

Advisor's Guide

Tax Planning

January, 08 to March, 08

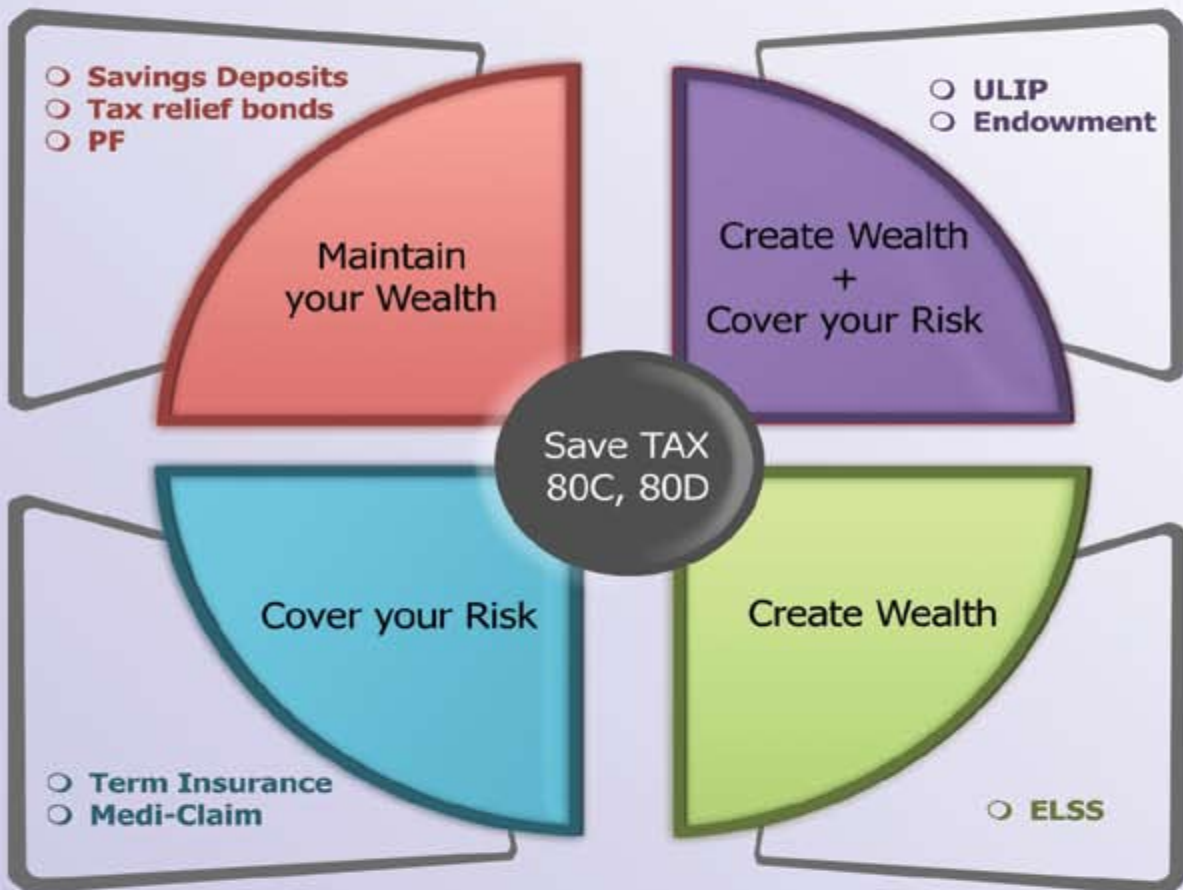


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Gyaan Darshan

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1 Tax Planning

1.1 Simplifying tax planning

Come January, and tax planning becomes the buzz word all round. Investors in their bid to save tax are investing in avenues and asset classes without any understanding of the product. Even if the product is understood, during most occasions' it does not suit the investor's requirements. Based on the investment pattern seen in the recent past, it is evident that while tax benefit is the primary objective; the asset class and the profile & objectives of the individual investor do not match with the investment being done. Investments need to be aligned to fulfill financial objectives and hence the need for proper tax planning.

To explain this further, if an individual is in the 'wealth accumulation' phase of his life and is looking at enhancing the wealth through various investment avenues available, when it comes to tax saving, invests in products which may not be in line with the investor's objective. This is due to the fact that these instruments historically were pertaining to the debt category. Though the Government has introduced various products which

might suit the profile of the investors, but these are not being fully exploited by them.

Herein sprouts the need to understand tax saving products and more importantly to match the same with the investor's profile so as to provide the best products to them. It would be mutually beneficial as it would help the investor in aligning his investments to his financial goals and would allow us to build a long term relationship with him.

But before we delve into the idea of tax planning let us try and understand how we can understand different investor profiles and advise accordingly. Investment objectives with which tax planning is done can be classified as under:

1. Maintaining your wealth
2. Cover your risk
3. Create wealth & cover your risk
4. Create wealth

Now it becomes very important for us and the investor to understand which category or profile does an individual fall into.



If the investor's primary objective is to safeguard his existing wealth and stay at par with inflation, he has the following option:

A. Maintain Your Wealth!

Provident Fund – The minimum and maximum investment amounts are Rs.500 and Rs.70,000 in a year respectively. The amount contributed offers an assured return of 8% p.a. However, there is a lock-in of 15 years. The amount invested is eligible for deduction u/s 80C of the IT Act. The interest earned is exempted from tax. The maturity amount is exempted u/s 10 (10D). He can withdraw the entire balance in lump sum or in installments (maximum one withdrawal in a year).

Savings Deposit – He can also invest his savings in a Savings bank account / FDs / NSC. The interest earned on savings bank balance / FDs are eligible for deduction u/s 80C of IT Act. Interest on FDs depends on investment duration and varies across industry. Savings bank interest is merely 3.5% pa. Amount invested in NSC is also eligible for deduction from Total Income u/s 80C of IT Act. NSC offers a return of 8% pa and has maturity tenure of 6 years.

Bonds with tax benefits – An investor can invest in bonds with tax-benefits like RBI bonds, Flexi bonds, Infrastructure bonds etc. Some of these bonds offer tax relief in terms of principal invested and interest earned up to Rs. 1 lac u/s 80C. Before making any investment one should compare post-tax returns of various instruments.

These are the traditional avenues of investment available to an individual investor. He can claim a total exemption up to a maximum of Rs.1,00,000 u/s 80C. Though risk of erosion of principal is very low, one will not be able to create wealth by investing in these avenues since returns are pretty low.

B. Cover Ur Risk!

If one's financial objective is mitigation of Life and Health risk, do not worry. The taxman has got something for you as well in his kitty! Here comes Term insurance, whole life plans and Medical insurance to your rescue.

Term Insurance - The insurance premium is typically lowest in these plans. One can avail a risk cover for

Rs. 5 Lacs for 20 years by paying merely Rs.1,800 pa! Though the maturity amount is nil, the death benefit is fully exempted u/s 10(10D). The premium paid is eligible for deduction u/s 80C.

Medical Insurance – If you are getting tensed with medical expenses of your family, take a medical insurance policy. These plans reimburse your medical bills relating to hospitalization, surgery etc.

C. Create Wealth!

If accelerated wealth creation is what an individual is looking for, here comes the **Guru-Mantra**: ELSS! Equity-linked saving scheme is a mutual fund scheme that invests primarily in equity and equity-related securities. Investment in ELSS offers tax benefit under Section 80C - a deduction of up to Rs.1 lakh from the taxable income. It has a lock-in of 3 years. As these investments get exposure to equity markets, there is a potential for accelerated wealth creation. If the investment duration is 3 years or more, ELSS is a great tax-saving investment with potential for wealth creation. Remember there is no risk cover in ELSS.

D. Create Wealth & Cover your Risk!

Getting tempted by all the above objectives? Thank god. There are solutions for this as well! One can invest in ULIPS and Endowment plans so that he covers his life and also accumulate substantial wealth over time.

ULIP – A Unit Linked Insurance Plan provides the twin advantage of the life assurance cover along with the wealth creation. The premium paid would be invested to certain extent in equity markets. One can even park surplus funds in these plans. The contribution to ULIP is eligible for deduction u/s 80C and the maturity / death proceeds are exempted from tax u/s 10 (10D). There is a lock-of 5 years post which one has options: continue paying premiums or withdraw the accumulated balance.

Endowment plans – Several endowment and money-back plans not only provide risk cover but also generate returns. The premium an individual pays for these plans is eligible for deduction u/s 80C and the maturity / death proceeds are exempted from tax u/s 10 (10D). Investment in them is suggested typically for a longer duration.

1.2 Back to basics

Tax planning under the Income Tax Act can be done under the following heads:

Exemptions

Any income is said to be exempt when it escapes the computation of income tax. In other words, it does not feature in the process of tax calculation.

Few important exemptions under the IT Act, available to individuals are as follows:

- 1) Receipt of any sum under a life insurance policy, either in the form of bonus or on death or on maturity is not taxable under section 10(10D).
- 2) Any income that received in the form of dividends is exempt from tax i.e. dividend income is not taxable under section 10(34).
- 3) Income received in respect of units of mutual funds is also exempt from tax under section 10(35).
- 4) In respect of salary income the following are some important exemptions:
 1. Exemption with respect to house rental allowance (HRA):

Exemption is the minimum of the following:

 - a. If you are staying in a metro – exemption is 50% of (basic + DA)
If you are staying in a non-metro – exemption is 40% of (basic + DA)
 - b. Rent paid in excess of 10% of (basic + DA)
 - c. Actual HRA received
 2. Children education allowance is exempt to the extent of Rs.100 p.m. per child for a maximum of 2 children
 3. Children hostel allowance is exempt to the extent of Rs.300 p.m. per child for a maximum of 2 children
 4. Conveyance allowance is exempt to a maximum extent of Rs.9,600 p.a.
 5. **Leave travel allowance (LTA):**
 - a. It is exempt to the extent of travel expenses against the costs incurred for the family in connection with travel undertaken any where in India.
 - b. The travel concession can be availed only on expenditure incurred towards TRAVEL FARES (Bus, Train or Air). No other expenses (viz., boarding and lodging etc.) will qualify for exemption.
 - c. The exemption is admissible only to the shortest possible route taken. If a journey is performed in a circular form touching different places, then exemption will be limited to what is admissible for the journey from the place of origin to the farthest point reached, by the shortest route.
 - d. The exemption is available for only 2 journeys performed in a block period of 4 calendar years.
 - e. If an employee has not availed travel concession during the specified block-periods on one of the two permitted occasions or both occasions, exemption can be claimed in the first calendar year of the next block in respect of one journey. This exemption will not be counted for the purposes of claiming the future exemptions allowable in respect of 2 journeys in the subsequent block period.

6 Death-cum-retirement gratuity: For tax treatments refer table.

Government employees and employees of a local authority	Employees covered under the Gratuity Act	Any other employee
Gratuity is fully exempt	<p>Gratuity is exempt to the extent of minimum of the following:</p> <p>a. Rs.3,50,000</p> <p>b. 15 days salary for every completed years of service or part thereof exceeding 6 months</p> <p>c. Actual amount received</p> <p>NOTE: Meaning of salary</p> <p>(i) Basic salary + DA</p> <p>(ii) Last drawn salary</p> <p>(iii) No. of days in a month to be taken as 26</p>	<p>Gratuity is exempt to the extent of minimum of the following:</p> <p>a. Rs.3,50,000</p> <p>b. Half months average salary of each completed years of service</p> <p>c. Actual amount received</p> <p>NOTE: Meaning of salary</p> <p>(i) Basic salary + DA</p> <p>(ii) Average of last 10 months salary</p> <p>(iii) Only completed year of service is to be taken</p>

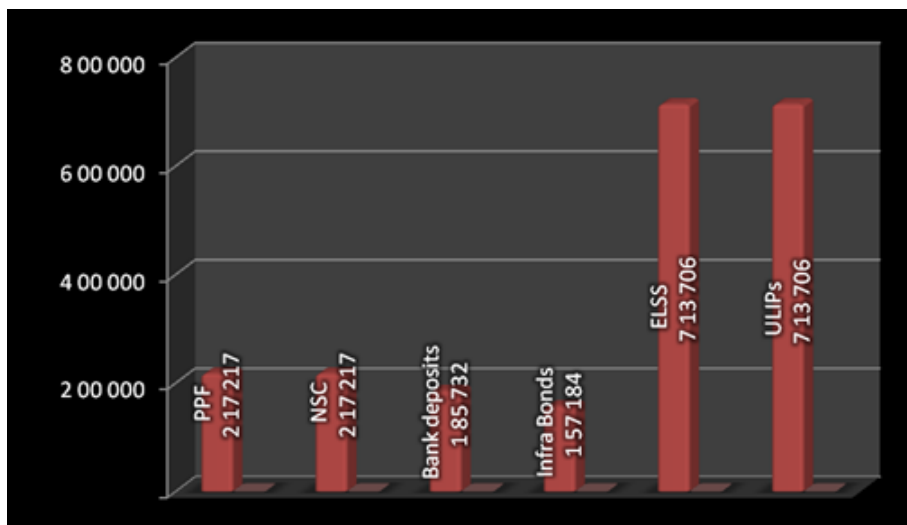
Deductions

An expense subtracted from adjusted gross income when calculating taxable income, such as for state and local taxes paid, charitable gifts, and certain types of interest payments.

Let us now try and understand how we can use deductions in taxable income to reduce an investor's tax liability under different sections by the way of deductions.

Section 80C of the Income Tax Act provides for deductions from the taxable income up to Rs.1,00,000 p.a. for the investments / contribution made towards specific avenues such as Public Provident Fund, National Savings Certificate, Infrastructure Bonds, Life Insurance premiums, ELSS, etc. Similarly, Section 80D of the IT Act provides for deduction from the taxable income for the premium paid towards medical insurance policies up to Rs.15,000 p.a. (Rs.20,000 in case of taxable income computation for senior citizens).

Comparison of 80C investment in a nutshell:



It is very important to analyse the investments well before you start investing. Here it is evident that your selection of investments can make a huge difference in your portfolio. The traditional plans have a very moderate rate of return as compared to the market linked plans. ELSS and ULIPs in growing market has given as high as 60% per annum also. WE cannot expect similar returns always but 15% is definitely doesn't look far away.

Instruments	Investment amount	Lock-in period	Indicative returns	Liquidity
PPF	Up to Rs.70,000	15 years	8%	Medium
NSC	Up to Rs.1,00,000	6 years	8%*	Low
Bank deposits	Up to Rs.1,00,000	5 years	7.25%*	Low
Infrastructure Bonds	Up to Rs.1,00,000	More than 3 years	6.5%* (average of recent launches)	Low
ELSS	Up to Rs.1,00,000	3 years	Market linked returns	High
ULIPs	Up to Rs.1,00,000	5 years	Market- linked returns	Low

Section 80D: The premiums paid towards a health insurance plan on the health of self, spouse, dependant parents and dependant children, will be available for a deduction under section 80D up to a maximum of Rs.15,000.

Section 80E: It covers deduction with respect to any amount paid towards interest on loan borrowed from any financial institution for the purpose of higher education. This can be availed only up to 8 years from the date of availing the loan

Section 80GG: Deduction in respect of rent paid (Not available for individuals who are in receipt of HRA). Quantum of deduction is the minimum of : (i) Rs.2,000 p.m. or (ii) 25% of taxable income or (iii) rent paid in excess of 10% of taxable income

Section 24: Interest payable on housing loans can be claimed as a deduction under this section. If you are staying in the property, the limit is Rs.1,50,000. In case you have given the property on rent, the entire interest can be deducted.

Rebates

It is a reduction from tax payable. Currently there is only one rebate you can avail.

Section 88E: If one has income arising from the business of dealing in securities, one can claim a rebate to the extent of securities transaction tax paid in respect of taxable securities transactions entered into in the course of business.

1.3 Case Study

We often attach so much importance to the 'BIG' things in life that the inevitable assumes negligible significance just because it is predictable and so sure to happen. We plan for our birthday parties, our friend's wedding gift, for vacations abroad well in advance but often ignore our fuel bills exceeding our allowances, phone bills which overrun the prescribed limits, team outings on those Saturdays we don't feel like eating at home, movies at the multiplexes fully loaded with cheese popcorn and soft drinks spilling on the Saturday special tee-shirt bought from last month's bonus which eventually has to go for a 'dry-clean'. Investments strike chords only in December when taxes come and axe our happiness.

Are we at all planned for these expected yet unpredictable, occasional yet day-to-day expenses?

The answer is an echoing NO.

Is there a solution?

There certainly is. The solution lies in commitment to being financially successful. Effective & systematic planning and periodic review of one's finances will lead one to the much desired 'Financial Nirvana'.

Some people dream of success, while others wake up and work towards it.

Pranav is a 23 year old engineer from 2006 batch of IIT Kanpur, specialized in civil engineering and placed with Larsen & Toubro Limited (L&T), India's largest engineering and construction conglomerate as a project engineer at a CTC of 5 lakhs p.a. His company also provides him with a health insurance cover and a personal accident cover along with the EPF contribution. Pranav has a younger sister Stuti who is 20 years old. Stuti is pursuing her degree course in NIFT, Delhi for which she's taken an education loan of Rs. 2,50,000 at 10.5% which Pranav would be repaying. His parents are working and are not dependent on him.

Profile:

Name:	Mr. Pranav Singhal
CTC:	5 Lakhs p.a.
Educational loan:	Rs. 4 lakhs @ 8.5 % p.a.
SIP of Rs. 5000 since 3 years (accumulated sum: Rs. 1,31,433)	

Observations

Pranav is not particularly organized or ambitious, but given the circle of friends, he has exploited the opportunity in the magic of compounding. So at age 20, while still in college, he began contributing Rs.5,000 a month to a moderately aggressive fund suggested by his neighbourhood bank. It produced annual returns of 9% on average which has accumulated to a sum of Rs.1,31,433.

However, due to lack of exposure and improper planning his taxes are in complete jeopardy and he's paying much more taxes than he should ideally be. Let's have a look at his salary structure.

Table-1 shows Pranav's salary breakup and the tax implications of each component. His exemption on tax liability on his HRA has been calculated as the minimum of the following:

1. Excess rent paid over 10% of salary	Rs.73,200 p.a.
2. 50% of basic	Rs.1,14,000 p.a.
3. Actual HRA received	Rs. 90,000 p.a.

Table - 1

Components of salary	Amount p.a.	Exempted p.a.	Taxable amount p.a.
Basic	2,28,000	0	2,28,000
HRA	90,000	73,200	16,800
Conveyance	21,600	21,600	0
Special allowance	42,000	0	42,000
Telephone allowance	24,000	24,000	0
Medical	0	0	0
P.F. (employer's contribution)	27,360	27,360	0
LTA	24,000	24,000	0
Bonus	43,200	0	43,200
CTC	5,00,160	Taxable	3,30,000

After taking into consideration his exemption up to Rs. 1,10,000 and deduction up to Rs. 1,00,000 under section 80C (for which he has made relevant investments under various heads), his taxable income works out to approx. Rs. 2,30,000 and thus he ends up paying Rs. 19,000 as taxes per annum. Thus, his post tax take home can be calculated as follows:

Table - 2

CTC Per month	Rs. 41,680
Professional tax per month	Rs. 200
Provident fund per month	Rs. 3,888
Take Home per month	Rs. 37,592
Tax per month	Rs. 1,583.33
Post tax per month	Rs. 36,008.67

However, he can save much more if he plans his taxes carefully. If he starts repaying his and Stuti's education loan this year onwards, he can avail a tax deduction up to Rs. 40,000 under Section 80E. Also, he should take a medical insurance with a premium of Rs. 15,000 per year which would be eligible for tax deduction under Section 80D. At present he doesn't have a home loan and neither has he expressed a desire to take up one, otherwise he would also have been eligible to tax deductions for home loan principal repayment under section 80 C and home loan interest repayment under section 24.

He is already using deduction up to Rs. 1 lakh under section 80 C, however he can further optimize the investments he has made. Section 80 C offers him deductions in respect of life insurance policy payments, payments made towards deferred annuity. (not exceeding 20% of the sum assured), contribution to PF, super annuation funds, P.O savings, payments to NSC, notified saving certificates, unit linked insurance plans, MF, bank deposits for a 5 year period, principal repayment of housing loans and investments in infrastructure bonds.

Table - 3

Taxable Income	3,30,000
Less: Under Sec 24 (Int on HL)	0
Less: Under Sec 80C (Till 100000)	1,00,000
Less: Under Sec 80D (MedClaim)	15,000
Less: Under Sec 80G (Donation for Charity)	0
Less: Under Sec 80GGC (Donation to PP)	0
Less: Under Sec 80E	40,000
Taxable	1,75,000
Tax Payable	8,000

After declaring his payouts this way, he would eligible for a total tax deduction of Rs. 1,39,000 and hence his total taxable income would reduce to Rs. 1,75,000 and thus tax liability would be Rs. 8,000 p.a. as shown in Table-3. His take home would thus increase to Rs. 36,925.33.

Financial planning is done with the objective of holistically preparing for all goals, contingencies, liabilities, taxes and other financial issues in life.

2 Mutual Fund Analysis Tools

With the increasing number of mutual fund schemes, it becomes very difficult for an investor to choose the type of funds for investment. By using some of the portfolio analysis tools, he can become more equipped to make a well informed choice.

There are many financial tools to analyse mutual funds. Each have their unique strengths and limitations as well. Therefore, one needs to use a combination of these tools to make a thorough analysis of the funds.

In the olden days, the investment decision taken by the investor's were very easy, because the markets were neither very volatile nor very buoyant. As compared to this, in the current scenario volatility seems to be the order of the day. This coupled with the surfeit of opportunities makes investing a matter of choice and not chance. The easiest available option for investors is to choose the best performing funds in terms of 'returns' which have yielded maximum returns.

Yes, the returns are important but it is also important to look at the 'quality' of the returns. 'Quality' determines how much risk a fund is taking to generate those returns. One can make a judgment on the quality of a fund from various ratios such as Standard Deviation, Sharpe Ratio, Beta, Treynor measure, R-Squared, Alpha etc. These terms may look intimidating, but are not so difficult to understand. Now in this issue of Business Associates Manual (BAM) we have tried to interpret all the above said ratios with the help of a case study.

a) Rolling Returns (RR): Generally it is not wise to decide on the performance of a fund just on the basis of its point to point return. The point to point returns can be misleading if the period considered is the one during which the fund has performed well. Rolling returns remove the limitation of point to point returns, as they constitute many point to point returns.

Example

Daily 1-year Rolling returns between 1 Jan 2000 to 31 Dec 2006 are calculated for the following period.

1 Jan 2000	to	1 Jan 2001
2 Jan 2000	to	2 Jan 2001
3 Jan 2000	to	3 Jan 2001
4 Jan 2000	to	4 Jan 2001
.....	to
.....	
.....	
.....	
31 Dec 2005	to	31 Dec 2006

1 yr rolling return will be calculated on daily basis from 1 Jan 2000 till 31 Dec 2006

Thus in the above case, if it is assumed that all days in an year are working days, there will be 2192 instances of 1-year point-to-point returns.

Number of leap years = 2 yrs. (366 days * 2 yrs = 732 days)

Number of normal years = 4 yrs. (365 days * 4 yrs = 1460 days)

Total number of years = 6 yrs. = 2192 days

One can read rolling returns in many ways. But the simplest way is to look at the minimum, maximum and average of the return values.

b) Standard Deviation (SD): In simple terms, standard deviation is one of the commonly used statistical parameter to measure risk, which determines the volatility of a fund. Deviation is defined as any variation from a mean value (upward & downward). Since the markets are volatile, the returns fluctuate every day. High standard deviation of a fund implies high volatility and a low standard deviation implies low volatility.

c) **Semi Standard Deviation (SSD):** While Standard deviation considers both upward and downward variations from a mean value, it could be misleading in some cases. For example if a fund gives very good returns, its SD could be high. This is because positive movement of NAV (from the mean value) is considered as deviation for computation of SD. From the investor's perspective, upward movements (returns) do not depict risk. Only the downward movement should be captured for computing risk. Semi Standard Deviation is used for measuring only the downside risk. SSD is also called as downside deviation (DD), the greater the value of downside deviation, the greater the risk. It is used to measure the effectiveness of the portfolio return.

d) **Downside Probability (DP):** It is the ratio of cases when negative returns were made to the total number of cases. For example, where the total number of instances is 100 in that 20 were the cases where negative returns were made. Which means $DP = 0.20$ (20%) for the total instances. The limitation of DP is that it does not capture the intensity / degree of negative returns. For example if there are two funds having downside probability of 20% each, it would not indicate which fund has lost more. In this case, we need to probe into DD for more details.

e) **Beta Analysis (β):** Beta is used to measure the risk. It basically indicates the level of volatility associated with the fund as compared to the market. In case of funds, Beta would indicate the volatility against the benchmark index. It is used as a short-term decision-making tool. A beta that is greater than 1 means that the fund is more volatile than the benchmark index, while a beta of less than 1 means that the fund is less volatile than the benchmark index. A fund with a beta very close to 1 means the fund's performance closely matches the index or benchmark.

The success of Beta is heavily dependent on the correlation between a fund and its benchmark. Thus, if the fund's portfolio doesn't have a relevant benchmark index then a beta would be grossly inappropriate. For example if we are considering a banking fund, we should look at the Beta against a bank index.

f) **R Squared (R^2):** R Squared is the square of 'r' (i.e. Co-efficient of Correlation). It describes the level of association between the fund's volatility and market risk. The value of R-squared ranges from 0 to 1.

A high R-squared (more than 0.80) indicates that beta can be used as a reliable measure to analyze the performance of a fund. Beta should be ignored when the R-squared is low as it indicates that fund performance is affected by factors other than the markets.

For example:

	Case 1	Case 2
R^2	0.65	0.88
β	1.2	0.9

In the above table R^2 is less than 0.80 in Case - 1, implies that it would be wrong to mention that the fund is aggressive on account of high beta. In Case 2, the R^2 is more than 0.85 and beta value is 0.9. It means that this fund is less aggressive than the market.

g) **Sharpe Ratio:** Sharpe Ratio is a risk to reward ratio, which helps in comparing the returns given by a fund with the risk that the fund has taken. A fund with a higher sharpe ratio means that these returns have been generated taking lesser risk. In other words, the fund is less volatile and yet generating good returns. Thus, given similar returns, the fund with a higher Sharpe ratio offers a better avenue for investing.

The ratio is calculated as

$$\text{Sharpe Ratio} = (\text{Average Return} - \text{Risk Free Rate}) / \text{Standard Deviation}$$

h) **Sortino ratio:** The Sortino ratio measures the risk-adjusted return of an investment or portfolio. It is a modification of the Sharpe ratio but considers only those returns falling below a user-specified target, or required rate of return, while the Sharpe ratio considers both upside and downside volatility equally, Sortino ratio considers only the downside volatility. It is thus a more realistic measure of risk-adjusted returns than the Sharpe ratio.

The ratio is calculated as

$$S = (\text{Average Return} - \text{Risk Free Rate}) / \text{Downside Deviation}$$

i) **Treynor Ratio:** It is also used as a measure of risk-adjusted return. It is computed by dividing the excess returns over and above the risk-free return by the scheme's beta. The higher the Treynor ratio, the better the fund's performance.

The ratio is calculated as

$$\text{Treynor Ratio} = (\text{Average Return} - \text{Risk Free Rate}) / \text{Beta}$$

j) **Jensen's Alpha (α):** Jensen's Alpha measures excess return generated by the fund in relation to its risk (Beta). Positive Alpha suggests strong performance

while negative Alpha reflects weak performance. Higher a fund's risk level, greater the returns it must generate in order to produce a higher Alpha. However, Alpha alone may not give a clear picture of the value that has been added by the fund manager.

Therefore, Jensen's Alpha is divided into two components which are Return due to net selectivity and Return due to improper diversification. The net selectivity represents the stock selection skill of the fund manager, while Return due to improper diversification captures excess returns which are generated on account of concentrated bets on stocks and sectors. These two components should be considered as a percentage of Jensen's Alpha while analysing. For example in the table below, fund XYZ has a higher Jensen's Alpha. However, net selectivity component is higher for fund ABC. Therefore, fund manager of ABC fund has proven to have better stock selection skills.

	ABC	XYZ
Jensen's Alpha	4.43	4.63
Return due to net selectivity	3.12	2.80
Return due to net selectivity %	70.43	60.48
Return due to improper diversification	1.31	1.83
Return due to improper diversification %	29.57	39.52

Case Study Analysis:

Ratios	ABC	XYZ	S&P Nifty (Equity)
Simp. Annualized			
Minimum	-28.90	-22.40	-70.50
Maximum	103.22	117.97	126.39
Average	38.94	41.00	37.43
Std. Dev.	29.41	27.98	18.95
Semi Std dev (Downside Deviation)	15.65	15.58	12.64
Downside Probability	0.29	0.25	0.20
Beta	0.98	1.05	1.00
R Squared	0.81	0.85	1.00
Sharpe	1.12	1.25	1.65
Treynor	32.91	33.08	31.43
Sortino	2.10	2.24	2.48
Jenson's Alpha	1.47	1.73	0
Return due to Net Selectivity	0.74	0.95	0
Return due to Im-proper	0.73	0.78	0

- Note:** 1. Daily annualized 6 months rolling returns have been considered.
2. Risk free rate of return = 6%

Analysis:

- ❖ From the above chart we find that the SD of the ABC fund as well as XYZ fund is higher than its index i.e., S&P Nifty. Generally lower the SD lower is the risk and vice versa. Also as a matter of comparison between the two funds, ABC fund carries a greater risk than its counterpart.
- ❖ In case of SSD only the negative deviations from a mean value are captured. In the above table we find that both the funds carry higher risk in comparison to the benchmark index and when a comparison is drawn between the funds, XYZ fund carries slightly lower risk than ABC Fund.
- ❖ As DP of fund XYZ is lower than fund ABC, it means that there were lesser number of negative return cases of XYZ fund.
- ❖ The β of XYZ fund is little higher than that of its benchmark index and its comparable fund. Therefore XYZ fund is more volatile than its benchmark and its counterpart. As R^2 values are more than 0.80 in both the cases, we can rely on the usage of β for the analysis of these funds.
- ❖ A collective look at Sharpe, Treynor and Sortino Ratios indicate that fund XYZ is an 'outperformer' against fund ABC but has delivered poor performance against the index.
- ❖ Both the funds have delivered positive α . In the above case we find that XYZ fund has a higher value of α than that of ABC fund and this signifies that XYZ fund gives better returns than ABC fund.
- ❖ The return due to net selectivity % and Jensen's Alpha is higher in XYZ fund than its counterpart. Therefore the performance of the fund manager is better in XYZ fund.
- ❖ The return due to net selectivity is negative for both the funds. On the other hand, return due to improper diversification has resulted in positive Alpha in both the funds. Though it may appear that both the fund managers have not delivered any stock selection value, such results are possible in thematic or sector funds.

3 Performance Review of Recommended Schemes

2.1 Equity Funds

Table - 2.1

Scheme Name	Crisil Ranking #	Returns (%)*				Risk		Load Structure		Preferred Investment Duration
		3 – months	6 – months	1 – year	3 – year	Downside probability	Sortino	Entry Load	Exit Load	
DSP Merrill Lynch India Tiger Fund	N.A	-3.84	30.34	47.53	54.22	0.22	1.73	2.25%	Nil	3-5 years
DSP Merrill Lynch Top 100 Equity Fund	1	-6.08	23.99	36.89	44.58	0.20	1.69	2.25%	Nil	3-5 years
DWS Alpha Equity Fund	2	-5.46	28.74	42.49	41.57	0.24	1.53	2.25%	Nil	3-5 years
Fidelity Equity Fund	N.A	-4.68	15.65	29.41	--	0.18	1.66	2.25%	Nil	3-5 years
HDFC Capital Builder Fund	4	-7.07	20.26	40.17	36.88	0.19	1.63	2.25%	Nil	3-5 years
ICICI Prudential Service Industries Fund	N.A	2.11	21.76	32.26	--	0.14	1.87	2.25%	Nil	3-5 years
JM Basic Fund	1	-0.62	24.13	60.26	44.11	0.11	2.15	2.25%	Nil	3-5 years
Principal Resurgent India Equity Fund	3	-6.94	13.67	30.10	35.54	0.15	1.73	2.25%	0.50%	3-5 years
Reliance Diversified Power Fund	N.A	0.09	57.74	95.62	76.72	0.16	2.00	2.25%	Nil	3-5 years
Reliance Growth	2	-0.90	27.23	43.01	51.10	0.20	1.90	2.25%	0.50%	3-5 years

Reliance Media & Entet Fund	N.A	12.13	19.98	41.34	47.60	0.05	2.47	2.25%	Nil	3-5 years
Reliance RSF - Equity	3	17.65	52.66	65.48	--	0.22	1.56	2.25%	Nil	3-5 years
Standard Chartered Premier Equity Fund	N.A	9.68	41.87	68.81	--	0.07	2.44	2.25%	1.00%	3-5 years
Sundaram BNP Paribas CAPEX Opportunities Fund	1	-10.71	28.14	49.42	--	0.24	1.45	2.25%	1.00%	3-5 years
Sundaram BNP Paribas Select Midcap	2	-1.81	21.86	28.67	48.85	0.23	1.42	2.25%	1.00%	3-5 years
Tata Infrastructure Fund	1	-6.73	31.76	51.94	54.69	0.24	1.52	2.25%	1.00%	3-5 years
Templeton India Equity Income Fund	N.A	-7.99	15.45	27.79	--	0.13	1.68	2.25%	1.00%	3-5 years

Notes:

1. Entry and exit load have been mentioned for the amount less than Rs.2 crores. The amount restriction for the load structure may vary according to the AMC.
2. Risk analysis is computed on daily 3-months rolling return for the period of the last 1-year as on January 31, 2008.

*Returns as on February 04, 2008. 3-months and 6-months returns are absolute, rest are annualised.

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The fund selection approach

We have followed the top-down approach for fund selection.

1. First step includes short listing of funds based on the outlook with reference to specific sectors, industries and market segment (large, mid and small capitalisation). This step generates a list of funds whose portfolio looks attractive and is likely to be among the top performers in its category.
2. Further, we have classified these funds into categories based on the risk associated with them. The criterion for assessing the risk associated includes portfolio concentration, sectoral focus, exposure to various market capitalisations and investment philosophy (growth and value).
3. Under each category, funds have been further filtered based on their performance and consistency in returns.

2.2 Balanced Funds

Table - 2.2

Scheme Name	Crisil Ranking #	Asset Allocation (% of corpus) @			Returns (%) *				Load Structure		Preferred Investment Duration
		Equity	Debt	Others	3- months	6- months	1-year	3-year	Entry load	Exit load	
HDFC Prudence Fund	3	75.3	15.4	9.3	-2.16	13.62	25.17	36.47	2.25%	1% if redeemed before 12 months	2-3 years
ICICI Prudential Child Care Plan - Gift Plan	N.A	95.7	3.4	1.0	5.65	28.15	34.83	35.19	1.25%	1% if redeemed between 1 to 3 year	2-3 years
Kotak Dynamic Asset Allocation Fund	N.A	122.7	64.5	-87.3	-9.29	35.82	46.57	--	Nil	Nil	2-3 years
PRINCIPAL Child Benefit - Career Builder Plan	N.A	58.7	15.2	26.2	7.09	24.01	39.45	39.64	2.25%	3% if redeemed between 0 to 3 year	2-3 years
SBI Magnum Balanced Fund	3	75.1	7.2	17.7	-4.23	18.85	26.65	36.49	2.25%	1% if redeemed between 0 to 6 months	2-3 years

Notes:

* Returns as on February 04, 2008. 3-months and 6-months returns are absolute, rest are annualised.

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@ As on January 31, 2008

1. Entry and exit load have been mentioned for amount less than Rs.2 crores. The amount restriction for the load structure may vary according to the AMC.
2. Any debt-oriented balanced scheme has not been listed. When the portfolio requires more than 50% exposure to debt, we recommend investing separately in equity and debt funds to achieve a desired debt-oriented asset allocation than investing in such balanced fund. This will result in a more tax efficient portfolio. For equity-oriented schemes, average monthly exposure to equities should be more than 65% of the net assets.

The fund selection approach: Balanced funds

Asset allocation and risk adjusted performance are primary factors for the selection of balanced funds.

2.3 Debt Funds: For long-term (more than 1 year)

Table - 2.3

Category	Scheme Name	Crisil Ranking#	Asset Allocation (% of corpus) @			Returns (%) *				Load Structure		Preferred Investment Duration
			Equity	Debt	Others	1 – months	3 – months	6 – months	1 – year	Entry Load	Exit Load	
MIP	DBS Chola Monthly Income Plan	N.A	18.68	0.00	81.32	4.94	15.97	23.01	22.97	Nil	0.5% if redeemed between 0 to 6 months	1-2 years
	HDFC MIP - LTP	3	25.87	52.12	22.01	-3.4	0.93	6.95	12.75	Nil	1% if redeemed between 0 to 12 months	1-2 years
	ICICI Prudential Income Multiplier Fund - Cumulative	N.A	25.56	58.23	16.21	-2.93	2.22	8.44	11.55	Nil	1% if redeemed between 0 to 12 months	1-2 years
	PRINCIPAL M I P Plus	N.A	21.61	32.93	45.46	-4.46	3.79	14.33	20.4	Nil	0.5% if redeemed between 0 to 180 days	1-2 years
Arbitrage	ICICI Prudential Blended Plan - Option B	N.A	19.06	0.09	80.85	0.93	3.24	4.79	10.1	Nil	0.5% if redeemed between 0 to 30 days	More than 1 year
	JM Arbitrage Advantage Fund	N.A	70.50	24.83	4.67	1.18	2.85	4.48	9.89	Nil	0.5% if redeemed between 0 to 30 days	More than 1 year
Income – LT	Birla Income Plus	2	0.00	85.78	14.22	2.33	5.7	8.6	15.53	Nil	0.6% if redeemed between 0 to 180 days	More than 1 year
	Birla SunLife Income Fund	1	0.00	78.55	21.45	2.38	5.52	8.55	15.99	Nil	0.6% if redeemed between 0 to 180 days	More than 1 year
	Kotak Flexi Debt Fund	N.A	0.00	44.32	55.68	0.71	2.17	4.21	8.58	Nil	0.1% if redeemed between 0 to 7 days	More than 1 year

The fund selection approach

MIPs: Asset allocation and performance analysis are the main criteria for fund selection. Further, funds having low exit load and low CDSC period have been preferred.

Arbitrage Funds: Suggested asset allocation and performance of the funds have been factored in while suggesting arbitrage funds. While the limit for exposure to equities and derivatives for JM Arbitrage Advantage Fund is 80% of the portfolio, it is 49% in case of Pru ICICI Blended Plan B.

Debt Funds: For medium-term (4 months to 1 year)

Table - 2.4

Category	Scheme Name	Crisil Ranking#	Corpus Size in Rs. Cr. @	Returns (%) *				Expenses ratio (%) @	Average maturity (years) @	Load Structure		Preferred Investment Duration
				1 - months	3 - months	6 - months	1 - year			Entry Load	Exit Load	
Floaters - LT	HSBC FRF - LTP - Regular Plan	4	112.70	0.74	2.25	4.31	9.03	0.80	0.36	Nil	0.5% if redeemed between 0 to 6 months	Close to 1 Year
	Kotak Floater - LT	N.A	69.05	0.78	2.45	4.59	9.13	0.60	0.72	Nil	0.5% if redeemed between 0 to 6 months	Close to 1 Year
	PRINCIPAL Floating Rate Fund - SMP	2	633.81	0.70	2.07	4.07	8.43	0.51	0.44	Nil	Nil	Close to 1 Year
Income - ST	Birla SunLife Short Term Fund	1	1027.53	0.73	2.21	4.20	10.06	0.64	2.26	Nil	0.25% if redeemed between 0 to 15 days	Upto 6 months
	DBS Chola Short Term -Cumulative	1	1207.59	0.69	2.11	4.16	8.58	0.50	1.53	Nil	Nil	Upto 6 months
	Tata Short Term Bond Fund	2	107.74	1.03	2.52	4.63	10.02	0.85	1.16	Nil	Nil	Upto 6 months
Floaters - ST	HDFC HIF - S T P	2	115.48	0.84	2.69	5.24	10.23	0.80	1.20	Nil	Nil	Upto 6 months
	LIC MF Floating Rate Fund - ST	2	945.01	0.88	2.34	4.53	8.79	0.47	0.21	Nil	Nil	Upto 6 months
	Templeton FRIF - Short Term - IP	3	711.18	0.71	2.14	4.19	8.82	0.55	0.55	Nil	Nil	Upto 6 months

The fund selection approach

Income funds and floaters: Historical returns, average maturity of the portfolio held and expenses ratios have been considered for the selection of funds. The weight assigned to each parameter differs for different categories. While expense ratio has been assigned more weight in short-term funds, average maturity has been assigned more weight in case of long-term income funds.

Debt Funds: For short-term (upto 3 months)

Table - 2.5

Category	Scheme Name	Crisil Ranking#	Corpus Size in Rs. Cr.@	Returns (%) *				Expenses ratio (%) @	Average maturity (years) @	Load Structure		Preferred Investment Duration
				1 - months	3 - months	6 - months	1 - year			Entry Load	Exit Load	
Liquid Funds	Birla Cash Plus - Institutional Premium Plan	2	7872.27	0.71	2.11	4.13	8.21	0.38	0.23	Nil	Nil	Upto 3 months
	HSBC Liquid Plus Fund - IP Plus	N.A	3833.31	0.72	2.17	4.22	8.65	0.40	0.44	Nil	0.1% if redeemed between 0 to 7 days	Upto 3 months
	ICICI Prudential Liquid - Super IP	1	16909.27	0.71	2.12	4.19	8.55	0.25	0.37	Nil	Nil	Upto 3 months

Notes:

- Others include cash and money market instruments
- Entry and exit load have been mentioned for the amount less than Rs. 2 crores. The amount restriction for the load structure may vary according to the AMC.

*Absolute returns as on February 04, 2008

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@ As on January 31, 2008

The fund selection approach

Liquid funds: Performance, expenses ratios and corpus size of the fund are the main parameters for the selection of the funds.



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