better at making predictions and understanding market movements than others.
- Self-control bias: Investors do not have the discipline to patiently work towards their long term goals.
- Status quo bias: Investors are afraid of change and they would rather not touch their portfolio and churn according to changing market environment.
- Endowment bias: Investors view assets differently based on their position on the asset. They would demand a higher price when selling an asset but would not pay the same if they were buying it.
- Regret aversion bias: Instead of being logical about their decision investors tend to avoid the pain of regret.

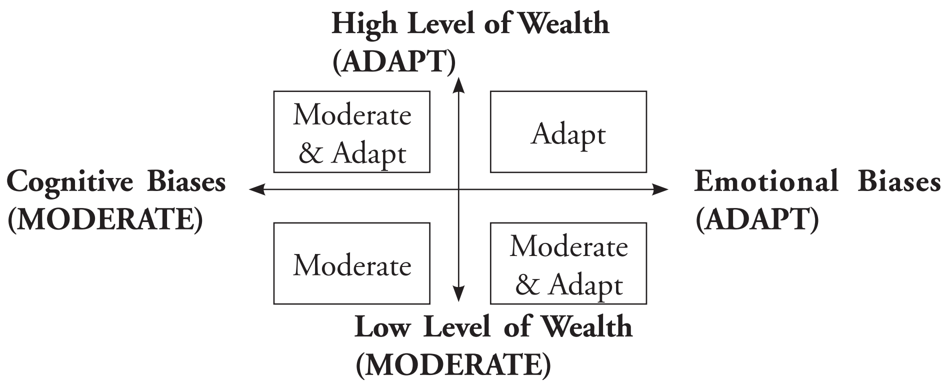
Analysts also suffer from certain biases like other individuals. They are vulnerable to human weaknesses which reflects in their decision making style. The following are certain commonly found analyst biases:

- Overconfidence: Analysts tend to become egoistic and perceive their skills as superior to others. In this thought of theirs, they underestimate risk and set confidence intervals too narrow. They believe they have more information than others and also can interpret it better. This can be mitigated by seeking at least one counter argument for their every decision.
- Influence of company's management: Analysts gather information from management of the company how might try to present their company in a better light thus leading to wrong analysis.
- Biased research: Analysts might collect too much information which may not be important but it leads the investors to believe they have more knowledge and can control the outcomes.

Behavioral Portfolio Perspective

Behavioral portfolio perspective believes that individuals are subject to emotional and cognitive biases. They do not necessarily always focus on their long term goals and prefer satisfaction over logical decision making. Investors structure their portfolio in layers according to their goals and manage each layer according to the importance of the goal and the risk they can afford to take. Investors tend to book profits really fast but hold on to the loss making investments as they are afraid of realizing the loss even if it means a lack of liquidity.

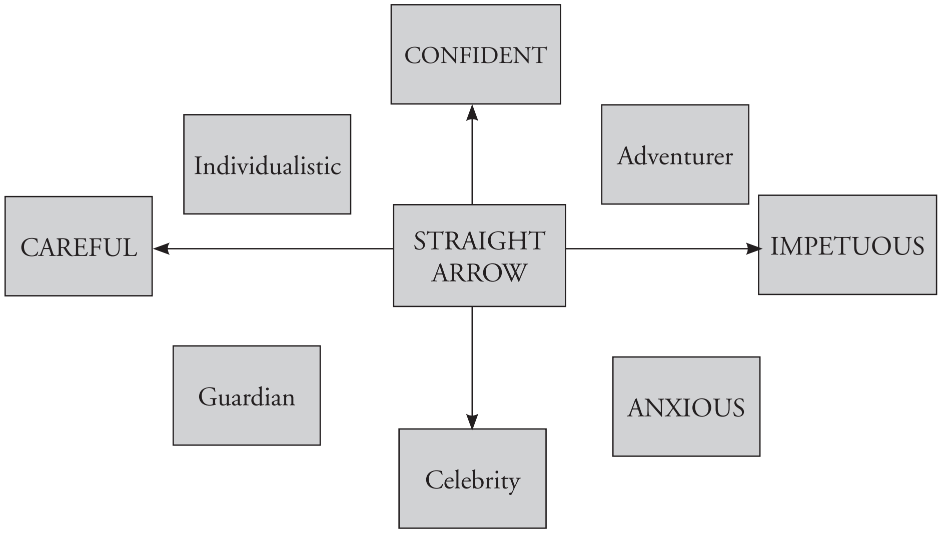
The IPS of each client must take into account the biases suffered by the investor. Cognitive biases can be mitigated but emotional biases usually need to be adapted. The level of adaption and mitigation depends on the effective wealth of the client. Effective wealth means the client's wealth measured in terms of his lifestyle in relation to his income. If the client's effective wealth is much more than his income then the client has low standard of living risk and the reverse is true for someone whose effective wealth is low.



A client whose standard of living risk is high cannot afford to have many biases incorporated in his portfolio but for a client whose standard of living risk is low the biases can be adapted.

4.10 DISCUSS PSYCHOLOGICAL PROFILING OF INVESTOR PERSONALITIES.

It is believed that if the investor's psychological make-up is recognized in the IPS the outcome is more favourable. Investors can be classified into five groups based on their psychological profile. This method categorizes investors according to the method and confidence in their decision making. This model was developed by economists Bailard, Biehl and Kaiser.



Investors can range from confident to anxious in their method of decision making and from careful to impetuous in their confidence in decision making.

Straight arrow is the rational investor who is not over confident or too anxious, not very conservative also not impetuous. They can take increased risk for an increase in expected rate of return.

Adventurer are investors who are highly confident and impetuous. They take huge risks and do not accept advice as they believe they have sufficient knowledge. They might hold highly concentrated portfolios. Analysts find them really difficult to work with.

Individualists are investors who are confident in their approach but also very careful. They base their decisions on proper analysis and research. They listen and process information carefully and analysts find them good to work with.

Guardian are anxious and careful. They usually seek advice from people they think have better knowledge them and are really concerned about their future.

Celebrity investors are anxious and impetuous. They also seek advice in their decision making process and are aware of their lack of knowledge and decision making capability.

4.11 CASE STUDY

Mrs. Samantha Johnson is a 72 year old retired women. She is considering investment among different asset classes. Total capital available with her is $450,000. Mrs. Johnson wishes to keep a cash reserve of approximately $40,000 for any emergency requirement. The portfolio return will bear her living expenses which annually comes to $33700 approximately. She also wishes to donate $1500 annually to charity for underprivileged children. Her investment advisor, George Smith, has presented her with the following asset allocations:

	Expected Return	Expected Standard Deviation	Expected Sharpe Ratio	Asset Weightages				
				Fixed Income	Domestic Equity	International Equity	Alternative Investments	Cash
1	6.4%	8.5%	0.49	27%	45%	10%	5%	13%
2	8.2%	10.5%	0.57	25%	47%	10%	8%	10%
3	8.8%	11.4%	0.57	15%	35%	35%	10%	5%
4	10.4%	16%	0.51	6%	40%	20%	24%	10%

The risk free rate of return is 2.25%.

Mrs. Johnson would require a minimum return of = (33,700+1,500)/450,000 = 7.8%

This eliminates the first strategy as it does not fulfill the minimum required rate of return.

The cash reserve to be created must have a weightage of 8.88% (40,000/450,000). Thus, the third strategy cannot be used as it only has a cash allocation of 5%.

Among the remaining two strategies, the second strategy provides a higher Sharpe ratio i.e. the return earned over and above risk free rate per unit of volatility is higher.

Mrs. Johnson has pre-decided a benchmark to measure Smith's performance. One year has passed, the following table provides a comparison between the benchmark and her portfolio:

Asset Class	Actual Weight	Actual Return	Actual Weighted Return	Benchmark Weight	Benchmark Return	Benchmark Weighted Return
Fixed Income	25%	6%	1.5	30%	6%	1.8
Domestic Equity	47%	9.58%	4.5	35%	8.45%	3.0
International Equity	10%	12.5%	1.3	15%	12.2%	1.8

Asset Class	Actual Weight	Actual Return	Actual Weighted Return	Benchmark Weight	Benchmark Return	Benchmark Weighted Return
Alternative Investments	8%	11.5%	0.9	10%	11.8%	1.2
Cash	10%	2.25%	0.2	10%	2.25%	0.2
Total	100%		8.4%	100%		8.0%

Here it can be seen that the investment advisor has outperformed the benchmark by 0.4%. However, this can be further evaluated if the return was attributed to his security selection skills or to his asset allocation skills.

His security selection skills have made the following contribution:

Asset Class	Difference in Return	Portfolio weight	Contribution
Fixed Income	0%	25%	0%
Domestic Equity	1.13%	47%	0.531%
International Equity	0.3%	10%	0.03%
Alternative Investments	-0.3%	8%	-0.03%
Cash	0%	10%	0%
Total			0.531%

The contribution by his asset allocation skills are:

Asset Class	Difference in Asset Weightage	Benchmark Asset Return - Benchmark Total Return	Contribution
Fixed Income	-5%	-2%	0.1%
Domestic Equity	12%	0.45%	0.054%
International Equity	-5%	4.2%	-0.21%
Alternative Investments	-2%	3.8%	-0.075%
Cash	0%	0%	0%
Total			-0.131%

This shows that while Smith's security selection skills were beneficial for Mrs. Johnson's portfolio his asset allocation skills proved to be detrimental to her portfolio.

The actual standard deviation of the portfolio was 11.5%.

The Sharpe Ratio of the portfolio = $(R_p - R_f)/\sigma_p$

= (8.4 - 2.25)/11.5 = 0.53

This means that the portfolio earned 0.53% excess return per unit of risk.

SUMMARY

1. Introduce the concept of financial planning.
    - Financial planning is a process by which an individual aims at achieving his life goals through proper management of his finances.
    - It includes tax planning, estate planning and long term investment plans.
    - It brings a discipline in the financial decision making process.
2. Discuss the process and components of portfolio management.
    - The portfolio approach to investment is when the funds are invested in an assortment of securities and other kinds of investment vehicles to diversify risk and maximize return.
    - The risk return trade-off is the balance between the highest possible return at the lowest possible risk. It must be analyzed for the portfolio as a whole and not individual securities.
    - The steps in portfolio management are:
        i. Planning
        ii. Execution
        iii. Feedback
3. Explain understanding client's needs and risk appetite.
    - Investment Policy Statement is a formal written document created between a portfolio manager and client to govern investment decision making.
    - The components of IPS are:
        i. Risk
        ii. Return
        iii. Tax consideration
        iv. Time horizon
        v. Liquidity

vi. Legal constraints

vii. Unique circumstances

4. Discuss asset allocation - strategic versus tactical.
    - Asset allocation is an investment strategy where the invested funds are divided into different asset categories like stocks, bonds, cash and other alternative investment classes to strike an appropriate balance between risk and reward inclined to the client's investment goals and risk tolerance.
    - Strategic asset allocation (SAA) is a portfolio strategy which determines how much money an investor should be invested in broad categories of investments, such as stocks, bonds and cash in the long term.
    - Tactical asset allocation (TAA) takes a strategic asset allocation and adjusts it for changing market conditions.
5. Discuss security selection and investment styles.
    - Security selection refers to identifying securities that would help one to make up each asset class.
    - Diversification can be achieved by investing in securities which are negatively correlated.
    - The different styles of investing are:

      i. Value investing

      ii. Growth investing

      iii. Market Investing
6. Explain separation of Alpha-Beta in Portfolio Construction.
    - Investment can be passive and active.
    - Passive investing is when portfolio tries to mimic an index whereas active investing involves applying different strategies in an attempt to outperform the market.
    - Alpha is the difference between investment return and benchmark return earned due to the skills of portfolio manager.
    - Beta is the systematic risk of a security or portfolio.

- In order to maximize returns and minimize risk of investment separation of alpha and beta is being used.
- Active fund manager's performance can be measured by information ratio.

7. Discuss monitoring and rebalancing of portfolio.
    - Portfolio monitoring is vital to ensure updation of portfolio according to changing market circumstances, deviation in asset allocation due to market movement and is aligned towards client's goals and needs.
    - Rebalancing is the process of buying or selling of investments to bring the portfolio back to its initial or updated allocation.
    - Methods of deciding rebalancing are:
        i. Calendar Rebalancing
        ii. Percentage of Portfolio
8. Explain methods and need of portfolio measurement.
    - Performance Measurement is basically an accounting function through which one can measure the return earned during their investment period or holding period of the portfolio.
    - Methods of performance measurement are:
        i. Sharpe Ratio
        ii. Treynor Ratio
        iii. Jensen Measure
9. Explain the basic concepts of behavioral finance.
    - Traditional finance explains how investors should behave whereas behavioral finance explains why investors behave the way they behave.
    - Behavioral finance recognizes the presence of two types of biases in investors: cognitive and emotional.
    - Cognitive biases are caused by faulty reasoning whereas emotional biases are due to feelings and sentiments of an individual.
    - Behavioral portfolio perspective takes into account individual biases and effective wealth.

10. Discuss psychological profiling of investor personalities.

- Investors can be classified into five groups based on their psychological profile.

  i. Straight Arrow
  ii. Adventurer
  iii. Celebrity
  iv. Guardian
  v. Individualistic

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	IV	3	Which of the following is a factor affecting risk of an investor?	Financial Strength	Liability	Spending Needs	All of the above	**D**	The factors which affect risk of an investor are: spending needs, wealth target, financial strength and liabilities.
2	IV	4	Which of the following statements is true?	SAA is when portfolio is adjusted for changing market situation.	IPS mentions the range of deviation from SAA allowed after which rebalancing is required.	TAA is referred as a buy and hold strategy	Asset allocation focuses on individual securities	**B**	TAA is when portfolio is adjusted as per changing market conditions. SAA is a buy and hold strategy and asset allocation focuses on broad asset categories instead of security analysis.
3	IV	8	Mrs. Greene has a portfolio of $ 25,000 out of which she has invested 40% in stock of Stanford Ltd and the remaining in Yaxla Ltd. Expected rate of return for Stanford Ltd is 8.9% while for Yaxla Ltd it is 5.6%. Calculate her expected rate of return from the portfolio.	6.55%	8.90%	6.92%	7.25%	**C**	Return = 8.9 x 0.4 + 5.6 x 0.6 = 6.92%
4	IV	3	Which of the following statements is false?	Active management believes in efficient market hypothesis	Passive managers charge lower fees than active managers	Active management includes higher transaction costs.	Passive management attempts to mimic its benchmark	**A**	Passive management believes in efficient market hypothesis.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
5	IV	3	Katherine is an investor and she wants to ensure that there is $55,000 in cash in the account on December 31, 2020. Classify this statement according to where it fits in the objective-constraints policies framework.	Constraint, horizon	Objective, regulation	Constraint, liquidity	Objective, taxes	**A**	The constraint is the $55,000 value and the horizon is determined by the ending date of December 31, 2020.
6	IV	10	Which of the following investor is rational in his approach towards investment?	Celebrity	Adventurer	Individualist	Straight Arrow	**D**	Straight arrow is the rational investor who is not over confident or too anxious, not very conservative also not impetuous.
7	IV	9	Which of the following is not a cognitive bias?	Loss Aversion	Control Bias	Framing Bias	Availability Bias	**A**	Loss aversion is an emotional bias.
8	IV	5	An economic boom is expected in the coming year. Portfolio Manager X has shifted his investment from the FMCG industry to the infrastructure industry. Portfolio Manager Y has shifted his investment from the oil industry to the pharmaceutical industry. Which of the portfolio manager is expected to outperform the market?	A	B	Both A and B	Cannot be determined	**A**	FMCG and Pharmaceutical industry are non-cyclical and tend to underperform during economic boom.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
9	IV	6	Which of the following statements is not true about portable alpha strategy?	A portable alpha strategy means that an investor can easily pick up systematic risk through a variety of positions.	This strategy obscures investment risk.	The alpha position is more costly than the beta position.	Alpha can be achieved through long short strategy	**B**	The investor can better understand and manage the risks in an alpha and beta separation approach.
10	IV	4	According to the old rule of thumb, equity allocation for a 70 year old retired individual should be?	35%	70%	30%	50%	**C**	According to old rule of thum, equity allocation should be 100 - age i.e. in this case, 100 - 70 = 30%.
11	IV	7	Which if the following is not a cost of trading?	Fees	Opportunity Cost	Interest	Taxes	**C**	Interest is an investment income.
12	IV	5	The dividend yield of Dalton industries is 7.3% while the industry average is 5%. Dalton stock can be categorized as:	Value stock	Growth Stock	Neutral Stock	Insufficient Information	**A**	Value stocks are characterized by high dividend yield.
13	IV	3	Which of the following is a component of IPS?	Tax Consideration	Return Objective	Liquidity Concern	All of the above	**D**	Components of IPS are: risk, return, tax, time, liquidity, legal and unique circumstances.
14	IV	6	The active return of a fund manger is 1% and the active risk is 1.4%. When compared to another fund manager with information ratio of 0.65, whose performance is better?	Fund Manager A	Fund Manager B	Both have same performance	Insufficient data	**A**	Information ratio of Fund manager A is 0.71 which is higher than 0.65 of Fund manager B.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
15	IV	9	Suppose an investor has high standard of living risk. His cognitive biases must be:	Adapted Fully	Adapted partly	Mitigated	None of the above	**C**	For an investor with high standard of living risk the congnitive biases must be mitigated.
16	IV	8	Consider the below provided information: Market Return = 10.8% Beta = 0.86 Risk free rate of return = 4.3% Calculate the expected rate of return.	9.40%	9.90%	10.30%	8.90%	**B**	$E(Rp) = Rf + \beta p\ (Rm - Rf)$
17	IV	3	Which of the following is not an example of portfolio constraint?	Unique needs and circumstances	Low risk tolerance level	Client needs to save for retirement	High capital gains taxes	**B**	Risk and return form investment objectives and not constraints.
18	IV	2	Which is the correct order of portfolio management process?	Execution, Planning and feedback	Planning, monitoring and feedback	Planning, execution and feedback	Monitoring, execution and rebalancing	**C**	The correct order of portfolio management process is planning, execution and feedback.
19	IV	2	Bottom up analysis is conducted in which step of the portfolio management process and which is the next task to be performed?	Execution, security selection	Planning, asset allocation	Feedback, rebalancing	Execution, forming capital market expectations	**A**	Bottom up analysis a part of the execution stage and is then followed by security selection.
20	IV	10	A guardian investor is:	careful and anxious	confident and careful	confident and impetuous	impetuous and anxious	**A**	A guardian investor is careful and anxious.
21	IV	6	Beta represents the _____ risk in a portfolio.	Unsystematic	Systematic	Total	Both a and b	**B**	Beta is the systematic risk of a portfolio.

Sl No.	Chapter	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
22	IV	8	Claire has an made an investment in an actively managed equity fund. The actual returned earned by her is 11.8% and the standard deviation is 15.4%. Calculate the Sharpe Ratio. Risk free rate of return is 3.8%.	0.65	0.47	0.87	0.52	**D**	Sharpe Ratio = (Rp - Rf)/βp
23	IV	9	An analysis of decision making of investors and managers is classified as	Traditional Finance	Research Finance	Behavioral Finance	Premium Finance	**C**	Behavioral finance analyzes decision making process of investors and analysts.
24	IV	3	A risk averse investor requires ______ return for an increase in risk.	higher	lower	same	cannot be determined	**A**	A risk averse investor requires higher return for an increase in risk.
25	IV	3	IPS must be reviwed atleast:	Daily	Quarterly	Monthly	Annually	**D**	Client's IPS must be reviwed at least annually.

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MODULE V
INTERNATIONAL WEALTH PLANNING

5

Learning Outcome Statements

1. Explain the concept of wealth management.
2. Discuss wealth planning tools that help uncover a client's succession, asset protection and philanthropic needs and other financial needs and goals.
3. Explain trust and estate planning common and complex structures
4. Discuss international tax concepts for wealth planners.
5. Case Study

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MODULE V
INTERNATIONAL WEALTH PLANNING

5.1 EXPLAIN THE CONCEPT OF WEALTH MANAGEMENT.

To understand wealth management, we will firstly break the word into wealth and management. Wealth is the sum total market value of physical and intangible assets owned by a person, community or country and it incorporates financial planning, investment portfolio management and a number of aggregated financial services.

The whole idea is to integrate pieces of advice and various products from a series of professionals to individuals who benefit from a holistic approach in which a single manager coordinates all the services needed to manage their money and plan for their own or their family's current and future needs.

The professionals providing this advice are known as wealth managers who are certified Chartered Financial Consultants, Certified Financial Planners or Chartered Financial Analysts, Chartered Strategic Wealth Professionals or any credentialed professional money managers who work to enhance the income, growth and tax-favored treatment of long-term investors.

Importance of Wealth Management

Not all investors have proper knowledge of managing wealth, it may seem that he is required to work only with due diligence but the manager needs much more skills to predict the outcome without leaving out any factors. Human psychology works in the most unpredictable way and therefore only experts of it can remain in the playground. Wealth managers take advantage of their knowledge and experience and keep updating the investments as per market factors as well as the client's situation. They take care of all the market risk and individual risk taking capacity while investing and try to reach the goals.

Benefits of wealth management

- A wealth manager can give the client detailed analysis of their financial health and possible steps that he/she must take to fulfill their goals.
- A wealth manager can help simplify complex market data and help the client to make him/her understand the difference between good and bad investment.
- Apart from investment decisions a wealth manager can help take all decisions of charities and tax benefits.
- A wealth manager can better help the client determine allocation of wealth, prepare for retirement, asset transfer, tax optimization, savings etc. with his expertise and experience.
- A wealth manager makes long-term as well as short-term investment planning based on needs, make the strategies to fulfill the goals and work to achieve the target.

Guiding principles of wealth planning

- The most important consideration is suitability. Each client's situation is unique and therefore our planning must be based on unique personal factors and external factors.
- Wealth management plan must be simple. It must be understandable by the client easily.
- Goal must be realistic. High expectations from planning can lead to manager's as well as client's dissatisfaction.
- There must be adequate allocation of wealth. Mistake in such decision can lead to very disastrous results.

5.2 DISCUSS WEALTH PLANNING TOOLS THAT HELP UNCOVER A CLIENT'S SUCCESSION, ASSET PROTECTION AND OTHER FINANCIAL NEEDS AND GOALS.

A client's investment objectives and constraints are defined in his Investment Policy Statement (IPS). This document formalizes the discussions between the wealth manager and client about his financial goals. It guides the investment decision making process and supports evaluation of portfolio performance. Risk taking ability and required return together form investment objective of the client. There can be some internal or external restrictions in the available investment universe which are termed as constraints. The five main classes of constraints are discussed below:

- **Time Horizon:** It is the time period over which the portfolio is expected to generate the required return. The portfolio require to meet some specific need (such as buying a property or paying for child's education) which defines its time horizon. A longer time horizon improves investor's risk taking ability as the portfolio has abundant time to recover from losses.
- **Tax Constraints:** The tax environment must be taken into consideration as income and capital gains are taxed differently under different regimes. Also returns on certain investments are tax exempt while on some tax is deferred until withdrawals are made.
- **Liquidity:** It relates to the cash requirement over and above regular income at a specified time. Generally, it is deemed prudent to set aside a certain sum of money for emergency situations and that amount is invested liquid securities to avoid loss of value during redemption. A higher liquidity requirement translates into lower risk tolerance as the investment cannot be made into risky products.
- **Legal Factors:** It is an external constraint. An investor might not be able to investment in certain product or geographical region due to regulatory concerns.
- **Unique Circumstances:** It represents social concerns of an investor. A socially aware investor might not wish to invest in companies involved in tobacco, alcohol or arms and ammunition business. Certain investors might support some cause, like cancer research or children education, and would wish to invest highly in those areas. These must be considered by the wealth manager while financial planning of the client.

Factors influencing wealth planning

Personal Factors:

1. **Age:** It is an important factor in deciding risk taking ability. A young age person can afford risky and long-term investment as in case of losing money, he has time and energy to regain it however it is not the case for an old person. In this case, the manger would prefer safe investment even if the returns are

lower. An old person may have unavoidable wealth requirements like medical emergencies. Thus, high risk must be avoided.

2. **Risk profile:** It includes two things- one is risk taking ability and other is willingness to take risk. Both must be matched in order to take an effective decision. Risk taking ability refers to the individual's financial strength. If his income is stable and sufficient then the manager can consider taking risky investments however, in case of fluctuating and low income, the investment decision must be more carefully taken. Risk taking willingness means how much risk the client wants to take? What's his approach towards risk? He may be risk-averse, risk-seeking or risk-neutral. An entrepreneur might desire to take higher risk while an investor who has acquired wealth through inheritance might be afraid to take risk.

   A risk averse investor requires higher return for a small increase in risk, where a risk neutral investor is not affected by risk and demands the same return and in the case risk seeking investors, they love risk and require lower return for an increase in risk. A client having high ability but low willingness or high willingness low ability must be educated by the wealth manager and take a decision that is appropriate as per scenario. If either of the parameters suggest a low level of risk then the assets must be managed as low risk assets.

3. **Number of dependents:** It is important to see the number of members dependent on the client's for providing financial aid. If the dependent members are low, client can afford investing in risky assets.

4. **Philanthropic needs:** A philanthropic investor seeks to invest in non-profit organization to achieve greater social impact. The investor often takes an active role in shaping the entity they have invested. However, the wealth manager must take a note if the investor has much resource to donate or invest in non-profit organization as the main concern of the wealth manager is to keep sufficient amount for client's own need and after that only to fulfill client's additional desires.

5. **Source of Income:** A risky job reduces an investor's risk tolerance level whereas an investor whose job is secured can afford to take risks in his portfolio.

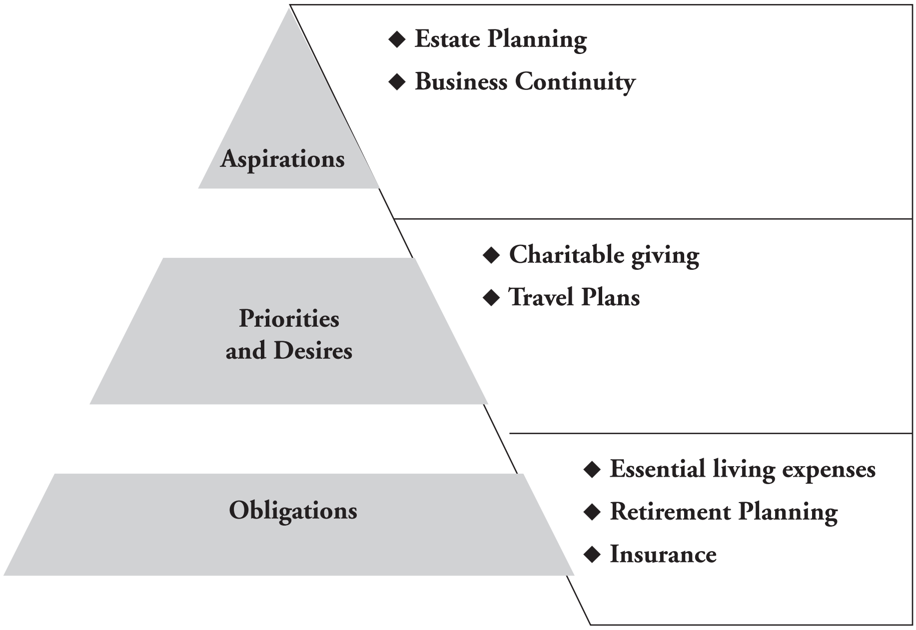
External Factors:

1. **Economic growth in the country:** Economic cycle influences the result of the investment. It really depends whether the cycle is moving towards recession or inflation. If the country is going well, the stock price will go up and vice versa. Therefore, it is necessary to examine the cycle and predict its movement in order to make investment strategy. It also helps in determining whether the investment should be in mid-cap or small cap, growth or value company. Risk free stocks or risky shares etc.
2. **Political stability:** Political stability helps economy to prosper and helps in good wealth planning. Instability in political and economic decision often imbalances the businesses and job sectors which ultimately affect wealth management.
3. **Interest rates:** This is the most important factor to take lending and borrowing decisions. Inflation, market demand etc. are the reasons of fluctuations of interest rates. Hence, interest rates influence the investment and wealth planning strategies.
4. **Global issues:** Finally, global economy affects the country's economy directly or indirectly which in turn affects the wealth planning. Global economy can directly affect in case of investment in foreign company's shares and it can effect indirectly through inflation, forex, export-import, lending-borrowing etc.

The above mentioned factors affect how the wealth manager needs to structure the financial plan to meet investor goals and desires.

Asset Protection

Investors tend to divide their assets in different layers and then assign the assets importance according to each level. It is known as goal based investing. The obligations level has the least amount of risk (like sovereign bonds) and the risk increases with each level. For the aspirational level the investor is ready to take any amount of risk and thus makes investments in products such as real estate or private equity which have huge upside potential. It helps the wealth manager in understanding the risk taking ability more clearly. However, the investor tends to ignore correlation between asset classes. It is consistent with the mental accounting concept of behavioral finance. It helps the investor to better understand his portfolio and improves client-manager relationship. The needs pyramid describes layers of goals based investing.



Client's succession

Succession planning

Let's first discuss client's succession planning. Effective wealth planning is a process which covers all the aspects of wealth i.e. financial, tax, equity, legal etc. Succession planning ensures that the wealth is managed sufficiently to payoff for the client's and his family. Few steps to achieve the goal of this planning are:

- Identify key stakeholders
- Determine financial needs and desires of the members
- Develop shared vision between client, his family and other parties.
- Prioritize most critical and important issues

Implementing succession strategy

After identifying goals, the next step would be to implement the strategy. It will include asset protection, ownership and management succession of companies or family, tax and insurance strategies, retirement planning and estate planning.

We need to consider issues such as legacy and birthright, interpersonal dynamics etc. to prepare successors to manage client's wealth in future. We can reduce future conflict for wealth by clarifying each member about their rights & responsibilities and about their ownership and authority. It's a responsibility of wealth manager to take care of such things and make them understand in the simplest manner possible.

Other Financial needs and goals

The client might wish to save certain sum of money for his retirement or for education of his children or any other goals as specified. The wealth manager needs to take everything into account while preparing the financial plan for the client.

Communication with the client

It is very important to effectively communicate with your client about the status of his wealth and the strategies the wealth manager is going to apply. More is the effectiveness of communication, better will be the client's understanding and better will be the client-manager relationship. Mode of communication must be decided as per the sensitivity of the subject. For example, sale of a high worth asset must not be communicated via personal meetings, etc. Different modes of communication:

Quarterly meetings

E-mail

Annual one-to one meetings

Annual client reviews

Phone calls

In-person meetings

5.3 EXPLAIN TRUST AND ESTATE PLANNING COMMON AND COMPLEX STRUCTURES

Estate Planning

Estate planning is a process of preparing and making arrangements, during client's life, for the client's estate for the time of client's incapacitation or death. An estate consists of all real and personal property. As the process includes minimizing gift, estate, generation skipping transfer and income tax, it requires extensive consultation with professional advisors including lawyers, accountants, financial counselors and life insurance representatives.

Purpose of Estate planning

The main purpose of estate planning is to ensure that all the properties of the client will be distributed as per his personal wish and there will not be any conflict after his death. It helps the client to decide who will get the benefit and to what extent. It helps in taking care of unnecessary tax imposed on transfer of asset at death. It also helps in encouraging the client to take important decision regarding his children and his health.

Some estate planning steps includes:

- Creating a will
- Limiting estate taxes by setting up trust accounts in the name of beneficiaries
- Establishing a guardian for living dependents
- Naming an executor of the estate to oversee the terms of the will
- Creating/updating beneficiaries on plans such as life insurance, IRAs etc.
- Setting up funeral arrangements
- Establishing annual gifting to reduce the taxable estate
- Setting up durable power of attorney (POA) to direct other assets and investments

Legal Systems, Forced Heir ship, and Marital Property Regimes

A country's legal system can affect the disposition of a will.

- Common law Jurisdictions: It allows the testator to freely dispose by will
- Civil law jurisdictions: Civil law countries place restrictions on such disposition.

Like legal principles in civil law, there are other statutes that place certain limitations on the free disposition of one's assets.

- Under forced heirship rules, children have the right to a fixed share of a parent's estate.
- Spouses also have marital property rights, which depend on the marital property regime that applies to their marriage:
    - Under community property regimes, each spouse has an indivisible one-half interest in income earned during marriage.

- In separate property regimes, each spouse is able to own and control the property as an individual, which enables each to dispose of property as they wish.

Taxes on assets

(1) **Tax on income**: It is levied at different rates for a variety of income categories such as compensatory income, investment income, etc. Investment income can be taxed annually on either an accrual or cash basis as income or gains are received. Also, tax can be deferred until the gain on an asset is ultimately recognized upon the sale or disposition of the asset.

(2) **Tax on spending**: It takes the form of sales taxes where a tax is applied to certain types of purchases.

(3) **Tax on wealth**: A jurisdiction may levy taxes annually on the principal value of real estate, financial assets, tangible assets, etc. Tax based on one's comprehensive wealth is often referred to as net worth tax or net wealth tax.

(4) **Tax on wealth transfers**: The two main forms of taxes on wealth transfers correspond to the primary ways of transferring assets: gifting assets during one's lifetime, and transferring assets upon one's death through a will.

Core capital and Excess capital

Core capital is required to maintain investor's lifestyle. It can be calculated based on life expectancy rate. Wealth manager need to determine the cost of core capital required and plan the investment and manage the wealth accordingly.

Excess capital is the extra capital to incorporate flexibility into estate plan. It helps in the cases of uncertainties or when the market resulted very poor. It helps in sustainability in such scenario. It also helps next generation to modify their plan in a better way without wealth constraint.

Transferring Excess Capital

There must be a proper planning to utilize excess capital as per the wish and requirements of the client. These ways to utilize could be:

Lifetime Gifts:

It is one of the very common methods of lowering taxable assets where one can donate or gift the discretionary wealth. However, to minimize tax strategy, countries having inheritance estate tax, also impose gift or donation taxes. Types and characteristics of gifts is also a consideration in order to determine about its taxability. Few of the considerations are:

- Tax-free gifts
- Taxable gifts
- Location of the gifts

A cross border gift can attract taxes in both of the donor's and the beneficiary's country. Also, if the tax liability is imposed on the donor's taxable estate rather than on the beneficiary, the tax benefit of the lifetime gift versus the bequest increases.

Generation Skipping:

Transferring assets directly to the third generation may reduce tax burden wherever the country's jurisdiction permits. Transferring excess capital to second generation and then the third generation will lead to the layering of double taxation. Hence, this strategy of generation skipping can help in avoiding the same.

Spousal Exemption

Most of the jurisdictions exempt the gift of assets by the decedents to their spouse without transferring any tax liability. It is advantageous for any state tax exclusions upon the death of the first spouse.

Valuation Discounts:

Transferring assets qualifying for valuation discount will help in mitigating estate taxes.

Deemed dispositions:

Some countries treat bequests as deemed dispositions, that is, as if the property were sold. The deemed disposition triggers the realization of any previously unrecognized capital gains and liability for associated capital gains tax. The tax is therefore levied not on the principal value of the transfer, but only on the value of unrecognized gains.

Charitable Gratuitous Transfers

Most jurisdictions provide two forms of tax relief for wealth transfers to not-for-profit or charitable organization:

- Most charitable donations are not subject to a gift transfer tax.
- Most jurisdictions permit income tax deductions for charitable donations.

- Charitable organizations may also be exempt from paying tax on investment returns, as well.

Estate Planning Tools

In most cases, estate planning tools include:

A. Trusts

B. Foundations

C. Life Insurance

D. Companies

Trusts

A trust is an arrangement to dispose or manage the property during grantor's life or after death. A trust will hold the property and can be flexible to the needs of the grantor. As a result, beneficiaries are just to get the benefits of the trust assets not the ownership.

Trusts can be categorized in many ways. Two important types of categorizations are:

Trust can be either Revocable or Irrevocable.

- **Revocable trust arrangement**: In this arrangement the grantor has the right to revoke the trust relationship and regain the title of trust assets. The settler is the owner of trust assets for tax purpose therefore, he is responsible to pay all the taxes and report trust's investment returns. Such revocable trust makes the trust assets vulnerable to the reach of creditor's having claims against the settler.
- **Irrevocable trust arrangement:** In this structure, trustee has the ownership and hence, he is responsible to pay the taxes and reporting asset's return. It provides greater asset protection from the claims of creditors against settler.

However, both a revocable and an irrevocable trust structure can result in the transfer of assets to the beneficiaries because the settler transfers legal ownership of the assets to the trustee and the transfer of those assets is as per the terms of the trust and not the settler's will.

Trust can be either fixed or discretionary structured

- Distributions to beneficiaries of a **fixed trust** are mentioned in the trust document to occur at certain times or in certain amounts.

- In **Discretionary trust structure**, the trust document enables the trustee to determine how much to distribute based on the beneficiaries' welfare and in the sole and uncontrolled discretion of the trustee. The settlor can make her wishes known to the trustee through language in the trust document or through a non-binding letter of wishes.

Other implications of trusts are:

I. **Control:** Trust structure lets the grantor share the benefits of trust assets with the beneficiaries without passing the ownership. It helps the grantor to have complete control over the asset.

II. **Asset Protection:** An irrevocable trust can protect the asset from the claims against the settlor while the discretionary trust can protect the asset from the claims against the beneficiaries. These structures must be established before the claims.

III. **Tax reduction:** Trusts also help in reducing tax:

   - A progressive tax rate schedule applied to trust income or beneficiary distributions may allow either the trust or beneficiary to apply taxable income to lower tax brackets
   - If an irrevocable trust is structured as discretionary, a trustee can consider a beneficiary's tax situation to decide whether or not to make a distribution in a particular tax period
   - A settler may create a trust in a jurisdiction with a low tax rate or even no taxes

Foundations

The main purpose of setting up the foundation is to fulfill specific goals like to promote education or philanthropy. Like trusts, foundations also continue after settler's death, fulfilling his desires to contribute towards society. However, foundation is a legal person that depends on client's residence or nationality.

Life Insurance

In this planning tool, the policy holder transfers assets to the insurer whose contractual obligation is to pay the regular premium to the beneficiary mentioned in the policy. It may be fixed or variable annuity. However the drawback of fixed annuity is the real value of the cash flows may decline over time. The main advantage of variable annuity is that it offers the opportunity to stay even with the rate of inflation. If an individual's human capital is fixed income like their financial portfolio than it should be weighted with similar non-risky fixed income assets. Life insurance premium also helps in reducing or exempt taxes and benefits the estate planning. It benefits:

- From a tax perspective, in many jurisdictions, Premiums paid to the beneficiaries are tax exempt and no reporting is required
- It effectively allows assets to transfer to the beneficiaries without any conflict.

Life insurance can help in protection of asset solely or one can take the combination of insurance and trust both. It is the most effective way especially in the case where the beneficiary cannot manage the assets by himself. The demand for life insurance will increase if human capital is bond like. Human capital is the expectancy of receiving a bonus is incorporated into the numerator it is zero at retirement. Example of human capital is social security payment retirement pension income. Life insurance is used to hedge against mortality risk and earnings risk but not longevity risk. Longevity risk can be solved through pension plans. Social security and other employment-related pension payments can be considered human capital because they are derived directly from the investor's labour but not financial capital because they are derived from an accumulation of the investor's past labour. An individual facing retirement does not have a greater amount of human capital than financial capital. Financial risk refers to the effects of volatility in the financial markets that could result in significant drops in portfolio values. Financial wealth and the demand for life insurance have negative relationship.

Also the volatility of human capital and the demand for life insurance are negatively correlated

Life annuity can be defines as a financial asset that is specifically designed to address the problem of outliving one's assets

Companies and Controlled foreign corporations

Assets can also be placed in companies. In Controlled foreign corporations, the company is located outside the home country and the tax payer has controlling interest in that company. One of the advantages of placing income generating assets in such companies is that the tax on earnings may be deferred till the timings the earning has been distributed to shareholders or company is sold. However, different countries have different rules regarding CFC, some may require the company to hold the assets in order to restrict tax payers to avoid taxes.

5.4 DISCUSS INTERNATIONAL TAX CONCEPTS FOR WEALTH PLANNERS.

International tax planning is necessary in order to determine the taxes subject to tax laws of different countries that will be imposed during investment or other wealth plan implementation. Governments of different countries imposes tax on individuals or companies on income. There are several types of such system of taxation, and there are no broad general rules. These variations create the potential for double taxation and sometimes no or very low taxation (tax havens). Income tax systems may impose tax on local income only or on worldwide income. Generally, where worldwide income is taxed, reductions of tax or foreign credits are provided for taxes paid to other jurisdictions. Limits are almost universally imposed on such credits. Multinational corporations usually employ international tax specialists to decrease their worldwide tax liabilities.

Tax Considerations

Income Tax: Taxation on the basis of sources of income

Source of income is where the income is considered to arise under the relevant tax system. The source of income is generally dependent on the nature of income. Sources of income can be income from services (e.g. wages), financing income like dividend or interests, income related to use of tangible property(e.g., rents) and income related to use of intangible property (e.g., royalties) is generally treated as arising where the property is used.

Capital Gain Tax: Taxation on the basis of appreciation at the sale of an asset or that has increased in sale.

The most common capital gains are realized from the sale of stocks, bonds, precious metals and property. Not all countries implement a capital gains tax and most have different rates of taxation for individuals and corporations. Taxes are charged by the state over the transactions, dividends and capital gains on the stock market. However, different countries have different fiscal obligations.

Wealth Transfer Tax: Taxation paid on total value of assets transferred via gifts, inheritance etc.

The wealth transfer tax is the transaction fee imposed on the transfer of title to property. This kind of tax is typically imposed where there is a legal requirement for registration of the transfer, such as transfers of real estate, shares, or bond e.g.

stamp duty, real estate transfer tax, and levies for the formal registration of a transfer. In broader sense, estate tax, gift tax, capital gains tax, sales tax on goods (not services), and certain use taxes are all transfer taxes because they involve a tax on the transfer of title.

Personal property tax: Taxes paid on the value of an asset.

As all personal property taxes are state imposed, each jurisdiction may include different types of property in the tax assessment. Additionally, these taxes are often imposed by local governments, such as cities and counties, making the rules even less uniform across the country. In some countries, this not only includes all furniture, tools and equipment one use in a business, but also the furniture inside your rental homes.

Tax Profiles of different types of investment account

Different countries have different criteria of imposing tax on investment account. The investor can invest in tax-advantaged manner. There are certain limits in such type of accounts to specified purposes like retirement and healthcare. These accounts are:

Tax-deferred accounts: Tax-deferred status refers to investment earnings such as interest, dividends or capital gains that accumulate tax free until the investor takes constructive receipt of the gains. It basically refers to an account where pretax funds are deposited. This helps in reducing the amount of tax to be paid as investors can claim tax deduction of the amount contributed which will help them to reduce taxable and also the tax due. In order to reap the benefit of tax deferred account one should allocate higher income generating assets to the tax deferred account. The individual retirement accounts (IRAs) and deferred annuities are the most common types of tax deferred investments. The advantage of tax deferral is that it allows compounded growth on the portion of earnings not forsaken to investment taxation.

Tax deferral benefits an investor in two ways. The foremost being it allows for tax free growth. The investment can grow unhindered without paying any taxes now. The second benefit of tax deferral is that, investments are typically made in the pre-retirement phase i.e. the earning phase of an investor. In comparison to the pre-retirement phase, the post-retirement phase has lower taxes. Thus, the investor would make withdrawals from the account when a lower tax rate is applicable on him/her.

Tax-exempt account: Tax exempt refers to income earnings or transactions that are free from tax at the federal, state or local level. A capital gain from sale of an asset usually creates a tax liability and a tax deduction can be used to reduce tax liability. However, in the case of tax exempt account, the gains are excluded from any tax calculations.

A tax deduction is usually allowed by government on certain expenses and investments by the tax payer. It is then reduced from gross income to arrive at taxable income. Federal and state tax codes provide many types of tax deductions, such as an individual taxpayer's deduction for home mortgage interest payments. Tax-exempt items, on the other hand, may be reported on the tax return for informational purposes, but the item is not part of any tax calculations.

If the investor has additional disposal funds i.e. the fund is not required for other purposes then he can contribute to the tax exempt account as it will help in maximizing the wealth even if the current and future tax rates are equal as it allows to save more money today and defer the current consumption. Moreover, it provides the highest wealth accumulation. Moreover, investors will be able to better fund their retirement as withdrawing money from this accounts are free from taxes and thus withdrawals from this types of accounts would not push them to higher tax bracket. Low income earners should focus on investing in Tax Exempt Account.

Tax loss harvesting

Tax loss harvesting is the practice of selling a security that has experienced a loss. In this process, investors are able to offset taxes on both gains and income. The sold security is replaced by a similar one, maintaining an optimal asset allocation and expected returns. Taking a loss now means that the loss amount is unavailable for future. If the benefit is taken now it will not be available for future and as a result taxes would be higher in future.

For example, an investor has invested $100,000 in the U.S. stock market via an exchange-traded fund (ETF), like SPDR S&P 500. Within the first week there is market correction and the value of investment comes down to $90,000. The investor can simply sell the ETF and reinvest the $90,000 back into the stock market.

In this manner, the investor has recognized a loss of $10,000 for tax purposes but his market exposure does not change. This recognized can later be used to offset taxable income leading to tax savings. Since the market exposure was constant there will not be any change in expected return (except for transaction cost).

Although you are keeping your market exposure constant, for IRS tax purposes, you just realized a loss of $10,000. You can use this loss to offset taxable income - leading to incremental tax savings or a bigger refund. Since you kept your market exposure constant, there really hasn't been a change in your investment cash flow, just a potential cash benefit on the tax return.

Benefits of tax loss harvesting:

- **The investor will not be exposed to short-term capital gains as a result of an attempt to harvest losses.** A dual-security asset class approach which enforces preference for one security, we never trigger short-term capital gains in an attempt to harvest losses.
- **Investor have zero cash drag at all times.** With fractional shares, and seamless handling of all inflows during wash sale windows, every dollar is always invested at the desired allocation risk level.
- **Investor will harvests also serve as an opportunity to rebalance** across all asset classes, rather than re-invest solely within the same asset class. This further reduces the need to rebalance during volatile stretches, which means fewer realized gains, and better after-tax returns.
- **Investor will never experience a disallowed loss through overlap with your IRA.** It eliminates the possibility of permanently disallowed losses due to subsequent IRA activity.

Limitations of tax loss harvesting:

- **Tax Regulations**

  The tax regulatory authority does not allow buying and then subsequent selling of an asset just for the purpose of paying less tax. The loss is disallowed if the same or substantially identical asset is purchased within 30 days. This is called the "wash-sale rule."

  However, an investor might buy an asset which is highly correlated to the previous asset but not "substantially identical". It enables to keep the market exposure without waiting for 30 days. Correlation is of vital importance here. For example, replacing the SPDR S&P 500 with another U.S. ETF, like SPDR Dow Jones Industrial Average, would get the investor almost the same market representation.

- **Income Threshold**

  There is a threshold on how much loss can be recognized. For an individual $3,000 and for a married couple filing separately is the limit of loss they can reduce from taxable income. While no revision of this income threshold is in place, most high net worth investors have gains in other aspects of their investment portfolios that render this tax loss useful. Even if it is not, the tax loss may be carried forward for use on future tax returns, creating only a slight decay in the time value of money on your tax loss.

- **Growing Portfolio**

  Realizing tax losses lowers tax basis, which makes harvesting harder to do the longer the portfolio grows; however, receiving the tax benefit up front is best, from the perspective of time value of money.

- **Administrative Cost**

  Additionally, transacting every time the market goes down can be onerous, from a tax-preparation standpoint. A general rule to use is that if the tax benefit outweighs the administrative cost, harvest the loss.

Potential Pitfall: The Wash Sale Rule

The place where people often trip up is by accidentally triggering the "wash sale" rule. A wash sale occurs when you:

1. Sell an investment for a loss, and
2. Buy "substantially identical" securities within 30 days before or after the sale.

When a wash sale occurs, the loss is disallowed. Fortunately, the cost basis of the investor's new shares is adjusted upward by an amount equal to the disallowed loss so that when he sells the shares in the future — assuming the wash sale rule has not been triggered— he will be able to claim the loss (or, depending on circumstances, a smaller capital gain).

Example: Dora had bought 500 shares of Google Inc. at $48 per share on 15th June, 2017. On 15th December, 2017 she sold those shares for $35 per share. On 20th December, 2017 she again bought 500 shares of Google at $38 per share. Her loss of $10 would be thus disallowed as the repurchase was within 30 days. Her new cost basis is $51 per share ($38 purchase price + $13 disallowed loss). It thus leads to a larger capital loss or smaller capital gain when she sells the shares in the future.

Wash Sales Due to a Spouse's Transactions

Investors hope to avoid the wash sale rule by having their spouse by the same investment after they themselves sell it at a loss. However, for the purpose of wash sale rules, an investor's spouse buying or selling an investment is considered as the same as he/she buying or selling the investment.

Wash Sales Due to Buying in an IRA

Investors also try to take advantage of tax profiling to avoid wash sale rules. They sell an investment in the taxable account for a loss and subsequently buy the same in their tax exempt account believing that since the accounts are titled differently the transaction would not trigger a wash sale.

This is not allowed either. Buying the same or substantially identical asset in any other account within 30 days of sale would result in wash sale.

Wash Sales Due to Buying Within 30 Days Prior to Sale

Investors often think that the wash sale is only triggered when the investment is re-purchased shortly after selling the same. However, the wash sale rule can be triggered if he/she has bought shares within 30 days prior to the sale.

Tax Planning

It is the analysis of the financial situation of a client from tax perspective. The purpose of tax planning is to create a tax efficient plan which aims at reducing the tax liability of the client by legally allowed methods. It helps in maximizing eligibility to contribute to retirement plans which is again vital for the success of the tax planning. It involves conceiving of and implementing various strategies in order to minimize the amount of taxes paid for a given period. The wealth manager can invest the client's money in different government approved schemes which are allowed as tax deduction.

Case Study

John Dawson is a financial advisor, counseling Bruce and his wife. Bruce is 75 years old with a 40-year-old son, Andrew. Andrew has a son of 15yrs old and a daughter of 19yrs old. Bruce wants to facilitate his family, but also wish to donate the majority of his assets to charity. Bruce's total asset base is currently USD 135,000,000.

Bruce lives in a community property jurisdiction where Andrew is entitled to receive half of the community property tax-free upon her death. Most of Bruce's wealth is considered separate property, with the community property amounting to only 15% of her total assets i.e. USD 20,250,000 where Andrew's entitlement is half of USD 20,250,000 which is USD 10,125,000.

Exhibit 1 summarizes gift and inheritance tax rates applicable to the Smith family.

Exhibit 1

Gift and inheritance tax rate

Tax Type	Tax Rate
Spousal inheritance tax	**20%**
Non spousal inheritance tax	**50%**
Spousal gift tax	**25%**
Non spousal gift tax	**30%**

Note: All taxes are due immediately at the time of the transfer and are paid for by the recipient.

Bruce feels that Andrew's legal entitlement under the community property rules will not be sufficient to meet his financial needs. John estimates that if Bruce were to die today, Andrew would need to inherit USD 12,000,000 net of any taxes to meet his needs. However, he will be entitled to get only USD 10,125,000 which will be USD 1,875,000 shortfall.

Assets bequeathed to Andrew, beyond his legal entitlement under the community property law will be taxed at spousal inheritance tax rate 20%. Therefore, Bruce would need to bequeath Andrew USD 1,875,000/(1-20%) which is USD 2,343,750.

Bruce's son, Andrew, works as a professor in a local college. He enjoys aluxurious lifestyle, as Bruce provides for his spending needs beyond his salary. Bruce states that he will stop providing ongoing support and instead make an immediate one-time gift to Andrew. His goals are to maintain his lifestyle, cover his children's' university expenses starting next year, and retire in five years. Bruce asks John to estimate the amount of the gift that would cover gift taxes and allow Andrew to achieve his goals. John will serve as Andrew's financial advisor and gathers the following information from him:

- Until retirement, Andrew's annual after-tax salary will be USD 35,000 and his annual spending needs will be USD 300,000.

- Combined annual cost of education for the twins is USD 180,000 for each of the next four years, and the first payment is due in a year.
- Andrew has no savings.

Andrew's annual net cash outflow during next 5 years =

Salary-spending needs-educational expense=

35,000-300,000-180,000 = USD -445,000

John determines that Bruce's gift to Andrew could be invested in a portfolio expected to earn a before-tax rate of return of 9% per year for the next five years. When Ryan retires in four years, he will need an investment portfolio valued at USD 4,000,000 to maintain his lifestyle in retirement. Andrew's investment returns will be taxed at 27% annually.

As required amount at retirement in 5 years is USD 4,000,000

After tax rate of return = 9% x (1-25%) = 6.75%

Present value of future needs = USD 2,546,343.84

Spousal gift tax = 25%, so before tax gift amount= USD/(1-25%) = USD 3,395,125.12

Therefore, Bruce needs to gift 3,395,125.12 out of her assets. After immediate payment of gift tax, Andrew receives USD 2,546,343.84

Andrew's high spending needs relative to his income is the prominent factor decreasing his ability to take risk. Andrew's major investments goals (children's education and maintaining lifestyle) rely almost entirely rely on portfolio withdrawals. Such a heavy reliance limits the portfolio's tolerance for losses. Other reasons that limit his ability to take risk are the desire to retire early and the lack of further financial assistance from Betty.

Factors that increase Andrew's ability to take risk are a long time horizon and the fact that he could return to work if necessary. Furthermore, Andrew can reduce his discretionary spending by reducing his standard of living.

Time horizon constraint Andrew's time horizon is long (20+ years) and has two stages separated by the substantial change in portfolio outflows starting at retirement:

- First stage (From present to the end of fifth year): The first stage is the next five years until the daughters graduate and Andrew retires.

- Second stage (Retirement period): The second period is from retirement until death.

Liquidity constraint Andrew has two needs for liquidity in the coming year:

Annual payment for the children's education	USD 180,000
(The first payment is due in 12 months)	
Annual living expenses	USD 300,000
Less salary	(USD 35,000)
Net liquidity need	USD 445,000

After children graduates from college and Andrew retires in five years, the portfolio's liquidity constraint declines substantially to his living expenses of USD 200,000 per annum

SUMMARY

1. Explain the concept of wealth management.
   - Coordinating all the services needed to manage client's money and plan for their own or their family's current and future needs.
   - A wealth manager can give the client detailed analysis of client's financial health and help in making long term and short term plans, taking decisions regarding important financial matters and helping him to fulfill wealth related goals.
   - Wealth management must be simple and planned as per client's suitability.
   - There must be adequate allocation of wealth and it must be reviewed and updated whenever needed.
2. Discuss wealth planning tools and succession planning.
   - A client's investment objectives and constraints are defined in his Investment Policy Statement (IPS).
   - There are personal and external factors that influence wealth planning. Personal factors include age, risk profile, number of dependents, philanthropic needs and unique constraints. Whereas external factors include economic growth in the country, political stability, Interest rates and global issues.

- Investors tend to divide their assets in different layers and then assign the assets importance according to each level. It is known as goal based investing.
- Succession planning ensures that the wealth is managed sufficiently to payoff for the client's and his family.
- Implementation of succession planning includes asset protection, ownership and management succession of companies or family, tax and insurance strategies, retirement planning and estate planning.
- Communicate effectively with the client about the status of his wealth and the strategies the wealth manager is going to apply.

3. Explain trust and estate planning common and complex structures.
    - Estate planning is a process of preparing and making arrangements, during client's life, for the client's estate for the time of client's incapacitation or death.
    - The main purpose of estate planning is to ensure that all the properties of the client will be distributed as per his personal wish and there will not be any conflict after his death.
    - A country's legal system can affect the disposition of a will. It may be common law jurisdictions or civil law jurisdictions. Also, there are other statutes that place certain limitations on the free disposition of one's assets which includes forced heir ship, community property regime and separate property regime.
    - Taxation must be considered during estate planning. 4 major tax assets are tax on income, tax on spending, tax on wealth and tax on wealth transfer.
    - Core capital is required to maintain investor's lifestyle. Excess capital is the extra capital to incorporate flexibility into estate plan. There must be a proper planning to utilize excess capital as per the wish and requirements of the client. These ways to utilize could be lifetime gifts, generation skipping, spousal exemption, valuation discounts, deemed dispositions and charitable gratuitous transfers.
    - Estate planning tools include trusts, foundations, life insurance & companies and controlled foreign corporations.

- A trust is an arrangement to dispose or manage the property during grantor's life or after death. It can be revocable or irrevocable trust agreement. Also, it can be fixed or discretionary structured.
- The main purpose of setting up the foundation is to fulfill specific goals like to promote education or philanthropy.
- In Life insurance, the policy holder transfers assets to the insurer whose contractual obligation is to pay the regular premium to the beneficiary mentioned in the policy.
- Assets can also be placed in companies. In Controlled foreign corporations, the company is located outside the home country and the tax payer has controlling interest in that company.

4. Discuss international tax concepts for wealth planners.
   - International tax planning is necessary in order to determine the taxes subject to tax laws of different countries that will be imposed during investment or other wealth plan implementation.
   - Main tax considerations are income tax, capital gain tax, wealth transfer tax and personal property tax.
   - Tax Profiles of different types of investment account includes Tax deferred account and tax exempt account.
   - Tax loss harvesting is the practice of selling a security that has experienced a loss by replacing it with a similar one, maintaining an optimal asset allocation and expected returns.
   - Tax planning is the analysis of a financial situation or plan from a tax perspective. The purpose of tax planning is to ensure tax efficiency, with the elements of the financial plan working together in the most tax-efficient manner possible.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	V	1	Sum total of market value of physical and intangible assets are _____.	money	properties	wealth	None of the above	**C**	Wealth can be calculated as sum total of market value of physical and intangible assets.
2	V	3	Which of the following is not considered human capital ?	Investment gains	Social Security payments	Retirement pension income	None of the above	**A**	Investment gains is not considered as human capital.
3	V	2	Which of the following investors would be considered to have low risk tolerance level?	High ability and Low willingness	Low Ability and High Willingness	High Ability and High Willingness	Both A and B	**D**	If either of the parameters suggest a low level of risk then the assets must be managed as low risk assets.
4	V	4	Tax loss harvesting is considered feasible when:	tax benefit outweighs administrative cost	tax benefit underweights administrative cost	tax benefit equals administrative cost	Either B or C	**A**	A general rule is that if the tax benefit outweighs the administrative cost, harvest the loss.
5	V	2	Which of the following is an internal constraint affecting wealth planning?	Unique Needs	Time Horizon	Liquidity Needs	All of the above	**D**	Unique constraints, liquidity needs and time horizon are all internal constraints affecting wealth planning.
6	V	3	Which of them is an advantage of a variable annuity over a fixed annuity ?	variable annuity offers the opportunity to stay even with the rate of inflation	variable annuity offers stable income over the life of the purchaser of the annuity	Rate of inflation is constant	None of the above	**A**	Variable annuity offers the opportunity to stay even with the rate of inflation is an advantage of a variable annuity over a fixed annuity.
7	V	1	Which of the following is not a guiding principle of wealth planning?	Standardization	Simplicity	Realistic	Adequacy	**A**	Wealth planning is done according to individual needs and not standardized for all individuals.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
8	V	3	Social security and other employment-related pension payments cannot be considered as:	financial capital because they are derived from an accumulation of the investor's past labor	human capital because they are derived directly from the investor's labor	neither human capital nor financial capital because they are received after retirement	None of the above	**A**	Social security and other employment-related pension payments cannot be considered as financial capital because they are derived from an accumulation of the investor's past labor.
9	V	3	In irrevocable trust who has the ownership?	Trustee	Grantor	Beneficiary	None of the above	**A**	In irrevocable trust, trustee has the ownership.
10	V	2	Mr. Pattrick is a client of, Frank Wheeler, wealth manager. Mr. Pattrick has instructed Wheeler to not invest in companies involved in selling of tobacco. How does it affect his risk tolerance level?	Increases	Decreases	Remains the same	Cannot be determined	**B**	As the investment universe available decreases risk tolerance level also decreases.
11	V	4	Accounts which accumulate capital gains tax free until the investor takes constructive receipt of the gains is known as:	Tax Deferred Account	Taxable Account	Tax Exempt Account	Tax Savings Account	**A**	Tax-deferred status refers to investment earnings such as interest, dividends or capital gains that accumulate tax free until the investor takes constructive receipt of the gains.
12	V	1	Which of the following statements is true about wealth managers?	They make both long-term and short-term planning	They takes decisions regarding charities and tax benefits	They determine allocation of wealth, asset transfer, savings etc	All of the above	**D**	Wealth managers are responsible for planning and taking all the decisions related to wealth.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
13	V	3	With regard to an individual's total wealth, which statement is least accurate? If an individual's human capital is fixed income like their financial portfolio:	should be weighted with similar non-risky fixed income assets	may be weighted more heavily towards risky assets	should be weighted with non-similar, non-risky fixed income assets	None of the above	**A**	If an individual's human capital is fixed income like their financial portfolio than it should be weighted with similar non-risky fixed income assets.
14	V	2	A client has specified that she has an investment horizon of 12 years in which she requires an annual return of 8%. The above statement relates to which of the following respectively?	Objective, Constraint	Both are Constraints	Both are Objectives	Constraint, Objective	**D**	Time horizon is a constraint whereas required return and risk form the investment objectives.
15	V	3	Which of the following is the benefit of transferring wealth to charitable organizations?	They are not subject to gift transfer tax	Charitable donations are permitted for income tax deductions	Charitable organizations may also be exempt from paying tax on investment returns	All of the above	**D**	All the above mentioned points are advantages of transferring wealth to not-for-profit charitable organizations.
16	V	1	Which of the following professionals provide wealth management advisory services?	Chartered Financial Consultants	Certified Financial Planners	Chartered Financial Analysts	All of the above	**D**	Chartered Financial Consultants, Certified Financial Planners or Chartered Financial Analysts, Chartered Strategic Wealth Professionals or any credentialed professional money managers provide wealth management advisory services.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
17	V	3	The volatility of human capital and the demand for life insurance are:	negatively correlated	positively correlated	uncorrelated	None of the above	**A**	The volatility of human capital and the demand for life insurance are negatively correlated.
18	V	4	Taxes applied on overseas contract worker is:	exempt	on income derived outside the home country only	on income derived within the home country and foreign countries	on income derived within the home country	**D**	Overseas contract worker pays tax only on the income earned within the home country.
19	V	4	Which account provides the highest wealth accumulation?	Tax Deferred Account	Taxable Account	Tax Exempt Account	Tax Savings Account	**C**	Tax exempt account provides for highest wealth accumulation.
20	V	2	Interest rates, global issues etc are part of ________.	Client's overall wealth planning	succession planning	Estate planning	Tax planning	**A**	Wealth planning gets effected by the personal as well as external factors like interest rates, global issues etc.
21	V	3	Which of the following is a tax on spending?	Wealth tax	Income tax	Export duty	Sales Tax	**D**	Tax on spending takes the form of sales tax.
22	V	3	Which of the following statements is incorrect regarding human capital ?	The demand for life insurance will decrease if human capital is bond-like	If an investor's human capital is equity-like they should allocate a greater amount of their financial capital to fixed income investments	When possible, one should maximize the correlation of human and financial capital	All of the above	**A**	The demand for life insurance will decrease if human capital is bond-like.
23	V	1	Which of the following statements is true about wealth managers?	They take both market and individual risk while making decision	They are concerned with only market risk not individual risk	They are concerned with only individual risk	They take all risks except market and individual risk	**A**	While making any investment decision, wealth managers take both market and individual risk.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
24	V	3	Which of the following statements regarding human capital volatility is least accurate? When human-capital is bond-like, an investor's financial assets should be	more aggressively allocated and their demand for life insurance will increase	more aggressively allocated and their demand for life insurance will decrease	allocated towards low risk assets and their demand for life insurance will increase.	None of the above	**B**	More aggressively allocated and their demand for life insurance will decrease.
25	V	2	In creating an investment policy statement, a portfolio manager needs to be aware that an investor's psychological profile may impact:	neither the investor's risk tolerance nor their return objective	the investor's risk tolerance and return objective	the investor's risk tolerance only	investor's return objective only	**B**	Psychological profile impacts investment objectives i.e. both risk and return.

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MODULE VI
FAMILY GOVERNANCE

6

Learning Outcome Statements

1. Explain the multinational nature of a family.
2. Discuss the ownership and family governance policies.
3. Discuss the need of informing the younger generation regarding family wealth.
4. Discuss informal & formal family constitution.
5. Describe leadership & decision making process.
6. Discuss dispute resolution in family business.
7. Discuss the family governance of Micro Media Group.

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MODULE VI
FAMILY GOVERNANCE

6.1 EXPLAIN THE MULTINATIONAL NATURE OF A FAMILY.

What is family governance?

Family governance means the structures and processes that families use to arrange themselves and channel their relationship with their business. With proper design and correct implementation family governance helps to set limits, create clarity, and result in better bond between family members, a more focused business, and also it becomes easier for the future generations. Family governance needs to look into the culture and objectives of a family in order to be useful.

Family governance doesn't just involve biologically related people. In-laws, individuals separated by divorce, adopted children, domestic partners and trusted family advisors can all be included in the family business. The interest of the unique family and its business needs to be balanced properly through family governance.

Need for Governance

It is very important to understand the best way in which a family works together and understand their decision making process and for that family governance is important. The aim of family governance is to reduce the number of conflicts and the number of poor decisions made by the business which can be achieved through proper clarifications over the decision-making process, responsibilities, business involvement and ownership privileges

One of the major plans of a family is to reserve its wealth for future generations and thereby as family grow, family governance becomes important. Family governance helps the families to preserve their wealth for more than three generations.

Family governance can help your family address and manage the following issues:

- Preserving the family and its wealth
- Addressing family and wealth dynamics

- Taking decisions together
- Proper communication
- How will we encourage stewardship and discourage entitlement?
- Development of future leaders
- Transition of control of wealth from one generation to the next
- Human and intellectual capital development
- Interaction between individual family members and family enterprise
- Deciding the appropriate limitations between family and family enterprise owners

Challenges

- **Loss of family identity and values** — A family has a plan to continue for successive generation and it forms the core of the family continuity plan along with its values and legacy. As the family increase in number these values starts to lessen. On one hand there are members who are making sure to continue the family values given by the founders, the other members are part of the management of the family business. It therefore becomes difficult as well as important to adapt those values and for these the wives of these members need to play an important role in order to ensure that the legacy of the family sans business is continued in future.
- **Family conflicts** — Business firms, due to ownership and management residing in the same people, have an advantage in the form of faster work. But as the family grows which faces conflict between different generations and the extended generations can because of this forget its basic advantage of speed with respect to other big organizations and thus lose out in the battle.
- **Dilution of wealth** — A division in the family leading to distribution of its capital o business, in addition to taxes, unnecessary spending can create a problem for the company by making it difficult for the family to get investments or any form of financial resources to flourish in its business. As it has less amount of capital, it can take advantage of fewer opportunities.
- **Lack of transparency** — Neither board of directors nor professional managers can make their value adding contributions to family enterprises without good metrics and clear scorecards. Shareholders themselves can seldom act as responsible shareholders in the absence of financial knowledge and finan-

cial controls. While entrepreneurial cultures often resist the call for greater transparency, after all the founding entrepreneur stayed on top of everything, next generation leaders are well served by investing in professionally assessing the pulse of the enterprise in real-time terms. Lack of transparency can also give rise to an absence of caring for the enterprise within the extended family. Absent caring, continuity is threatened

- **Lack of oversight and keeping it in the family** — In a normal corporate firm the management is held responsible to all the shareholders and it helps to maintain discipline in such firms .For family businesses that are not publicly traded this discipline is always lacking . Even if the business is publicly traded, there is lack of proper oversight because of complacence and resistance to change. It might just happen that some shareholders are given priority over others. This is one of the major challenges in a family business and keeping things inside a family only but creates more trouble.

Stages of Family Governance

- Fewer owners
- Less generations
- Owner & manager roles overlap
- Simpler decision making

- More owners
- Multiple generations
- Owner & manager roles separate
- Complex decision making

FAMILY CHARACTERISTICS

EARLY FOUNDER	LATE FOUNDER	EARLY SIBLING	LATE SIBLING	COUSIN
Parents with some college-age children	Parents with young adults entering the business	Parents, adult children and rising adults	Sibling parents and cousins (G3)	G3 siblings/cousin parents with G-4 siblings/cousins

FAMILY MEETING FORUM

◆ Informal family business meeting ◆ Irregular ◆ As needed	◆ Full family meeting 3-4x/year ◆ Often combined family & shareholder topics	◆ 61 & G2 adults ◆ G2 meetings ◆ Shareholder meeting ◆ G-3 education	◆ All adults or representative group ◆ Assembly ◆ Shareholder meeting ◆ Owner's council possible	◆ Representative family council ◆ Assembly ◆ Shareholder meeting

FAMILY COUNCIL

Key considerations

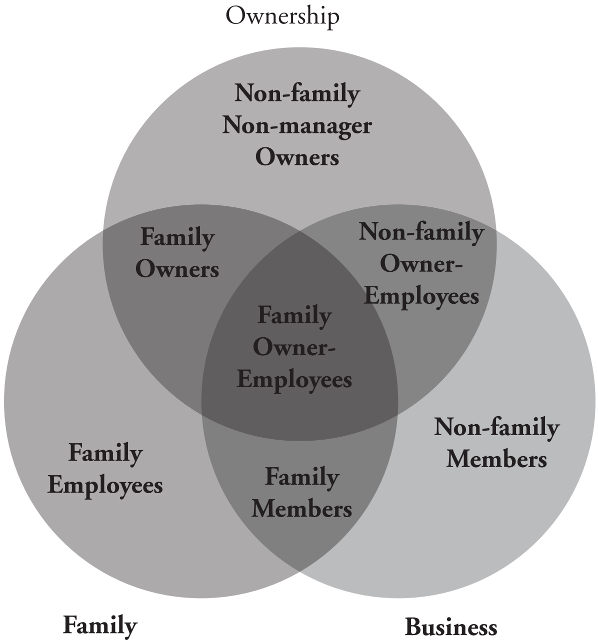
- **Make it purposeful -** The vision of the company should be taken into consideration while designing the family governance in order for it to be useful .Governance should be made good enough to achieve the business's objectives and not just for its own sake. It should be good enough to make sure the family business continues for generations to come and in making a difference.
- **Take it slow -** While improving family governance, importance must not be given to revolution. Instead evolution should be taken into account .One should not rush into things and take it slowly at the pace in which the family can prosper. Time is spent on reviewing one's habit and then making respective changes.
- **Keep it simple -**It is not necessary to make the family governance system complex in order for it to be good. It is more important for it to work properly. Ruthless changes with regard to boards or committees becomes too much and might overcomplicate everything.
- **Make it fit -** Different families have different needs and something which is right for one family might not be right for another one. Therefore it becomes necessary to create family governance which fulfills the needs of a particular family.
- **Do it together -** The entire family should be involved while making the family governance so as to ensure that there is a common objective behind making it and the unity of the entire family is helpful for financial success..
- **Be flexible** - One needs to be flexible in order to be successful and the same is with family business. Even the best plans needs changing at time and therefore it is important to make amendments at regular intervals. It is also suggested that the families come together every five years and make a review of the governance to see if it is in line with its goals and objectives and if it is not, make appropriate changes.

6.2 Discuss the ownership and family governance policies.

Three circle model

At the beginning of the start of family businesses the few people endorsing it were mostly concerned only about the business part. Gradually people realized the importance of another circle - family dynamics. People started taking into consideration the effect of family on businesses and vice versa. But the importance of ownership factors was ignored.

THREE-CIRCLE MODEL OF THE FAMILY BUSINESS SYSTEM



TAGIURI AND DAVIS, 1982

A proper model was needed to understand the dynamics of this business system and thus in 1982 the Harvard Business School developed The Three-Circle Model of the Family Business System The diagram represents three interdependent and overlapping systems in a family enterprise: family, ownership and business. Each of these systems must learn to communicate well in order to ensure that the business is efficient. Each system has a different responsibility and different decision to make and they should accept it. Family governance revolves around the way these systems interact for the benefit of the enterprise. In this way family governance helps to create interactions between family members and also helps in addressing and solving problems as it takes into account the interaction between the business and the family as well.

The Role of Family Governance

The following are the roles of efficient family governance -

- Set the vision for family business and look out for its philosophy relating to the relationship between the business and family.
- Define the set of values which will be followed in the business as well as while operating the business.
- History of the family, its ownership and values should be taught to everyone in order to prepare them.
- A proper plan for change in ownership and leadership succession should be made.
- Celebrate individual and family milestones.
- There should be proper communication with the owners.

Family councils

Different family members have different expectations and with the increase in the number of family members it is important to coordinate and ensure that their concerns are done with. Therefore a system is needed when building a family business and family council helps to do that. They stress that family governance simplifies and brings uniformity. Therefore it helps to keep the family governance up to date and with this consistency it can last for a considerable amount of time.

The family council grows with the growth in family. Family values are the core of a family and it helps to keep the family together. Family council helps to strengthen these family values. Both formal as well as informal family councils are used to better the family business governance. Family councils help the family members to come to a conclusion regarding the principles and practices.

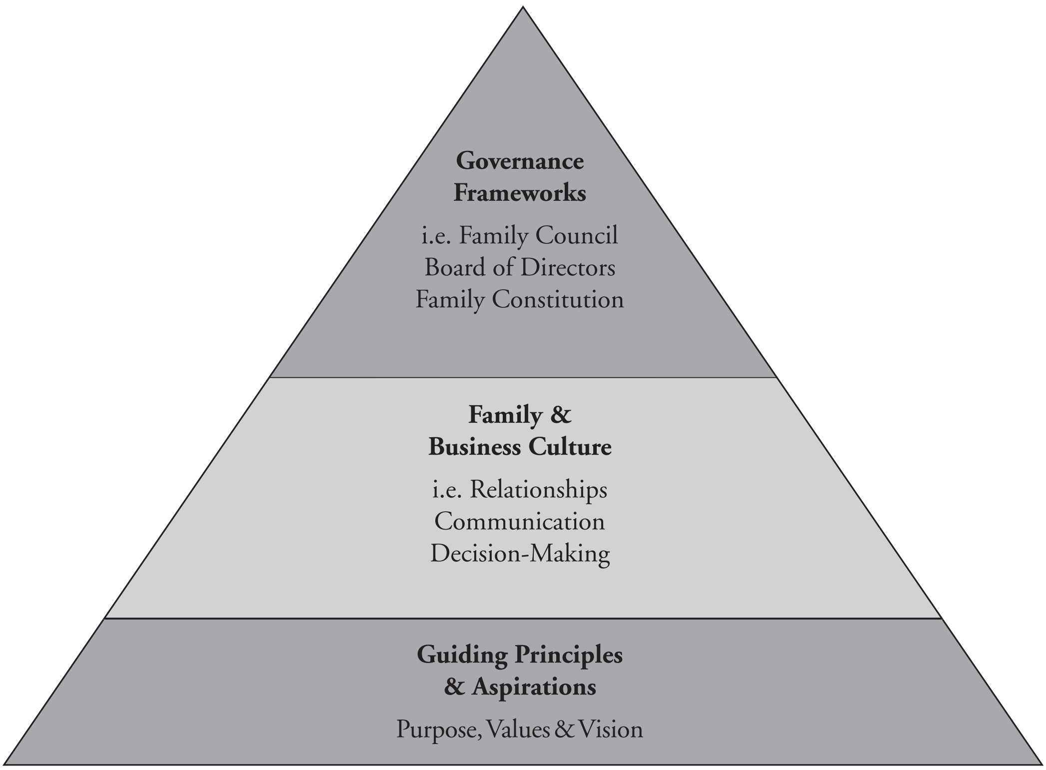
Family members often have various questions regarding the business and family and family council can be used as a platform to ask these questions. The council's governance can be either formal or informal. While informal means that the meetings are organized as and when required, formal means that there is a particular structure which needs to be followed.

A company's future needs to be discussed regarding how to mentor the successors or making sure that the competition between family members do not turn ugly. Family councils help to discuss all these and thus help in the continuity of family business.

Family council's role increases with the increase in the distance between the family and the company. Family council's structures and procedures needs to be changed when there are new owners (new generation). It is important to have activities where each member of the family can be present. It is very important to make sure that younger generations don't lose interest in the business. Family meetings needs to be organized to ensure that they are interested.

Each member has some expectation from each other as well as regarding their roles in the business. While some of them are realistic, others are not and therefore are needed to be clarified. Family meetings help to clarify these and create a sense of clarity in the family.

Pyramid of Family Ownership Success



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Few benefits of family council meetings are

- It helps to develop the business by understanding the family values and making sure that the coming generations are also aware of it.
- The history of the family business, how it operated and its strategies are appreciated so as to motive the family members.

- It looks after the needs of the family members. Family council meeting are important with regard to helping the members both emotionally and financially. For example providing education expenses of the children. It should become a proper support group of the family.
- It helps to solve the problems of different family members and make sure there is no conflict. There might be a case where a few members of the family are unhappy. It might be if other people are chosen over them on the basis of favoritism. Family council is an appropriate forum for them to address their feelings.

6.3 DISCUSS THE NEED OF INFORMING THE YOUNGER GENERATION REGARDING FAMILY WEALTH.

Most family business owners and wealth creators share an important vision of perpetuating the wealth their enterprise has created for many generations to come. To do this they make different plans and try to maintain a system so as to preserve the family wealth created by them.

It has been seen that wealth continuity is not being achieved in many families and a part of the problem is the failure of proper planning.

The problem usually arises when the founders pass away and their children inherit the wealth and they are not able to properly use it. This is because of lack of prior knowledge regarding the wealth. Therefore it is really important for the founders to inform the younger generation regarding the family wealth so that when the time comes they can help to take the business forward.

It is also important to involve the younger generation in decisions regarding them. Children need to be taught how to handle failure and this should start at a young age. Various opportunities need to be given to them to grow properly. They need to be taught about the difference between self-worth and net worth. They have wealth and they need to be the given the responsibility which comes with wealth.

Families cultivate "Family Champions" and identify these potential future leaders of the family early (young adulthood). Family Champions is the next generation leader and helps to bring all the owners together as stakeholders and making the business effective. The aim is to make sure that the family business continues through the generations.

Most of the times there is a need for those children who wants to be entrepreneur whether or not they want to be a part of the family business or they want to start their own venture. But children are rarely the exact copy of their parents and therefore even if they want to be entrepreneur they might start a business which has very little relation with the family business. These families need to make sure that the younger generation gets the prefect platform to start their new venture. There should be a proper approval process through which it can be done.

The CEO parent has the difficult task to choose the children who will lead the family business. They want to avoid making this decision and therefore they turn towards the board to make this decision. Even if a particular child is much better than the other one it is emotionally draining for the CEO parent to choose one of them

Growth in family business is much more challenging than growth in non-family enterprises because the shareholders have a lot at stake: family.

6.4 DISCUSS INFORMAL & FORMAL FAMILY CONSTITUTION

Most of the family families have failed before reaching the third generation and it more because of conflicts within the business and not the external factors. In order to avoid the risk of damaging the governance of family wealth structure it is important to lay down a clear set of value for the members.

Family constitution is a concept which has come up because of the growing disputes and complexities in business. It helps to reduce conflicts in business by making a formal document regarding the family's values and wealth and its vision over time. In larger businesses, a thorough family charter lays down policies to ensure and define long-term ownership. It keeps the family together but also provides a mechanism for division. It explains the contract with regard to the members who want to exit.

The family constitution is also known as "Family Creed", "Family Protocol", "Statement of Family Principles", "Family Rules and Values", "Family Rules and Regulations", and "Family Strategic Plan". The constitution changes as the business continues and evolves. In other words, it needs to be updated on a regular basis to incorporate all changes in the family and in the business. However, a typical family constitution will cover the following elements:

1. Vision of the family and its values.

2. Family institutions
3. Board of directors (and board of advisors if one exists).
4. Senior management.
5. Authority, responsibility, and relationship among the family, the board, and the senior management.
6. Policies regarding important family issues such as family members' employment, transfer of shares, CEO succession, etc.

Formal constitution has been lacking in most of the family companies, they have a set of informal constitution consisting of the different rules and regulations. This informal constitution talks about the expectations of the various family members and their rights and obligations. But this can lead to conflicts and therefore it is important that with increase in the family size a well written family constitution is developed and shared with all the members.

- Family Member Employment Policies

  Family member employment policies form an important part of the family constitution. One of the problems of family businesses is that they end with more employees than what is needed and these employment policies help to overcome this. Sometimes it might just happen that an employee is not good enough for the job only. In some cases members end up owning business which has no relation with their family business or are unprofitable just to make sure everyone in the family has a job.

  When a family reaches the sibling partnership stage it becomes important for the families to make their family members` employment policies official by setting up rules regarding the terms and conditions for a member to get employed in the business. In addition to this it also states about the rules for leaving the business or staying in the business. It also covers the difference in the treatment of the family members from the non-family members.

  Family employment policies have different matter in different business. A particular concrete set of rules is not followed everywhere. While there are families which do not allow their members to work in the business while there are families which want the members to have certain qualifications in order to work in the business. Employment conditions should be prepared in such a way that it doesn't favor any of the family members or discriminate against any of them. It helps to maintain an environment of equality and it motivates them to be better.

After preparing it properly and making sure everyone agrees to it, it should be distributed to all the family members. It helps to create understanding among the family members and they will know what to expect.

- Family Member Shareholding Policies

  Family members need to have knowledge regarding the shares ownership rights and therefore for some companies it becomes important to describe the shareholding policies at the starting of the family business. It helps the family members by stating what are the produces regarding their shares i.e. how they can sell their shares if they prefer cash over shares.

  As the number of shareholders increase, each shareholder will have a smaller share and therefore they will get lower dividends. This is more harmful for the minority shareholders and this frustrates them and it can create conflicts in the organization. Shareholders love having a liquidity option and giving them the same for their shares can avoid conflicts in the business and increase its chance of survival.

  There are a lot of hurdles in the implementation of the constitution, mainly the legal hurdle. In addition it is costly to implement it.

  The constitution also leads to formation of revocable and irrevocable trust structures and testamentary wills of family members. In several cases, promoters want to transfer shares of listed companies to the trust, which needs clearance from the capital markets regulator.

6.5 DESCRIBE LEADERSHIP AND DECISION MAKING PROCESS

Family vs. Non-Family Managers

During the first years of their existence, family businesses are usually directed and managed by the founder(s). Their management structure may remain quite informal and the decision-making power is concentrated in the hands of the founder(s) and a few close relatives. This management structure usually works well during the early stage of development of the company. A driven and hard-working founder(s) is usually the main reason for the success of a family business at this stage.

As the company grows in size and its business operations become more complex, a more formal management structure, a decentralized decision making process, and a qualified management body become necessary to deal with the complexity of the business and the more challenging day-today operations. Unfortunately, many family businesses ignore the need for professionalizing their businesses and keep senior management positions exclusively for family members.

Although many of these family members are skilled managers that add value to their business, often they are not qualified to perform such duties. Even in the cases where all family members are good managers, they may not have the specialized skills and expertise that the growing and more complex company requires. Successful families in business understand that in the longer term, some family members should step down and be replaced by more professional and skilled outsiders.

Ensuring that the family-owned company has the right senior managers is a process that should start early, even as early as during the founder(s) stage of the family business. Some of the steps of this process are:

- Analyzing the organizational structure and contrasting the current and optimal roles and responsibilities (compared to peer companies) of each senior manager.
- Designing a formal organizational structure that clearly defines the roles and responsibilities of all senior managers. This should be based on the company's current and future business operations' needs.
- Evaluating the skills and qualifications of the current senior management based on the new organizational structure.
- Replacing and/or hiring senior managers.
- Decentralizing the decision-making process and approval levels as necessary. Decision-making powers should be linked to the roles/responsibilities of managers and not to their ties to the family.
- Establishing a clear family employment policy and making its content available to all family members.
- Developing an internal training program that allows skilled employees to be prepared for taking on senior assignments in the future.
- Establishing a remuneration system that provides the right incentives to all managers depending on their performance and not their ties to the family.

CEO and Senior Management Succession

One of the most important issues that affect the family business is the succession of CEO and senior management. Top management has a lot of hand in the growth of the company and in order for the company to do well it is important to have proper successor. This becomes even more important in case of a family business. With increase in the number of family numbers more and more members are up for the post of the senior manager and the family needs to select from the pool. A family shouldn't leave this planning until the last minute because it can create problems. For instance, in case of the sudden death of a family member it can create problem and conflicts within the family. Poor senior management succession planning could indeed be one of the reasons most family businesses disappear before they reach their third generation

Senior management succession is a process that follows several steps in order to ensure proper succession to key management positions including the CEO one. A formal succession plan ensures business continuity and thus increases the chances of survival of a family business as it is handed over from one generation to the next. The purpose of this plan is to ensure the skills and leadership necessary to replace any outgoing senior manager are available when needed. An effective CEO succession plan should allow for the selection of the most competent person (whether it is a family member or not) as the next CEO. In addition, it is crucial to involve all family members, the board, key senior managers, and other important external stakeholders in the selection process and make sure they agree on the next CEO choice.

Board of directors

The board of directors is a central institution in the governance of most companies, including family-owned ones. Different family businesses have different composition, role or structure of the board of directors. The factors which determine these are the size and complexity of the business. Board of directors is appointed to make sure that the company works in accordance to the legal requirements.

The board meets once or twice in a year and they meet for short periods. All these depend on the local regulation. Most of the times, the board includes of the family members while it some cases it can include non-family senior managers who are trusted well. The company's owners are also seen as the member of the board or as a senior manager. Such a governance structure adds little value to the family business as each element of this structure (board, management, and family) could separately play a more active and constructive role within the governance of the company.

With the increase in the complexity in the family business the board's importance increases with regard to the company's strategies and the review of the performance of its managers. The company relies a lot on the board. All these require the board to meet more and in order to be effective they need to be given independence and they need to be proper experts.

Before moving to a fully professional board that has the ability to act in the best interest of the business, independently from the management and controlling shareholders, many family businesses set up an advisory board that complements the skills and qualifications of their current directors.

Family Assembly

Also called "Family Forum", the family assembly is a formal forum for discussion for all family members about business and family issues. Initially when the company is formed assemblies are organized informally and are termed as family meetings. These help to transfer the family values. It also leads to creation of new business ideas and help the new generation to develop as leaders. But with the increase in the complexity in the family business it becomes important to establish a family assembly formally.

Purpose: Its main purpose is to get all the family members together so that they can work on the basis of their common interests. In the family assembly every member is given the opportunity to say what they feel whether it is regarding the family issues or the business development. Possible conflicts are avoided due to these assemblies by providing equal access to information. It is held once or twice in a year. Some of the issues handled during family assemblies include:

- Changes in the values of the family or its vision which needs to be approved
- The rights and responsibilities of the members need to be educated to them.
- Approval of family employment and compensation policies.
- Election of family council members (if the council exists).

6.6 DISCUSS DISPUTE RESOLUTION IN FAMILY BUSINESS.

Though most difficulties that the family business encounters are same as the other businesses but there is another challenge that they face. This is the challenge with regard to maintaining proper relationship between the family members and this happens all the more when the business is going through a bad phase.

Problems go on to increase with the coming of the new generations and therefore it is the least when the first generation handles the business. As the second-generation people become a part of the business problems begin to grow. It is important to have a proper system to deal with the conflicts between the family members because if they go against each other it can lead to a lot of expenses as legal actions are taken.

Formal conflict resolution systems are being created. It has increased in importance as it gives the perfect platform for the members to voice their opinion and clear out the differences between the different members. Because of the high emotions involved, it becomes difficult to resolve the issues. Therefore the family conflict resolution mechanism can be effectively used to resolve the conflicts between the members. Usually outside members who are respected by the family members and are trusted by them are involved to clear out the differences. It helps to give an independent voice in the organization. Therefore what the independent person does become very important becoming the best way to resolve the internal conflicts.

If the conflicts are not resolved on time, it will lead to delay in decision making which is harmful for the business. Family meetings, no matter how difficult it gets, is only useful in the end. These help to make decisions faster and resolve the conflicts within the organization. It helps to build trust among the members which helps them to work together in order to make the business successful in the long run.

Formal governance can help lessen family and financial issues by unraveling ownership of the business from its management functions. It helps people to voice their opinion and helps to save the business problems which can arise when people feel that they are not being listened to or appreciated.

Family members should be encouraged to properly say what they feel whether it is a concern or a suggestion or anything they feel bad about. The management should listen to them properly and then come to a conclusion.

Many large complications begin as small problems that could have been sorted with early intervention. Sometimes, spotting issues early and addressing them through clear communication can be enough to prevent a conflict from developing. Even when family members see each other regularly in the business, formal family meetings can be a better place to hash out complex issues.

Whether it's at a family retreat or simply at a separate meeting, making a break from daily routine to tackle the big issues can help open lines of communication. A formal setting can also help ensure that issues are not ignored and that members of the family have the opportunity to make their opinions heard.

6.7 DISCUSS THE FAMILY GOVERNANCE OF THE MIRO MEDIA GROUP

In 2003, the Miró family began to meet regularly as a family to discuss family and business issues. They maintained this tradition and over a period of time they developed a family constitution. This constitution was prepared for guiding the future generations regarding succession and planning. In this the guidelines were established for the involvement of family members and the eventual transition across generations.

The family constitution included a statement of family values; criteria for employing family members and restricting the employment of in-laws; behavioral expectations of next-generation members involved in the company; principles regarding the relations between family and nonfamily managers; guidelines for decision making, including the CEO/father's tie-breaking role during the next five to seven years; policies for the performance reviews of next-generation members; and a commitment to the professional management of the family-owned enterprise by both family members and key nonfamily executives.

Family council meetings were given top priority; these monthly meetings had to be attended by all the owners and managers. These meetings were conducted for discussing about the business, investments, stress management, the succession process, conflict between the siblings or between family and non-family managers and relationships between family members. Any kinds of conflicts arising between them were addressed.

According to one in-law, family dynamics improved as a result of the meetings: "I am a lot more confident and optimistic since these family meetings started and the brothers and sisters started communicating more and more regularly. It takes time to express and listen to other opinions and understand the different perspectives. Without it, and without accommodating others' ideas, all you are doing is competing."

The main purpose of conducting these meetings was to establish unity in the family; and through much communication, listening, and compromising, trust was built. In 2005, the first family weekend retreat was held. It included the spouses of next-generation members. Spouses were briefed on the state of the business (financial results, strategy of the various business units, and new developments). Later in the retreat, the family reflected on its legacy and recommitted to several core values that it wanted to pass on to the next generation. Subsequently, the family developed a mission statement for its principal holding, the newspaper El Diario, and for the Miró family.

The family mission statement was formed which stated the role of spouses in a supportive yet vital role vis-à-vis the family members who worked in the family enterprise. Several spouses had demanding careers of their own in other fields. Over the next several years, these annual retreats continued to update spouses on the family enterprise, promote analysis and discussion of family business cases with relevance to the family's current situation, nurture candid discussion about the unique skills and career aspirations of various next-generation members, and review the dynamic vision for the family and the firm.

Preliminary designs for the holding company were drafted; this company was to become the GrupoMiró. In 2010, one of the legacy family enterprises that was not part of its now core media industry holdings was sold to a strategic buyer. This created a US$200 million windfall for the family to re-deploy as a family enterprise.

Carlos Miró successfully transferred power to the fourth generation at the end of the eight-year generational transition period much as he had planned. According to him the most important resource available to family enterprise is the family unity. The most direct contributors to family unity in the eight-year plan, besides the very large reservoir of love and goodwill with which he and his wife had endowed the family, were his family council/family retreats and the entrepreneurial spirit of that next generation. After the fourth generation took over management and ownership control of the family enterprises, they decided that they needed a family office to assist them in the combined mission of creating and preserving wealth.

The family office was initially staffed with key finance and administration staff from the existing family enterprise, in due course of time the fourth generation that they needed fully dedicated staff and advisors to run the family office. Soon thereafter, key staff was moved to a separate building and a professional non-family director of the family office was hired. Investment advisors to the family were retained, a multi-family office was charged with providing additional investment and administrative services and a separate board of directors for the family office was established.

SUMMARY

1. Explain the multinational nature of a family
    - Family governance means the structures and processes that families use to arrange themselves and channel their relationship with their business
    - Family governance doesn't just involve biologically related people
    - It is very important to understand the best way in which a family works together and understand their decision making process and for that family governance is important
    - The vision of the company should be taken into consideration while designing the family governance in order for it to be useful
    - One needs to be flexible in order to be successful and the same is with family business
2. Discuss the ownership and family governance policies.
    - At the beginning of the start of family businesses the few people endorsing it were mostly concerned only about the business part
    - A proper model was needed to understand the dynamics of this business system and thus in 1982 the Harvard Business School developed The Three-Circle Model of the Family Business System
    - Different family members have different expectations and with the increase in the number of family members it is important to coordinate and ensure that their concerns are done with
    - Family council's role increases with the increase in the distance between the family and the company

3. Discuss the need of informing the younger generation regarding family wealth
   - Most family business owners and wealth creators share an important vision of perpetuating the wealth their enterprise has created for many generations to come
   - It has been seen that wealth continuity is not being achieved in many families and a part of the problem is the failure of proper planning
   - Children need to be taught how to handle failure and this should start at a young age
   - Family Champions is the next generation leader and helps to bring all the owners together as stakeholders and making the business effective
4. Discuss informal & formal family constitution
   - Most of the family families have failed before reaching the third generation and it more because of conflicts within the business and not the external factors
   - Family constitution is a concept which has come up because of the growing disputes and complexities in business
   - The family constitution is also known as "Family Creed", "Family Protocol", "Statement of Family Principles", "Family Rules and Values", "Family Rules and Regulations", and "Family Strategic Plan".
   - Formal constitution has been lacking in most of the family companies, they have a set of informal constitution consisting of the different rules and regulations
   - Family member employment policies form an important part of the family constitution
   - Family members need to have knowledge regarding the shares ownership rights and therefore for some companies it becomes important to describe the shareholding policies at the starting of the family business
   - As the number of shareholders increase, each shareholder will have a smaller share and therefore they will get lower dividends
5. Describe leadership and decision making process
   - During the first years of their existence, family businesses are usually directed and managed by the founder(s)

- As the company grows in size and its business operations become more complex, a more formal management structure, a decentralized decision making process, and a qualified management body become necessary to deal with the complexity of the business and the more challenging day-today operations
- Top management has a lot of hand in the growth of the company and in order for the company to do well it is important to have proper successor
- Senior management succession is a process that follows several steps in order to ensure proper succession to key management positions including the CEO one
- The board meets once or twice in a year and they meet for short periods. All these depend on the local regulation
- In the family assembly every member is given the opportunity to say what they feel whether it is regarding the family issues or the business development.
- Possible conflicts are avoided due to these assemblies by providing equal access to information

6. Discuss dispute resolution in family business
    - Though most difficulties that the family business encounters are same as the other businesses but there is another challenge that they face
    - This is the challenge with regard to maintaining proper relationship between the family members and this happens all the more when the business is going through a bad phase
    - Formal conflict resolution systems are being created
    - Many large complications begin as small problems that could have been sorted with early intervention

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	VI	3	Why is growth in family enterprises much more challenging than the non-family ones?	Lack of proper management	Lack of funds	Family sentiments	Lots of owners	**C**	Growth in family business is much more challenging than growth in non-family enterprises because the shareholders have a lot at stake: family.
2	VI	4	Family constitution contains:	Family institutions	Vision of the family	Board of directors	All of the above	**D**	All these form part of the family constitution.
3	VI	2	Which of these is a role of family governance?	Set vision for family business	Celebrate individual and family milestones	Ensure proper communication	All of the above	**D**	All these form part of the role of family governance.
4	VI	1	Family governance helps in preserving wealth for how many generations?	One	Two	Three	More than three	**D**	Family governance helps the families to preserve their wealth for more than three generations.
5	VI	6	Why is resolving of issues difficult in case of family business?	Emotions	Legal Problems	Complex structure	Time taking	**A**	It becomes difficult to resolve the issues in family business because of the high emotions involved.
6	VI	2	Which of the following statements is false about family council?	Family council grows with the growth in family.	Its governance is formal in nature.	It helps to keep the family governance up to date.	It helps to strengthen the family values.	**B**	Family council governance can be either formal or informal.
7	VI	6	Which of the following is false?	Problems increase with the coming of new generations	It is important to have a proper system to resolve the conflicts	Family meetings might not be useful in the end	Family members should be encouraged to say what they feel	**C**	Family meetings, no matter how difficult it gets, is only useful in the end.
8	VI	3	Who is family champion?	The next generation leader	The brightest of all the children of a family	The founder of family business	None of the above	**A**	Family Champions are the potential future leaders of the family.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
9	VI	6	Which of the following statements is false?	Formal family meetings are a good place to hash out complex issues.	Formal governance can help lessen financial issues.	Family meetings slow the decision making process.	Family meetings help resolve conflicts within the organization.	**C**	Family meetings fasten the decision making process.
10	VI	5	Which of these is false?	Top management has a lot of hand in the growth of the company	A formal succession plan ensures business continuity and thus increases the chances of survival of a family business	it is crucial to involve all family members, the board, key senior managers, and other important external stakeholders in the selection process and make sure they agree on the next CEO choice	None of the above	**B**	All these are true.
11	VI	1	How does family governance help?	Makes decisions for the family	Reduces family conflicts	Forms a rigid set of rules to follow	All of the above	**B**	The aim of family governance is to reduce the number of conflicts and the number of poor decisions made by the business.
12	VI	2	Which of these are the benefit of family council meetings?	Family needs	Problem solving	Understanding family values	All of the above	**D**	All these form part of the benefits of family governance.
13	VI	2	The three circle model was introduced in the year _____.	1990	1984	1982	1980	**C**	In 1982 the Harvard Business School developed The Three-Circle Model of the Family Business System.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
14	VI	3	Which of the following must be followed to continue family business across generations?	Teaching children how to handle failure	Informing younger generation about family wealth	Involving younger generation in decision making	All of the above	**D**	The generations must be involved and informed in the family business and also must be taught to handle failure to ensure growth of family business across generations.
15	VI	5	A formal succession plan is integral for:	Legal simplicity	Business Ownership	Business continuity	None of the above	**C**	A formal succession plan ensures business continuity.
16	VI	4	What happens with the increase in shareholders?	Smaller share and lower dividends	Higher share and higher dividends	Lower share but higher dividends	Higher share but lower dividends	**A**	As the number of shareholders increase, each shareholder will have a smaller share and therefore they will get lower dividends.
17	VI	5	As the company grows what becomes necessary?	A more formal management structure	A decentralized decision making process	A qualified management body	All of the above	**D**	All these are necessary for a company to grow.
18	VI	4	What is used to resolve family disputes?	CEO	Board of directors	Family conflict resolution system	None of the above	**C**	Formal conflict resolution systems are being created to resolve family disputes.
19	VI	4	What is employment policy needed?	It covers the difference in the treatment of the family members from the non-family members	They solve the problems of family ending with more employees than what is needed	It also states about the rules for leaving the business or staying in the business	All of the above	**D**	All of these are included in the employment policy.
20	VI	1	Which of the following statements is false?	The family governance system must be simple.	The vision of the company should be considered while designing the family governance.	Only the elder most generation is involved in the family governance process.	The governance plan must be flexible.	**C**	The entire family should be involved while making the family governance.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
21	VI	3	What is the major reason for family not achieving wealth continuity?	Overcrowding of shareholders	Members envying each other	Poor planning	Industry distress	**C**	It has been seen that wealth continuity is not being achieved in many families and the major part of the problem is the failure of proper planning.
22	VI	5	Family assembly is also known as:	Family forum	Family council	Family creed	All of the above	**A**	Also called "Family Forum", the family assembly is a formal forum for discussion for all family members about business and family issues.
23	VI	2	Which model states about the relationship between family, ownership and business?	The Triangle model	The relationship model	The family business model	The three-circle model	**D**	A proper model was needed to understand the dynamics of this business system and thus in 1982 the Harvard Business School developed The Three-Circle Model .
24	VI	1	Who all should be involved while making family governance planning?	CEO	Board of directors	Founders	Entire Family	**D**	The entire family should be involved while making the family governance so as to ensure that there is a common objective.
25	VI	5	The success at the initial stage of family business can be accredited to:	Board of directors	CEO	Entire Family	Founder	**D**	A driven and hard-working founder(s) is usually the main reason for the success of a family business at the initial stage.

MODULE VII
FAMILY OFFICES

7

Learning Outcome Statements

1. Explain the concept of Family Office.
2. Discuss the management and structure of family offices.
3. Discuss the benefits of setting up a family office.
4. Discuss the operations or services provided by a family office.
5. Discuss family office investments.
6. Discuss family offices and technology.
7. Discuss family offices and governance.
8. Discuss risk management in family offices.
9. Discuss the family offices in India.

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MODULE VII
FAMILY OFFICES

7.1 EXPLAIN THE CONCEPT OF FAMILY OFFICES.

Private wealth management advisory firms which serve the ultra-high-net-worth individuals are known as family offices. They provide a complete financial and investment solution to affluent individuals and families hence contrasting from wealth management firms. They provide services like tax advice, insurance planning, family-owned business, estate planning and philanthropy activities. As the provision of advice ultra-wealthy families under a wealth management plan is beyond the capacity of any one professional advisor, family offices offer an outsourced solution for the same.

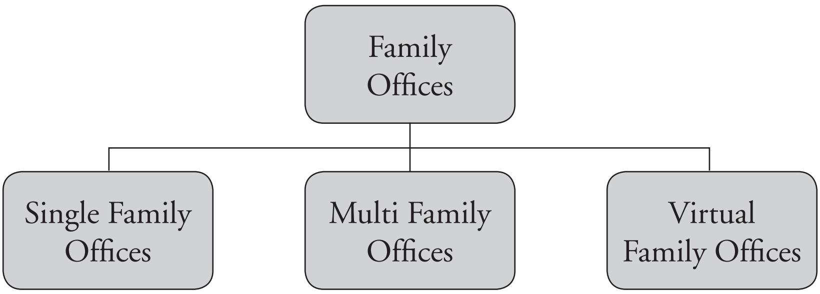
It is believed that the amount of family wealth under management should at least be USD 100 million since the individual services of a family office are tailored to the family, and are correspondingly costly for lower levels of wealth sizes to run profitable offices. The costs of the family office in addition to the return target must be covered by the assets with the help of chosen asset allocation and structure.

Family offices can be arguably called the fastest growing investment vehicles in the world today. Globally there are approximately 3,000 single family offices 50% of which were set up as early as the last fifteen years. The growth of family offices has been fueled by the increasing concentration of wealth among certain individuals or families and the globalization of financial sector. In the emerging markets, there are various large family businesses found however, family offices are yet to take hold in those markets. It will be a very important market for growth of family offices in the years to come.

7.2 DISCUSS THE MANAGEMENT AND STRUCTURE OF FAMILY OFFICES.

Family Offices are a team of professionals from the legal, insurance, investment, estate, business and tax disciplines. These professionals together make a collaborative and coordinated effort to provide the planning and advice needed. Most family offices combine asset management, cash management, risk management, financial planning, lifestyle management and other services to provide a comprehensive wealth management service required.

There are three major types of family offices:



(*a*) Single family offices: A private company that manages the wealth of a single family is called a single family office. While multi-family office seeks to build a portfolio of clients, single family offices serve one ultra-affluent family. Typically, a fully functional SFO will engage in all, or part of the investments, trusts and estate management of a family, apart from handling the non-financial issues too, such as concierge functions like private schooling, travel arrangements and miscellaneous other household arrangements.

(*b*) Multi-family offices: A multi-family office manages the financial affairs of various unconnected families to avoid the risk of bearing high operational cost of a single-family office. They manage trusts, estates and tax issues of multiple families and also their investment accounts. Often due to the success of the single family office, it transitions to a multi-family office as other families push for access. When the single family office starts to manage affairs for other families as well, it becomes a multi-family office. They are generally commercial and sell their services to these families.

(*c*) Virtual family office: Families who do not wish to set up an actual company to achieve the benefits of a family office can opt for a virtual family office.

A virtual family office can be set up by outsourcing all services to external consultants and service providers.

7.3 DISCUSS THE BENEFITS OF SETTING UP FAMILY OFFICES.

The root cause to set up family offices has been to facilitate the smooth transfer of wealth to the next generation and reduction in intra-family disputes. With every generation families grow to be larger and more complex thus increasing complexity in managing their wealth. The following points discuss the benefits and need of a family office:

1. Governance and management structure: A family office can transparently deal with complexities of the family's wealth and provide governance and management structures that help the family to avoid future conflicts. Wealth management as well as other advisory services for the family members can now be covered under a single entity, as confidentiality is ensured under the family office structure.
2. Alignment of interest: In this structure, the advisor works towards the goals of the family as a whole and thus, the interests are better aligned. It is, however, difficult to achieve in a situation where different advisors work for different family members.
3. Potential higher returns: Family office structure ensures lowering of risks and higher return through the centralization of asset management activities. As the portfolios of all the family members are combined better diversification can be achieved under professional management. The investment process can be better formalized to help maximize investment returns for all family members.
4. Separation: Family offices help in distinction between the family business and the remaining wealth of the family and thus, managing it accordingly.
5. Centralization of risk: Family offices manage consolidation of operational performance management and reporting. This can help the advisor and the family owners to make effective decisions in order to meet their investment objectives.

6. Centralization of other services: Family offices also help in coordinating professional services including philanthropy, tax and estate planning, family governance, communications, and education to meet the family's mission and investment goals.

7.4 DISCUSS THE OPERATIONS OR SERVICES PROVIDED BY FAMILY OFFICES.

The most important service provided by any family office is investment advisory. Family offices provide other services too ranging from training and education to monitoring family governance. This chart below provides the full range of services a mature family office could potentially provide:

A. Financial planning

Investment management services: This is the main reason for setting up a family office. These services include:

- Analysis of the financial situation of the family
- Determining their return objectives and perception towards investment
- Determining the family's investment horizon and risk tolerance levels.
- Appropriate asset allocation strategy
- Supporting banking relationships
- Managing liquidity for the family
- conducting due diligence on investments and external managers

Philanthropic management: Managing a family's philanthropic efforts is an important part of the role of a family office. This would involve the establishment and management of a foundation to cater to charitable causes. These services would typically involve planning of the philanthropic activities of the family, assisting then in the establishment and operation of a charitable institution, assistance in the creation of foundation and trust and also in the organization of any charitable activities.

Life management and budgeting: Although these services are defined as concierge services, but they are broader in scope as they also include budgeting services. Services under this heading include:

- Club (golf, private, etc.) memberships.
- Management of holiday properties, private jets and yachts.
- Budget services, including wealth reviews, analysis of short- and medium-term liquidity requirements, and long-term objectives.

B. Strategy

Training and education: This revolves around the education of the next generation on issues including wealth management and financial literacy, as well as wider economic matters. These services include:

- Organizing family meetings.
- Ensuring family education commitments.
- Coordination of generational education with outside advisers.

Estate and wealth transfer: Family offices will be involved in business succession and legacy planning, enabling the transfer of wealth to the next generation. These services include:

- Wealth protection, transfer analysis, and planning related to the management of all types of assets and income sources.
- Customized services for estate settlement and administration.
- Professional guidance on family governance.
- Professional guidance regarding wealth transfer to succeeding generations.

Business and financial advisory: Beyond asset management advisory, family offices will also provide advisory services on financing and business promotion. These include bridge financing, private equity, business development, business combinations, structured financing, etc.

C. Governance

Administrative services: Administrative services, or back-office services, are essential to the smooth running of a family office. These services include opening bank accounts, bill payments, compliance and control management, legal referrals, employee management, etc.

Succession planning: A smooth succession and planning for future generations is an integral to the long-term wealth management of the family it serves. These services include:

- Continuity planning relating to unanticipated disruptions in family leadership.
- Evaluation of the strengths, weaknesses, opportunities and threats (SWOT analysis) of senior executives both within and outside the family.
- Re-evaluation of the family board regarding the roles of non-family directors.
- Structuring corporate social responsibility platforms and programs.
- Development of formal knowledge-sharing and training programs.

- Implementation of intergenerational estate transfer plans.
- Adoption of a family charter or constitution, specifically aiming to:
  - Formalize the agreed structure and mission of the family business.
  - Define roles and responsibilities of family and non-family members.
  - Develop policies and procedures in line with family values and goals.
  - Determine processes to resolve critical business-related family disputes.

Reporting and record keeping: The maintenance of records and ensuring there is a strong reporting culture is another core element of a family office's services. Key to these services are annual performance reporting, benchmark analysis, tax preparation, consolidating performance reporting etc.

D. Advisory

Risk management and insurance services: This is a service that has assumed a more important role in recent years because of the financial crisis of 2008-09 and the subsequent fallout. It will be a crucial service for family offices in the future as well.

Compliance and regulatory assistance: Family offices need to ensure strict compliance with regulations pertaining to investments, assets and business operations.

Tax and legal advisory: Tax advisory is a very important function for a family office and family offices have proved to play a large role in management of tax issues of their clients. A family office typically employs a general counsel and/or accountant and tax experts.

7.5 DISCUSS FAMILY OFFICE INVESTMENTS.

Risk Management Services

Risk analysis, measurement and reporting.

Assessment of insurance requirements, policy acquisition and monitoring.

Evaluation of existing policies and titling of assets.

Evaluation of security options for clients and property.

Formulation of disaster recovery options and plans.

Protection of assets, which could involve the use of offshore accounts.

Development of strategies to ensure hedging of concentrated investment positions.

Compliance and regulatory assistance

Providing internal auditing.

Establishing a corporate governance mechanism.

Ensuring quality of staff hiring.

Group performance monitoring and compliance.

Offering recommendations on independent and board advisory formation.

Strengthening the regulatory investment process.

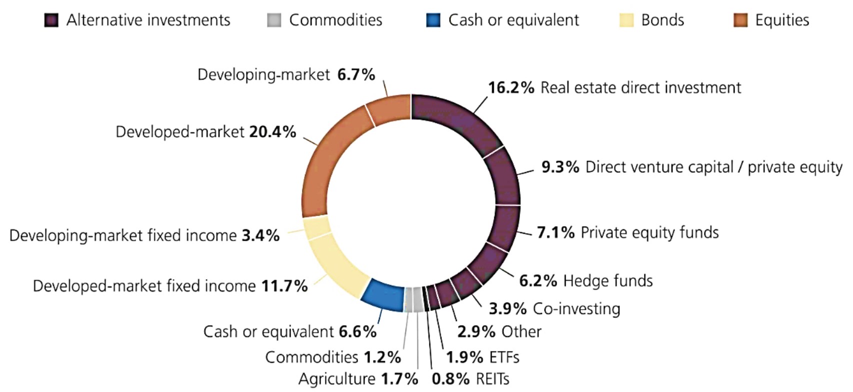
Tax and legal advisory

Construct a tax plan to best suit the family.

Design investment and estate planning strategies that take into account both investment and non-investment income sources and their tax implications.

Ensure that all parts of the family office are tax compliant.

Fig 1.1. Average family office portfolio
in % of global composite portfolio



Equities have represented large chunk of investments made by family offices in keeping with previous trends. Allocations to this asset class rose even further to account for over a quarter of the average family office portfolio, after a year of improved performance. Investment in equities rose 2.5 in the year 2017, according to a report surveying multi-year participants in developed markets. However, investment in developing markets equities remained relatively unchanged, at 7.8%, according to the same report. Many family offices are looking to earn private equity returns without having to pay large fees to an outside manager, managing the fund. In a survey released in May 2017 by the Global Family Office Report, Family Office Exchange found that out of the 118 family offices surveyed, on an average two of the three investment staffers in each office were focusing on private equity.

"Direct investing gives family offices the opportunity to invest — as a lead or co-investor — in companies they know well and where they, on average, expect double-digit returns," Sara Hamilton, Family Office Exchange's chief executive officer, said in a statement at the time.

Also, on an average surveyed Family Offices gave $5.7 million to philanthropic causes in the past year, with 95% eager on maintaining or increasing their donation commitment in the coming year.

7.6 DISCUSS FAMILY OFFICES AND TECHNOLOGY.

Technology has been a major player in the making of the modern day family office. Hence, finding the right professionals to manage these platforms has become imperative. Historically, the family office first identifies its core technology needs and once these can be fulfilled, choosing or creating solutions becomes simpler. Automation is another important key to controlling costs and mitigating risk. The IT tools and platforms that a family office should consider are:

- Custody platform (bank, brokerage or trust company).
- Consolidated reporting.
- Trading and portfolio management tools.
- Risk management tools.
- General ledger and accounting software.

- Client Relationship Management (CRM) tools.
- Tax preparation software.

The selection of these tools is focused on finding ways to provide efficient reporting, trading, portfolio management, and accounting. Given the common nature of service, the software can be outsourced easily, such that the family office resources can focus on growing wealth. The tools discussed above range from standard products to sophisticated and customized solutions.

1. Custody platform: The use of multiple custodians creates the obligation to consolidate assets. This can be done by a third party vendor, in-house with the proper investment in systems, or through a global custodian. The custody of bankable assets is the safekeeping and servicing of assets, either with one or multiple custodians or banks.
2. Consolidated reporting: Championing this process early on will allow families to understand their investments and identify the risks related to them. It will also strengthen confidence in their family office. Consolidated reporting is highly recommended and is known to be valuable for the Family Office.
3. Trading and portfolio management tools: Family offices can either employ an asset allocation model or make their investments on their own, in which case portfolio management and trading systems become more important. Various functionalities can be added to the model infrastructure for the increased scale and complexity.
4. Risk management systems: This is split into two different systems: Real-time/Near-time and End of Day. Real-time/Near-time risk is provided by some portfolio management system providers and functionality includes real-time sensitivities, valuations, scenario analysis, among other things. End of day risk system includes Value at Risk calculations, complex scenario analysis, etc.
5. Client relationship management(CRM): A CRM tool is used to manage critical information, in one central database. Information in a CRM database mostly includes the contact information of the family, family discussions regarding services or major family events, the structure of the family and third party contacts such as, accountants, lawyers and insurance contacts.
6. Human capital and technology: It is crucial to have the right person(s) in place for managing and operating the solutions. Such individuals, who may

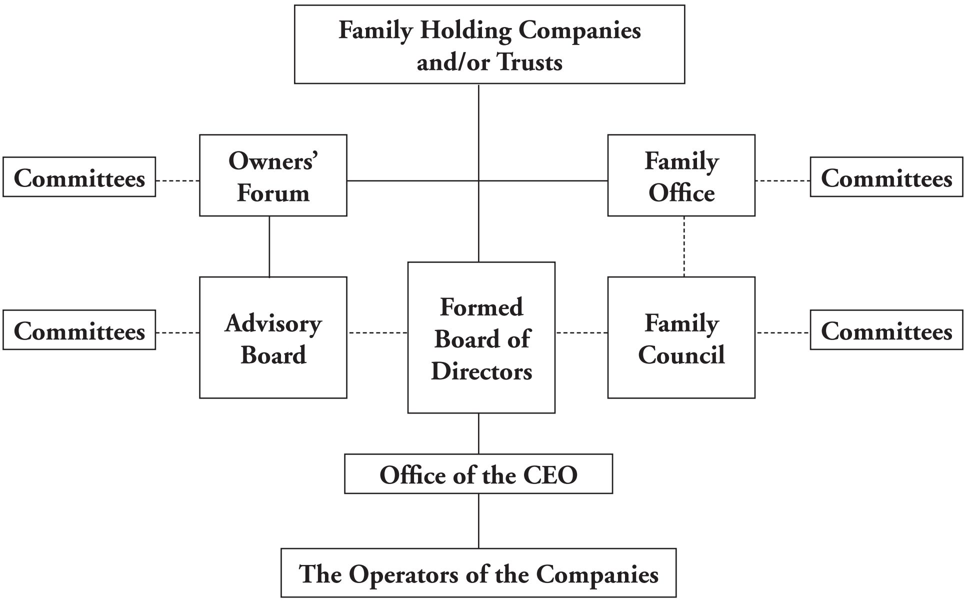
be in dual operational roles, should have an understanding of performance analysis and of accounting principles. They should have the ability to leverage technology for integrating various processes. Depending on the size and technical complexity of the office systems, some family offices need a Chief Technology Officer and a team responsible for support, updates, communication and software training. In this case, the division might need the involvement of external consultants too, who can provide advice with regard to implementation.

7. Implementing technology: After deciding on the core needs and appropriate solutions for the same, effective implementation is vital. Appropriate implementation may include the following:
    a. A detailed project plan that sets out the responsibilities with regard to each process.
    b. Agreeing the data import processes with each vendor.
    c. Creating data and functionality test scripts for each platform.
    d. Hiring an external consultant for data output testing.
    e. Holding frequent meetings with each vendor on progress and on project plan milestones.

7.7 DISCUSS FAMILY OFFICES AND GOVERNANCE.

Family office governance is a system that establishes structures and policies to facilitate joint decision-making. It is led by a board of directors and a family council, which helps a family to govern its wealth and businesses. The aim of family governance is to support the long-term survival of the family business and the family's wealth by ensuring rational economic decisions. A family office board of directors oversees the operations in the family office at the same time, safeguarding the family's interests by liaising with them. The board can help to avoid conflicts by controlling the relationships between family members, shareholders, and professional managers. They also support the achievement of financial goals and promote and protect the unity of the family.

As the family grows, family members are often reluctant to formalize their decision-making process as ground rules for decision making makes some family members feel their decisions have been confined. However, gradually, stakeholders start trusting the ground rules for group decision-making. These rules time and again prove valuable in times of crises and without guiding principles and a predictable decision-making structure, the family cannot function efficiently. It may happen that the lack of a decision-making process may result in missed opportunities, or worse, it might disintegrate. The family typically evolves in stages over time, and by the third or fourth generation, the enterprise can become a complex system to support the evolution as shown in the diagram below.



In complex systems, multiple boards are required for decision making. Leadership is shared by family members from each branch who are supported by experienced external advisors to ensure that a broad perspective encourages the family to grow and develop new visions.

The decision-making process develops over time, based on historical family practices and preferences. As the less experienced family members analyze the various alternatives, the quick minded owners would need to wait patiently. The group decision is only as solid as the commitments made by each member of the family, even when each branch of the family speaks through the voice of one representative leader. As families grow large, branch differences are replaced by age diversity across branches. In such families, the voice of the newer generations must be heard by the older ones, to develop a shared vision of the future.

For a family office, effective governance has the following benefits:

1. It helps the office to achieve the family's vision of success while acting in accordance with the family's values
2. It can be scaled up or down in line with the complexity of the family, the assets, the clients and the services
3. It ensures that the family office abides by relevant laws and regulations and hence creates accountability
4. It helps to manage risk while promoting fast decision-making and improves transparency
5. The structure operates as designed even in times of extreme stress and conflict

Single family offices can work efficiently and effectively with natural governance as it is possible to make informal decisions as and when they are needed. Hence, it is widely believed that family office does not necessarily lack governance without formal structures with set policies and procedures for making decisions. Informal ways of doing things a certain way can be equally successful.

Other family offices, particularly those that become more complex over time or change in a way that makes decision-making more difficult, require a more formal method to ensure that they operate effectively. The respective rights and responsibilities of three separate and distinct groups comprising of the family office. Family members and the management will need to be clarified. Each will see the family office from a different perspective, having its own needs and objectives:

- A family office would provide appropriate investment advice, financial advice, reporting, tax and administrative services. Families are mostly concerned about return on investment, timeliness, accuracy, compliance, privacy and risk management. While these services are necessary, the cost of delivering these services should be reasonable for the family.
- Members of the management group, who run the family office operations, should be having the same interests as other senior executives. What they should aim for is appropriate compensation with an added bonus potential, a comfortable working environment, professional staff, right business relationships and the budget to accomplish the work. They also seek balance of responsibility and authority, and opportunities for job and personal advancement.

- Family members expect the family office to provide services in a way which supports the family's shared purpose and promotes family legacy and values. They want the family office to make their lives simpler in terms of wealth management, to enable them to reach their own individual goals and remove hindrances from that path.

However, as the wants of all groups cannot be satisfied at any point, as a result, conflict becomes unavoidable. For successful family governance, different perspectives, needs and objectives of each group should be properly harnessed to make the family office more successful. The idea should be to design a decision-making or governance system that will promote optimal intra-group or inter-group decision-making to resolve conflicts effectively and achieve the strategic objectives of the family office.

Natural governance

Particularly when a small group with a common value system and objectives work together, natural governance can not only be effective, it is also efficient. But as the family grows and its structure becomes more complex, it generally proves difficult to maintain a natural governance system. Newer additions to the family such as employees, spouses and next generation family members don't have the background, experience or firsthand knowledge to understand the way things have been done until now.

As such natural governance has proven to be prone to catastrophic failure in times of crises. As has been generally observed, natural governance often falls short, giving way to a more formal governance system, when a larger, more diverse group seeks to exercise joint control over the family office. This situation typically arises as the family and the family office grow more complex over time.

Formal governance

Designing a formal and effective governance system for family offices is a four-step process:

1. Understand the family's vision and purpose

   It is common knowledge that no two families have the same purpose. And therefore understanding the family's vision for the future, its plans for achieving that vision, and the individual life aspirations of family members, all shaped by the family's values is incredibly important.

2. Understand the complexity of the family office

   Formal governance will be all the more important in complex family structures. As multiple decision-makers make interlocking decisions, the nuanced and unspoken rules that make up a natural governance system, will tend to break down. Decisions such as liquidity decision, implicate management, clients and family and to be made effectively, will require balancing the short and long-term needs and interests of all three groups.

3. Determine appropriate governance structures and policies that suit the shared purpose and complexity

   Governance structures and practices need to be formal enough to allow the family office, clients and family to not hinder fast decision making but providing an impetus to effective decision making about the assets being managed. However, the more complex the family and its assets are, the more complex the governance structure will need to be.

4. Implementation of feedback systems to ensure organized accountability

   In an effort to design better governance, best practices have been adopted by many family offices. However, many such family offices revert to their old patterns instead of following the practices in the manual and are often surprised when conflict resurfaces. 'Best practices' have over time, proven to be a good starting point, but they are rarely specific or targeted enough to handle the specific circumstances that a family office would typically find itself in. The family, clients and management instead need to work together to design a governance system that will fit the value system, purpose and complexity for its effective adoption in the family.

   Family office can be a valuable tool for appropriately situated families seeking greater control over the management of their affairs. However, establishing a family office is only the first step of what should be viewed as an ongoing process. For example, a governance system that was sufficient in a family office's earlier years can't be expected to function effectively as it evolves and becomes more complex in nature.

   Revaluating the suitability of the family office's governance system from time to time is the key to ensuring that a family office's benefits are optimized. Designing effective governance requires an understanding of each family's unique and changing circumstances.

7.8 DISCUSS RISK MANAGEMENT IN FAMILY OFFICES.

Risk, return and liquidity are among the most important issues to be considered in any investment decision and asset allocation process. A risk management process is therefore a vital part of the family office structure needed to formalize the family's approach to risk. The basis for the risk management system are what these prerequisites will be, which in itself will cover risk mitigation and cost reduction and may lead to value creation.

Risk review	◆ Establish risk appetite of family and family office: Which level of risk is acceptable? ◆ Define a common understanding of the risk level among family members, the investment committee or other relevant boards and the family office.
Risk identification	◆ Establish a detailed risk identification process. ◆ Identify and document quantitative and qualitative risks. ◆ Define the main drivers of volatility of the main asset classes/ investments.
Risk measurement	◆ Measure impact of risks on investment decisions. ◆ Prioritize risks according to impact level and likelihood of occurrence.
Risk reporting	◆ Include relevant and sufficient level of information in regular reporting. ◆ Establish family governance to deal with the risk management.
Risk mitigation	◆ Establish measures to mitigate at least the top priority risks. ◆ Chances need to be identified in the same way as risks. ◆ Establish regular monitoring of the family risk landscape.

7.9 DISCUSS THE FAMILY OFFICES IN INDIA.

Family businesses are widely found all across India, but family offices are a relatively new phenomenon signaling to the drastic changes taking place in India's financial culture. Traditionally, Indian families have exercised tight control over their businesses through the generations, ploughing back most of their profits into operations to ensure they remain under the family's control. In the past five years, however, many first-generation Indian entrepreneurs, influenced by global business trends and a focus on professionalism over family, have cashed out large portions of their original businesses, releasing substantial funds. Many have also set up family offices through which they are investing some of this wealth, focusing on traditionally lower-risk assets such as property, treasuries and alternative investment funds.

1. Catamaran Ventures

   Catamaran Ventures is the family office of NR Narayana Murthy, one of the founders of Infosys, the Indian technology company. The office was set up in 2010 and reportedly had an original fund of ₹ 6bn ($94m today). So far, Catamaran has invested in sectors such as healthcare, pharmaceuticals, education technology, insurance, retail and ecommerce. Catamaran looked as though it had a big winner when it invested ₹ 280m in SKS, a Hyderabad based micro-lender that was valued at $1.5bn in an initial public offering (IPO) six months later. But before Catamaran's one-year lock-in period was over, SKS was hit by a repayments crisis that sent the business crashing down. The family office is also the majority owner of a joint venture with US-based Amazon called Prione, whose Cloudtail arm is the largest merchant on Amazon India. The venture seems to have helped Amazon, which is investing heavily in India, to circumvent government restrictions on foreign direct investment in retail businesses. Prione describes itself as dedicated to helping small enterprises to sell their wares online.

   Catamaran was also an early investor in Hector Beverages, which produces traditional Indian drinks in modern packaging under the Paper Boat brand. Catamaran's stake is worth $36m, according to Crunchbase, the data provider. But having identified a successful market, Paper Boat faces growing competition from global beverage heavyweights and there is no timeframe for an IPO.

2. RNT Associates and RNT Capital Advisors

   RNT Associates is the personal investment vehicle of Ratan Tata, former chairman of Tata Sons, the conglomerate whose interests range from salt to steel. After his retirement, Tata became an adviser to venture capital firm Kalaari Capital and its companies. Inspired by India's young tech entrepreneurs, he also began to invest in a personal capacity, taking meetings and decisions himself. The investments were, for the most part, small — one of Tata's friends says his stakes are often less than 1 per cent of the equity — but the endorsement of one of the most formidable personalities in Indian business has helped put many start-ups on the public radar. In 2014, RNT invested in ecommerce platform Snapdeal and the following year in Ola, India's homegrown answer to Uber, the ride-hailing business, and Paytm, the electronic payments company whose founder Vijay Shekhar Sharma posted a selfie with Tata to express his elation. Tata has also made small personal investments in businesses such as Urban Ladder, an online furniture retailer. But Tata is now ready to make bigger investments through RNT Capital Advisors, a joint venture with the investment arm of the University of California. In April, the venture made its maiden investment, putting $61m into Ola Cabs.

3. UniLazer

   UniLazer is the family office of Ronnie Screwvala, who sold the media company he co-founded in 1990 to the Walt Disney Company in 2012 in a $454m deal. Since then, Screwvala has co-founded his own educational technology company, UpGrad, as well as a sports business, Usports, focused on kabaddi, football and other sports that appeal to young Indians. Through UniLazer, Screwvala has acted as a private equity investor, allocating 15-20 per cent of his total assets to some 15 start-ups in a wide range of sectors. He has sought out early-stage investments in which he could take significant minority stakes, ranging from 25 to 40 per cent, in sectors he feels that he can add particular value, given his background in media and with his knowledge of brand positioning and consumer tastes. The investments include three ecommerce companies — Lenskart, which sells spectacles, contact lenses and eye-care products; Zivame, a lingerie retailer; and ShopClues, a general ecommerce platform that targets consumers in India's smaller towns. UniLazer has also invested in social enterprises, such as Micro Housing Finance Corporation, which provides home loans to working-class Indians, and an online insurance business in which UniLazer has taken a majority stake.

4. PremjiInvest

PremjiInvest is one of India's largest family offices, managing the estimated $1bn of assets of AzimPremji, chairman of Wipro, the Bangalore-based technology company, and its affiliated consumer product companies. PremjiInvest was established in 2006 but has generally shied away from the limelight. PremjiInvest is said to have a position in more than 40 listed and unlisted companies, with exposure to a broad range of sectors, including retail, financial services, healthcare, information technology and hospitality. Given its size and scale, PremjiInvest does not make small, early-stage investments in start-up companies, but rather takes sizeable stakes in larger businesses that have achieved a certain size but need assistance to scale up further and improve their systems.

Last year, PremjiInvest paid $52m for an 8 per cent stake in FabIndia, an ethnic fashion company in which it had purchased a 7 per cent stake in 2012. The investment was said to help fuel further expansion. It also took a 2.2 per cent stake in Aditya Birla Capital, the financial services arm of the Aditya Birla conglomerate, and invested in unlisted Equities, a micro-finance company that is becoming a small finance bank, a type of niche bank in India. This year, PremjiInvest has taken an additional 3.26 per cent stake in Future Lifestyle Fashions, which owns and markets a suite of more than 20 Indian and global fashion brands, sold either in dedicated shops or department stores. PremjiInvest made the purchases on the open market, adding to the 8.17 per cent stake it already held.

The family office is run by TK Kurien, who took over this year after five years as chief executive of Wipro.

5. Burman Family Holdings

Burman Family Holdings is the private investment arm of the controlling shareholders of the Dabur Group, one of India's largest fast-moving consumer goods companies and a traditional family business, founded by SK Burman in 1884. The family office was established in 1995, shortly after Burman went public, and it has since invested more than $500m in various businesses. The entity is run by Gaurav Burman and its investments range from being the

Indian partner for global companies such as Yum! Brands' Taco Bell fast-food restaurants to taking stakes in promising domestic start-ups. The family office, which is seeking new opportunities in healthcare, education, hospitality, education and financial services, says that, as a proprietary platform, it has more flexibility to take a long-term view than other investors.

SUMMARY

1. Explain the concept of family offices.
    - Private wealth management advisory firms which serve the ultra-high-net-worth individuals are known as family offices.
    - They provide a complete financial and investment solution to affluent individuals and families hence contrasting from wealth management firms.
2. Discuss the management and structure of family offices.
    - There are three major types of family offices: Single, Multiple and Virtual family Office
3. Benefits of setting up family offices
    - Governance and management structure
    - Alignment of interest
    - Potential higher returns
    - Separation
    - Centralization of risk
    - Centralization of other services.
4. Discuss the operations or services provided by family offices.
    - Financial Planning:
        - *i*. Investment management services
        - *ii*. Philanthropic management
        - *iii*. Life management and budgeting
    - Strategy:
        - *i*. Training and education

ii. Estate and wealth transfer
iii. Business and financial advisory

- Governance:
  i. Administrative services
  ii. Succession planning
  iii. Reporting and record keeping
- Advisory:
  i. Risk management and insurance services
  ii. Compliance and regulatory assistance
  iii. Tax and legal advisory

5. Family office investments
   - Equities have represented large chunk of investments made by family offices
   - Many family offices are looking to earn private equity returns with many family offices employing professionals from a private equity background
   - Many family offices also directly invest in companies they know well to earn double digit returns.
6. Family offices and technology
   - Technology has been a major player in the making of the modern day family office
   - Automation has become key to controlling costs and mitigating risk
   - The IT tools and platforms that a family office should consider include:
     i. Custody platform (bank, brokerage or trust company).
     ii. Consolidated reporting.
     iii. Trading and portfolio management tools.
     iv. Risk management tools.
     v. General ledger and accounting software.
     vi. Client Relationship Management (CRM) tools.
     vii. Tax preparation software.

7. Family offices and governance
   - Family office governance is a system that establishes structures and policies to facilitate joint decision-making
   - The aim of family governance is to support the long-term survival of the family business and the family's wealth
   - As the family grows, family members are often reluctant to formalize their decision-making process, it may happen that the lack of a decision-making process may result in missed opportunities, or disintegration of the family
   - In complex systems, multiple boards are required for decision making and leadership is shared by family members
   - Single family offices can work efficiently and effectively with natural governance as it is possible to make informal decisions and complex family structures require a more formal method
   - There exists three separate and distinct groups comprising of the family office, family members and the management, each of who have rights and responsibilities
   - Natural governance can be effective when a small group with a common value system and objectives work together, it is however prone to failure in complex structures
   - For this reason formal governance structures need to be designed. Designing a formal and effective governance system for family offices is a four-step process:
     - *i*. Understand the family's vision and purpose
     - *ii*. Understand the complexity of the family office
     - *iii*. Determine appropriate governance structures and policies that suit the shared purpose and complexity
     - *iv*. Implementation of feedback systems to ensure organized accountability

8. Risk management in family offices
    - Risk, return and liquidity are among the most important issues to be considered in any investment decision and asset allocation process. The system involves:
    - *i*. Risk Review
    - *ii*. Risk Identification
    - *iii*. Risk Measurement
    - *iv*. Risk Reporting
    - *v*. Risk Mitigation
9. Family offices in India
    - Family businesses are widely found all across India, but family offices are a relatively new phenomenon
    - In the past five years, however, many first-generation Indian entrepreneurs, influenced by global business trends and a focus on professionalism over family, have cashed out large portions of their original businesses, releasing substantial funds.
    - Many have also set up family offices through which they are investing some of this wealth, focusing on traditionally lower-risk assets such as property, treasuries and alternative investment funds
    - Some examples include Catamaran ventures, RNT Associates and RNT Capital Advisors, Unilazer, PremjiInvest, Burman Family Holdings.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	VII	1	Family office is a synonym for ______.	Private Wealth Advisory firms	Asset Management firms	Investment Bank	None of the above	**A**	Private wealth management advisory firms which serve the ultra-high-net-worth individuals are known as family offices.
2	VII	2	_____ is (are) type of family offices.	Single and Virtual	Single and Multiple	Multiple and Virtual	Single, Multiple and Virtual	**D**	There are 3 major types of family offices: single, multiple and virtual
3	VII	3	Which is not a benefit of setting up a family office?	Alignment of interest	Potential higher returns	Potential higher risk	Centralization of risk	**C**	Family offices help in centralizing as well as managing risk.
4	VII	4	What is not included in investment management services?	Tax planning	Asset allocation	Risk profiling	Managing liquidity	**A**	Investment management services do not include tax planning, which is a part of advisory services.
5	VII	4	Formation of grant making foundation is a part of which service provided by a family office?	Advisory	Philanthropic management	Strategic planning	Governance	**B**	Managing a family's philanthropic efforts is an important part of the role of a family office.
6	VII	4	What revolves around the education of the next generation on issues including wealth management and financial literacy, as well as wider economic matters?	Training and Education	Estate and wealth transfer	Administrative services	None of the above	**A**	Training an education is a part of strategic planning services provided by family offices.
7	VII	4	Administrative services do not include _______.	Support on legal issues	Public Relations management	Opening Bank accounts	Reporting and Record keeping	**D**	The maintenance of records does not form a part of Administrative Services.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
8	VII	4	What is a service that has assumed a more important role in recent years because of the financial crisis of 2008-09?	Compliance Assistance	Tax Planning	Risk Management	Succession Planning	**C**	Risk management and insurance planning has assumed a more important role in recent years.
9	VII	4	Succession planning is important for ________.	Smooth succession for future generations	Long-term wealth management	Both	None of the above	**C**	A smooth succession and planning for future generations is an integral to the long-term wealth management of the family it serves.
10	VII	5	Which asset has the highest chunk of investments by family offices?	Debt	Equity	Private Equity	None of the above	**B**	Equities have represented large chunk of investments made by family offices in keeping with previous trends.
11	VII	6	The use of multiple custodians creates the obligation to consolidate assets through?	Global Custodian	Third Party vendors	Custody Solutions	All of the above	**D**	The use of multiple custodians creates the obligation to consolidate assets through global custodians, etc.
12	VII	6	A CRM tool is used to manage critical information in ______.	One central database	Files and Reports	A directory	None of the above	**A**	A CRM tool is used to manage critical information, in one central database.
13	VII	7	A family governance system is most often led by _______.	Board of Directors	Family Council	Family members	Both A and B	**D**	Family governance system is led by a board of directors and a family council, which helps a family to govern its wealth and businesses.
14	VII	7	In a complex family structure what is needed to govern the office?	Family members	Multiple Family Offices	Multiple Boards of Directors	All of the above	**C**	In complex systems, multiple boards are required for decision making.
15	VII	7	Natural governance systems do not work?	They do, but in simple family structures	True	They always work	They work 75% of the time	**A**	It is widely believed that family office does not necessarily lack governance without formal structures.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
16	VII	7	Three separate groups comprising of the family office are?	Family Office, leaders and management	Family Office, members and management	Family members, relatives and management	None of the above	**B**	The respective rights and responsibilities of three separate and distinct groups need to be clarified.
17	VII	7	When does natural governance systems do not work?	Newer additions to the family happen over time	In times of crises	Neither A nor B	Both A and B	**D**	Natural governance systems do not work in times of crises and when newer members are not aware of the systems in place.
18	VII	7	Formal governance is more important in?	Virtual family offices	Single family offices	Complex family offices	New family offices	**C**	Formal governance will be all the more important in complex family structures.
19	VII	7	What is or are the role of board of directors of family offices?	It oversees the operations in the family office.	It safeguards the family's interests by liaising with them.	It helps to avoid conflicts by controlling the relationships between family members.	All of the above	**D**	The board oversees the operations in the family office and at the same time can help to avoid conflicts by controlling the relationships between family members, shareholders, and professional managers.
20	VII	9	RNT Associates is the personal investment vehicle of?	Ratan Tata	Azim Premji	Ronnie Screwvala	NR Narayana Murthy	**A**	RNT Associates is the personal investment vehicle of Ratan Tata, former chairman of Tata Sons, the conglomerate whose interests range from salt to steel.
21	VII	8	What does risk identification include?	Establishing risk appetite	Measuring impact of risk	Risk mitigation	Define main drivers of risk	**D**	Risk identification includes documenting and indentifying risk.
22	VII	6	Which of the following statement is correct with respect to implementation of technology?	Agreeing the data import processes with each vendor	Creating data and functionality test scripts for each platform	Holding frequent meetings with each vendor on progress and on project plan milestones	All of the above	**D**	Implementation technology includes: Agreeing the data import processes with each vendor, creating data and functionality test scripts for each platform, hiring external consultant for data output testing and holding frequent meetings with each vendor on progress and on project plan milestones.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
23	VII	7	Which kind of governance is a must in a complex family office?	Informal	Formal	Group discussion	None of the above	**B**	As the size of the family grows to be very big and complex, formal governance is important for it.
24	VII	6	The use of _______ creates the obligation to consolidate assets.	Family office	Single custodian	Multiple custodians	None of the above	**C**	The use of multiple custodians creates the obligation to consolidate assets.
25	VII	4	What is not included in advisory services?	Taxation	Legal	Investment management	Compliance and regulatory assistance	**C**	Investment management is a financial planning service not an advisory service.

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MODULE VIII

MANAGING SUCCESSFUL CLIENT RELATIONSHIPS

8

Learning Outcome Statements

1. Discuss the framework for establishing rapport and techniques for enhancing trust with clients.
2. Discuss techniques for more effective negotiations of advisor fees.
3. Developing an effective account plan.
4. Discuss strategies to manage the pipeline, identify opportunities and expand connections.
5. Explain client segmentation.
6. Explain the approach to building a client's book.
7. How to leverage on internal resources to help your client.
8. What constitutes a good account review.
9. Discuss the meaning and process of due diligence.

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MODULE VIII

MANAGING SUCCESSFUL CLIENT RELATIONSHIPS

8.1 DISCUSS THE FRAMEWORK FOR ESTABLISHING RAPPORT AND TECHNIQUES FOR ENHANCING TRUST WITH CLIENT.

Goals Driven Wealth Management aims at encouraging clients to identify the size, timing and character of each financial goal which are to be met. Each client has a different set of goals. The wealth manager can add more precision to the asset management process by understanding each goal in more detail. This will also help in developing an asset allocation that focuses on meeting each specific goal over time. But the important thing is not to set the goal but how to go about achieving it and staying with that plan.

Goals-based reporting is helping wealth managers to build stronger and longer-term relationships with clients, otherwise conversations with the client would just focus on market benchmarks to communicate performance. It is easy to report results to clients based on market indices because manager's think that is what the client understands the best. While prospecting for clients, wealth managers may report general returns against market benchmarks. It is useful because it's the manager who wants the job of managing that client's portfolio. A wealth manager can showcase his ability by presenting reports based on market benchmarks to compete with peers. This generally produces positive result, which is important at the beginning of the process.

Once the client has decided to engage the firm, it is important to meet their individual goals along with beating market benchmarks. On having a new client, one of the first meetings is about the client's goals for his or her investing activity.

In reporting meetings, wealth advisors can call out specific goals to report the period's results against those goals as an important aspect of the meeting. This can develop trust in the client relationship. All modules, time periods and reports can be customized based on the client's needs. Once the conversation is focused on goals, the manager can later convince the client to make adjustments to goals if needed. This becomes easier if the relationship between the manager and client is well established and there's a record of trust and fulfillment of client goals.

It is important for a wealth manager to take out time to get to know the client and their family before recommending an investment strategy. There should be a continuous evaluation of the progress of the portfolio and its performance. A set it and forget it approach should be avoided. The manager should make changes when necessary and also rebalance to ensure that they are invested to the target allocation. A scheduled and open communication with clients should be maintained. Additionally, strive to provide timely, relevant and relatable communications to out the clients including Investor Letter. An investment letter is an establishment that the buyer of new securities in a private placement does not intend to resell them within a short period of time, but instead plans to hold them as an investment.

A simple three-step financial planning process is unintimidating and informative for both manager and client.

Step 1: Initial Meeting

During the initial meeting, the manager should discuss the current situation, risk tolerance, and financial goals of the client. These may include the desire to retire at a certain age, wanting to fund a child's education, or purchasing a second home. The manager should talk about what the client is looking for in the financial advisor and about how they work with their clients.

Step 2: Presenting the Financial Plan

Using the information gathered during the initial meeting, a written financial plan should be created. This lays out the goals and a personalized strategy on how to reach them for the clients. Details of complete disclosure of the fees associated with becoming a client should be included in the plan as well. This plan is to be taken home, reviewed, and discussed by the client. If the client is in agreement with the recommendations the manager should move forward with the plan.

Step 3: Implementation and Ongoing Monitoring

Once the investment portfolio has been established, a plan is established in place to ensure continuous monitoring of the investments and regular communication with the client. This may include frequent phone calls to update the client on their progress. This will also help in finding out about any changes in the client's circumstances or goals. Regular email updates with relevant financial planning information, opportunities to attend education events, and annual review meetings to keep the client updated. Additional contact should always be available according to the needs.

Financial Planning:

Financial planning is an integral part of the wealth planning services where companies offer to build, protect and manage wealth over time of individuals and families. It's difficult to measure the progress along the way without an appropriate plan to pursue established goals. Retirement income planning, education, tax and estate planning and insurance services are among the many parts of a comprehensive plan. They are designed to help pursue numerous financial goals. Comprehensive plans are developed that are customized to each client's requirements and goals. Full assessment of the financial situation and goals are made for this purpose.

Asset Management:

This model consists of a customized portfolio framed using asset allocation strategies. An asset allocation and investment strategy designed for the customer's need is developed following a detailed analysis of the investment goals, risk tolerance and other important aspects. The portfolio is diversified across multiple asset classes to manage portfolio risk. Alternative Investments are available, if suitable for the portfolio, these include Real Estate Investment Trusts (REIT's) and Separately Managed Accounts.

Product-Based Strategies:

Clients with relatively simple needs that can be achieved with the purchase of a financial instrument can make use of this model. These can be used for client's looking for retirement planning or funding their children's education. Compensation for this type of service comes through commissions from the sale of insurance or investment products. Strategies developed are based on individual needs and risk tolerance.

In wealth management, manager-customer relationship has far-reaching implications on the client's financial and life goals. Customer experience holds higher weight for wealth management clients compared to other products they use.

Clients have options and are open to switching to other wealth management providers these days for better user experience. This forces firms to innovate to keep up with their client's demands. The wealth management firms have started treating client- specific needs as the most essential part of wealth manager-client relationship. A good customer experience helps building trust and gaining client confidence.

Changing demographics and demands of high net worth investors (HNWIs) are requiring wealth management firms to adapt their service offerings. HNWIs are becoming more financially savvy and are becoming more empowered in their wealth management firm relationships.

Firms are becoming more customer-centric and should follow a bottom-up approach to find out what problems the customer faces in his journey and how can they be corrected. It is now essential for firms to reframe their business models to keep up. Firms want to leverage the rising interest in digital channels to provide convenience to the clients along with implementing automated advisory and automated investment management to enhance the overall experience of customers and the wealth managers. Increasing HNWI awareness and changing demographics are increasing demand for customized and sophisticated advice on digital channels.

Wealth managers who invest time to understand customers' needs improve their relation with the client. Customers look for personalized advice, so managers should be ready to customize asset plans.

A number of firms are building new relationship management capabilities into their organizations. Approaches such as career-long face-to-face training programs for sales, relationship and product skills, with remote learning available for routine training are being used. This paves way to achieve the goal of the programs, which is to foster ongoing professional development and not just product knowledge.

8.2 DISCUSS TECHNIQUES FOR MORE EFFECTIVE NEGOTIATIONS OF ADVISORS FEE.

Types of fees

Percent of Account Value

A client should expect to pay a higher fee if the wealth manager is providing full-service financial planning along with investment management.

An advisor can charge in fee-only or fee-based manner. The advisors who charge fee-only generally use low-cost funds in the account, which minimizes the overall expenses the client needs to pay. Fee-based advisors might also collect commission, along with the percentage fee charged on assets.

In a percentage of assets payment agreement, the advisor makes more money as the account value grows. If the account value goes down, they make less money. This gives them an incentive to grow the client's account and to minimize losses. An asset management fee ranges from 2.0% to 0.50% per year. If a client has more assets, the fee charged is lower.

Flat Fee to Complete a Specific Project

When a client needs a specific project to be completed, such as retirement planning, it may make sense to pay a flat fee to get the work done.

A flat fee is not proportionate to the value of investments made, or generated by the purchase of any specific investment. This makes the clients feel more confident on receiving an objective advice. There should be no discrepancies while quoting the fee, and a clear description of what will be provided for that fee should be stated.

Management fees

Investment managers generally charge an annual management fee for handling an investment portfolio. This ranges around 1.0-1.5% per annum, charged on the total assets under management. This fee is also called 'ad valorem' fees.

Banking fees

A private bank will usually charge its customers a custody fee on deposits in the range of around 0.2% a year.

Transaction fees

A manager may or may not include transaction fee in management fee based on the relation he maintains with the client. It is always prudent for investors to consider the impact of transaction fees. If an investor changes his holdings too often it is known as 'churning'. This drags the profits down as the returns are eaten away by transaction fees.

Product fees

Investing in products like hedge funds, private equity and structured products require a payment of upfront fee on entrance, annual management fees and an exit fee. The hurdle rate can also be used in this context. It denotes an appropriate compensation for the level of risk present in the project. Riskier projects generally have higher hurdle rates than those that are deemed to be less risky. A hurdle rate is defined as the minimum rate of return on a project or investment required by a manager or investor.

Performance fees

Performance fees are calculated based on the returns a wealth manager creates by handling the investment portfolio, as a percentage of the overall performance. It is upto the wealth manager to charge the performance fee.

Leverage

Some of the benefits of investment leverage are:

- **Magnified Investment Results:** By the use of leverage an investor can invest a huge sum of money at once. If the investment pays off the profits are magnified, if not, the magnified losses are to be borne by the investor as well.
- **Attractive Tax Deductions:** Leveraging leads to payment of interest, which is tax deductible if the money is used for investment purpose. Thus leveraging reduces tax burden.
- **Time Horizon to Achieve the Goals:** Leverage helps in investing more money than an individual is capable of which reduces the time horizon of achieving goals if the investments rise in value.

Investment Leverage can provide exorbitant benefits and opportunity if an investor uses it correctly. However it is well established that using borrowed money to finance the purchase of securities involves greater risk than purchasing investments through cash. For this reason, an investor should take adequate caution before making any investments using leverage.

8.3 DEVELOPING AN EFFECTIVE ACCOUNT PLAN.

A portfolio recommendation should be developed with specific goals, risk tolerance, tax situation and time horizon of the client in mind. A portfolio's composition of strategies for every client should be customized to their individual needs while a common set of strategies can be used across all the clients. Manager should pay close attention to asset location when recommending a specific investment plan. This means he should try holding appropriate assets in appropriate accounts to improve the after-tax returns.

Wealth manager should provide the insight and direction to help build a diversified retirement plan for the customer that is focused on fulfilling their individual needs and financial goals. It is crucial to offer access to a full range of financial and retirement services as it stands as a valuable resource especially for those individuals who are actively planning for their non-working years.

During the preparation of the client's future the process needs to be carefully considered keeping in mind the possibilities of longer life spans, increasing health care costs, changing tax regulations, and rising cost of education. All of this can be a hurdle in the financial plans. An established and experienced financial manager can help set up the proper retirement structure that:

- Takes the guesswork out of investing
- Allows client to pursue their unique goals
- Provides a logical and systematic investment process
- Enables client to enjoy the things that matter most

Not depending on insurance alone:

A majority of advisors report that clients do not want to buy life insurance. But affluent clients do want what life insurance can accomplish like protection for their families and their businesses and tax-advantaged growth. Wealth managers present life insurance as a medium to achieve the desired goals of the client.

Another large group of financial advisors feel that selling life insurance would disrupt their practices. Offering life insurance can often be confusing for the clients. Besides, an unpleasant experience with life insurance can hamper advisor's reputation. Wealth managers know that only managing money cannot solve every financial problem of the client. It is vital to keep an open mind when seeking solutions for the clients and foregoing the professional alliances will allow them to deliver those solutions.

Some of the financial advisors also criticized insurance and see it as a bad investment, and there are usually other options that are more suitable. The principal purpose of insurance is not to provide investment results, but rather mitigating risk by providing death benefits. These benefits can be deployed at the decedent's direction to pay estates taxes or fund business buy-outs, among other things.

Some advisors are of the opinion that life insurance is too complicated to add to their list of offerings. Without doubt, insurance is complex and becomes even more when used as part of sophisticated wealth management strategies.

Holistic approach

Holistic wealth management is a money management philosophy that highlights all areas that need to be considered for successful retirement planning. It enables the client to prepare for their retired life with confidence and precision by removing guesswork in the planning. A holistic approach involves reviewing details of several elements. These include:

- Estate planning
- Cash flow statement
- Net worth statement
- Emergency reserve
- Asset allocation statement
- Insurance
- Social Security benefit statements
- Pension estimates/income

A holistic wealth manager should ask for current statements pertaining to bank accounts, business assets, personal property, qualified retirement accounts, deferred annuity accounts, investments, real estate, residence, social security benefit statements, pension estimates, and liabilities. From these documents, he prepares net worth, cash reserves, and asset allocation statements, which serve as the foundation for retirement planning. It is difficult to provide an accurate retirement income projection without preparing these and it represents the client's current financial status.

When a client evaluates the kind of wealth manager to trust his retirement income with, it is essential for him to look for someone who can provide a detailed analysis and take a holistic approach rather than just focusing on investment assets. Or else, the client is making a critical decision in a vacuum.

8.4 DISCUSS STRATEGIES TO MANAGE THE PIPELINE, IDENTIFY OPPORTUNITIES AND EXPAND CONNECTIONS.

In wealth management, referrals play an important role in helping most advisers build their business. Many a times, advisers ask for referrals in an outright self-centered way, informing the clients that they want to build their business. This may create a negative impact. Some clients may be willing to help, but some won't, especially if they aren't completely satisfied with their adviser.

Asking for referrals and getting them can be as natural as any other part of the business. But asking for it cannot be an impulsive decision. It requires a well thought out strategy that makes the manager and his clients more comfortable with the process.

First, of course, decide whom to approach. Generally it's best to start with the top 20 to 25 clients, who most closely approximate to the ideal client and are most likely to lead to the type of prospect manager wants to target. But this doesn't imply that one should only ask for referrals from the topmost priority clients.

Manager also has to decide when to bring up the request for referrals. In some cases, he might want to take the client out to a nice meal and use the time to discuss the topic or he may include it in his regular client meetings.

It is to be noted that the mechanics of the asking can be tricky as it can backfire and spoil the relation with client. It is especially a difficult decision to make for those who have worked hard and put in a lot of time to develop collegial relationships with clients.

The other tricky part is persuading clients to offer actual names of individuals who might be of some help and interested in the business. One solution is to assemble only the names of people the client knows who might actually be interested in the financial advisory services. Or the manager can sometimes get the information simply by being alert during their conversations for mentions of names. They can be of colleagues, acquaintances and family friends, and by keeping a record of them it can be verified later whether they can be of any help.

Another strategy commonly used is to tap carefully the cultivated network of attorneys, accountants and other professionals for referrals. But that's a time taking process. This can cover lawyers, accountants, and businesspeople that are present at networking events. Some of the people can be professionals who the manager already knows with whom the relationship needs a little nurturing while others can be new.

The best way to develop relations with attorneys, accountants and other professionals is by adhering to a give and take relation. This means that the manager can refer business to them as well.

Advanced presentation skills

Wealth management is a sector where individual performance is measured by how much revenue one can generate from their clients, so it's not surprising that all relationship managers need to have "great selling skills" like:

- **Passion:** As an investment manager, days will be long, challenging and focused. It is a stressful job and to get results of the hard work, one needs to be a passionate person, willing to devote all their energy to a job he enjoys. If someone does not love the work he does, the person can never be successful at it.
- **Intellectual curiosity:** Intellectual curiosity is when one would wake up in the morning wondering what happened in the markets overnight, and if their predictions were correct. It is important to have intellectual curiosity to truly understand the sector and be passionate about the work.
- **Analytical skills:** To predict how a stock will behave, both qualitative and quantitative analysis needs to be performed.
- **Communication skills:** Investment management firms require managers with articulate and effective communication skills. Presentation skills are especially important for investment managers as the presentation skills influence the clients the most rather than the quality of findings. One will have to spend a lot of time in presenting their findings and recommendations to senior colleagues and clients to be convincing enough.
- **Confidence:** To succeed in asset management, one needs to be confident in their abilities. One should be quick and accurate at evaluating the options, making a decision and taking necessary actions. Guessing is not an option. Projecting a confident persona is also important so that colleagues and clients trust what you have to say.
- **Problem-solving skills:** Wealth management is a one man's job and it will be up to the manager to take ownership of problems and turn them into opportunities. Colleagues should be willing to help but the solution is solely of the manager's.
- **Business understanding:** Some decisions that an asset manager makes will be based on a 'gut feeling', so the business instincts needs to be razor sharp. It is not vital for the manager to have a business degree but strong analytical skill and overall understanding is needed of how businesses and markets operate.

8.5 EXPLAIN CLIENT SEGMENTATION.

The level of segmentation and degree of service personalization in part depends on the firm's type of business and the clients they are targeting. They can be divided into:

- **Demographics**: Factors such as age, sex, and family status should be kept in mind before framing a client's investment goals, service requirements, and revenue potential as they could affect them.
- **Risk profile**: Every client has a specific requirement and risk that they can take. Each client's risk profile differs. Soit is vital to ensure that the manager targets the right investment products to the right customers. Trying to sell the client an inappropriate product could jeopardize the relationship as well as be a waste of time and resources.
- **Tax status**: Different kinds of investments have different tax slabs and are suitable only for few investors. Selling a client a product with a higher tax liability could degrade the firm's name and weaken their relationship.
- **Fee structures**: Managers need to ascertain the amount of fees a client would pay. This helps them to determine how much flexibility they have to amend the fee schedule, and which clients to focus their sales efforts on when launching new products with particular fee structures.
- **Career status**: Whether the client is a young entrepreneur with a rapidly growing business, or a near-retirement company owner about to pass over the reins, will have a significant influence on the products they are interested in and their future potential value.
- **Communication preferences**: There is no single definition of great service. A manager should be smart enough to figure out the client's communication preferences. This will help strengthen the relationship by ensuring that details and opinions are communicated in the desired way. When and how frequently the client wants to be contacted will vary as well.
- **Cost to serve**: Some clients may take up a lot of an advisor's time, or want such an individualized service that it is not so cost effective to retain them as a client. In such situations service demands should be decreased or fees should be increased. Having the right segmentation gives manager the necessary insights to see what service levels they can deliver, and whether the service expected by a client is sustainable. Managers can in this way focus on

providing the best services to the clients who give them maximum business and enhance his long-term profitability.

Advisors with differing credentials and experience for each tier:

CFP - Certified Financial Planner

The Certified Financial Planner(CFP)are professional certification marks granted in the United States by Certified Financial Planner Board of Standards, Inc. A majority of American families and individuals do not have any type of comprehensive financial plan. The CFP mark opens huge array of opportunities with the increasing demand for unbiased and competent advice in this area. They provide a level of professionalism that is difficult for their competitors to duplicate. It is perhaps the most widely recognized and respected financial planning credential in the industry.

CFA - Chartered Financial Analyst

The Chartered Financial Analyst (CFA) charter is a globally respected, graduate-level investment credential awarded by CFA Institute.

The CFA Program curriculum provides basic knowledge and skills used in the investment profession. A comprehensive framework of knowledge for investment decision-making is provided through this professional course. The CFA Program tests proficiency with a wide range of fundamental and advanced investment topics.

CPA - Certified Public Accountant

CPAs are licensed and regulated by their state boards of accountancy.

In addition to the Code of Professional Conduct, AICPA members who provide personal financial planning services are required to follow the Statement on Standards in Personal Financial Planning Services (the Statement). CPAs are experts who do a detailed analysis and advice on tax and financial matters. The designation doesn’t mean that the individual is giving the best advice, but a CPA has a better understanding of tax and puts his license at stake by giving tax and financial advice.

CAIA - Chartered Alternative Investment Analyst

The CAIA Charter is the globally recognized credential for professionals who have mastered in the field of alternative investments. They manage, analyze, distribute, or regulate alternative investment decisions. The CAIA Charter designation provides deep knowledge and expertise in alternate investment and is the highest standard of achievement in the field.

Different service model

Segmenting client base is about tailoring the services the manager offers to what is realistic for him. For advisers who wish to re-focus their business, segmentation provides a framework upon which to build a flexible, reliable and realistic service proposition. Asking yourself what type of clientele to target and assessing your team's time capacity will go a long way to decide on the segmentation policy. Below are a number of steps you can follow to assess the value of clients and adjust the level of service to reflect that value.

1. Select criteria for segmentation

Manager's client segmentation criterion goes beyond the client's Asset under management (AUM). Research from the US, where many advisers voluntarily moved to fees, showed that referrals potential was rated almost as important as client AUM, while ease of working with the client came next.

2. Segment client base

A scoring system is the most consistent way to arrive at a relevant segmentation structure. It is used to rate the clients in order of preference.

3. Manage time

Advisers often comment that they spend less than 50% of their available time in actually seeing the clients. The amount of time available per year with managers can give an estimate of the time available for their customers. A typical employee has around 1,800 hours available per year.

4. Differentiate your service levels

A top client might demand 10 times as much attention as compared to the lowest-maintenance clients, which is why manager must be disciplined in assessing how many high-priority clients he could realistically service. Exploring additional ways to automate your services for other clients that you wish to retain should also be there in the list. Manager must be realistic about his time.

5. Set expectations with clients and staff

Always give the client a choice by giving them a structured set of options enabling them to dictate the service they require. A clear service structure also gives your staff a set of guidelines, along with an immediate understanding of what each individual client expects from your practice.

6. Automate your processes

Automating processes helps to maintain and reinforce the service levels for clients. It can be as sophisticated as implementing a new, intelligent database or as simple as using Outlook more efficiently to set up recurring reminders for client meetings. At some practices, an increased focus on support staff has helped to reinforce a centralized and well-managed process.

8.6 EXPLAIN THE APPROACH TO BUILDING A CLIENT'S BOOK.

The easiest way to target new clients is through the existing ones. The current clients most likely have a good sense as to whether their friend or associate would be a good fit with the business since they know the manager. They are also likely to refer clients who are similar to them. This means that, if the manager maintains a list of clients he is happy and satisfied with the existing clients will bring in better clients. It's important to inform clients that you are looking for new business, rather than assuming they already know. Sending out emails or letters asking clients to refer new clients to you can be an effective way. Referral process can be made easier by handing out a few business cards or brochures. Most of the successful advisors have all the clients they need and a wealth management mindset will help ensure this reality.

Existing clients are the wealth manager's best source of referrals. The successful wealth manager understands this potential and systematically positions their practice to deepen existing client relationships. Profiling can help make new clients, i.e., regularly asking simple questions in different ways with the goal of uncovering new business opportunities.

In turn, well-coordinated profiling can lead to client advocacy. The processes of letting the ideal client know how important they are to your practice and showing them how to give natural referrals.

Indirect promotion

Clients would be less attracted to the manager if he promotes himself and his business through ads and fliers. A more subtle, but effective approach should be used. A manager should show prospective clients that he knows his stuff well by writing letters to the editor of local newspaper about issues in his field. Interview opportunities should be pursued instead of advertising on the radio or television to show off the knowledge and experience. Hosting charitable events and getting ones name out in the community can also build an image. Such actions allow potential new clients to see how the manager operates and see what he is all about, before they commit to hire him. These methods are an effective way of indirect promotion.

Website

Having a website for any business is a basic and important way to present your company to the public in today's world. A website allows potential clients to find out more information with ease on what services a company or a person offers, without having to endure a sales pitch, as they would call directly if they are interested. A website should be more than just an electronic version of the brochure providing with a lot of helpful information, along with the sales pitch. A manager can also set up an electronic newsletter that readers can sign up for if they're interested by providing articles on financial topics in the news and other current issues. It would be better to hire a professional to match the quality of the site with the quality of the manager's work. Website makes the manager available to a wide range of potential clients to whom he did not exist, that too with very little efforts.

8.7 HOW TO LEVERAGE ON INTERNAL RESOURCES TO HELP YOUR CLIENTS.

Cloud based solutions

Cloud helps in two ways. If a company is large and has a development team to create solutions in-house, cloud gives a platform to develop and test these solutions. Cloud goes way beyond the big public cloud providers that can bring concerns over data privacy legislation given they are all US owned. Look closer at home and one can find many local cloud service providers that will meet your needs and be far more responsive. Secondly if a company does not have an army of agile developers then mobile and analytics solutions already exist. Even IBM and Apple have jointly created a wealth management mobile app so certainly any local provider will already be on the case. Cloud is about putting the right workload in the right place.

Increasing focus on strategic initiatives is a business imperative for capital market firms. The cloud is economically feasible as it provides an opportunity to reduce IT infrastructure investment, head count, software development and application support cost. The infrastructure requirements can be reduced and transferred to cloud services provider. The IT team can retain its oversight to maintain data security requirements and further free up IT resources by this process. This will decrease IT and operational costs. The firms can also avoid capacity planning for unprecedented infrastructural requirements since cloud services are available on-demand.

Cloud computing helps the firm to focus on delivering superior functionality to end-users and develop new services and mechanisms of service offerings. An investment or wealth manager can virtually interact with the clients by keeping in touch via social media through a portal. The firm needs to pay only for services used without owning the social media portal. The cloud provides a competitive edge for amateur firms to compete with well-established players.

Human resource

Trends show that companies have started valuing human capital even more in the recent years. Be it basic measurement of the effectiveness of everything, from training programs to employee engagement. Companies pay a premium to human resource department to help them make decisions on hiring and firing to retain the best talent in the firm.

The definition of human capital varies in every sector, but a general definition would be the abilities and skills of any individual, especially those acquired through investment in education and training, that enhance potential income earning. Economist Adam Smith explains human capital as “the acquisition of such talents, by the maintenance of the acquirer during his education, study, or apprenticeship, always costs a real expense, which is a capital fixed and realized, as it were, in his person.”

Human capital is gaining emphasis at high-end firms. More organizations are using quantitative analysis to gauge their efforts, including strategic risks and rewards. Companies are putting more efforts to measure the effectiveness of the workforce rather than just getting the work done, while increasing the role of monitoring the risk of human capital.

Meanwhile, as companies are becoming more service oriented, they are increasingly depending on the intellectual capital of their own workers. Major changes in workplace have also taken place.

8.8 DISCUSS WHAT CONSTITUTES A GOOD ACCOUNT REVIEW.

Every wealth management account must be reviewed periodically by the wealth management firm and the client. The review is conducted as per the terms of agreement or at least annually. The important points which are focused upon during the review are:

- Change in financial goals
- Change in tax environment
- Fees charged by the wealth manager
- Portfolio performance in comparison to benchmark
- Adequacy of asset allocation and security selection strategies
- Alignment of strategies with client's goals

Periodic review is essential as it boosts client's confidence and also keeps a check on the wealth manager's activities. It brings a discipline in the wealth management approach and does not allow for any deviations from the client's goals. It ensures that the client's thought process and the manager's point of view are aligned and thus improves client-manager relationship.

8.9 DISCUSS THE MEANING AND PROCESS OF DUE DILIGENCE.

The investment challenge is to create portfolios that are driven by analytical skills rather than simply guesswork and sheer market performance. Past performance of markets or managers may determine future success trend, but is not the answer to it. The due diligence team takes an objective and disciplined approach to review and oversight the manager's decision. They employ a comprehensive analytical software tool, running a series of analysis, to ensure a complete and comprehensive assessment of all investment managers. The team also conducts detailed interviews with the investment managers on a regular basis using both quantitative and qualitative analysis. An internal supervisory structure is created to ensure the clients' assets are being managed prudently as their money is at stake.

The industry is responding to the changing dynamics. There's more of a focus on operational due diligence, rather than just relying on performance and track record.

Broker and dealers are building out their due diligence capabilities, outsourcing more, or spending more time and resources in getting their products approved. Alternative investments, which tend to be illiquid and less transparent, have come under particular scrutiny. Some firms have cut back on the number of products on their platforms, including alternatives, while others have tried to steer clear of alternatives altogether. It's clear that we've entered the age of new due diligence. The investors have become aware of the malpractices going on in the industry and at no cost they can risk their money. Thus thorough inquiry into the investment plan can reassure the client that their investments are in safe hands.

The due diligence process**:**

Step 1: Analyze the Capitalization of the Company

Determine how big the company is. The company's market capitalization speaks volumes about how volatile the stock is probably going to be, how the broad ownership might be and the potential size of the company's market. Examining the revenue and profit figures give some perspective about the market cap.

Step 2: Revenue, Profit, and Margin Trends

Understanding a company's gross revenue, profit margins and return on equity and whether it is growing or decreasing is essential in any equity or corporate bond investment. Profit margins should also be checked to see their usual trends whether they are generally increasing, decreasing, or remaining constant.

Step 3: Competitors and Industries

Most of the major research sites have information about competitors on the company profiles. If one is still uncertain of how the company's business model works, he should revisit to understand their business model before moving further along. Sometimes just reading about the competitor's model may help to understand what the target company does.

Step 4: Valuation Multiples

P/E ratios can form the initial basis for looking at valuations. P/B ratio may be useful where assets are a core driver of earnings such as capital-intensive industries. While earnings can and will have some volatility, valuations based on trailing earnings or on current estimates are the parameter that allow instant comparison with the broad market multiples or direct competitors.

Step 5: Management and Share Ownership

Looking at the consolidated bios of top managers to see what kind of broad experiences they have can increase the confidence of the investor in the firm. This information may be found on the company's website or on SEC filings.

Step 6: Balance Sheet Exam

Look up a consolidated balance sheet to see the actual financial position of the company by paying special attention to cash levels and the amount of long-term debt held by the company. Having excessive amount of debt is not necessarily a bad thing, if the company has the resources to repay them depending on the company's business model. The debt-to-equity ratio should be looked at to see how much positive equity the company has generated from it. A parallel comparison with competitors can be made to gain clarity on this note. If a company generates sufficient amount of cash, the investment will generally be fruitful in such a case.

Step 7: Stock Price History

The investor would now like to find just how long all classes of shares have been trading, including both short-term and long-term price movement. This would indicate the profit experience of an average owner of the stock, and what can influence the price of the stock in future. Stocks that are continuously volatile tend to have short-term shareholders, which can add extra risk factors to certain investors. Looking at the history can showcase trends if there are any in the stock.

Step 8: Stock Options and Dilution Possibilities

Investors will need to verify the 10 Q and 10 K reporting. Such quarterly SEC filings are required to see all outstanding stock options and the conversion expectations under a range of future probable stock prices. This can be used to understand how the share count could change under different price scenarios. While employee stock options are potentially a powerful motivator, investor should be aware of shady practices like re-issuing of underwater options or any former investigations that have been made into illegal practices like options backdating.

Step 9: Expectations

This requires some extra digging. Investors should look out for what the consensus of other analysts for earnings growth, revenue and profit estimates are for the next two to three years. Investors should also analyze predictions of long-term trends affecting the industry and company. News about a product or service on the front may have initially turned the investor's attention to the stock, but now it is the time to examine it more carefully with the help of everything they have accumulated so far.

Step 10: Examine Long and Short-term Risks

The vital part is always kept for the last where the invertor emphasizes on the risks inherent with investing making sure to understand both industry-wide and company-specific risk. Investors should perform scenario analysis to picture the worst-case scenarios and also be prepared for it and should also examine their potential outcomes on the stock.

SUMMARY

1. Discuss the framework for establishing rapport and techniques for enhancing trust with clients.
    - Goals Driven Wealth Management aim at encouraging clients to identify the size, timing and character of each financial goal which are to be met.
    - Goals-based reporting is helping wealth managers to build stronger and longer-term relationships with client's otherwise conversations would just focus on market benchmarks to communicate performance.
    - The manager should make changes when necessary and also rebalance to ensure that they are invested to the target allocation.
    - A three-step financial planning of initial meeting, presenting the financial plan and implementation and ongoing monitoring should be followed.
    - A service model of financial planning, asset management and product-based strategy should be implemented.
    - Clients have options and are open to switching to other wealth management providers for better user experience and hence innovation is required.
    - Firms are becoming more customer-centric and should follow a bottom-up approach to find out what problems the customers face in their journey.

2. Discuss techniques for more effective negotiations of advisor fees
   - Types of advisory fees include percent of account value, management fees, banking fees, transaction fees, product fees, performance fees, etc.
   - Some of the benefits of investment leverage are magnified investment results, attractive tax deductions, time horizon to achieve the goals, etc.
3. Developing an effective account plan.
   - A portfolio recommendation should be developed with specific goals, risk tolerance, tax situation and time horizon of the client in mind.
   - This means he should try holding appropriate assets in appropriate accounts to improve the after-tax returns.
   - An established and experienced financial manager can help set up the proper retirement structure that takes the guesswork out of investing and allows client to pursue their unique goals
   - Affluent clients do want what life insurance can accomplish like protection for their families and their businesses and tax-advantaged growth. Wealth managers present life insurance as a medium to achieve the desired goals of the client.
   - Holistic wealth management highlights all areas that need to be considered for successful retirement planning. It enables the client to prepare for their retired life with confidence and precision by removing guesswork in the planning.
4. Discuss strategies to managing the pipeline, identifying opportunities and expanding connections.
   - In wealth management, referrals play an important role and require a well thought out strategy that makes the manager and his clients more comfortable with the process.
   - Attorneys, accountants and other professionals can also be asked for referrals but it's a time taking process. The best way to develop relations with them is by referring business to them as well.
   - Individual performance in wealth management is measured by how much revenue one can generate from their clients, so a manager needs to have great selling skills.

5. Explain client segmentation.
    - Clients can be divided on the basis of demographics, risk profile, tax status, fee structures, career status, communication preferences, cost to serve, etc.
    - Advisors with differing credentials and experience for each tier are Certified Financial Planner, Chartered Financial Analyst, Certified Public Accountant and Chartered Alternative Investment Analyst.
    - For advisers who wish to re-focus their business, segmentation provides a framework upon which to build a flexible, reliable and realistic service proposition.
6. Explain the approach to building a client's book.
    - The easiest way to target new clients is through the existing ones who are also likely to refer clients who are similar to them.
    - Prospective clients should be targeted by writing letters to the editor of local newspaper, interviews and hosting of charitable events.
    - A website allows potential clients to find out more information with ease on what services a company or a person offers, without having to endure a sales pitch. It also opens to awide range of potential clients who he did not know existed.
7. How to leverage on internal resources to help your clients
    - The cloud is economically feasible as it provides an opportunity to reduce IT infrastructure investment, head count, software development and application support cost.
    - If a company is large and has a development team to create solutions in-house, cloud gives a platform to develop and test these solutions.
    - If a company does not have an army of agile developers then mobile and analytics solutions already exist.
    - Cloud computing helps the firm to focus on delivering superior functionality to end-users and develop new services and mechanisms of service offerings.
    - Companies pay a premium to human resource department to help them make decisions on hiring and firing to retain the best talent in the firm.

- More organizations are using quantitative analysis to gauge their efforts, including strategic risks and rewards.

8. Discuss what constitutes a good account review.
   - Wealth management client account must be reviewed periodically.
   - It boosts client's confidence, keeps a check on the wealth manager's activities and ensures alignment of investment with client goals.
9. Discuss due diligence.
   - The due diligence team takes an objective and disciplined approach to review and oversight the manager's decision.
   - They employ a comprehensive analytical software tool, running a series of analysis, to ensure a complete and comprehensive assessment of all investment managers.
   - The team conducts detailed interviews with the investment managers on a regular basis using both quantitative and qualitative analysis.
   - A due diligence process should be adopted for analyzing the company, competitors, balance sheet, etc.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	VIII	1	Which of the following does not form a part of the financial planning process?	Presenting the plan	Implementation and monitoring	Dinner with client	Initial meeting	**C**	All the rest of them are a stated step in financial planning
2	VIII	4	Which of the following is a difficulty faced in getting referrals from professionals?	It requires nurturing relationship with professionals.	Networking events need to be attended	It is a time taking process.	It covers businessmen.	**C**	Referrals from professionals is a time taking process.
3	VIII	7	How does human resource management help a firm?	make decisions on hiring and firing	Retain talent in the firm	A and B	None of the above	**C**	Companies pay a premium to human resource department to help them make decisions on hiring and firing to retain the best talent in the firm.
4	VIII	9	Which of the following asset classes is the least trasparent?	Equity	Money Market	Debt Securities	Alternative Investemts	**D**	Alternative investments have the least amount of transperancy and are thus very difficult to conduct due diligence.
5	VIII	2	Which fees provides an incentive to the fund manager to perform better?	Percent of account value	Performance fee	Management fee	Flat fee	**A**	Percent of account value fees changes as per fund value and thus gives the fund manager an incentive to perform better.
6	VIII	6	Which of the following is an indirect method of promotion?	Website	Writing letters to the editor of local newspaper	Referral from existing clients	None of the above	**B**	Writing letters to the editor of local newspaper is a method of indirect promotion of wealth manager.
7	VIII	9	Which process in due diligence requires verifying 10 Q and 10 K filings?	Stock price history	Stock options and dilution possibilities	Valuation multiples	Competitors and industries	**B**	Such quarterly SEC filings are required to see all outstanding stock options and the conversion expectations under a range of future probable stock prices.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
8	VIII	5	Which characteristics typically differ in financial planning of a young entrepreneur differ from a retiring individual?	Time Horizon	Risk Tolerance	Liquidity Needs	All of the above	**D**	A young entreprenuer usually has high risk tolerance, longer time horizon and lower liquidity needs than a retiring individual.
9	VIII	4	Which of the following is the first task in deciding which clients to approach for referral?	Selecting clients which closely resemble an ideal client	Selecting top priority clients	Selecting clients with maximum investment capital	None of the above	**A**	It is best to start with the top 20 to 25 clients who most closely approximate to the ideal client.
10	VIII	1	Which of the following is not an approach used by wealth management firms for better management capabilities?	Market knowledge programs	Training for sales	Training for client relationship	Training about product skills	**A**	Approaches such as career-long face-to-face training programs for sales, relationship and product skills, with remote learning available for routine training are being used to enhance management capabilities.
11	VIII	3	Which of the is not a hurdle in financial planning?	Longer life span	Rising cost of education	Increasing health care costs	None of the above	**D**	Longer life spans, increasing health care costs, changing tax regulations and rising cost of education can be a hurdle in the financial plans.
12	VIII	7	Which of the following economists explains human capital as a real expense?	Adam Smith	Karl max	Paul Samuelson	Amartya Sen	**A**	Economist Adam Smith explains human capital as "the acquisition of such talents, by the maintenance of the acquirer during his education, study, or apprenticeship, always costs a real expense, which is a capital fixed and realized, as it were, in his person."
13	VIII	6	What are the different ways of targeting new clients?	Indirect promotion	Website	Existing clients	All of the above	**D**	All of the following are the different ways to target new clients.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
14	VIII	5	Which of these form the steps of a segmentation service model?	Manage time	Set expectations with clients and staff	Automate your processes	All of the above	**D**	Given options are the 3rd, 5th and 6th step respectively in the Segmentation service model.
15	VIII	6	Electronic news letters by wealth managers provide:	articles of financial topics	discuss manager's fees structure	provide details of existing clients and strategies used	None of the above	**A**	Electronic newsletter provide articles on financial topics in the news and other current issues.
16	VIII	7	How is the cloud solution economically feasible?	Reduces IT infrastructure investment	Reduces head count	Reduces software development	All of the above	**D**	The cloud is economically feasible as it provides an opportunity to reduce IT infrastructure investment, head count, software development and application support cost.
17	VIII	2	What is another name for ad valorem fee?	Management fee	Transaction fee	Performance fee	Product fee	**A**	Management fees is also called 'ad valorem' fees.
18	VIII	5	Advisors typically spend how much of their time with their clients?	100%	70%	50%	60%	**C**	Advisors often spend less than 50% of their available time in actually seeing the clients.
19	VIII	4	Which of the following is not a skill required for a better business understanding?	Business Degree	Analytical skills	Business instincts	Understanding of market conditions	**A**	A business degree is not a vital aspect of business understanding.
20	VIII	1	Which of the following is a result of digital innovation in wealth management?	Goals based investing	Relative benchmarking	Product based strategies	Automated advisory	**D**	Rising digital channels have caused implementation of automated advisory and automated investment management.
21	VIII	9	What is the objective of the due diligence team?	Review and oversight the manager's decision	Make the investors investment more risky	Waste time doing unnecessary analysis	None of the above	**A**	The due diligence team takes an objective and disciplined approach to review and oversight the manager's decision

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
22	VIII	4	How should the manager ask clients for referrals?	Over a nice meal	Pestering client all the time	Being attentive during conversations with client for names and enquiring about it	A and C	**D**	Asking for referrals requires a well thought out strategy that makes the manager and his clients more comfortable with the process.
23	VIII	2	The minimum rate of return on a project required by a manager is known as _______.	Hurdle rate	Required return	Expected return	Deduction return	**A**	A hurdle rate is defined as the minimum rate of return on a project or investment required by a manager or investor.
24	VIII	5	Which among these professionals are regulated by their state boards of accountancy?	CFP	CPA	CAIA	CFA	**B**	CPAs are regulated by their state boards of accountancy.
25	VIII	3	Which of the following is a document required for holistic approach to wealth management?	Bank statement	Personal property details	Pension Estimates	All of the above	**D**	A holistic wealth manager should ask for current statements pertaining to bank accounts, business assets, personal property, pension estimates, etc.

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MODULE IX

CLIENT ONBOARDING, COMPLIANCE, RISK AND CRISIS MANAGEMENT

9

Learning Outcome Statements

1. Discuss the regulatory framework governing wealth managers.
2. Discuss fair dealing guidelines for managing wealth.
3. Discuss Anti-Money Laundering laws.
4. Discuss the industry trends impacting wealth management.
5. Discuss the risk in Wealth management.
6. Discuss managing client risk and exposure.

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MODULE IX

CLIENT ONBOARDING, COMPLIANCE, RISK AND CRISIS MANAGEMENT

9.1 DISCUSS THE REGULATORY FRAMEWORK GOVERNING WEALTH MANAGERS.

Regulatory Framework is the existence of the necessary infrastructure which helps to control and adopt the course of action, rule, principle or law. Markets and financial intermediaries are subject to asymmetric information which makes regulations of prime importance. It enables markets to absorb shocks and also maintain financial stability. Wall Street, the financial capital of US, is the major influencer among markets worldwide.

The major financial regulators with respect to wealth management in US are:

- Securities & Exchange Commission (SEC)
- Financial Industry Regulatory Authority (FINRA)

The objectives of financial regulators are:

- To maintain confidence of the investors in the financial system
- To ensure financial stability and to protect and enhance the stability of the financial system
- To protect the investors
- Encourages fair competition among financial service providers

The U.S. Securities and Exchange Commission

Securities and Exchange Commission is an independent government agency which was established in 1934 by the Securities Exchange Act. It is focused on protecting investors and ensuring fairness. The SEC has broad regulatory authority including the oversight of exchanges and the enforcement of regulations powers relating to

U.S. securities markets. Investment advisers that have over $110 million in assets under management are regulated by SEC.

Any firm that manages portfolios for clients or gives advice with respect to investing in securities is considered to be an investment adviser. SEC can carry unscheduled audits in the firms that are regulated by them. Registration with the Securities & Exchange Commission means that the firmagrees to adhere to SEC rules and has made certain disclosures and should not be considered an endorsement of any kind.

The Financial Industry Regulatory Authority

FINRA operates under the scope of the SEC is a self-regulating organization. It is responsible for enforcing SEC rules and regulations, and also has responsibility for regulating the activities of brokerage firms and brokers. FINRA regulates any individual selling securities to public as a broker or a representative of a dealer.

A single asset manager could be regulated by both SEC and FINRA. There is an overlap between FINRA and SEC regulation.

Other Regulatory Agencies

Other regulatory agencies include the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), Commodity Futures Trading and The Treasury Department. There are also state regulatory agencies.

Large asset management firms with multiple operating activities might get regulated by more than one regulatory body, which can cause complexity for these firms.

Financial industry companies may have to face overlapping and sometimes contradictory regulatory frameworks. The FSOC acts as a coordinating body to simplify bank regulation and monitor systemic risks facing the financial industry.

Regulators for other major markets are:

Country	Regulatory Authority
China	China Securities Regulatory Commission (CSRC) China Banking Regulatory Commission (CBRC)
European Union	European Central Bank (ECB) European Securities and Markets Authority (ESMA) European Banking Authority (EBA)

Country	Regulatory Authority
India	Securities and Exchange Board of India (SEBI) Reserve Bank of India (RBI)
Japan	Financial Services Agency Securities and Exchange Surveillance Commission (SESC)
United Kingdom	Bank of England (BoE) Financial Conduct Authority (FCA)

9.2 DISCUSS FAIR DEALING GUIDELINES FOR MANAGING WEALTH.

Fair dealing responds to inclination to prioritize one's most profitable clients and also to place self-interest ahead of clients. It is necessary to maintain public's trust and do not discriminate. Fair dealing is required while disseminating analyst's recommendation and trading on it.

I. Changes in recommendation: The first way to deal fairly with clients is to inform them in case of any change in recommendation i.e. buy, sell or to hold the security. It considers time gap between the change and public awareness of that change. The information must be material non-public and it should be distributed in an unbiased way with proper due- diligence as per the suitability of the securities to the clients.

   Few methods to disseminate are:

   - A complete and detailed report.
   - Summary of the changes and action to be taken
   - Addition or deletion from a recommend list with detailed explanation of the same.
   - Oral communication.

II. Investment action: It is addressed to the portfolio managers who are responsible for acting on the recommendation. There must be process to make sure that there won't be any discrimination against a group of accounts while paying a price to buy e.g. in block trades. The process must be fair and clearly disclosed to the clients so that they can make informed decisions.

III. Fairness in Initial Public Offering: This is most important time which tests the intention of fair dealing as it is like handing the client an automatic profit. A portfolio manager might want to give this sure-shot profit to his big clients but it would violate the ethics of dealing fairly with all the clients. So, the best way to deal with it is distributing it on a pro-rata basis.

Few guidelines to comply with rules of fair dealing are:

- Distribute non-public information quickly
- Summarize the lengthy and detailed reports
- Establish guidelines for pre-dissemination
- Inform everyone simultaneously
- Restrict trading before client awareness
- Establish procedure of trade allocation
- Refrain from holding shares
- Disclose trade allocation
- Review accounts systematically

Apart from giving equal priorities, there are other aspects where the wealth manager must make sure that he is dealing fairly with the client. Few of the other aspects are:

- Securing confidential matters of the clients: To make financial decisions of the client, the wealth manager needs to know a lot of personal and professional information of the client which must be preserved in a manner which cannot make any third party to take advantage of it. Confidential information are sensitive in nature and therefore must be protected responsibly and prevent careless disclosure. Unless the client has provided the consent in writing or there is legal or professional right or duty to disclose, one must keep it private.
- Misrepresentation of facts: A false statement of facts which affects the other party's decision in contract. It makes the contract void as it is based on wrong information. Misrepresentation can also occur if any important statement is omitted as a missed material fact can also change the recommendation. Correction of the statement after knowing the fact is also necessary as leaving it uncorrected also makes it misrepresented.
- Other unfair dealing practice: Manipulation, concealment, abuse of privileged information etc. can also be considered violation of fair dealing.

Hence, Wealth Managers must treat the clients and the investors' interests equally. They are not supposed to favor one client or investor to the detriment of another. They must treat clients equally with respect of the allocation of securities as per suitability. Equal treatment in the allocation of securities should be considered globally. Compliance with this obligation should be considered over a given period and not on a transaction specific basis.

Any compliance program is based on unique factors of the firm like size and scope of the activities. However, all process will share a common platform of fairness and avoid systematic discrimination.

There are ethics and code of conduct for wealth managers that they must comply in order to practice honest and ethical business. This means principles of fairness, good faith and respect laws and regulations consistently. These are:

- Wealth Managers must not incline towards trading in a client's account that is excessive in size or frequency with the view of the financial resources and character of the account.
- Wealth Managers must make investment decisions with due diligence on reasonable grounds as per the suitability of the client on the basis of information provided by the customer.
- Wealth Managers must place discretionary orders only after getting clients' authorization as evidenced by our Client Agreement and the broker's trading authorization,
- Wealth Managers must not ever borrow money or securities from, or lend money or securities to a client.
- Wealth Managers must not placebuy or sell order of any un-registered security, or if the security or transaction is not exempt from registration in states where managers provide investment advice.
- Wealth Managers must not place orders for clients, or recommend that the client place an order to buy or sell a security through a broker/dealer or agent or any investment advisory firm which is not licensed under states the managers provide investment advice.
- All Advisory Representatives must report all but exempt personal securities trading to the Chief Compliance Officer for themselves and for beneficial relationships.

9.3 DISCUSS ANTI-MONEY LAUNDERING LAWS.

Money Laundering is an attempt to disguise illegally-gained proceeds so that they appear as legal i.e. came from legitimate sources or activities. Some countries define money laundering as obscure sources of money which is unidentifiable by any financial institutions or services. Other countries may include money from such activity which is considered as a crime in that country even if the activity is legal in the country where the particular conduct occurred.

There are many activities that can be considered as predicate crimes to money laundering like corruption of public funds, trading of illegal goods, tax evasion, Insider trading and market manipulation etc. To stop this practice, Anti-Money Laundering Laws came into existence.

Anti-Money Laundering (AML) Laws are set of rules and regulations which limits the number of transactions and regulates the possible activities which can give rise to money laundering. It regulates and set standards to conduct trade and business and investigates & report in case of any suspicious activities.

Financial institutions that issue credit or open customers account should investigate to ensure that they are not taking part in any kind of money-laundering scheme. They must verify and monitor suspicious activities and report cash transactions exceeding $10,000. Also, to comply with AML laws, financial institutions are expected to make clients aware of these laws and guide people.

Although, anti-money laundering regulations have been adopted worldwide, a new online world has emergedas a new challenge for eradicating this problem. One example is digital money Bitcoin. It is one more challenge as it doesn't require customer identification. Online market, e-commerce merchants and almost all entity has an online identity and AML still have to go a long way to identify complex identities and therefore financial institutions need to be more stringent.

The money laundering started when people used to hide money to avoid tax or confiscation. In 2000 BC, wealthy Chinese merchants laundered profits due to ban of many commercial trading. Mean while, many rules were imposed to stop this practice however the loopholes continued.

In the 20th century, seizing of wealth could be seen unusually popular. The first time was during prohibition in US in 1930s. State and law enforcement agencies got the necessity to track the sources and confiscate money. Organized crimes and illegal sources of funds forced government to impose money laundering laws.

During late 19th and early 20th century many acts and laws were enacted to prevent money laundering. Few of them are: Money Laundering Act 1986 in US, Prevention of money laundering act 2002 in India, Financial Transaction Reports Act 1988 in Australia etc. However, Anti-money laundering guidelines became globally prominent when Financial Action Task Force (FATF) came into existence in 1989.

Fight against money laundering activities sped after a research finding by FATF through which FATF globally picked up the countries that were not complying with anti-money laundering laws. As per this finding, there was serious systemic problem with money laundering controls which required improvement of rules and practices. Then, Wolfs berg Anti-Money Laundering Principles in October 2000 came into existence. It was outcome of thinking of 11 world money center banks addressing private banks. The motto was that the worldwide operations of banks shall not be used for criminal purposes. Finally, the United Nations Convention against Transnational Organized Crime in December 2000 came, with more than 125 Countries as signatories; it includes many significant provisions with respect to money laundering and international cooperation in financial investigations.

The regional Acts governing money laundering still regulates the country. Financial Institutions and non-financial institutions need to investigate suspicious accounts and report to their respective country. Apart from manual handling of data and investigations, institutions also need to have anti-money laundering software that filters customer data and inspect for anomalies.

Global Organization: Financial Action Task Force on Money Laundering (FATF)

It is an intergovernmental body formed in 1989 by G7 countries to develop policies to fight against money laundering. Currently, 35 countries and territories and 2 regional organizations are its members. It has developed 40 recommendations on money laundering and countries non-compliant with the same are subject to financial sanctions.

Provisions of anti-money laundering act

As per the provisions of the Act, every banking company, financial institution (which includes chit fund company, a co-operative bank, a housing finance and a non-banking financial company) and intermediary (which includes a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee to a trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and any other intermediary associated with securities market) shall have to maintain a record of all the transactions. Such transactions include:

- All cash transactions of the value of more than $ 10,000 or its equivalent in foreign currency.
- All series of cash transactions integrally connected to each other which have been valued below $ 10,000 or its equivalent in foreign currency where such series of transactions take place within one calendar month.
- All suspicious transactions whether or not made in cash and including, inter-alia, credits or debits into from any non-monetary account such as demat account, security account maintained by the registered intermediary. It may, however, be clarified that for the purpose of suspicious transactions reporting, apart from 'transactions integrally connected', 'transactions remotely connected or related' should also be considered.

9.4 DISCUSS THE INDUSTRY TRENDS IMPACTING WEALTH MANAGEMENT

Re wired investor

Re-wired Investor refers to a new generation of investors with new thinking patterns, standards and expectations. The new generation of investors also includes baby boomers who are influenced by their younger peers.

The Re-wired investor wants to be treated as unique individuals with specific goals and preferences and they consider advice differently. They want to play a much more active role in the process of wealth management and expect to interact with advisors differently. They want advice based on their unique needs and constraints.

They want to play a more active part in wealth management by staying in control of their financial lives and making the important decisions themselves by considering the pros and cons of the advice. They are comfortable to conduct their own research and hesitate to buy discretionary services. The Re-wired Investor seeks opinions and views from multiple sources simultaneously and thus more skeptical than the investors of previous generation.

They consider the wisdom of their peers which is not only limited to advice from wealth advisors. Their expectations are shaped by their interactions with friends and colleagues and also social platforms like Google, YouTube and Facebook. Getting professional advice is easier than ever because of digitals devices like smart phones which gives investors access to advice anywhere and at any time through multiple sources.

The Re-wired Investor views risk differently: considers risk to be a downside, rather than volatility.

As a result, advisors have to give special importance to hedging strategies that gives more downside protection than traditional portfolio and manage risk through diversification.

The re-wired investors consider themselves entitled to the products and investment strategies available to the High Network Individuals (HNI's) or even institutional investors. This poses great challenge to the wealth management firms to think new ways to gives access to alternative investment strategies and other active strategies to the retail investors.

As time passes the influence of the new generation investors over the rest of the investor class is likely to increase thus the wealth management firms need to think of ways to adjust their offerings and services to these investors.

There is a trend that will impact the Wealth management sector in the coming decade:

- The aging of advisors- expectation that many will be retiring soon.
- Transfer of wealth from parents to their children.

Both of these could result in a massive change in advisor-client relationships. The advisor population is aging rapidly and preparing for a significant transition. It is expected that about one third of the current workforce will retire within a decade.

The Wealth management industry will need to hire and train about 240,000 advisors to maintain service at current levels. It is very challenging and costly to recruit and train a new generation of advisors at such a scale in a short span of time. A risk that the new recruits may learn and leave to join some other organization adds to the problem.

Understanding the preferences and needs of the re-wired investor is challenging for some advisors due to the increasing generation gap between the advisors and the Re-wired investor, which results in weakening of the advisor-client relationships.

Wealth management industry struggles with another issue i.e. advisors find it difficult to evolve toward new models that balance advice based on human and scientific factors. Adopting new techniques is difficult for these advisors thus the retiring wave is expected to impose significant problems for the wealth management industry.

This will encourage creative recruiting (e.g., tapping new talent pools for future advisors), better training (to encourage managing advisors to adopt new techniques). Firms should make efforts to strengthen client-advisor relationships to enable continuity of relationships even as the senior executives retire.

Firms can shift to new technologies and robo advice capabilities to entertain a greater number of clients. However, increasing regulatory requirements because of such increase in efficiency may be a concern.

Transfer of wealth possesses both an opportunity and threat to wealth management firms. Historically, 90% of the time, transfer of wealth from one generation to the next has resulted in a change of advisors. Firms should focus on building better relationships with their clients and their families—and by adapting to meet the expectations of their new clients, which may be very different from their parent's expectations.

Macro factors

The financial crisis in many ways has changed the investing parameters for both wealth managers and investors. Investors now have to consider the following to invest in such an environment:

- Low Interest Rates that make it difficult for investors to generate returns on their deposits and short-term investments;
- Low inflation rates with deflationary risk that has forced investors to reconsider assumptions about financial and real assets appreciation;
- Low economic growth that makes it more challenging to meet investors return expectations without taking unreasonable risks.
- High volatility across financial markets has made everyone reconsider the benefit of diversification or market timing.

As a result, investors are left confused. This uncertainty has several key implications for wealth management firms and advisors.

Convergence and new competitive patterns

The wealth management industry has experienced an increase in competition after the financial crisis, driven by a renewed commitment by wealth management firms. More firms and advisors are fighting for the same clients and assets.

Key competitive trends include:

- Convergence of brokerage and private banking models to serve big clients with a varied range of investment, advisory and lending capabilities. Brokerage firms are working on banking/lending capabilities whereas private banks try to enhance their sales and investment capabilities.
- Continued fragmentation of financial advisory with Independent Registered Investment Advisors (RIAs) continuing to gain market share at the expense of wirehouses.
- Increasing interests of established asset managers in the retail markets has led to their entry in the retail sector, competing head to head with entrenched discount brokerage providers.
- Competition for big clients is getting intense because both banks and discount brokerage firms are targeting the same segment. Robo advice capabilities will likely enable asset managers and insurance companies to entertain to the same clients and increasingly compete with other wealth management firms.
- Start-ups are getting valued in the wealth management industry by proving to be innovative. This will support these trends to drive a further increase in competition across most Wealth management markets and client segments and this in turn will impact the profit margins of wealth management firms.
- Investors throughout the world have never had so many options for advice, and they will use this leverage to get the most of out of the wealth management firms.

Rising cost

In just the past few years, the wealth management businesses have attracted significant regulatory action from the government. These regulatory actions highlight the risks that wealth management businesses pose on their parent companies (and how the cost of risk of these businesses has increased). Wealth management firms have always had to manage risk activities, from running adequate Know Your Customer processes for on-boarding clients to performing due diligence on the managers, from processing transactions to extending credit to clients. The cost of these risks is especially high for HNW businesses because of the large variety of products they offer and the sensitivity and high profile of their client base.

The regulatory environment has changed drastically after the 2008 crisis—and the entire regulatory impact is still unclear. The regulatory burden on wealth management firms, their advisors and their clients is getting more complex. This is where we could see regulatory burden shifting in 2015-2016:

- **Consumer Protection**: Regulatory focus is centered on consumer protection issues. The concept of putting the customer first and acting in their best interest is the main agenda of the regulators. Regulators want to enforce firms to have a culture of compliance.
- **Financial Products**: There are a lot of products that raise regulatory concern including retail alternative investments, non-traded real estate investment products and other structured products. Such products are a concern because they may be subject to liquidity, market, operational, interest rate or credit risk
- **Conflicts of Interest**: There may be conflicts of interest between the advisor and the client which restricts the managers to act in the best interest of the investor and is also a concern. Regulators globally are determined on having fund managers identify and reduce such conflicts. Example- Fees and compensation incentives, trading-fee rebate, etc.
- **Outsourcing**: Outsourced activities need to be in full compliance with all applicable securities laws and regulations (FINRA and MSRB rules). Whether appropriate due diligence is performed on potential providers has to be ensured.
- **Cyber-security**: This has proved to be a great threat in recent times. Thus the regulators want to ensure that controls and processes at wealth managers are well thought out are in compliance and this risk is mitigated.

A risk event such as a cyber-attack or a regulatory fine can destroy the trust the wealth management industry is based upon. This will also hamper the reputation of the institution. As the volume has significantly increased compared to the past, regulatory issues cannot be overlooked. As such, regulatory risk management is not a cost of doing business but an investment to build the institution's reputation.

9.5 DISCUSS THE RISK IN WEALTH MANAGEMENT

Human error

Mistakes can be made by anyone. Human error can have catastrophic consequences. Incomplete or inaccurate mandates to your asset manager or conveying decisions late can have an investor in grave danger. Timing is very important in reference to investing, and getting the timing wrong can have both positive and negative effects i.e. you may gain or may lose a fortune by getting the timing wrong.

Market risks

Market is dynamic and the rates can change at any time, and accurately predicting these changes can be really difficult. In this era of globalization where all economies are interconnected, any global macro event can have a huge effect on the local market rates. Market risks can be divided as follows: interest rate risks; currency risks; commodity risks; stock risks; the added risks associated with alternative investments, structured products and derivatives.

Location-based risk

The political and economic scenario of a country directly affects the markets and investments made in those markets via financial instruments.

Investing in countries that are politically unstable poses higher levels of risk. Political stability is one of the important requirements for growth. Location-based risks include transfer risks: changes to legal systems or political relations can make it impossible for you to transfer securities from a country in which you have invested to an exchange in another country, or to the country in which you reside. Complicated legal structure and flawed political regime make wealth planning more complex and in turn more risky.

Liquidity risks

A market suffers liquidity risk when the demand for securities or other assets is not enough to meet the supply of the securities i.e. buyers of the securities are much less than the sellers of the security. Buying or selling of securities can be particularly difficult in illiquid market and are generally accompanied by wider bid-ask spread. Liquidity risk is highest in alternative investments, real estate and private equity. The wealth manager might not consider any emergency liquidity requirement of the client would later result in loss in value of investment.

Divergence of Client and Manager Views

The manager might get too focused on earning for the client's portfolio and in turn might diverge from the client's investment goals. The client also might hesitate or not trust his manager and not explain his requirements from the portfolio. This divergence can be disastrous down the road as it will cause dissatisfaction in the client for his manager.

There are some more risks in wealth management that are focused on family business:

Family fallouts

This is the risk that a conflict between family members results in splitting of the family business and thus the wealth gets divided as well. Family fallouts ruptures wealth management. Such an event results in irrational distribution of assets which may increase the risk of low diversification and illiquidity risk, if sudden selling of assets takes place.

Sustainability risks

Sustainability risks refers to the risk that the assets may not be able to generate returns at the current rate in future. This may happen due to internal or external factors which adversely affects wealth management. Financial risk, political risk and credit risks effect sustainability. An increase in any of these risks will increase the sustainability risk.

Orientation of stakeholder goals

It refers to the alignment of stakeholder goals. Risk arises from two main factors i.e. the lack of common vision among members and inefficient leadership. With many members involved in a family business, it becomes difficult to align the interests of everyone, the lack of good leadership can result in frequent disputes and bad decision making.

9.6 DISCUSS MANAGING CLIENT RISK AND EXPOSURE.

Client-Advisor relationship

In today's scenario, client-advisor relationship is not limited to professionalism. The need of personal likability and trustworthiness is much more than professional knowledge alone as it is not a sole deciding factor, one need to know the satisfaction level and the expectations of the client. Maintaining such relation and knowing the client personally will make the decision of the advisor more satisfying for the clients.

Putting too much emphasis on professional aspects will end up giving no time to make the client understand the effect of economic and his personal requirement on the outcome which may lead to dissatisfaction and may end the relation. Therefore it is necessary to synthesize all the information and make the client understand where they are and what they need to do. This will help the advisor from any unrealistic expectations of the client and help the client to know exactly the effort advisor is putting and possible outcome of the same.

The following are few steps the advisors can take to build the strongest relationship possible with client:

- Gather personal details that can possibly effect the decision, to improve business-social relationship. It may include knowing the basic spending habit of the client, any particular plan or idea where they want to put their finance on, any one-time but heavy expenditure on education, medical assistance, acquirement of property etc. This would help to achieve the financial goal with all the other factors in mind. Advisor can also invest in Customer Relationship Management or marketing platform which would help to capture the data and personal information.
- Stay in constant communication with the client, especially in volatile times. Make sure of the mode of communication the client is comfortable with. Send the monthly updates and intimate during sudden changes. Ask the client the mode he would prefer during volatile times as he might me convenient with call or email etc.
- Know the intentions and requirements of the client. Listen to him. There might be a need to make him understand the context and current scenario so that he gets the gist of the present financial condition. Also, there might be any important information the client has to give to the advisor which will have a major impact on the decision. Track levels of client engagement. The best CRM systems should actively track the response and provide teams with real-time feedback and gives the direction to proceed further to the current strategy or modify if required.
- Keep it simple and relevant. Simplify the information to make it understandable to the client. It will help them to put forward any question they have and get better understanding of the same.

Understanding client's need, goals and priorities and work to reach their objectives.

Develop investment strategies and allocate capital accordingly to create maximum adjusted risk-return

Financial investment knowledge must not be limited by region or for only individual or institutional investors.

Risk involves the probability that the actual return will differ from expected return. It might means losing all or some of the invested money. The risk involved need to be assessed and then strategize the means to manage it.

Risk Management

Risk can be managed in multiple ways based on the type of subject of which risk need to be managed, frequency of risk and severity of loss. Also, the risk depends on the objectives of the client's interpretation and financial ability. A particular amount of risk might be very high for highly risk averse client having very low ability and willingness and same risk might be worth taking for a client having better ability and willingness. There are many other factors contributing to risk like time horizon, income, age etc. Risk factors are also different for an individual person and for an institutional entity. All of these contribute towards deciding the type and amount of risk to be taken. Here are few steps to control the risk:

- Predict and recognize the risk and the factors contributing to it.
- Estimate the probability and severity of loss.
- Select suitable method of treating the risk.
- Implement a plan to carry out the method.
- Evaluate and monitor.

Methods of treating the risk:

1. **Risk Transfer:**

   Risk transfer is a concept of transferring risk by one party to another contractually or via insurance. It can be transferred from individual to insurance company or by insurers to reinsurers.

   - Risk transfer to Insurance Company: In this case the individual agrees to pay a particular sum of amount to insurance company every term like monthly or annually. In return the insurance company promises a lump sum amount or percentage of amount to be provided in case of the happening for which the insurance had been taken. The amount to be paid by insurer depends on the certain factors related to the subject insured.
   - Risk transfer to Reinsurance Company: Insurance companies already take a lot of risks and therefore they too sometimes require to be insured and it can be done through the concept of reinsurance. In Reinsurance, in case of mishap, both insurance company and Reinsurance Company bear the loss of the reinsured subject. This helps the insurance company to lessen its burden of compensation and also gets bankrupt in case of heavy losses.

   Example of Risk Transfer: In an earthquake prone area, generally people run to get their property insured and during disaster, it becomes extremely tough for the insurance company to bear the burden of so many properties at a time and compensate the amount so in this case, reinsurance really helps the insurance company to share its burden and help all the property owners at a time.

2. **Risk Avoidance:**

   This is the easiest way to handle risk i.e. to avoid it either partly or altogether. It can be avoided by not accepting or engaging in the activities that possess risk. However, this option is not always advantageous as it may require giving up some most beneficial projects or investments. Although this method is simple way to tackle the situation however it may result in lost revenue. It is only good for the option where risk avoidance is possible and desirable.

Example of Risk Avoidance: A project having very good potential and high NPV may have very high investment. However, to avoid the risk of investing such high amount, one may decide to avoid such risk and give up such profitable opportunity.

3. **Risk Reduction:**

   Risk reduction or mitigation involves decreasing the negative consequences or effect of risk. It can be done in many ways like establishing security methodologies, records duplication, preventive maintenance etc. Basically, it can be done with properly analyzing the areas where there is possible to reduce the risk with little change in decision or modification of the idea. It can be better off with proper education and training.

   Example of risk reduction: One might find areas where cost cutting is possible which will decrease the possibility of suffering loss.

Monitoring and Evaluation of Risk

Monitoring and Evaluation is an ongoing process that involves regular checking and surveillance. The results should be noted down and proceed for further review and improvement. A well-developed monitoring and evaluation plan allows for adjustments to the strategies based on arrival of uncertainty and developments or new opportunities. Schedule of monitoring and evaluation activities:

- What sort of monitoring will be done (observation visits to area; client opinion surveys etc.)?
- How frequent will each activity take place (annually, monthly, etc.)?
- At what level (e.g. planning, execution, analyzing etc.)?

Monitoring:

It involves gathering, analyzing and recording data on planning, execution, result and impact. It aims to provide all the feedback on input, output and progress necessary for managers, decision makers and other stakeholders. It helps in taking corrective measures and act as early indicators of problems. It also helps in analyzing the reasons of gap between actual and expected performance. Hence, it is a timely and regular process that seeks to provide important and useful information required to analyze the whole scenario.

Evaluation:

Evaluation is a time- bound and periodic assessment that helps in providing important and useful information that guide the decisions by wealth managers. It tries to answer few questions like, how effective is the program? What is the outcome? What is the impact? Is it sustainable? Etc. It examines the theories and assumptions made and hint to modify if needed. Hence, there must be a proper structure of evaluation and people responsible for evaluating must have clear understanding of the system.

The firm's monitoring and evaluation structure must include all aspects of the risk management process to:

- Ensure that controls are effective and efficient in both design and implementation.
- Obtain further information to improve the assessing of risk.
- Analyze and take out lessons from risk events like changes, developments, successes and failures
- Detect changes in the external and internal context, including changes to risk criteria, which may require modification of risk managing processes and treatments
- Identify new or emerging risks.

Hence, assessing and facilitating monitoring and evaluation processes proactively improves the client risk and exposure.

SUMMARY

1. Discuss the regulatory framework governing wealth managers.
    - Regulatory Framework is the existence of the necessary infrastructure which helps to control and adopt the course of action, rule, principle or law.
    - The major financial regulators with respect to wealth management in US are: Securities & Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA).
    - The objectives of financial regulators are to protect the investors, ensure and enhance the stability of financial system and to maintain the confidence of investors in the system

2. Discuss fair dealing guidelines for managing wealth.
   - Fair dealing responds to inclination to prioritize one's most profitable clients and also to place self-interest ahead of clients.
   - Wealth Managers must treat the clients and the investors' interests equally
3. Discuss Anti-Money Laundering laws.
   - Money Laundering is an attempt to disguise illegally-gained proceeds so that they appear as legal i.e. came from legitimate sources or activities.
   - There are many activities that can be considered as predicate crimes to money laundering like corruption of public funds, trading of illegal goods, tax evasion, Insider trading and market manipulation etc.
   - Anti-Money Laundering (AML) Laws are set of rules and regulations which limits the number of transactions and regulates the possible activities which can give rise to money laundering.
   - Financial Action Task Force on Money Laundering (FATF) is an inter-governmental body formed in 1989 by G7 countries to develop policies to fight against money laundering
4. Discuss the industry trends impacting wealth management.
   - The aging of advisors & upcoming transfer of wealth
   - Macro Factors
   - Convergence and new competitive patterns
   - Re wired investor
   - Rising cost
5. Discuss the risk in Wealth management.
   - **Human error-** Mistakes can be made by anyone. Human error can have catastrophic consequences.
   - **Market risks**- Market is dynamic and the rates can change at any time, and accurately predicting these changes can be really difficult.
   - **Location-based risk**- The political and economic scenario of a country directly affects the markets and investments made in those markets via financial instruments.

- **Credit and counterparty risks**- it refers to the risk that the creditworthiness of the counterparty to the transaction will decline.
- **Liquidity risks**- A market suffers liquidity risk when the demand for securities or other assets is not enough to meet the supply of the securities
- Some other risks concerning a family are family fallout, sustainability risks and orientation of stakeholder's goals.

6. Discuss managing client risk and exposure.
    - Risk can be managed in multiple ways based on the type of subject of which risk need to be managed, frequency of risk and severity of loss.
    - A particular amount of risk might be very high for highly risk averse client having very low ability and willingness and same risk might be worth taking for a client having better ability and willingness.
    - Risk transfer is a concept of transferring risk by one party to another contractually or via insurance.
    - This is the easiest way to handle risk i.e. to avoid it either partly or altogether. It can be avoided by not accepting or engaging in the activities that possess risk.
    - Risk reduction or mitigation involves decreasing the negative consequences or effect of risk.
    - Monitoring and Evaluation is an ongoing process that involves regular checking and surveillance.

ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
1	IX	5	Liquidity risk is the highest in:	Alternative investments	Corporate bonds	Publicly traded stocks	T-bills	**A**	Alternative investments have the highest liquidity risk.
2	IX	1	FDIC stands for:	Federal Deposit Insurance Corporation	Finance Deposit Insurance Corporation	Federal Deposit International Corporation	Futures Deposit Investment Corporation	**A**	FDIC stands for Federal Deposit Insurance Corporation.
3	IX	2	A portfolio manager has distributed an oversubscribed IPO to her clients not as per pro-rata basis due to minimum lot size requirement. Is it violation of fair dealings guidelines?	Yes, as pro-rata basis must be strictly followed.	Yes, as IPO must only be offered to big clients.	No because the portfolio manager can allot shares at her own discretion	No, as minimum lot size requirement had to be followed	**D**	It is not a violation as the minimum lot size requirement has to be followed.
4	IX	5	Which of these risks in wealth management is specific to family business?	Sustainability risk	Market risk	Liquidity risk	Credit risk	**A**	Option A is the correct answer.
5	IX	4	Which of the following is the reason for growing difficulties for advisors in understanding re-wired investors preferences?	Impact of social media	Market fluctuations	Generation gap	All of the above	**C**	Understanding the preferences and needs of the re-wired investor is challenging for some advisors due to the increasing generation gap between the advisors and the Re-wired investor.
6	IX	1	Which of the following authorities monitors systemic risks in US?	FCA	FDIC	FINRA	FSOC	**D**	The FSOC acts as a coordinating body to simplify bank regulation and monitor systemic risks facing the financial industry.
7	IX	6	Schedule of monitoring and evaluating risks include:	What sort of monitoring will be done	How frequent will each activity take place	At what level these activities will take place	All of the above	**D**	Option D is the correct option.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
8	IX	3	United Nations Convention against Transnational Organized Crime included:	Provisions on Foreign Exchange management	Provisions on Money Laundering	International Cooperation in Financial Investigations	Both B and C	**D**	United Nations Convention against Transnational Organized Crime includes many significant provisions with respect to money laundering and international cooperation in financial investigations.
9	IX	6	________ aims to provide all the feedback on input, output and progress necessary for managers, decision makers and other stakeholders.	Evaluation	Preserving	Monitoring	None of the above	**C**	Monitoring aims to provide all the feedback on input, output and progress necessary for managers, decision makers and other stakeholders.
10	IX	3	FATF is an intergovernmental body formed to fight against ____.	Insider trading	Money laundering	Market manipulation	Bribery	**B**	FATF was formed in the year 1989 to fight against money laundering.
11	IX	2	A wealth manager has proposed an investment in a large cap equity index fund with a guaranteed return of 12%. Is it a violation of guidelines of fair dealings?	Yes because it is misrepresentation of facts	No because the fund might be giving 12% return on an anverage	No because he is just proposing the product and not trading	No because large cap equity is a safe investment	**D**	It is considered as misrepresentation of facts which is a violation of fair dealing guidelines.
12	IX	1	Financial Services Agency is the financial regulator for which economy?	Germany	India	Japan	European Union	**C**	Financial Services Agency is the regulatory authority in Japan.
13	IX	6	Which of the following factor help in improving client-advisor relationship?	Professional knowledge	Understanding of economy	Client's personal requirement	All of the above	**D**	Client's personal requirement, economic understanding and professional knowledge affect client-advisor relationship.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
14	IX	5	________ refers to the risk that the creditworthiness of the counterparty to the transaction will decline.	Market risk	Liquidity risk	Credit risk	Human error	**C**	Credit risk is the risk that creditworthiness of the couterparty will decline.
15	IX	4	All of these are industry trends that impact wealth management except:	Ageing of investors	Micro Factors	Rising costs	Convergence and new competetive patterns	**B**	Option B is the correct answer.
16	IX	5	______ is the risk when the demand for securities or other assets is not enough to meet the supply of the securities.	Market risk	Liquidity risk	Credit risk	Human error	**B**	Liquidity risk is the risk when the demand for securities or other assets is not enough to meet the supply of the securities.
17	IX	3	AML stands for:	Anti money laundering laws	Association against money laundering	Annual maturity Life	None of the above	**A**	Option A is the correct answer.
18	IX	4	The firm's monitoring and evaluation structure must include all aspects of the risk management process to ______.	Ensure that controls are effective and efficient in both design and implementation.	Obtain further information to improve the assessing of risk.	Identify new or emerging risks.	All of the above	**D**	All of the above are correct
19	IX	2	Code and ethics for wealth manager includes all except:	Wealth Managers must not incline towards trading in a client's account that is excessive in size or frequency with the	Wealth Managers must borrow money or securities from, or lend money or securities to a client.	Wealth Managers must not place buy or sell order of any un-registered security, or if the security or transaction	All of the above	**B**	Wealth Managers must not ever borrow money or securities from, or lend money or securities to a client.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
				view of the financial resources and character of the account.		is not exempt from registration in states where managers provide investment advice			
20	IX	4	Convergence and new competetive patterns include:	Continued fragmentation of financial advisory with Independent Registered Investment Advisors (RIAs) continuing to gain market share at the expense of wirehouses.	Increasing interests of established asset managers in the retail markets has led to their entry in the retail sector, competing head to head with entrenched discount brokerage providers.	Investors throughout the world have never had so many options for advice, and they will use this leverage to get the most of out of the wealth management firms.	All of the above	**D**	Option D is the correct option
21	IX	2	A wealth manager has lied to his client about his qualifications to attract more clients. However, he has always earned above average returns for all their portfolios. Is it a violation of guidelines of fair dealing?	No because he has provided his clients with excellent returns	Yes because it is misrepresentation of facts	No because the clients did not do thorough due dilligence of wealth manager	None of the above	**B**	It is considered as misrepresentation of facts which is a violation of fair dealing guidelines.
22	IX	5	Sustainability risk is defined as:	Inability to generate returns at the current rate in future	Inability to sell an instrument at its correct value	Changes to legal systems	None of the above	**A**	Sustainability risk is the inability to generate returns at the current rate in future.

Sl No.	Module	LOS	Question	Option A	Option B	Option C	Option D	Right Answer	Explanation
23	IX	1	Which of these is an objective of financial regulators?	To protect the investors	To ensure stability of financial system	To maintain investors confidence in financial system	All of the above	**D**	Al of these are the main objectives of the financial regulators.
24	IX	4	Macro factors include:	Interest rates	Inflation rates	Economic growth	All of the above	**D**	Macro factors includes all of the following.
25	IX	6	How do insurance companies reduce risk exposure?	Risk transfer to reinsurance company	Not providing further insurance policies	Risk Reduction	Insurance companies cannot reduce risk	**A**	In Reinsurance, in case of mishap, both insurance company and Reinsurance Company bear the loss of the reinsured subject.

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